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Tracking of Merger Savings
Acquisition Adjustment
Witness: Janis E. Fischer
Sponsoring Party: MoPSC Staff
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Case No.: EM-2000-369

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

JANIS E. FISCHER

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

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JANIS E. FISCHER

UTILICORP UNITED INC.

AND

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM–2000-369

Q. Please state your name and business address.

A. Janis E. Fischer, 3675 Noland Road, Suite 110, Independence, Missouri 64055.

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

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

Q. Please describe your educational background.

A. I graduated from Peru State College, Peru, Nebraska and received a Bachelor of Science degree in Education (Basic Business) and Business Administration. In May 1985 I completed course work and earned a Bachelor of Science degree in Accounting. I passed the Uniform Certified Public Accountant examination in May 1994 and received my license to practice in March 1997. Prior to my employment at the Commission, I worked over six years as the office and accounting supervisor for the Falls City, Nebraska Utilities Department (Utilities Department).

While with the Utilities Department, I completed water and electric rate reviews, developed procedures for PCB monitoring and disposal, implemented a program to verify the accuracy of remote water meters, supervised office staff and handled customer complaints. I assisted with the acquisition of Falls City's natural gas distribution system from Kansas Power and Light Company, predecessor company of Western Resources, Inc., (Western Resources) by compiling asset records, nominating gas supplies for the municipal power plant and monitoring gas transportation customer loads. I was appointed by the Board of Public Works to the Nebraska Public Gas Agency (NPGA) Board and later elected Vice Chairperson of the Board. NPGA is comprised of members from municipal natural gas systems who collectively purchase natural gas and acquire natural gas wells to supply gas to municipal gas systems and power plants at reduced costs.

I also was employed as a staff accountant with the accounting firm of Cuneo, Lawson, Shay and Staley, PC, in Kansas City, Missouri, for approximately two years. While employed as a staff accountant, I assisted in various audits, compilations and reviews of corporations and prepared individual and corporate state and federal tax returns. I researched tax issues, assisted with compliance audits and interacted with various clients.

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 testified in Case No. ER-97-81, The Empire District Electric Company (Empire or EDE); Case No. GR-97-393, Union Electric Company

(Union Electric); Case No. EM-97-515, the Western Resources/Kansas City Power & Light Company (KCPL) merger; and Case No. EM-2000-292, the UtiliCorp United Inc. (UtiliCorp or UCU)/St. Joseph Light & Power Company (St. Joseph) merger.

Q. What was your involvement in the KCPL merger with Western Resources?

A. My area of responsibility was the review of the merger savings estimates developed by KCPL and Western Resources. I also addressed the rate treatment of the merger transaction costs and the "costs to achieve" the merger, also referred to as transition costs.

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

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

Q. What is the purpose of your rebuttal testimony?

A. I will address certain aspects of the Companies' estimated merger savings, including savings in labor costs, and the concept of calculating merger savings based on a "current dollar" basis. My testimony will also include comments on the proposed tracking of merger savings, and the use of the Empire 1999 budget as the baseline for savings calculations. Testimony addressing additional savings related to employee benefits will be submitted by Staff Accounting witness Steve M. Traxler and generation/joint dispatch savings by Staff witness Dr. Michael S. Proctor of the Electric Department. I will also present information on how other state jurisdictions have addressed "acquisition premiums" (also referred to as "acquisition adjustments" or "merger premiums") for rate purposes relating to utility mergers/acquisitions and compare and contrast the proposed merger savings "regulatory plan" offered by UtiliCorp with those reviewed by other state utility regulatory bodies. The "acquisition adjustment" issue will be addressed in more detail in the rebuttal testimony of Staff Accounting witnesses Mark L. Oligschlaeger, Cary G. Featherstone and Charles R. Hyneman, as well as in the testimony of Staff witness David P. Broadwater of the Financial Analysis Department and Dr. Proctor.

