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REBUTTAL TESTIMONY

OF

MARK L. OLIGSCHLAEGER

UTILICORP UNITED INC.

AND

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Jefferson City, Missouri
June 2000

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Q. Please state your name and business address.

A. Mark L. Oligschaeger, P.O. Box 360, Jefferson City, Missouri 65102.

Q. Please describe your educational background and work experience.

A. I attended Rockhurst College in Kansas City, Missouri, and received a Bachelor of Science degree in Business Administration with a major in Accounting in 1981. I have been employed by the Missouri Public Service Commission (Commission) since September 1981 with the Accounting Department. In November 1981, I passed the Uniform Certified Public Accountant (CPA) examination and, since February 1989, I have been licensed in the state of Missouri as a CPA.

Q. Have you previously filed testimony before this Commission?

A. Yes. A listing of the cases in which I have previously filed testimony before this Commission is given in Schedule 1, which is attached to this rebuttal testimony.

Q. With reference to Case No. EM-2000-369, have you examined the books and records of UtiliCorp United Inc. (UtiliCorp or UCU) and The Empire District Electric Company (Empire or EDE) (together, the Companies or Joint Applicants)?

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

Q. What is the purpose of this rebuttal testimony?

A. The purpose of this testimony is to present the Staff's recommendations regarding treatment of the costs and benefits associated with the proposed UCU/EDE merger that is the subject of this proceeding. In conjunction with recommendation, I am also submitting testimony in the following areas:

1) A discussion of the relationship between the UCU/EDE merger transaction and the proposed merger between UtiliCorp and St. Joseph Light & Power Company (St. Joseph or SJLP);

2) A brief history of the UCU/Empire merger transaction; and

3) A rebuttal to the Joint Applicants' proposed regulatory plan.

I also briefly address a proposed condition to any merger approval granted by the Commission to this transaction concerning so-called "stranded cost" implications of the merger.

Q. Please describe each of the Joint Applicants, UCU and EDE.

A. UtiliCorp is a corporation providing both regulated and nonregulated services to customers in eight states within the U.S. and internationally. In Missouri, UCU offers regulated electric and natural gas service to customers through its Missouri Public Service (MPS) division.

Empire provides electric service within the state of Missouri, as well as in Arkansas, Kansas and Oklahoma. Empire also operates a small water system in Missouri, and offers a variety of non-regulated services in telecommunications, home security and other fields.

Q. How did the Staff conduct its audit and investigation of the Companies' Joint Application in this proceeding?

A. To obtain data and information from which to better make recommendations to the Commission in this proceeding, the Staff submitted data requests to the Joint Applicants and also conducted interviews of certain of the Joint Applicants' personnel. In some instances, these interviews were transcribed by court reporters. When this procedure was followed, the UCU/EDE employees had the opportunity to revise the transcript to make corrections and expand upon the responses given in the interview, if desired.[1]

Q. Based on the evidence present in the Staff's testimony, please present an overview of the Staff's findings and conclusions regarding the UtiliCorp/Empire Merger Application.

A. The proposed UtiliCorp/Empire merger transaction appears in to be a highly unusual one. Most merger applications before this Commission feature claims by the merging entities of overwhelming benefits to customers in the form of merger savings, relative to merger costs. This transaction is different. The Joint Applicants' own evidence shows that the identified merger savings are less than the identified merger costs of the transaction (before one even gets to a consideration of the acquisition premium), for the first ten years following the merger. Most merger transactions purport to show sufficient savings

[1] For many years, the Staff has conducted interviews of company witnesses/personnel in addition to the other forms of discovery. The interviews were followed up with a more formal manner of discovery, such as data requests. In the last decade as a means of furthering the discovery process, the Staff has had these interviews transcribed. The interviews are not depositions conducted by Staff attorneys, but like a deposition the interviewee is provided a coy of the transcript and the interviewee is encouraged to make corrections and provide any additional information the interviewee chooses. As a way of facilitating the Staff's audit, other utilities have not objected to the Staff's use, in testimony and at hearing, of transcripts of interviews of company witnesses by Staff auditors. When the Staff proposed proceeding in the above manner in the instant cases, UCU, SJLP and EDE exercised their rights to object to such a procedure. The Staff and the merger applicants thought that interviews would still serve a beneficial purpose and agreed to proceed in such a manner, with the Staff to follow up the interviews with either data requests and/or depositions rather than use the transcripts of the interviews directly. When the Staff decided to conduct limited depositions of most of the UCU/SJLP witnesses that it had interviewed, it was determined that the Staff and the companies believed that the transcribed interviews as corrected and amended by the UCU/SJLP witnesses obviated any need for depositions. This same determination has been made relating to transcribed interviews of UCU/EDE witnesses.

amounts to allow for (at least) the opportunity of fair sharing of merger benefits between utility shareholders and customers. The UCU/EDE transaction, however, does not provide for any material sharing of merger benefits with customers. This is because the Joint Applicants seek to recoup as much of the merger costs from their customers as possible. The proposed "regulatory plan" is designed to meet this goal.

The Staff believes that this is the intent behind the proposed regulatory plan, and it is illustrated by the following points:

1) When measured on a net present value basis, the regulatory plan will only pass approximately 3% of the Companies' estimated gross merger savings to customers over the first ten years of the merger, with the remaining 97% being conferred on the merged utility.

2) The Joint Applicants are proposing that merger savings be almost entirely assigned to a division , EDE, proposed to undergo a five-year rate moratorium, thus allowing 100% retention of merger savings for that entire period. (To make this situation worse, the moratorium is proposed to start only after EDE receives full reimbursement from customers of pre-merger revenue requirement increases, most notably that associated with the new State Line combined cycle unit currently being constructed). Meanwhile, the Missouri UCU division that is projected to need rate increases over the next five years, MPS, is to be assigned only a very minimal amount of merger savings over this time period, a position that could ensure that UCU Missouri customers in total will artificially be deprived of the opportunity to benefit from savings associated with this merger for an extended period of time.

3) While the Joint Applicants are purporting to seek direct recovery of only half of the acquisition adjustment associated with this transaction, in reality the proposals to "freeze" capital structure for Empire's customers and "freeze" corporate allocation factors for MPS' customers are designed to ensure that UCU recovers all, or the vast majority of, the acquisition adjustment. Again, this recovery would severely limit the ability of UCU's Missouri customers to derive meaningful benefits from this merger.

One fundamental reason for the lack of customer benefits from this transaction is the fact that UCU has very high levels of A&G costs, the inappropriate allocation of which to the proposed new UCU divisions has the impact of negating large amounts of merger benefits otherwise available to customers. This fact, in and of itself, is highly unusual in a merger context, because most merging utilities will claim overall savings in A&G costs and corporate overheads. The Staff believes that UCU's high overhead levels are historically linked to UCU's wide ranging efforts in merger/acquisition activities and non-regulated business activities, and that assignment of these costs to customers inevitably raises cross-subsidy concerns. While in the past, these concerns were limited to MPS customers, if the EDE and SJLP transactions are approved then this concern will also apply to current St. Joseph and Empire customers. Corporate overhead allocations to St. Joseph and Empire customers are also a problem in that the mergers may have the overall impact of driving the currently low SJLP and EDE rates upward toward the current MPS rate levels, which are considerably higher. In fact, the Staff believes a major reason why MPS rates are usually higher than Empire and St. Joseph rates is UCU's excessive corporate overheads situation.

Based on the cost/benefit evidence presented by the Joint Applicants, this merger, as with the UCU/SJLP Merger, on its face does not seem to make economic sense. The Staff believes that UtiliCorp must be assuming substantial non-regulated benefits associated with the merger to justify the premium paid for Empire. While this belief is supported by evidence cited in several Staff witnesses' testimony, UtiliCorp cannot address openly in the proceeding the matter of non-regulated merger benefits, without endangering its overall strategy of seeking to place the recovery of the bulk of the acquisition adjustment on its captive regulated customers.

Finally, UCU has implicitly tried to justify the merger and the regulatory plan by citing Missouri "economic development" aspects of the transaction (i.e., touting the merger as involving Missouri companies, with the result that the merger benefits remain in Missouri instead of being "exported" to other states.) Presumably, UCU does not offer this kind of merger rationale when it is undertaking one of its frequent merger and acquisition transactions in other states and internationally. Nevertheless, a legitimate interest in Missouri economic development cannot by itself outweigh approval of a one-sided and unfair regulatory plan, when assessing the full spectrum of Missouri public interest issues. If UtiliCorp's price for closing the Empire and St. Joseph transactions is approval of the similar proposed regulatory plans, or something like them, then that is simply far too high a price to pay.

The St. Joseph Merger Transaction

Q. Is the proposed UtiliCorp/EDE merger transaction the only merger involving Missouri jurisdictional utilities that UCU is currently seeking approval from the Commission?

A. No. In March 1999, UCU and St. Joseph announced that they had reached an agreement to merge the two utilities. St. Joseph is a regulated utility that operates only in

Missouri and offers electric, gas and industrial steam services. UCU and St. Joseph are seeking Commission approval of their proposed merger transaction in Case No. EM-2000-292.

Q. Are the UtiliCorp-Empire and UtiliCorp-St. Joseph merger transactions identical to each other?

A. Not entirely. There are some financial differences in the structure of the two merger deals. However, there are also many similarities between the two transactions, most notably that the details of the regulatory plans proposed for both merger transactions by UCU are largely identical. Therefore, the Staff believes that the majority of issues potentially of concern to the Commission from these two merger applications will be common issues.

Q. Has UCU reflected the existence of the proposed St. Joseph transaction in any of the materials it has presented in the instant case, Case No. EM-2000-369?

A. Yes, in some instances. In the area of estimated merger savings, for example, the Joint Applicants in the UCU/EDE transaction have assumed a three-way combination (UCU/Empire/St. Joseph) in the calculation of estimated generation/joint dispatch savings for St. Joseph. UCU and EDE have also assumed a three-way combination in estimating the impact of UCU corporate allocations on Empire's revenue requirement. In other areas of estimated savings, however, UCU and EDE did not take into account the proposed St. Joseph transaction.

Q. Is the testimony filed by the Staff in this merger proceeding identical to that previously filed in Case No. EM-2000-292, the UCU/St. Joseph merger case?

A. Not entirely. As previously discussed, there are some differences in the two merger applications that have to led to a few unique issues in the separate merger cases.

However, as most of the issues raised by the Staff in this rebuttal testimony filing are common and identical to the two cases, there is correspondingly a large degree of duplication and overlap in the content, conclusions and recommendations contained within the Staff's rebuttal filing in this case and the Staff rebuttal filing in Case No. EM-2000-292. The same characterization could be made in comparing the Joint Applicants' direct testimony in the UCU/St. Joseph merger case to the direct filing made by UtiliCorp and Empire in the instant merger proceeding.

Q. How does your testimony filed in this Merger Application compare to the testimony you filed earlier concerning the same merger issues in the UCU/SJLP merger case, Case No. EM-2000-292?

A. This testimony is very similar to that which I filed in Case No. EM-2000-292, and in some sections is identical. However, this testimony does reflect some differences in the regulatory plan proposed by UtiliCorp and Empire, when compared to the regulatory plan proposed for the UCU/St. Joseph merger. These differences largely concern Empire's so-called "pre-moratorium rate case", and is discussed in this rebuttal testimony at pages 56-58.

Q. Based upon the concurrent nature of the two merger transactions, and the many common issues, how does the Staff recommend that the Commission consider the St. Joseph transaction when making its deliberations upon the UCU/EDE merger?

A. The Commission has made a previous determination that the two merger applications should not be consolidated. Nevertheless, the Staff has reflected and discussed some St. Joseph merger matters in its rebuttal testimony in this proceeding when it was believed appropriate and relevant for the Commission in considering various aspects of the proposed UCU/EDE transaction. Given the overall commonality of issues raised by

UCU/EDE and UCU/St. Joseph in their separate merger cases, the Staff recommends that the Commission review and consider the presentations in both cases before making decisions in either case. This will better ensure that the customers of all three utilities receive consistent treatment on merger issues.

History of the Merger Transaction

Q. Please provide an overview of the proposed merger transaction.

A. On December 15, 1999, UCU and EDE filed with the Commission an Application to authorize a merger of the two Companies. The proposed transaction calls for EDE to lose its separate corporate identity and become an operating division of UtiliCorp.

