Exhibit No.:
Issues: Transition
Transaction Costs
Witness: James M. Russo
Sponsoring Party: MoPSC Staff
Type of Exhibit: Rebuttal Testimony
Case No.: EM-2000-369

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

FILED[2]
JUN 21 2000
Missouri Public Service Commission

REBUTTAL TESTIMONY

OF

JAMES M. RUSSO

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Jefferson City, Missouri
June 2000

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Q. Please state your name and business address.

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

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

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

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

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

Q. Have you previously filed testimony before this Commission?

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

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

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

Q. What is the purpose of your rebuttal testimony?

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

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

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

TRANSACTION COSTS

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

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

Q. How should transaction costs be accounted for?

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

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

A. The Staff proposes that the transaction costs be posted to Account 425, Miscellaneous Amortization:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Transaction Costs Through August 31, 1999

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

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

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

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

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

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

- Prohibit any recovery of the transaction costs that were originally expensed by Empire that are outside of a test year used in a future rate proceeding.

- Allocate a portion of amortized costs to non-regulated companies.

- Prohibit rate base treatment of transaction costs.

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

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

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

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

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

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

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

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

COSTS TO ACHIEVE

Q. What are "costs to achieve?"

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

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

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

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

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

> . . . Estimated costs to convert Empire computer systems to UtiliCorp's systems are $2.7 million. These conversion costs include the costs to convert the customer billing, financial systems and new equipment. The cost of converting Empire computer systems to UtiliCorp systems were estimated by UtiliCorp's Information Technology function. Transaction costs were estimated to be $19.3 million, which includes the legal fees, bond solicitation costs, and Empire's investment bank fees to complete the transaction. These are the costs incurred to both achieve the combination and to implement the synergies.

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

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

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

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

Summary of Costs to Achieve Synergies

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

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

A. Mr. Siemek indicates on page 8 of his direct testimony that UCU will amortize the "costs to achieve" over the first 10 years of combined operations. This is the same treatment proposed by the Company for what the Staff considers to be the majority of transaction costs.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. Executive severance packages within an organization are compensation packages that typically guarantee payments to top executives and key employees on the occasion of a takeover, merger or some other related situation to ensure officers' neutrality. The industry refers to these severance packages as "golden parachutes." Payment of such "golden parachutes" does not have any direct correlation or benefit to ratepayers. Instead, these are the costs that benefit only a very few employees, and are primarily created for their personal protection. Staff further believes these costs are shareholder costs, because these severance packages are also designed to ensure the officers' neutrality in considering potential takeovers, sales and acquisitions. The Staff's position, therefore, is that no recovery of these costs from ratepayers is warranted.

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 JAMES M. RUSSO

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

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

James M. Russo

Subscribed and sworn to before me this 19th day of June, 2000.

ANNETTE KEHNER
Notary Public – Notary Seal
STATE OF MISSOURI
Cole County
My Commission Expires: July 17, 2003