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

A. While the issues covered in both testimonies are the same, and portions of the testimonies are identical or nearly so, I have in some instances expanded my arguments in this testimony compared to the testimony filed in Case No. EM-2000-292. There were also differences between the two mergers in the estimates of merger savings and differences in the Staff's proposed adjustments to these estimates.

MERGER SAVINGS

Q. Do the Joint Applicants expect any merger savings to occur because of the merger of Empire into the UtiliCorp corporate structure?

A. Yes. UtiliCorp witness Vern J. Siemek identifies the estimated merger savings in his direct testimony and attached schedules. UtiliCorp claims the merger with Empire will result in total estimated savings of $383.6 million over a ten-year period. UtiliCorp believes these merger savings will occur as follows:

Year	Amount in $
1	$ 24,656,000
2	31,163,000
3	35,633,000
4	37,876,000
5	44,117,000
6	41,994,000
7	44,552,000
8	43,059,000
9	37,295,000
10	43,228,000
Total	$383,573,000

[Source: Response to Staff Data Request No. 1]

Based on Mr. Siemek's testimony and that of other Joint Applicant witnesses, UtiliCorp believes it will be able to achieve significant savings from the merger with Empire. Furthermore, UtiliCorp claims that it will be able to identify and quantify actual merger synergies to demonstrate in future rate proceedings that these savings exceed the costs relating to the merger.

REGULATORY PLAN

Q. How is UtiliCorp proposing to treat these merger savings and merger costs in future rate cases?

A. UtiliCorp is proposing a "regulatory plan" identified in the direct testimony of UCU witness John W. McKinney in which the merger costs would be recovered in rates from the customers of Empire beginning approximately five to six years or more after the merger is completed. This is dependent upon when a planned Empire rate case (the so called "Post-Moratorium Rate Case") is filed during the last year of a five-year rate moratorium. The Joint Applicants also discuss a planned Empire rate case (the Pre-Moratorium Rate Case) to include the new State Line generating station that is projected to be operational in May or June of 2001. The proposed pre-moratorium rate case will be concluded before the rate moratorium proposed in this case begins. Therefore, the estimated merger savings presented in Schedule VJS-1 are calculated for the time period beginning after the proposed pre-moratorium rate case yet the baseline that UtiliCorp uses for its merger savings estimates is the Empire 1999 budget.

Q. How does UtiliCorp propose to use these savings estimates in its regulatory plan?

A. UtiliCorp witness John McKinney, at page 6 of his direct testimony, explains that the rate filings during the fifth year following the close of the merger will include an accounting of the synergies realized during the five-year moratorium. Mr. McKinney goes on to say, "Included in the Post-Moratorium Rate Case will be the complete flow-through of all test-year operation and maintenance (O&M) synergies, adjusted to the forward average level of savings for 5 years following the rate moratorium, net of the costs to achieve the synergies, resulting from the merger." According to Mr. McKinney, UtiliCorp's regulatory plan "guarantees" approximately $3 million in net merger savings to Empire customers in years six through ten following the merger close.

UtiliCorp is in effect guaranteeing that the amount of the estimated savings will exceed fifty percent of the acquisition premium (recovery of the premium and a return on the premium) plus other merger related costs. UtiliCorp then proposes to use the savings to pay for the fifty percent of the acquisition premium that it has assigned to ratepayers and for the other merger related costs. The ability to verify that the estimated merger savings exceed these costs is critical to UtiliCorp's regulatory plan.

Q. Will the water operations of Empire be part of UtiliCorp's proposed regulatory plan?

A. No. The water operations of Empire will not be assigned any of the costs of the merger transaction and, therefore, will not be included in the rate moratorium. Mr. McKinney also states that water rates will not be increased as a result of the merger.

Q. Please continue to describe the proposed regulatory plan.

A. According to the regulatory plan, UtiliCorp proposes to retain, through a rate moratorium, all merger savings for the first five years. Supporting documents for the regulatory plan provided by the Company in response to Staff Data Request No. 1 show that these savings are proposed to be recovered net of the amortization of the transaction costs and costs to achieve.