Q. Please describe briefly how this merger transaction came about.

A. According to Empire witness Myron W. McKinney in his transcribed interview with the Staff and the Office of Public Counsel (OPC), held on May 22, 2000, Empire has been interested in a merger and/or acquisition transaction since at least the mid-1990s. This interest was triggered by a belief at EDE that EDE would not be a big enough company to survive in the future in a potentially deregulated and competitive environment for electricity (Transcript, p. 3). As a result of this belief, Empire engaged in preliminary discussions with a number of utilities in the last five years or more concerning a potential merger transaction. For various reasons, none of the discussions ultimately resulted in a merger (Transcript, pp. 7-8).

In mid-1998, UCU and Empire negotiated an agreement in which EDE would jointly market gas service to large customers in Empire's service territory with Aquila Energy Corporation, UCU's non-regulated gas marketing concern. In the aftermath of those discussions, UtiliCorp indicated an interest to Empire concerning a possible merger/acquisition transaction. Empire in turn indicated a willingness to talk to UCU, and a series of meetings began in late 1998 between officials of the two utilities. The Empire Board approved the UtiliCorp/Empire Merger Agreement (Merger Agreement) on May 10, 1999, and the transaction was announced publicly the following day. Empire's shareholders formally approved the proposed merger on September 3, 2000. An approval by UCU's shareholders was not required.

Staff Accounting witness Cary G. Featherstone discusses the course of events leading up to the Merger Agreement in greater detail in his rebuttal testimony.

Q. What are some of the more important terms and conditions contained within the UCU/EDE Merger Agreement?

A. The agreed-upon purchase price for Empire stock at $29.50 a share results in a total valuation for EDE of approximately 2.2 times its net book value (original cost of assets less accumulated depreciation), or a "premium" or "acquisition adjustment" of approximately $275 million. The deal is to be accounted for under generally accepted accounting principles as a "purchase" transaction. Among other items, closing of this transaction is conditioned upon UCU/EDE receiving regulatory approvals from this Commission and other regulators under terms that will not have a materially adverse effect upon the financial condition of the combined company. Specifically, the Merger Agreement states that failure of the Commission to articulate its policy on the extent to which the merged company may recover the premium related to this transaction may be considered a materially adverse effect. The significance of all of these items will be discussed later in this testimony, as well as in the rebuttal testimony filed by other Staff witnesses.

The Joint Applicants' Regulatory Plan

Q. Please generally describe the Joint Applicants' proposal for treating merger savings and costs in the future if the merger is approved and implemented.

A. The Companies' regulatory plan is set out in the direct testimony of UCU witness John W. McKinney, and is further supported in the testimony of other Joint Applicant witnesses. The key points of the plan as they apply to Empire are as follows:

- There would be a five-year rate moratorium implemented once the merger is approved for Empire electric customers. The moratorium will follow the conclusion of a rate proceeding to be filed by Empire later this year. That rate proceeding will be referred to within the Staff's rebuttal filing in this merger application case as the "pre-moratorium" rate case.
- Empire will file an electric general rate case in the last year of the moratorium (i.e., the fifth year following the conclusion of the pre-moratorium rate case) to institute new rate levels. In this rate proceeding (to be referred to in this testimony as the "post-moratorium rate case), Empire is to be allowed to recover 50% of the acquisition adjustment (both a return of and a rate base return on this amount), as well as amortizations of transaction costs and "costs to achieve" (transition costs), both without rate base treatment.
- UCU will guarantee Empire customers at least an approximate $3.0 million reduction (total company) in revenue requirement from net merger savings in the post-moratorium rate case and any subsequent rate proceedings in the five years following that rate case. The $3.0 million is the average estimated amount of annual merger savings for years six through ten following the pre-

moratorium rate case, less the average annual revenue requirement impacts of: (a) 50% recovery of the acquisition adjustment; (b) recovery of other merger costs; and (c) the revenue requirement impact of inclusion of EDE in UCU's corporate allocations system. The estimated savings amount used to determine the \$3.0 million amount reflects assignment of almost the entire amount of merger savings to EDE for rate purposes, as opposed to other divisions of UCU, such as MPS. The guaranteed merger benefit to customers is to be ensured by a method of "tracking" (quantifying) total benefits resulting from the merger.

- For any rate proceedings in Years Six through Ten following the completion of the pre-moratorium rate case, a capital structure purporting to represent EDE's pre-merger capital structure is to be used to set rates.

Q. Is EDE the only Missouri jurisdictional utility that will be impacted by savings and costs associated with the merger?

A. No. MPS is a Missouri jurisdictional division of UCU that will experience financial impacts from this proposed transaction.

Q. Have the Joint Applicants proposed a specific regulatory plan that would apply to the assignment of merger savings and costs to MPS in future rate proceedings?

A. Not explicitly. However, based upon the specific terms of the EDE regulatory plan proposed by the Joint Applicants, the implicit regulatory plan for MPS customers appears to be as follows:

- Only a very minimal portion of estimated merger savings should be assigned to MPS for rate purposes, with the bulk of such savings to be assigned to the

EDE division. With the exception of these minimal savings in the generation/joint dispatch area, MPS should be treated in future rate proceedings as essentially being unaffected by this merger;

- For rate purposes, MPS's allocated level of UCU corporate costs should be calculated as if the EDE merger transaction had not taken place in the first ten years following the merger.

Q. What is the Staff's recommendation concerning the regulatory plan put forward by the Companies in this proceeding?

A. The Staff opposes this plan, and recommends that the Commission reject it in its entirety. The major concerns that lead to this Staff position are:

- The proposed recovery of the acquisition adjustment, even at the purported 50% level, would require that UCU's Missouri customers inappropriately pay for costs properly assignable to shareholders. A significant driver of the merger premium is perceived benefits to UCU in nonregulated areas. These points are further addressed in this testimony and the testimony of Staff witnesses Featherstone, Charles R. Hyneman, Janis E. Fischer, Michael S. Proctor and David P. Broadwater.
- The proposed regulatory plan will actually result in the Joint Applicants receiving recovery of far more than 50% of the premium, when the impact of "regulatory lag" and the Companies' proposal concerning the "frozen" EDE capital structure and "frozen" MPS corporate allocators are properly taken into account. This will also be discussed in the rebuttal testimony of Staff witnesses Broadwater, Featherstone and Steve M. Traxler.

- The Joint Applicants' proposal would require customers to pay for merger transaction costs, which should be treated in a similar manner to the acquisition adjustment and be assigned to shareholders in entirety. In addition, the proposed regulatory plan would allow recovery from ratepayers of certain "costs to achieve" (transition costs) that also should be assigned to shareholders, such as executive severance payments ("golden parachutes"). These points are addressed in the rebuttal testimony of Staff witness James M. Russo and Mr. Traxler.
- UCU/EDE's proposal to use a "frozen" stand-alone EDE capital structure in rates after the merger is implemented would deny customers any benefit for what should be a major source of savings to them: substitution of a lower-cost UCU capital structure for a higher-cost EDE capital structure. This issue will be discussed in detail in the testimony of Mr. Broadwater.
- The "guarantee" of the Joint Applicants that EDE customers will receive a minimum merger benefit in a reduction to the EDE revenue requirement is based on their assertion that they will have the ability to measure and quantify actual merger savings starting in the fifth year after the pre-moratorium rate case. However, the Joint Applicants have failed to present any detailed plan for "tracking" merger savings in their direct testimony, so the purported ability to track merger savings is totally unsupported in actuality and illusory. This situation is addressed in the testimony of Staff witnesses Featherstone and Fischer.

- The Joint Applicants' plan will result in UCU customers in Missouri receiving the benefit of only a very small, insignificant portion of total merger savings during the first ten years after the closing of the merger. The vast majority of the savings will be retained by UCU to pay off the acquisition adjustment or will be offset by the detrimental impact of increased corporate cost allocations from UCU to EDE customers. This item is addressed in my testimony and that of Staff witness Traxler.
- The regulatory plan is premised upon the ability of UCU to recover from EDE customers significant amounts of increased administrative and general (A&G) costs compared to EDE's stand-alone A&G levels. Not only is this recovery from EDE ratepayers of a significant increase in A&G expenses counter-intuitive to legitimate expectations of what should result from a merger of two utilities, but the increase in A&G expenses that would be borne by EDE customers is in no way related to the provision of safe and adequate service at just and reasonable rates. This topic is covered in the rebuttal testimony of Mr. Traxler.
- The proposed plan would result in a disproportionate amount of purported merger savings being assigned to EDE customers at the expense of MPS customers who have historically paid a portion of the costs associated with the "economies of scale" which in part cause the purported potential savings from this proposed transaction to exist in the first place. In addition, this assignment of purported merger savings will pass most purported merger savings to EDE which under the Joint Applicants' proposal will operate under

a rate moratorium, while not assigning any material portion of purported merger savings to MPS which under the proposed plan will seek increases in rates during the next several years. Also, this assignment of purported merger savings will result in most of the savings going to EDE's customers who already pay significantly lower rates in Missouri than MPS customers who have relatively high rate levels. These issues will be further addressed in my testimony and that of Staff witnesses Philip K. Williams, Traxler and Proctor.

- The Joint Applicants' regulatory plan is designed to allow Empire to intentionally overearn for five years or more to allow for an indirect recovery of the acquisition adjustment. It is UCU's and Empire's position that the pre-moratorium rate case should explicitly exclude from the revenue requirement calculation all merger costs and savings that have occurred up to that point. Particularly given the significant number of current employee vacancies that Empire claims are related to the merger, the Joint Applicants' position would potentially lead to a significant overstatement of EDE's payroll expense in the pre-moratorium rate increase case, which would be carried forward for five years or more under the Companies' moratorium proposal.
- As stated in Empire witness Robert B. Fancher's direct testimony at pages 2-5, the Joint Applicants are seeking that the Commission make a number of ratemaking determinations concerning the upcoming pre-moratorium rate increase case in the context of the instant Merger Application. The Staff opposes in general, and for the items listed in Mr. Fancher's direct testimony specifically, ratemaking determinations in non-rate case applications.

All of the above concerns have led to the Staff's conclusion that adoption of the Applicants' proposed regulatory plan would be detrimental to the public interest, and should be rejected by the Commission.

Q. You earlier stated that the Joint Applicants are seeking Commission approval in this docket of recovery of at least a portion of the acquisition adjustment associated with UCU's purchase of EDE assets. Please explain this further.

A. Yes. In Mr. McKinney's direct testimony in this proceeding, he explains that UCU is seeking recovery of one-half of the annual amortization of the acquisition adjustment in above-the-line expense, as well as one-half of the unamortized portion of the acquisition adjustment to be placed in rate base for UCU to earn a return on. The result of this position, if adopted by the Commission, would be that current EDE customers would have to reimburse UCU for half of its above-book value "investment" in EDE, among other costs, before any purported merger savings would be available to flow through to EDE customers in rates. In short, the direct recovery of the acquisition adjustment puts the risk of attaining estimated merger savings on the customers, not the utility shareholders that approved the utility management's to pursue the acquisition on the terms of the Merger Agreement.

Q. Is UCU's decision to purchase the assets of EDE equivalent to any other investment that UCU might make in providing service to utility customers that would be includable in rate base?

A. No. Mr. McKinney in his direct testimony at page 16 implies that UCU's investment in EDE is analogous to UCU investment in "real assets." An example of a "real asset" investment would be building a power plant to meet customer needs. The analogy does not hold. Construction of power plants generally is required in order for the utility to provide safe and adequate service to ratepayers. Mergers and acquisitions, in contrast, are rarely if ever required in order for utilities to serve customers, and certainly the Joint Applicants in this proceeding have not alleged that the public interest <u>requires</u> them to enter into this transaction. Rather, this transaction by all appearances is a voluntary action by both UCU and EDE that was triggered by both managements' perception of their shareholder interests. This is not to deny that EDE and UCU customers may also benefit in some respects by this merger, but rather that the primary emphasis of both UCU and EDE in their merger decisions have been their shareholders. This has crucial ramifications in how the acquisition premium and other direct merger costs should be assigned for rate purposes between the customers and shareholders of merging utilities.

Q. Should customers be directly responsible for recovery of any portion of acquisition adjustments in rates?

A. No. The requirements and interests of utility shareholders inherently drive the process of entering into mergers and acquisitions. For this reason, acquisition premiums should be treated as a below-the-line expense and assigned to shareholders. This general Staff position is reinforced in this particular merger application by the evidence that UCU was motivated, at least in part, to enter into this transaction by the perception that benefits in nonregulated areas of its operations are expected to occur as a result of this transaction. The issue of allocation of the merger premium to nonregulated operations is addressed in the rebuttal testimony of Staff witness Hyneman.

Q. If UCU is seeking to recover only half of the EDE acquisition adjustment from its customers, would it be reasonable to assume that the nonregulated assignment of the premium would be covered in the other 50% of the acquisition adjustment?

A. Both Mr. McKinney and UCU witness Vern J. Siemek made this argument in transcribed interviews with the Staff and Office of the Public Counsel (OPC). However, the Joint Applicants have presented no evidence in this proceeding: (1) respecting what an appropriate assignment of the acquisition adjustment would be to nonregulated operations, or (2) why more than 50% of the total acquisition premium should not be assigned to nonregulated operations.

Q. Is there any evidence that a substantial portion of the acquisition adjustment arising from the EDE transaction may relate to perceived nonregulated benefits of the transaction from the perspective of UCU?

A. Yes. On page 24 of Mr. Green's direct testimony, he makes a statement that UCU had considered transferring the generation assets of both MPS and EDE into an exempt wholesale generator (EWG). (An EWG is an unregulated affiliate of a regulated electric utility where the EWG sells electric power at wholesale but not at retail.) Further, Mr. Green says that a portion of the acquisition premium would have also been transferred to the EWG if the creation of an EWG had taken place. According to Mr. Green, UCU chose not to establish an EWG at this time due to concerns respecting how property taxes would be assessed on the EWG generation.

Q. What is the relevance of the EWG question to the issue of the merger premium allocation?

A. It is clear from a number of sources that Empire's existing generating assets are considered to be low-cost units, with a potential market value in an unregulated electricity generation marketplace in excess of their net book value. Please refer to Staff Witness Hyneman's rebuttal testimony for a detailed discussion of this topic. Based on the evidence presented by Mr. Hyneman, the expected additional profits that EDE could make in sales of electricity in a competitive market compared to the regulated rates set by the Commission would be undeniably attractive to potential buyers of EDE, including UCU.

The perceived value of these assets in the future for UCU is one reason why UtiliCorp would be willing to pay a sizeable merger premium for the EDE properties. That perceived value, and its impact on the premium, is not dependent upon UCU's political, legal and strategic decisions regarding the timing of when to make regulatory filings to get approval to set up an EWG. In short, if UCU indicates it would have been appropriate to allocate part of the acquisition adjustment to non-regulated operations, i.e., an EWG, if that affiliate had been created and approved, it is just as appropriate to allocate a portion of the acquisition adjustment to nonregulated operations in the situation in which an EWG has not been formed. This is the case because the perceived future value of the generating assets is present under either scenario, and therefore contributed to the premium amount.

Q. Do all merger and acquisition transactions result in acquisition adjustments?

A. No. Acquisition adjustments only result from transactions that are accounted for using the "purchase" method of accounting. Purchase transactions are in essence sales of assets by one entity to another. Some merger transactions are accounted for using the "pooling of interests" method of accounting, and represent, conceptually, a combining of shareholder interests by two previously separated firms through an exchange of stock. No additional investment is recorded on the combined entity's books when a pooling transaction is entered into, so there is no acquisition adjustment for this type of merger. The UCU/EDE transaction will be accounted for as a purchase transaction.

Q. What is the impact on a utility's cost of service of incurring an acquisition adjustment?

A. An acquisition adjustment represents an additional amount of payment by an acquiring utility, reflected in the purchase price, above the asset values previously reflected on the acquired entity's books at an original cost valuation. Further, the additional amount paid over the net book value is required by current financial accounting standards to be amortized on the acquiring utility's books over a period not to exceed 40 years. Therefore, the purchasing utility will naturally desire to recover a return of the acquisition adjustment (i.e., the amortization amount) through rates and a rate base return on the acquisition adjustment; otherwise, its book earnings and return will decrease. If the earnings level decreases significantly, the transaction will be dillutive to earnings. Pooling accounting, in contrast, does not result in the potential decrease in earnings that purchase accounting can result in .

Q. Would it have been possible for the UCU/EDE transaction to be structured as a pooling transaction, and thus to eliminate the possibility of an acquisition adjustment?

A. Yes. It is the Staff's view that the Joint Applicants opted for purchase accounting for that transaction primarily for shareholder benefit reasons. Mr. Hyneman will discuss this matter further in his rebuttal testimony in this proceeding.

Q. Does the Staff believe that, in general, utilities undergoing mergers and acquisitions seek different rate treatment of merger costs and savings for pooling transactions compared to purchase transactions?

A. Yes. In general terms, utilities undergoing pooling transactions typically offer regulatory plans that are much more benign from a customer perspective than those utilities seeking approval of purchase transactions. This difference is understandable, when one takes into account the need for utilities with "purchase" transactions to seek to offset the detrimental financial statement impact on its earnings of the premium amortization amount and the return on the premium.

Q. Please provide an example of utilities asking for different regulatory treatments for mergers accounted for as poolings as opposed to purchases.

A. An excellent example is the proposed UCU merger with Kansas City Power & Light Company (KCPL) in 1996, for which approval was sought from this Commission in Case No. EM-96-248. That transaction was to be accounted for as a pooling of interests. (UCU and KCPL later abandoned their merger bid when Western Resources, Inc. successfully outbid UCU for the KCPL properties.)

In Case No. EM-96-248, UCU and KCPL proposed a regulatory plan for that merger which included the following terms:

- A two percent rate reduction, for both KCPL and UCU Missouri customers, effective immediately upon closing of the merger;
- Establishment of an alternative regulation/sharing plan, with customer sharing to begin at a 12.00% return on equity;
- Accelerated depreciation for the Wolf Creek Nuclear Generating Station.

The contrast between the proposed regulatory plan in the UCU/KCPL transaction and the regulatory plan offered by the Joint Applicants in this proceeding could hardly be starker. In Case No. EM-96-248, UCU was willing to offer customers an immediate rate reduction upon closing of the transaction, the opportunity to receive annual rate credits after the merger was closed through operation of an incentive sharing plan, and future rate benefits to customers through a proposal for accelerated depreciation during the term of the regulatory plan. The regulatory plan offered by UCU and EDE in this case would deny EDE customers any immediate or deferred benefits of the merger (through pass-through of any achieved merger savings) for five or more years after closing of the merger. Then, after the proposed moratorium would lapse, EDE customers would be expected to pay directly in rates for a portion of the acquisition adjustment.

The reasons why UCU was willing to offer customers much more generous terms related to merger benefits in 1996 than in the current case are not entirely clear. The Staff believes, though, that a major reason (and probably primary reason) for the difference is the simple fact that the UCU/KCPL transaction was intended to be a pooling, while the UCU/EDE transaction is to be a purchase transaction.

Q. Are you aware of any additional evidence that merging utilities undergoing purchase transactions typically offer different regulatory plans than those undergoing pooling transactions?

A. Yes. The Western Resources, Inc.(WRI)/KCPL merger transaction, considered by the Commission in Case No. EM-97-515, went through various "negotiation" stages between the two utilities. In its first phases, the WRI/KCPL deal was negotiated as a pooling transaction. In its last phase, the transaction was re-negotiated so that, among other items, the deal was to be accounted for as a purchase transaction. In its rebuttal testimony in Case No. EM-97-515, the Staff commented that WRI's and KCPL's regulatory plan provided much less merger benefits to customers when it reflected the existence of a purchase transaction, compared to the regulatory plan proposed when this merger was earlier to be structured as a pooling.

Q. Should the Commission authorize different terms to utilities for treatment of merger savings and costs for those utilities undergoing purchase transactions than for utilities undergoing pooling transactions?

A. No. The Staff believes the Commission should be indifferent between the purchase and pooling methods of accounting, purchases versus pooling, in setting rate policy for recovery and retention of merger savings and costs.

The fact that transactions qualifying for pooling accounting allow utilities to avoid charging earnings for acquisition adjustment amortizations clearly makes this accounting method preferable for most utilities, all other things being equal. It is equally clear that in this case that a primary driver for the inequitable and unfair regulatory plan proposal of the Joint Applicants is the perceived need to offset the financial impact of the acquisition adjustment amortization that it must begin to book as a result of purchase accounting if the merger is consummated.

This merger did not have to be structured as a purchase accounting transaction. If the interests of its customers were at all paramount to UCU, greater efforts could have been made comply with the current requirements for pooling accounting. This is not to argue that the reasons for which purchase accounting was deemed to be appropriate by the Joint Applicants are trivial or unimportant; only that clearly the interests of their shareholders drove the structure and the terms of this merger. The Staff is also not arguing that UCU's emphasis on the interests of its investors in making this transaction is inappropriate or improper. The point is that UCU's investors should bear financial responsibility for the merger premium resulting from a voluntary decision to use purchase accounting for the transaction. The ultimate decision of the Joint Applicants to set up this merger as a purchase should have no customer impact whatsoever, as that decision should properly be considered as a shareholder issue.

Q. Does the purchase/pooling choice have any relationship to the amount of benefits potentially available to customers from this merger?

A. Not at all. Whether this merger is accounted for as a pooling or a purchase will not change the Joint Applicants' merger savings estimates or actual merger savings at all. In short, there are no greater customer savings or benefits associated with purchase accounting to offset the greater costs the Companies are seeking to have their customers shoulder as a result of the UCU/EDE merger being treated as a purchase transaction.

Q. On pages 18-19 of his direct testimony, UCU witness Green implies that the trend in the electric industry towards greater competition provides a justification for the Commission to modify its traditional ratemaking policy to allow recovery of acquisition premiums. Please comment on this argument.

A. The argument is ironic. One of the reasons that the electric industry appears to be moving towards greater competition in the first place is that, under traditional regulation, some have argued that utility managements operated under a "cost-plus" mentality, that treated its customers as captive ratepayers and was typified by the claim of "we invested the money; now make us whole". This attitude arguably has led to above-market rates in some areas of the country, and some customers seeking to choose their electric supplier. UCU, which purports to be one of the most dynamic and progressive utilities in the U.S., now comes before this Commission, and in regard to both the St. Joseph and EDE transactions, essentially takes the position that they invested the money to acquire these companies; now make them whole.

The Staff is aware that utility investors, like all investors, expect an appropriate return on money invested. The philosophical question here is what degree of risk should utility customers and shareholders, respectively, face in regard to merger and acquisition investments. The Staff believes there are better and more balanced ways to provide utility shareholders with the opportunity to earn an adequate return on prudent merger and acquisition investments than having Missouri regulators adopt a "cost-plus" approach. The Staff's approach, which will be discussed later in this testimony, is more consistent with the increasingly deregulated environment that electric utilities may operate under in the future.

Q. Is the attempt by UCU to seek recovery of part of a merger premium in this proceeding a detriment to the public interest?

A. Yes, the Staff asserts that it is. The voluntary nature of merger and acquisition transactions in the electric industry makes clear that utilities cannot justify recovery of acquisition adjustments on the basis of their being necessary for the provision of safe and adequate service. Therefore, utilities must advocate inclusion of merger premiums in rates on the basis of cost/benefit analysis; i.e., that the cost savings passed on to customers as a result of the merger transaction outweigh the increase in rates associated with the acquisition adjustment. However, viewing rate treatment of merger premiums in the context of cost/benefit analyses turns out to be inherently biased against the interests of utility customers. The amount of an acquisition adjustment is known with certainty once a merger transaction is closed, and therefore its impact on customers if allowed in rates in rate base and/or as an element of expense is also known and certain at that time. Merger cost savings, in contrast, are very speculative, and difficult, perhaps impossible, to accurately measure. Merger savings are likely subject to contentious disputes in rate case hearings. One can never be as sure of the amount of the savings component on the cost/benefit analysis as one can be of the amount of "cost" component, the premium. It will always take a leap of faith to make a tentative determination that merger savings exceed merger costs, and that determination inherently places the risk of attaining merger savings on customers rather than utilities. For this reason, the Staff views recovery of acquisition adjustments in rates as detrimental to the public interest, because of the very high likelihood that customers' rates are actually being increased as a result of the inclusion of merger premiums.

Q. What further information should have been provided by the Joint Applicants regarding its proposal for recovery of its acquisition adjustment?

A. Given the evidence presented by the Staff in the proceeding concerning UCU's perception of significant merger benefits in nonregulated areas, a good faith proposal to recover an acquisition adjustment would require merging companies to provide the following:

1. A description and quantification of expected merger savings/benefits/synergies in nonregulated areas of operations; and

2. A proposal for allocation of an appropriate amount of the acquisition adjustment to nonregulated operations, with detailed support provided.

Without this type of evidence presented, any recovery of an acquisition adjustment in rates places a significant risk on customers of subsidizing utilities' nonregulated specifications.

Q. If the Staff believes that UCU's attempt to recover a part of the merger premium in rates in this case is detrimental to the public interest, what action does it recommend the Commission take as a result?

A. The Staff recommends that the Commission condition approval of the UCU/EDE Merger Application on the Joint Applicants agreeing to book the acquisition adjustment below-the-line and to forego future rate recovery of a return of and/or a return on the acquisition adjustment amount.

Q. Should the Commission be influenced in its decision on the acquisition adjustment issue by UCU's characterization that it is only seeking recovery of one-half of the revenue requirement impact of the acquisition adjustment?

A. No. All of the theoretical reasons why direct recovery of acquisition adjustments in rates from customers is inappropriate apply whether the recovery being sought is total or partial. More practically, the net effect of all of the Joint Applicants' ratemaking requests in this proceeding would have the impact of allowing recovery of well over half of the acquisition adjustment in rates for UCU. In particular, this point applies to UCU's proposal to "freeze" EDE's capital structure at pre-merger levels for the first ten years following the merger in setting rates for the Empire division of UCU.

Q. Please explain.

A. As discussed in Mr. McKinney's direct testimony at pages 28-29 and Mr. Fancher's direct testimony at page 4, UCU is proposing that a capital structure of 47.5% equity and 52.5% long-term debt be used in any rate proceeding for the EDE division in the first ten years following the merger. This capital structure is based upon EDE witness Fancher's belief that this represents a "normalized" capital structure for EDE's stand-alone operations on a going forward basis. Both the actual EDE capital structures used by the Staff in past rate proceedings and the "normalized" capital structure proposed by Mr. Fancher are considerably higher-cost than UCU's current and historical capital structures (i.e., the EDE capital structure is more equity intensive than UCU's). For example, UCU's current capital structure "target" approximates 40% equity and 60% long-term debt. Please refer to the testimony of Staff witness Broadwater on this point.

Q. What would be the impact on Empire's customers after the merger of UCU's proposal to freeze EDE's capital structure?

A. The impact of maintaining a pre-merger EDE capital structure for rate purposes instead of reflecting an actual UCU capital structure after a merger would be to maintain higher rates for EDE customers than the actual costs incurred by UCU to provide service to EDE customers. The Staff estimates that the additional revenue requirement to be incurred by EDE ratepayers if the capital structure incorporates a pre-merger EDE level of capital structure components as opposed to a post-merger UCU level of the components is at least approximately $2.5 million on an annual basis. (Please refer again to the rebuttal testimony of Staff witness Broadwater for an explanation of this calculation.) Another way of looking at UCU's capital structure proposal is that EDE's customers are being asked to forego a potentially significant source of savings that would otherwise accrue to them as a result of this merger. The Staff believes that the intent of the Joint Applicants in seeking to retain this potential source of customer savings is to provide further recovery of the merger premium being incurred as a result of this transaction.

Q. How does UCU's capital structure proposal relate to the issue involving acquisition adjustment recovery in this case?

A. A utility's recovery of an acquisition adjustment can be accomplished in two different manners. The first manner is through direct recovery of the acquisition adjustment in rates through a regulatory agency's decision. The second manner is if regulators allow the utility to retain a sufficient portion of merger savings in order to offset the financial impact of the acquisition adjustment on the utility's financial results. Through this "indirect" approach, UCU is seeking Commission authorization to retain all capital structure merger savings in order for it to increase its recovery of the merger premium.

Q. What is the Staff's position on UCU's proposal to "freeze" EDE's capital structure for rate purposes after the merger?

A. The Staff is opposed to using merger savings otherwise available to benefit customers to allow utilities to specifically recover acquisition adjustments. This position is also addressed in the rebuttal testimony of Staff witnesses Broadwater and Featherstone.

Q. The regulatory plan sponsored by Mr. McKinney purports to protect customers from potential rate harm under UCU's regulatory plan by "guaranteeing" an overall merger benefit to customers. Please comment.

A. It is true that UCU claims it can guarantee that EDE customers will derive an overall benefit in revenue requirement associated with the merger under its proposed regulatory plan. However, as will be demonstrated in the Staff's rebuttal testimony, this alleged "guarantee" is illusory in that the Joint Applicants have come forward with no serious proposal that would effectuate or enforce the guarantee. UCU is seeking to collect real dollars from its customers in the form of acquisition adjustment recovery in return for hollow promises that customers will benefit overall from such rate treatment five or more years later.

Q. Please explain how the purported "guarantee" of a customer benefit from the merger is intended to work.

A. The "guarantee" aspect of the proposed regulatory plan is illustrated in Schedule VJS-1 to UCU witness Siemek's direct testimony. Schedule VJS-1 presents the

Joint Applicants' estimates of merger savings and costs to be applied to EDE customers over the first ten years after the pre-moratorium rate case; with the yearly estimates averaged together separately for the first five years after completion of the pre-moratorium rate case, and then for years 6-10 following that case. These amounts show that during the first five years, UCU expects total merger costs (including 50% of the merger premium) on average to be greater than estimated merger savings. The Joint Applicants purport to protect customers during this period (Years 1 –5) by recommending a rate moratorium be in place for EDE customers. But during the second five years following the pre-moratorium rate case (years 6-10), Schedule VJS-1 shows that merger savings exceed merger "costs" by an average of approximately $3.0 million a year (total company) over that period. The merger "costs" include half of the acquisition adjustment, an amortization of the merger transaction and transition costs, some relatively minor capital costs associated with integrating the MPS and EDE systems for transmission purposes, and the net revenue requirement increase associated with placing EDE into UtiliCorp's corporate allocations system.

Q. What is the significance of the $3.0 million amount described above from Schedule VJS-1?

A. Because this is the alleged annual net benefit in revenue requirement that EDE customers should expect to receive in years 6-10 if the Joint Applicants' estimated costs and savings are considered accurate, the Companies are proposing to guarantee that customers actually have that net benefit reflected in rates during that period. Since this amount reflects a belief that merger benefits will be greater than merger costs during years 6-10, the Joint Applicants are arguing that ensuring that the net benefit will be reflected in rates would mean that inclusion of part of the acquisition adjustment in rates cannot be considered to be a detriment, because merger savings would be greater than merger costs (and customer rates, hence, would be lower because of the merger).

Q. Mechanically, how do the Joint Applicants propose to "ensure" receipt by customers of the minimum $3.0 million net merger benefit during years 6-10?

A. In the rate cases to be filed in year 5 following the pre-moratorium rate case, UCU states its intent to measure or "track" merger savings in the test year used in that rate proceeding. If the total merger savings measured at that time are less than the estimated $3.0 million, then UCU's regulatory plan proposal states that it will propose an adjustment to impute the additional merger savings to ensure that customers will receive the benefit in rates of that full amount. By imputing savings into cost of service to reflect expense reductions that have not actually been achieved, the financial impact that will result would be a recovery of less than 50% of the acquisition adjustment. In turn this process, in theory, would place the risk of attaining the Joint Applicants' estimated merger savings on UCU and not on its customers.

Q. Can this process of "guaranteeing" a certain level of merger benefits for customers work in reality?

A. This proposal can only work if UCU's ability to track merger savings in the Year 5 rate case is feasible, realistic and successful. However, the Joint Applicants have provided absolutely no evidence that they can accomplish the at best extremely difficult and nearly impossible job of measuring merger savings after the fact.

Q. Why is it difficult to identify and quantify actual achieved merger savings on an after-the-fact basis?

A. Conceptually, the difficulty is that it 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 never taken place. Of course, no one can "know" what would have happened if a merger had not taken place if, in fact, a merger does take place. This requires guesswork on someone's part to come up with a hypothetical scenario in order to quantify actual merger savings. This guesswork can take two basic forms: first, an assumption that the involved entity's financial results at the time the merger was entered into would have essentially been "frozen" in place from that point on or, second, that some way can be found to accurately project prospectively and retrospectively what the entity would have done on a stand-alone basis (i.e., what savings will be or would have been achieved, what major decisions will be or would have been made, etc.). The first assumption is unrealistic, in that no business entity stands frozen in place for an extended period of time. The second assumption involves hopelessly subjective speculation as to what a business concern will do or would have done when faced with a set of hypothetical facts and circumstances not actually known prospectively or necessarily even accurately known retrospectively.

For a regulatory commission to believe that tracking merger savings is possible is to invite further subjective, self-serving speculation in rate proceedings, with no objective facts or standards available to guide the utility commission in judging the savings tracking claims put before it once the agency places itself in the box of deciding that tracking merger savings is possible.

Q. Given the conceptual difficulties in measuring merger savings, how do the Joint Applicants propose to overcome them?

A. The short and truthful answer is that the Joint Applicants have not proposed a way to overcome these problems, for the reason that they have made no serious proposal as to how their tracking system would work. While Mr. McKinney devotes several pages of his testimony to a very general discussion of how savings tracking will conceptually work to guarantee merger benefits to customers, the only other discussion of the proposed savings tracking system can be found in one short question and answer in the direct testimony of UCU witness Jerry D. Myers (page 10, lines 14-23). Neither Mr. McKinney nor Mr. Myers gives any substantive description of how cost tracking is actually going to be accomplished. The bulk of Mr. Myers' testimony, in fact, concerns UCU's ability to track merger costs using state-of-the-art accounting systems. The reader is asked to assume that modern accounting and financial reporting systems are sophisticated enough to accomplish after-the-fact measurement of merger savings. However, the problem with merger savings tracking is not lack of 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 cannot cure that problem.

Q. Has UCU expanded on a proposal to track merger savings subsequent to the filing of its direct testimony?

A. In his transcribed interview with the Staff and the Office of Public Counsel (OPC), Mr. Myers discussed an informal proposal as to how this tracking might occur. In the context of the proposed SJLP merger, his idea called for a comparison of actual SJLP financial results after the UCU merger with calculation of stand-alone SJLP earnings results produced by "indexing" the SJLP 1999 budget for inflation. Since a multitude of factors, both merger related and non-merger related, can affect the total SJLP or EDE division earnings results after the proposed mergers, this informal proposal does not in any real way constitute a merger savings tracking system. Staff witnesses Featherstone, Traxler and Fischer further address the issue of merger savings in their rebuttal testimony.

Q. Should lack of a detailed and substantive proposal for savings tracking from the Companies mean the rejection of the Joint Applicants' entire regulatory plan?

A. Simply stated, yes. Keep in mind that UCU is asking the Commission to agree now, in this Merger Application, that it will be allowed rate recovery five or more years in the future of half of its $275 million acquisition adjustment from the EDE transaction. In return for that commitment involving hard dollars from ratepayers, the Joint Applicants are claiming that its customers will be protected from future detriment by its minimum net savings guarantee, to be enforced by a savings tracking mechanism. But not only have the Joint Applicants failed to demonstrate that savings tracking is possible in practice, they have failed to offer any specific proposal to do so. The Companies are seeking that the Commission commit their customers now to pay the merger costs at a future time, with any safety mechanism to be developed at a later time. It is truly difficult to be more polite than to say that what the Joint Applicants are proposing is a classic example of the proverbial "pig in a poke." The Companies' proposed regulatory plan should be rejected for this reason alone.

Q. Given that any tracking mechanism would not have to be applied in practice until Year 5 after the pre-moratorium rate case, what is the harm in having the parties work together to develop a tracking mechanism between the time of this Commission's approval of this Application and the Year 5 rate case?

A. The problem, again, is that the Joint Applicants want the Commission to commit now to rate recovery of half of the acquisition adjustment. Given this request, development of a tracking system cannot be prudently left to the future.

Q What is the Staff's position in this proceeding concerning development of a savings tracking procedure?

A. The Staff recommends that the Commission reject the idea of a tracking mechanism for the UCU/EDE merger transaction, primarily the development of such a mechanism is practically impossible. The Staff also notes that the Joint Applicants have failed to make a meaningful proposal regarding such a tracking system and how such a tracking system would work. It should not be the Staff's or other parties' jobs to try to develop or propose what they believe it is not possible to do. In the event the Commission is interested in the concept of the use of merger savings tracking in the future, Staff witness Traxler has some alternative recommendations concerning an appropriate tracking "baseline" for the Commission's consideration on this issue.

Q. Is it possible that the Joint Applicants will provide a more detailed merger saving tracking "plan" in its surrebuttal filing in this proceeding?

A. Yes. It is the Staff's position that the appropriate time for the Companies to provide a detailed tracking proposal in this proceeding would have been in their direct testimony in this proceeding. In the event the Joint Applicants seek to supplement their regulatory plan in the savings tracking area in their surrebuttal filing, the Staff would reserve the right to seek to file responsive testimony on such a subject matter, among other remedies.

Q. Returning to the subject of the alleged $3.0 million merger benefit "guarantee" to customers, how significant is this amount compared to total savings projected by the Joint Applicants from the merger?

A. This alleged "guarantee" of net savings to customers would have the effect of only providing customers only a very minimal and inadequate share of total purported merger savings.

Q. What is your support for that statement?

A. The support for that statement can be found entirely within Siemek Schedule VJS-1. That Schedule shows that after deducting all merger-related costs and corporate allocation impacts of the transaction from the merger savings expected from the transaction, UCU's best estimate of the amount of savings residually available to customers is approximately $3.0 million annually (for Years 6-10 after the pre-moratorium rate case.) The Joint Applicants' proposed rate moratorium for EDE following the merger and pre-moratorium rate case would ensure that EDE customers receive no merger benefits at all during the first five years or more following the closing of the merger. Then, for years 6-10, Schedule VJS-1 reflects that these customers can expect $3.0 million a year in net merger benefits through a flow-through of this amount of merger benefits in a rate case processed in year 5. Therefore, total merger benefits expected to be passed on to customers in rates during the first ten years after the closing of the merger would be approximately $15 million ($3 million * 5).

Mr. Siemek's Schedule VJS-1 further shows that total purported merger savings for the first ten years after the consummation of the merger equal $383.6 million, calculated by taking the average annual gross savings amounts for Years 1-5 and multiplying it by five, and multiplying by five the average annual savings amount for Years 6-10, and then adding the two results together. The customers' share of total merger savings under UCU's proposed sharing plan would, therefore, be approximately 3.9% ($15million /$383.6 million). However, the customer benefits that do exist are "back loaded" to the last half of this ten-year period. As discussed in Ms. Fischer's testimony, the Joint Applicants are proposing to pass on the customers only 3.0% of the total savings over the ten-year period when the merger savings amounts cited above are appropriately calculated on a net present value basis.

Q. What is the Staff's opinion on the fairness of the Joint Applicants' regulatory plan as it relates to customer rates?

A. The Staff believes that UCU's proposed regulatory plan would provide for a wholly inadequate level of merger savings to be shared with customers over the first ten years after the consummation of the merger, should the Commission approve the merger.

Q. If customers will only receive 3.9% of total merger savings on a nominal dollar basis over ten years after the closing of the merger under the Companies' proposed regulatory plan, what will happen to the other 96.1% of the savings?

A. That amount of savings would be retained by UCU. More specifically, Schedule VJS-1 to Mr. Siemek's testimony shows the different amounts of total merger savings to be retained by the combined company following the merger. In particular, the indicated derivation of the $3.0 million customer benefit "guarantee" shows that a relatively small portion of merger savings is proposed to be retained by UCU as compensation for merger transaction, transition and miscellaneous capital costs associated with the merger. A far larger amount of merger savings are proposed to be retained by UCU to allow it to recover directly in rates its requested 50% portion of the acquisition adjustment from the

UCU/EDE merger. The largest single "reason" for lack of customer benefit from UCU's regulatory plan, is the amount of merger savings that are negated by the additional UCU corporate A&G costs that will be charged to EDE customers after the merger through UtiliCorp's current corporate allocation system, compared to EDE's pre-merger stand-alone level of A&G costs. Staff witness Traxler addresses the issue of EDE customer detriment from UCU corporate overhead charges in his rebuttal testimony.

Q. How would the Staff define a fair percentage of merger savings to be passed on to customers of merged utilities?

A. In past merger applications, the Staff has expressed the opinion that at least 50% of total merger benefits should be reflected in customer rates over the long term if a specific "regulatory plan" for a merger is to be adopted. The Staff also has stated that if utilities propose to assign less than half of total merger savings to customers through a regulatory plan, then the company should state compelling reasons why the public interest would justify that result.

Q. In this case, has UCU cited any compelling reason why EDE customers should receive far less than half of total merger savings over the ten-year period of time after the closing of the merger?

A. No, not at all. The Staff certainly does not believe that recovery of merger premiums in rates and charging of additional corporate overheads to customers following a merger are persuasive rationales for limiting the purported customer benefit from this merger to a truly insignificant portion of purported total merger savings.

Q. If the Commission was to consider adopting a minimum benefit amount for customers as part of any regulatory plan it would order in this proceeding, what amount would the Staff recommend?

A. The Staff does not recommend that the Commission adopt the approach of defining a minimum net benefit standard for customers in rates because of the previously mentioned difficulties in measuring actual merger savings incurred after the fact. However, if the Commission were to find conceptual merit in the idea, the Staff would recommend that any "guarantee" should encompass 50% of the estimated merger savings claimed by the Joint Applicants for the first ten years of the conclusion of the merger. These amounts would be as follows:

Year 1	$ 24,656,000
Year 2	$ 15,581,500
Year 3	$ 17,816,500
Year 4	$ 18,938,000
Year 5	$ 22,058,500
Year 6	$ 20,997,000
Year 7	$ 22,276,000
Year 8	$ 21,529,500
Year 9	$ 18,647,500
Year 10	$ 21,614,000

(Source: Response to Staff Data Request No. 1)

The magnitude of these numbers, compared to the Companies' advocated minimum benefit amount of $3.0 million, points out the extremely de minimus nature of the Joint Applicants' "guarantee" to EDE customers.

Q. Is there any additional evidence of the relative lack of customer benefit in the Joint Applicants' proposed regulatory plan?

A. Yes. The Companies themselves seem to recognize a problem in the total merger savings allocated to Empire customers over the first ten years of the merger under their regulatory plan. This is best shown in the proposal by UCU witness Siemek at page 8 of his direct testimony that certain types of transaction costs (bankers fees, bond solicitation costs) be amortized to expense over 40 years. In the St. Joseph merger application, the Joint Applicants proposed that all transaction costs be amortized over ten years. When asked to explain the different positions UCU was taking between the two merger applications relating to transaction cost amortization periods, the response to Staff Data Request No. 136 in Case No. EM-2000-369 stated that the 40-year amortization period in the UCU/EDE merger case was proposed due to the "size of the synergies expected in the Empire case". Further, in his May 30, 2000 transcribed interview of Mr. Siemek, the following statements were made on this point:

> Q. In St. Joe I believe all the costs to achieve were amortized over the first ten years. And then in Empire the bank fees and bond soliciation costs were going to be amortized over 40 years. Why the difference between the two?
>
> A. Well, there were no bond solicitation costs in St. Joe.
>
> Q. But there were bank fees?
>
> A. That's a separate issue. There were bank fees. In this case the synergies were much tighter. And in attempting to get a benefit to the customers we chose to amortize the banker fees over 40 years instead of 10.
>
> Q. You used the words much tighter. Can you further elaborate that for me?

> A. Well, had we amortized the bankers fees, for example, over 10 years instead of 40, we would have increased the transaction cost amortization by $550,000 to $600,000 on an annual basis. And if you follow that through on Schedule VJS-1, it reduces the average synergies on line Roman Numeral VIII by the same $5000,0000 to $600,000. And that seemed somewhat disproportionate for the number of customers between St. Joe and Empire.
>
> (Transcript, p. 45-46).

Apparently, if the same treatment proposed for the transaction costs in the SJLP merger were utilized in the Empire merger, the savings available to pass on to EDE customers would be even less.

Q. Are there other aspects of the Joint Applicants' proposed regulatory plan that are of concern to the Staff?

A. Yes. The fact that no merger benefits whatsoever are to be passed on to EDE customers over the first five years or more after the merger, and only a very minimal amount of savings are intended to be passed on to MPS customers over the first ten years of the merger under the regulatory plan, is of significant concern to the Staff.

Q. Please further explain your concern as it applies to EDE customers.

A. This concern exists for several reasons. First, the Companies project that this transaction will have major and positive impacts on EDE's current cost of service through expense reductions, etc. To deny EDE customers any portion of the savings for a full five years or more after the merger closing seems unreasonable and excessive on its face.

Q. What has UCU's past position been concerning timeliness of customer receipt of merger benefits?

A. In Case No. EM-96-248, UCU's Application to merge with KCPL, UCU witness Jon R. Empson made the following statement in his direct testimony: ". . .The two percent rate reduction coupled with a five year general retail electric rate increase moratorium will provide our customers with an immediate benefit and a period of rate stability". . . . (emphasis added. Empson direct p.7). Other KCPL and UCU witnesses made similar statements in their direct testimony. Obviously, the fact that both UCU and KCPL customers were intended to receive an immediate benefit in rates from the UCU/KCPL combination was considered to be a major selling point by UCU/KCPL at that time. To expect customers to wait five years or more to receive any benefit from the UCU/EDE merger, as proposed by the Joint Applicants, is an instructive contrast.

Q. Is there any other problem with the proposal for a five-year waiting period for customers to receive the benefit of merger savings?

A. Yes. In the current environment for the electric industry, such a proposal would significantly increase the risk that EDE customers will not receive any benefits from the merger at all. There has been an ongoing discussion of possible electric restructuring and deregulation in this state for the past several years, as well as actual initiatives to deregulate the generation component of bundled electric service in other jurisdictions in the same time period. If a similar legislative initiative were to be adopted in Missouri, it is a certainty that the current regulatory process in this state would undergo material modification. At a minimum, all of the generation savings identified by the Joint Applicants in its Application and testimony probably would be no longer available to be passed on to customers after restructuring would take place in EDE's service territory. Further, many of the restructuring bills that have been passed and implemented in other jurisdictions have called for rate freezes or caps pertaining to the distribution functions of bundled electric service, mechanisms that would serve to potentially prevent pass-through of non-generation merger savings if these provisions are part of restructuring legislation in Missouri.

The relevance of this topic to UCU's regulatory plan is that electric restructuring, if it occurs, will probably make any intention to distribute specific amounts of merger savings in the future to customers problematic. Further, common sense indicates that the chance of restructuring legislation passing in Missouri and being implemented increases over time, which makes waiting five years or more to pass any merger savings on to EDE customers more risky from a ratepayer perspective.

Q. What is UCU's position on electric restructuring legislative issues?

A. UCU has been very supportive of the passage of restructuring legislation, both on the federal and Missouri levels.

Q. Your comments on UCU's proposed regulatory plan have focused so far on its impact on EDE customers. Will those customers be the only UCU ratepayers directly affected by this merger if it is approved?

A. No. Existing MPS customers will also be directly impacted by the merger, and therefore should receive a fair share of potential merger benefits.

Q. How will MPS be affected by the proposed UCU/EDE merger?

A. MPS will be directly affected in several ways. First, the Joint Applicants' testimony in this proceeding is filled with references to merger savings brought about by "economies of scale." Economies of scale is the concept that, for some utility functions, the per unit cost of providing service declines as a result of the increasing size of the organization, therefore creating savings. Since UCU after the merger will be a larger organization than either of the stand-alone EDE operations or the pre-merger UCU, it is alleged by the Joint Applicants that some economy of scale benefits will be created as a result of the merger. These savings will be reflected in the financial results of all the operating divisions of UCU, not just MPS and EDE, if normal financial reporting and allocation practices are followed by UCU after this merger.

Also, under UCU's current corporate cost allocation system, the addition of a new division, such as EDE, will cause a re-allocation of the total corporate costs among the divisions of UCU, with existing divisions such as MPS benefiting as some level of pre-existing corporate costs are allocated to EDE after the merger.

Finally, the EDE and MPS service territories are contiguous, meaning that there are significant opportunities for savings in transmission and distribution costs, as well as the potential for savings in generation operations through the use of joint dispatch. The Joint Applicants' estimated generation savings are addressed in the rebuttal testimony of Staff witness Proctor.

Q. Given the above, does UCU's proposed regulatory plan propose to assign some portion of purported merger savings arising from the merger with EDE to the MPS division?

A. Only an insignificant portion. A small component of the expected generation savings (in capacity) are recommended to be split between MPS and EDE. As far as the Staff can determine, the remainder of the entire amount of estimated merger savings is intended to be assigned to EDE customers for rate purposes.

Q. Would this result represent a fair allocation of merger savings?

A. Absolutely not. There are several reasons for this opinion. First, and fundamentally, no true merger savings can occur without the combination of both the pre-merger UCU and EDE organizations. Since customers of both utilities have historically paid in rates the costs that are potentially subject to reduction through the purportedly beneficial impacts of the merger, it is a matter of elementary fairness that both sets of customers be given a reasonable opportunity to share fairly in any benefits of this merger.

Second, as demonstrated in the rebuttal testimony of Staff witness Williams, MPS rates are currently significantly higher than EDE customer rates for electric service. It is simply unfair to assign nearly all merger savings to those customers that are already paying lower rates than customers of other utility divisions that will benefit from the merger at some level.

Third, while the Joint Applicants are proposing a five-year moratorium for EDE (after an initial rate increase for which it is recommended that no merger savings or costs be reflected), it appears that MPS is planning to request rate relief from the Commission one or more times within the next 24-30 months. Assigning all merger savings to a division undergoing a rate moratorium, while assigning little or no savings to a division planning to seek rate increases, serves only to artificially allow UCU to keep all estimated merger savings for an extended period of time following the merger, at MPS customers' expense, in particular.

Finally, the financial data on Schedule VJS-1 seems to indicate that the Joint Applicants must assign nearly all of the purported merger savings resulting from this transaction to EDE, or else the merger savings allocated to that utility operating division will be less than the costs assigned to that division related to the merger. While this fact points out a potential problem with detriment to EDE customers, depriving MPS customers of their fair share of merger benefits is not a just or equitable solution to the problem.

Q. Is there an inter-jurisdictional subsidy issue involved in the question of assignment of savings to MPS, as well?

A. Yes. MPS' electric operations are all located in the state of Missouri. Empire, in contrast, also has most of its electric operations located in Missouri, but small portions of its electric business are located in the states of Arkansas, Kansas and Oklahoma. Therefore, to the extent that the Joint Applicants' proposed regulatory plan would have the impact of assigning merger savings disproportionately to Empire relative to MPS, then this would have an effect of assigning a portion of merger savings properly assignable to Missouri customers of MPS to Arkansas, Kansas and Oklahoma customers of EDE. Reflecting this inter-jurisdictional subsidy in Missouri rates is improper and should not be accepted by the Commission.

Q. What is the Staff's recommendation concerning assignment of merger costs to MPS following the merger?

A. The Staff recommends that any rate decisions involving merger savings should be implemented based on the general principle that a fair share of such savings be assigned to EDE, the new division of UCU, and to the pre-existing divisions of UCU, including MPS. The Staff believes that normal financial reporting and corporate cost allocation procedures would serve as at least a starting point for assignment of merger savings among the divisions of UCU. No arbitrary assignment of merger savings to EDE or any other division of UCU should be permitted as a result of this Application.

To the extent that assignment of a reasonable portion of merger savings to MPS would mean that a similar portion of prudent above-the-line merger costs (i.e., "costs to achieve") should also be assigned to MPS, the Staff would support such an assignment.

Q. In your testimony, you seem to be arguing that (1) the Joint Applicants' regulatory plan is unfair to MPS, in that it assigns almost all merger savings to EDE, and (2) the amount of merger savings allocated to EDE is very minimal and insignificant. Are you being contradictory?

A. Unfortunately, from a customer's perspective, no. Apparently the potential rate benefits of this merger are so small in relation to merger costs that the companies are compelled to slant the savings allocation process unfairly in favor of EDE in order to make any claim that overall EDE customer merger benefits exceed the cost. In the Staff's opinion, the root cause of this unusual situation is, first, the large premium paid for EDE by UCU, and second, the very large level of A & G costs incurred by UCU, and the problems associated with allocation of those overheads to the new EDE division.

Q. In the Staff's opinion, is the Joint Applicants' regulatory plan detrimental to the public interest as proposed?

A. Yes. Particularly in seeking to have the Commission order that customers be responsible for merger costs now, with no meaningful proposal to ensure that customers actually receive the benefit of a share of merger savings later to offset those costs, EDE and MPS ratepayers will be exposed to significant risk under the Companies' proposed regulatory plan. As such, the Staff considers the plan to be detrimental to the public interest, and the Commission should reject the entire plan.

Staff Merger Recommendations

Q. What is the Staff's overall conclusion regarding the benefits of this merger from a customer perspective?

A. The Staff believes that the Companies' analysis of ten-year merger savings and costs, as set out in Schedule VJS-1 to Mr. Siemek's testimony, is seriously flawed. As discussed in Mr. Traxler's and Dr. Proctor's rebuttal testimonies, the merger savings shown on that schedule are overstated, and the merger costs depicted therein are understated (if one regards the shifting of corporate overhead expenses onto EDE to be a "cost," which it certainly is from an EDE customer perspective). When the necessary corrections are made to Schedule VJS-1, as shown in Mr. Traxler's testimony, the results show that total merger costs exceed total merger savings for each of the first ten years following the merger, before the costs associated with the acquisition adjustment are considered at all. Clearly, under these conditions, this merger is detrimental to the public interest. The detriment is further magnified when one considers the nature of the regulatory plan proposed by the Joint Applicants. Conditions proposed by the Staff and other parties to this proceeding to attempt to eliminate detriments in the areas of the acquisition adjustment, corporate overhead allocations and other matters can limit the potential harm from this merger to customers, but cannot entirely eliminate merger-related risk to EDE and MPS customers. Moreover, such conditions may affect the financial viability of the merger transaction from UCU's perspective.

Q. Under these conditions, does the Staff recommend that the Commission approve UCU's and EDE's Application to merge?

A. No. The Merger Application, as proposed by the Joint Applicants, is detrimental to the public interest. Given the low level of merger savings associated with this transaction relative to the level of identified merger costs, as well as UCU's extremely high level of corporate costs, and the possible exposure of EDE to excessive corporate cost allocations, the Staff cannot affirmatively recommend that this proposed merger be approved by the Commission even with conditions.

Q. Is the Staff proposing conditions for merger approval for the Commission's consideration if the Commission decides to approve the Merger Application?

A. Yes. The Staff is not recommending that the Commission proceed in this manner because it does not believe that proposed conditions can eliminate sufficient customer risk from the merger, given the specific facts and circumstances discussed in the Staff's testimony. However, if the Commission believes approval of this transaction is warranted, the Staff is proposing certain conditions that will serve to limit, to some degree, customer exposure to merger-related risk.

Q. Does the Staff believe that this merger and regulatory plan will be detrimental to MPS customers as well?

A. Yes. The Joint Applicants' estimated merger savings and costs amounts in Schedule VJS-1 pertain only to EDE. As previously explained, it appears the Joint Applicants' intent is not to assign a significant level of merger savings to MPS over the ten-year period covered by the proposed regulatory plan. However, UCU is also proposing to "freeze" MPS corporate cost allocation factors over the course of the regulatory plan so that no reduction in these factors can take place due to the EDE addition to the UCU structure. In practical terms, this means that MPS customers would pay in rates a level of corporate costs that will exceed the actual amounts indicated for MPS under UCU's own allocation system. This deviation from cost-based rates for MPS customers is detrimental in and of itself. There is a further discussion of this issue in Mr. Traxler's testimony.

Q. Can the Commission be confident that potential customer detriments related to this proposed merger can be identified and eliminated in future MPS and EDE rate proceedings?

A. Future rate proceedings are the proper forum to attempt to examine actual impacts on customers from the merger, if the merger is ultimately approved and closed. However, the inability to identify with certainty merger-related costs and (especially) merger related savings after the fact means there will always be a risk of merger costs exceeding merger savings to customers in rates. This inherent risk is particularly troubling in this proposed merger, because the Companies' own projections show there is strikingly little "margin for error" when examining projected merger costs and savings as shown in Siemek Schedule 1. The Staff's adjustments to the amounts shown on that Schedule (as depicted in Schedule 3 attached to Staff witness Traxler's testimony) demonstrate the likelihood that merger costs in fact will exceed reasonable projected merger savings.

To leave issues involving merger costs and savings to future rate proceedings will mean the Commission will have to deal with subjective and contentious arguments about actual levels of merger savings and costs, the adequacy of purported methods of tracking costs, etc. This would also involve litigation of issues involving corporate cost assignments to UCU Missouri utility divisions, (i.e., the MPS and EDE divisions) including issues of merger detriment and excessive levels of corporate cost allocations. Past MPS rate proceedings in this jurisdiction provide examples of how strongly contested and important corporate costs allocation issues are. UCU corporate costs and UCU corporate allocations are not new issues that the Staff is raising for the first time.

Q. Does the Staff believe that the Commission should make ratemaking findings in the context of non-rate applications, such as this Application for a merger?

A. The Staff has attempted to take a consistent position in past merger proceedings that the Commission should not make rate determinations in a merger case, except when such findings may be necessary to cure a public detriment. We are also taking this position in this case. The reason for this Staff position is that the Staff believes that ratemaking findings are best made in rate cases or earnings complaint cases, when the Commission has the necessary information before it concerning all relevant factors affecting utility revenue requirement (revenues, expenses and rate base investment). Complete evidence concerning all relevant ratemaking factors is not generally present in non-rate case non-complaint dockets, such as the instant merger application.

Q. Are the Joint Applicants asking that the Commission make certain ratemaking findings in this Application?

A. Yes. These include:

- A finding that 50% of the acquisition adjustment resulting from this merger be given rate recovery in future EDE rate proceedings;
- Setting EDE's capital structure at a pre-merger stand-alone level in future EDE rate proceedings;
- Ordering a ten-year amortization of transaction costs and costs to achieve for rate purposes; and
- "Freezing" MPS' corporate allocation factors at pre-EDE merger levels.
- Making various determinations concerning the test year, update period, true-up period to be used for Empire's planned pre-moratorium rate case,

as well as the in-service criteria to be applied to Empire's new State Line Combined Cycle unit, in the context of the current merger application.

Q. Should the Commission in this proceeding adopt any of these ratemaking proposals?

A. No because, among other reasons, the Commission does not have the benefit of examining all aspects of EDE's or MPS's revenue requirement factors at this time. Regardless, the specific reasons why the Commission should reject each of these proposals in any event are discussed in my and other Staff witnesses' testimony.

Q. Can you provide an example of why the Commission should not approve the ratemaking findings requested by the Joint Applicants?

A. Yes. As previously discussed, the Companies are seeking a finding from the Commission upfront in this Merger Application that it will be allowed 50% recovery of its acquisition adjustment in future rate proceedings. This approval is sought even though the Commission obviously has not and will not have the opportunity at this time to examine evidence regarding the extent of actual (as opposed to estimated) merger benefits that may exist in the future as a result of this transaction. While the Staff is opposed to acquisition adjustment recovery in concept as being inherently detrimental to the public interest, the Staff certainly believes that if the Commission allows recovery of this particular cost, it should only make that determination after a thorough examination of evidence from all parties concerning actual merger savings and costs in the context of a general rate proceeding.

As another example, Commission adoption of the Joint Applicants' proposed minimum customer merger benefit "guarantee" amount of $3.0 million would appear to implicitly reflect UCU's positions regarding acquisition recovery, transaction/transition cost recover, allocation of UCU corporate overheads to EDE and the proposed assignment of merger savings between EDE and MPS. The Commission definitely should not adopt the Companies' position on these matters explicitly or implicitly at this time.

Q. Has the Commission recently ruled on the issue of the appropriate forum for the issue of acquisition adjustment recovery?

A. Yes. In Case No. WM-2000-222, the proposed acquisition of all of United Water Missouri's stock by the Missouri-American Water Company (MAWC), the Staff recommended that the Commission make any approval of the application conditional upon a finding in the acquisition docket that the acquisition adjustment associated with the transaction be booked below-the-line and not allowed recovery in future MAWC rate proceedings. The Commission denied the Staff's recommendation, stating that the issue of acquisition adjustment recovery should be reserved for a future MAWC rate proceeding. (MAWC had sought no ratemaking findings in its acquisition application case concerning the acquisition adjustment, merger savings and other merger costs.)

Q. If the merger is approved, should potential issues on corporate overheads be handled in future EDE rate proceedings?

A. Yes. The Staff recommends that the Commission state a specific intent to enforce the "no detriment" standard in future EDE rate proceedings as it applies to potential increases in corporate costs from an EDE customer perspective. The Staff views that extraordinary rate mechanisms, such as use of an A & G indexed expense cap, may need to be considered in this area to protect EDE customers in future rate cases.

Q. You previously indicated that UCU is seeking to have the Commission "articulate" its policy on acquisition adjustment recovery in this case as a condition for closing the merger. Please explain this point further.

A. Yes. The section on regulatory approvals in the Merger Agreement reads in entirety as follows:

> . . . the Company Required Statutory Approvals and the UCU Required Statutory Approvals shall have been obtained, such approvals shall have become Final Orders (as defined below), and none of such approvals or Final Orders shall require or be conditioned upon any requirement that any of the Company, UCU or the Surviving Corporation provide any undertaking or agreement, or change or dispose of any assets or business operations, or take or refrain from taking any other action, which would cause, individually or in the aggregate, either (i) a UCU Material Adverse Effect, or (ii) a material adverse effect on the financial condition, income, assets, business or prospects of the business operations presently owned and operated by the Company. <u>For purposes of this Section, the determination of UCU Material Adverse Effect may, without limitation, include the failure of the Public Service Commission of the State of Missouri ("MPSC") to articulate prior to Closing, its policy on the extent to which the Surviving Corporation may recover the Premium (as defined below) related to this transaction</u>. . . .
> [Emphasis added] (UtiliCorp/Empire Merger Agreement, Section 7.01 (b))

The exact meaning of the highlighted language is not entirely clear. To the extent that it means that the Commission must rule now on the recovery of the acquisition adjustment in this case, presumably the Commission will do so since the Joint Applicants have raised this issue for the Commission's consideration in this proceeding. If it means that the Commission cannot defer a decision on rate recovery of the acquisition adjustment to a future rate proceeding, then the impact of the above highlighted language may be more consequential.

Q. Why?

A. The Staff understands the Commission's recent position on the issue of acquisition adjustment recovery to be that it is willing to consider the issue of recovery on a case-by-case basis in the context of rate proceedings. (For example, refer to the Commission's Report and Order in Case No. WR-95-205, Missouri-American Water Company.) For the reasons previously given, the Staff is opposed to this approach. Nonetheless, UCU may be threatening that the Commission change its current position on acquisition adjustments, or it will back out of this merger deal. As a practical matter, UCU's desired change to the Commission's position would have the Commission rule upfront on the question of the recovery of the acquisition adjustment without any true knowledge or confidence that merger related savings will exceed merger related costs. To the extent that the UCU/EDE Merger Agreement language would require that result, then UCU's position is unreasonable and should be rejected without question or hesitation.

Q. In regard to the various ratemaking determinations that the Joint Applicants are seeking that the Commission make in this Merger Application case relating to the upcoming Empire pre-moratorium rate case, what is your understanding of the rationale behind the Companies' requests?

A. It is the Staff's belief that the ratemaking requests proposed by the Joint Applicants are designed to reduce their risk that the planned Empire combined-cycle capacity addition at the State Line site will not be reflected in rates in the pre-moratorium rate case. This risk is associated with the timing of the planned rate case (Fall, 2000) in relationship to the timing of the planned capacity addition to Empire's system (June 1, 2001).

Q. Is the desire to reduce risk associated with future rate treatment of the new State Line unit unreasonable on the part of the Companies?

A. The desire to reduce risk on this point is certainly understandable, but the means by which the Joint Applicants propose to reduce their risk is inappropriate. The Staff believes that issues relevant to rate proceedings should be decided in rate proceedings, and issues relevant to merger applications should be decided in merger application proceedings. The issues of what the test year should be in the upcoming pre-moratorium rate increase case, what the true-up period should be and the items to be trued-up, and what the appropriate in-service criteria should be for the new State Line unit will have to be made regardless of whether Empire continues as a stand-alone operation or UCU takes over the Empire system. The Joint Applicants have made no claim that the Commission's ultimate decision on any of these issues would be different based upon different ownership of Empire, and the Staff is at a loss as to why the Commission's test year, true-up and in-service determinations should be any different based on merger impacts. The Staff believes that the Companies simply desire that the Commission make these decisions much earlier than the Commission normally would and outside of the appropriate forum, in order to reduce UCU's inherent risk associated with that rate case. Although I am not an attorney, it is my understanding that a Commission decision on these matters in the merger application proceedings cannot preclude these issues from being put before the Commission for decision in the pre-moratorium rate case.

Q. Are there other ways that the Joint Applicants can reduce regulatory risk associated with the new State Line unit other than seeking rate determinations in a non-rate proceeding?

A. Yes. It should be kept in mind that utilities are in complete control of the timing of the rate change applications that they may file. The Staff is always willing to discuss with utilities and other parties its thinking in respect to procedural and timing aspects of rate cases. In this particular instance, if Empire and UCU are concerned whether a rate increase application timed for the Fall of 2000 will accommodate inclusion of the new State Line unit in rates, then the Staff would be willing to discuss this matter with the Companies, so the Joint Applicants can take the Staff's thinking into account when making the decision as to the most optimal time to file the pre-moratorium rate case. The Joint Applicants can also pursue this course of action with the Office of Public Counsel and other interested parties.

Q. What about the Companies' proposed in-service criteria for the new State Line unit, as found in Mr. Fancher's supplemental direct testimony in this proceeding?

A. Staff witness David W. Elliott of the Electric Department will respond to the proposed criteria in his rebuttal testimony. My point in this testimony is to state that the Staff is not opposed to, and is willing to talk with utilities at any time, to discuss matters such as in-service criteria. However, the appropriate forum for determining when the new State Line unit is in service is the rate case when the rates reflecting that the unit has gone into service is heard by the Commission. What the Staff is opposed to is the Commission deciding issues such as in-service criteria in a merger application proceeding.

Q. Before continuing with this discussion, what is the Staff's overall philosophy concerning appropriate regulatory treatment of merger savings?

A. The Staff believes it is good policy to allow shareholders some opportunity to retain benefits from mergers and acquisitions, as well as other actions undertaken that have the potential to increase efficiency and productivity. Such retention of a portion of benefits is possible under traditional regulation as well as with alternative regulation structures.

Q. Should a utility be given the opportunity to retain sufficient savings in order to allow it indirect recovery of an acquisition adjustment?

A. No. The purpose of allowing utilities an opportunity to retain some level of merger savings is to encourage actions that will have potential long-term benefits to utility customers, which some mergers and acquisitions do. Explicit policies to allow retention of merger savings in sufficient quantity to allow recovery of acquisition adjustments is equivalent to allowing direct recovery of this item, and is inappropriate for the reasons given in this and other Staff witnesses rebuttal testimony.

Q. Why is it acceptable to allow utilities to retain some portion of merger savings, but not to allow them to recover in rates acquisition adjustments?

A. Merger savings that apply to regulated utility operations by definition are relevant to and should benefit utility ratepayers. Acquisition adjustments, in contrast, generally (and in this proceeding, specifically) relate to some degree to utility expectations of savings and strategic positioning in nonregulated areas. To tie savings retention to the amount of the acquisition adjustment runs the risk of causing customers to finance utility efforts in nonregulated operation arenas.

Allowing utilities to retain some level of merger savings is therefore superior, in that it allows for a sharing to be accomplished in a currency (merger savings) that benefits customers and utility shareholders alike.

Q. If the Commission were to approve this requested merger, what is the Staff's recommendation regarding how merger savings and costs resulting from the merger transaction should be treated in future rate proceedings?

A. Though specific rate findings concerning merger savings and costs should be reserved to those future rate cases, in general the Staff believes that traditional ratemaking practices, when examined in the context of the occurrence of "regulatory lag," will be sufficient to achieve fair treatment of merger revenue requirement impacts from the perspective of both UCU customers and shareholders. (In the context of this case, "fair treatment" presumes that total merger savings will exceed total merger costs.) In practice, use of traditional regulatory practices would mean that merger savings would be flowed to customers by means of periodic rate proceedings, with appropriate merger costs (i.e., "costs to achieve") charged to expense as incurred as well. In between rate proceedings, UCU would be allowed to retain in total the net amount of any merger savings it can create. Regulatory lag allows, therefore, for a fair sharing of merger savings between customers and shareholders in most situations.

Q. What is "regulatory lag?"

A. "Regulatory lag" is the time between when a utility experiences a change in its cost of service and when that change is actually reflected in the utility's rates. In this context, under current regulatory practices in Missouri, utilities such as UCU have the opportunity to retain achieved merger savings for a period of time before they may be required to pass through those savings to customers prospectively through a reduction in rates.

Q. Are there instances in which regulatory lag may not provide for a fair sharing of merger savings to a utility?

A. That is possible. In particular, when a company undergoing a merger faces increasing revenue requirements even when estimated net merger savings are factored in, rate increase cases may serve to pass on achieved merger savings to customers without a chance for the utilities to retain a share of merger savings for a reasonable period. In these instances, the Staff would not be opposed in concept to proposals by utilities to "share" merger savings in the context of a rate proceeding.

Q. How would the Staff view such proposals if they were made by UCU in future rate proceedings?

A. The Staff's position on such proposals would depend upon the specific facts and circumstances surrounding the request at that time. Any future Staff consideration of merger savings sharing proposals would be tied to production of evidence demonstrating incremental net customer benefits that can clearly be tied to the EDE merger, and that would not have been possible without the merger occurring. The amount of any savings retained by the utility should not be tied to the amount of the consideration paid by UCU for the EDE properties (i.e., the acquisition adjustment). Finally, the Staff would evaluate the past ability of UCU to retain merger savings through means of regulatory lag before considering any proposals to share merger savings in rate cases.

Q. By taking a position that ratemaking decisions should not be made by the Commission in this merger proceeding, the Staff believes that the Joint Applicants will argue that this will not provide them with enough "certainty" to go ahead with the agreed upon merger. Please comment.

A. The Staff is not aware of any occasion in the past in which the Commission has the kind of sweeping ratemaking decisions in a merger application which UCU and EDE have requested in this case. By seeking upfront rate commitments from the Commission, the Joint Applicants are in essence urging the Commission to change its past policies in order to encourage this transaction (or, in general, merger and acquisition transactions) to be entered into and approved.

The Staff continues to believe that the Commission should maintain a "neutral" stance towards mergers and acquisitions in general, neither seeking to encourage utilities to combine, or taking steps to discourage potential combinations. Applying consistent regulatory policies to merger applications before it, and allowing utilities to enter into combinations when the companies reasonably show that they can make a beneficial deal under those policies, is the best way to foster a "neutral" attitude in the Staff's opinion. For this particular transaction, given the Staff's analysis showing merger-related costs in excess of probable merger benefits, Commission "encouragement" of this deal is not appropriate in any event. Given the facts and circumstances surrounding this Merger Application, the regulatory focus should be on protecting customers if this transaction is approved, not in "incenting" UCU to close this or other like deals.

Q. Is the Staff proposing an overall "regulatory plan" for the Commission's consideration if this merger is approved?

A. No. In this context, the Staff defines "regulatory plan" as an agreement to provide some special (non-traditional) treatment to merger-related savings and costs. As previously discussed, the Staff believes that traditional rate practices should be extended to the merger-related savings and costs arising from this specific transaction.

Q. What kinds of special treatment of merger related revenue requirement impacts are often discussed in the context of "regulatory plans?"

A. These special treatments generally range from rate moratoriums for a set period of time, to special regulatory mechanisms to allow sharing of merger savings/costs through a defined period, to full-scale earnings sharing/alternative/incentive plans to allow some sharing of earnings (above pre-defined levels) associated with both merger and non-merger-related events.

For informational purposes, Staff witness Proctor discusses some hypothetical examples of how special rate treatments for merger impacts in general, and specific areas of merger savings, might work.

Q. The Joint Applicants have recommended a five-year rate moratorium be put in effect for EDE as part of their overall proposed regulatory plan. Has the Staff considered the use of rate moratoriums for EDE after the merger?

A. It is my understanding that rate moratoriums cannot be ordered or imposed by the Commission. Therefore, in the context of discussions with utilities and other parties, the Staff is not opposed to consideration of negotiated rate moratoriums, if reasonable and if appropriate customer protections are part of an overall settlement. The moratorium should be for a reasonable length of time and, if appropriate, coupled with an upfront and/or deferred rate reduction if necessary to balance customer/utility interests. In the context of a merger application, the rate reductions would have the effect of passing on a reasonable share of expected merger and non-merger related savings to customers after a merger.

Q. Is there anything unusual about the Joint Applicants' request for a moratorium in conjunction with the UCU/EDE Merger Application?

A. Yes. It has been the experience in Missouri that rate moratoriums are generally part of a stipulation and agreement after a utility has agreed to reduce its rates in response to a Staff audit which has determined that an over-earnings situation exists. In the context of the UCU/Empire merger, the proposed regulatory plan would have a five-year moratorium following the conclusion of an Empire rate increase proceeding (the pre-moratorium rate case). Moreover, the Companies propose that the pre-moratorium rate case not reflect any merger savings and costs that may have been incurred and reflected in the test year selected for the rate case. Since Mr. Fancher's direct testimony in this case states that EDE has already had substantial decreases in employee numbers purportedly associated with the merger, this position, if agreed to, will likely result in an overstatement of Empire's need for a rate increase, and lock in the resulting overearnings for at least five years afterward.

Q. Does the Staff have concerns with the Joint Applicants' proposals for handling merger costs and savings in the pre-moratorium rate case?

A. Yes. The Companies' position seems to be that customers should be 100% responsible for any non-merger cost of service impacts (i.e., the new State Line unit), while the shareholders should retain in entirety for five years any net merger related savings that would otherwise have the impact of offsetting part of the items driving the non-merger rate increase. If UCU is going to be diligent in ensuring that customer rates increase when its revenue requirement increases, then similar diligence is justified when Empire's revenue requirement decreases, whether due to merger or non-merger impacts.

Q. Should the Commission consider establishment of a moratorium for Empire in this merger application?

A. The Staff recommends that the Commission not consider any UCU/Empire request for rate moratoriums until after the pre-moratorium rate case has been completed. The terms of such a moratorium, including its duration, will be affected by the decisions coming out of that rate proceeding, particularly as the decisions pertain to merger savings and costs. For example, if the Commission were inclined to accept the Companies' request that merger savings and costs not be included in the pre-moratorium rate case, then the Staff would suggest that any long-term moratorium implemented at that point would be completely inappropriate, in that it would serve to prevent customers from receiving any merger-related benefits in rates for years to come. Conversely, reflection of any net merger savings in customer rates in the upcoming pre-moratorium rate case would perhaps make the concept of a rate moratorium more acceptable to the Staff, all other things being equal. However, it is certainly premature at this point to make decisions involving the possibility of rate moratoriums that balance the interests of customers and the Companies when Empire's near-term rate case results are not yet known.

Q. Notwithstanding the above comments, if a moratorium is to be considered at any time for EDE as a result of the UCU merger, what reasonable customer rate protections would be necessary as part of an overall agreement?

A. At a minimum, customer protections would have to be agreed to in the areas of the acquisition adjustment and allocated corporate costs.

For the acquisition adjustment issue, the only satisfactory customer protection is agreement that the premium will be treated below-the-line in future rate proceedings.

For corporate allocated UCU costs, from an EDE customer perspective, there would need to be an agreed upon procedure to limit potential increases in the allocation of corporate costs above the A&G expense levels incurred by EDE on a stand-alone level. The best and simplest way to do this is to agree on the use of "caps" for EDE A&G expenses in future rate proceedings, in which EDE's rate recovery of this item would be limited to the pre-merger level of Empire A&G costs, perhaps inflated by an appropriate escalation factor.

Q. Did the Staff examine Empire's current revenue requirement during the investigation of this Merger Application?

A. No. The Staff believes that review of Empire's current earnings in the context of this Merger Application was not necessary, given EDE's plans to file a rate increase case later this year.

Q. Is the Staff open to possible use of so-called "alternative regulation" for EDE and/or MPS after a merger?

A. In Case No. EM-96-149, Union Electric Company's (UE) application to merge with CIPSCO, Inc., a stipulation and agreement reached in that case called for merger savings and some merger costs to be flowed through an earnings sharing grid, that had been previously established as part of UE's first Experimental Alternative Regulation Plan (EARP). To utilize the same approach for this Merger Application would require that an entire earnings sharing plan be negotiated among the parties in this proceeding, a project that would have many ramifications beyond consideration of merger- specific issues.

At this time, the Staff is opposed to the introduction of new earnings sharing plans similar to UE's first or second EARP or the more limited sharing plans that are applicable to gas costs for gas local distribution companies in Missouri. This Staff position is because of the various problems that have been encountered in the operation of these plans to-date, and that have been brought previously to the Commission's attention previously.

Q. If the Commission were interested in earnings sharing/incentive plans as a way to treat merger savings and costs in this case, what does the Staff recommend that it do?

A. In the event the Commission is still interested in exploring the usefulness of "alternative regulation" methods in general for utilities in a post-merger environment, the

Staff sees two options as to how the Commission could proceed. First, the Commission could direct the parties to attempt to develop a joint plan to set up an earnings sharing approach for EDE and/or MPS after this merger. This could be done in a new docket to be ordered for that purpose. Second, the Commission could indicate that it is interested in UCU proposing an alternative regulation approach in a future EDE and/or MPS rate proceeding in Missouri. In that docket, the Staff and other parties could respond to UCU's proposal or propose alternatives, as they see fit.

If the Commission is interested in the use of alternative regulation approaches in this context, the Staff recommends that the Commission indicate that interest in the Report and Order in this proceeding, as well as indicate what approach listed above the Commission believes is preferable.

STRANDED COSTS

Q. Please define the term "stranded costs."

A. "Stranded costs" (also commonly known as "stranded investment") is a term that is widely used to describe those costs presently charged by electric utilities in rates that may not be recoverable when and if electric utilities must set their prices based upon a competitive electric market. In short, "stranded costs" are "above-market" costs.

Q. What types of costs are most often thought to be potentially "stranded" if competition is implemented for the electric industry?

A. Because the generating function of electric utilities is thought to be the function most subject to competitive pressures, stranded cost concerns are usually centered on generation assets and expenses.

Q. Is the Staff currently aware of any major stranded cost concerns that may exist for either EDE or MPS?

A. No. For MPS, the Staff examined evidence about its potential exposure to stranded costs from its generating assets at the time of MPS' last electric rate proceeding, Case No. ER-97-394, et al. The Staff found no evidence that MPS was likely to face positive stranded costs when all of their generating assets were taken into account at that time, and is aware of no evidence available since the time of that rate proceeding that would change that conclusion.

For EDE, as previously discussed, UCU's assumption appears to be that Empire's generating assets will be worth more in an unregulated marketplace than under continued regulation. This is the opposite situation than exposure to positive "stranded costs."

Q. Why is the Staff concerned about potential stranded costs in the context of this proceeding?

A. While stranded cost policy does not appear to be directly at issue in this proceeding, the Staff wants to ensure that approval of the Application not serve to increase the amount of stranded costs that may be charged to EDE's or MPS' customers at a later time.

Q. Does the Staff have any recommendations for the Commission's consideration concerning the merger and its potential impact on future stranded costs?

A. Yes. As previously mentioned, stranded costs are usually defined as the difference between net book value of a regulated asset and its market value if the electric industry is restructured. If electric restructuring occurs, it is possible that the Joint Applicants in the future may argue that any failure to recover UCU's valuation of EDE's assets (i.e., the portion of the acquisition adjustment allocable to generation operations) would constitute a "stranded cost." This result would mean that EDE (and perhaps MPS) customers might be exposed to stranded costs in the future, whereas they might not have had such exposure without the merger. This would be a detriment to EDE and MPS customers. Therefore, the Staff recommends that the Commission order as a condition to any approval of the Merger Application that the Joint Applicants' commit not to seek recovery in any future Missouri regulatory proceeding of any portion of the acquisition adjustment under the claim that such costs represent a recoverable "stranded cost." Further, the Joint Applicants should commit not to seek or endorse legislation in Missouri that would mandate the recovery of all or a portion of the acquisition adjustment as part of claimed "stranded costs."

SUMMARY/CONCLUSIONS/RECOMMENDATIONS

Q. Please summarize the Staff's overall conclusions and recommendations concerning this Merger Application.

A. The evidence presented by the Staff in this case is that the expected rate impact of this proposed merger on EDE and MPS customers will be negative, in that expected merger costs will exceed expected merger savings when calculated using reasonable assumptions, and without even considering the proposed recovery of the acquisition adjustment. Based on this evidence alone, the Merger Application as proposed by the Joint Applicants is detrimental to the public interest, and should be rejected by the Commission. Given the relationship between merger costs potentially assignable to customers from this merger, and estimated merger savings calculated under reasonable assumptions, the Staff believes that even imposing conditions for merger approval by the Commission may not serve to adequately eliminate customer risk from this transaction.

In the event the Commission determines approval of the Merger Application is appropriate, however, the following conditions and recommendations (among others listed in the Staff's rebuttal testimony) should be agreed to and accepted by the Joint Applications before approval is granted:

- The Joint Applicants' regulatory plan should be rejected.

- The acquisition adjustment should be booked below-the-line, and not be recoverable at any time in future EDE or MPS customer rates.

- A fair share of merger savings should be assigned to MPS in the future, and available to be flowed through to customers in rate proceedings.

- Any requested recovery of UCU corporate overheads in future EDE rate proceedings should be subject to strict scrutiny, with enforcement of the "no detriment" standard from the perspective of EDE customers in this area.

- The recommendation concerning treatment of EDE's pension plan after the merger, found in Staff witness Traxler's rebuttal testimony, should be accepted.

- The recommendation concerning the "Electric Allocations Agreement", found in Staff witness Proctor's rebuttal testimony, should be accepted.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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

AFFIDAVIT OF MARK L. OLIGSCHLAEGER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Mark L. Oligschlaeger, is, of lawful age, and on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 70 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Mark L. Oligschlaeger

Mark L. Oligschlaeger

Subscribed and sworn to before me this 21st day of June, 2000.

J. Kay Niemeier

J KAY NIEMEIER
NOTARY PUBLIC STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. MAR. 26,2004

MARK L. OLIGSCHLAEGER

COMPANY	CASE NO.
Kansas City Power and Light Company	ER-82-66
Kansas City Power and Light Company	HR-82-67
Southwestern Bell Telephone Company	TR-82-199
Missouri Public Service Company	ER-83-40
Kansas City Power and Light Company	ER-83-49
Southwestern Bell Telephone Company	TR-83-253
Kansas City Power and Light Company	EO-84-4
Kansas City Power and Light Company	ER-85-128 & EO-85-185
KPL Gas Service Company	GR-86-76
Kansas City Power and Light Company	HO-86-139
Southwestern Bell Telephone Company	TC-89-14
Western Resources	GR-90-40 & GR-91-149
Missouri-American Water Company	WR-91-211
UtiliCorp United Inc. / Missouri Public Service	EO-91-358 & EO-91-360
Generic: Expanded Calling Scopes	TO-92-306
Generic: Energy Policy Act of 1992	EO-93-218
Western Resources, Inc./Southern Union Company	GM-94-40
St. Louis County Water Company	WR-95-145
Union Electric Company	EM-96-149
St. Louis County Water Company	WR-96-263
Missouri Gas Energy	GR-96-285
Empire District Electric Company	ER-97-82
UtiliCorp United, Inc./Missouri Public Service	ER-97-394
Western Resources, Inc./Kansas City Power & Light Company	EM-97-515
United Water Missouri, Inc.	WA-98-187
Missouri-American Water company	WM-2000-222
UtiliCorp United Inc. / St. Joseph Light & Power Company	EM-2000-292