After the moratorium period, UtiliCorp believes it is appropriate to include the remaining unamortized portion of transaction costs and costs to achieve (transition costs) in the revenue requirement for Empire. In addition, UtiliCorp further proposes that Empire's customers, through rates, pay for one-half of the merger premium (acquisition adjustment) associated with the merger transaction. UtiliCorp's proposal is requesting direct recovery from Empire's customers of both the amortization of the premium and return on the one-half of the acquisition premium by including these amounts in the rate base assigned to Empire customers.

After deducting these costs from the projected merger savings, UtiliCorp purports to guarantee the residual of approximately $3 million of net merger savings in Years 6-10 following the close of the merger (as shown in Schedule VJS-1) as a revenue requirement reduction, even if the merger does not actually generate savings at this level. Based on this residual amount, Empire customers in years 6-10 will be allegedly "guaranteed" the benefit of $15 million in total net savings ($3 million multiplied by five years). Therefore, under the regulatory plan, Empire customers will be given approximately 3.91% of the total $383.6 million projected merger savings during the first ten years following the merger's close ($15 million divided by S383.6 million). Even based on UtiliCorp's estimates, the total costs of the merger are significant when compared to total expected merger savings.

Q. Has the Staff reviewed the estimated merger savings presented by the Companies?

A. Yes. The Staff has reviewed the direct testimony of Mr. Siemek and the Companies' response to Staff Data Request No. 1. This Data Request response contains the documents and supporting workpapers to Mr. Siemek's schedules attached to his testimony that identify the merger savings UtiliCorp believes will result from the merger of these two companies. The Staff also asked questions of Mr. Siemek in the March 2, 2000 and May 30, 2000 transcribed interviews to gather additional information concerning how the estimated savings were calculated.

Q. Has the Staff reached any conclusions about the estimated merger savings projected by the Joint Applicants?

A. Yes. The Staff believes the estimated merger savings calculated by the Joint Applicants should not be relied upon in determining whether the Commission should approve the merger.

Q. Why does Staff believe UtiliCorp estimates of merger savings are unreliable for purposes of evaluating the proposed merger?

A. Estimating or projecting the cost impact of future events is difficult. Predicting what a merged organization will look like and how it will operate is extremely difficult before the fact. The combining of Empire into the UtiliCorp corporate structure, along with UtiliCorp's merger with St. Joseph, will result into a completely different organization than exists today for each of these pre-merger entities. Stating with high accuracy what the merger impacts will have on the processes of providing utility services to post-merger customers is very speculative. Procedures and processes will dramatically change in these post-merger organizations, particularly at Empire and St. Joseph. Based on customer size, the operational size of UtiliCorp's Missouri properties will almost double.

The elimination of any redundancy in the organizational structure of the three separate entities once the mergers are completed is an important consideration of planning for the mergers, but is highly speculative in nature. How much and to what level merger savings will actually materialize is guesswork. Projecting merger savings for a ten-year period is well beyond a utility's normal planning horizon. It is beyond the practical limits of utilities and regulators, for rate purposes, to identify and quantify with sufficient accuracy the merger savings that will result from the creation of an organization that does not yet exist. The analysis of the cumulative impact of Empire and St. Joseph both combining with UtiliCorp has not even been done by UtiliCorp, except on a limited basis. Yet UtiliCorp anticipates the three-way combination with St. Joseph and Empire will create more opportunities for savings. Mr. Richard C. Green, Jr., Chairman and CEO of UtiliCorp, has publicly stated that UtiliCorp sees a lot of potential for savings with the combination of all three of the companies. The Staff does not believe the Commission should rely on the estimated merger savings, in part, because of these uncertainties. This point will be discussed in more detail later in my rebuttal testimony.

Q. How would Staff characterize the use of the estimated merger savings in the regulatory plan?

A. The estimated merger savings are used to justify the recovery of the merger premium through the proposed regulatory plan. To improve the likelihood that an acquisition premium could be recovered from ratepayers in Missouri, UtiliCorp proposed only recovery of fifty percent of the acquisition premium. This position allows UtiliCorp to claim that the estimated savings exceed estimated merger costs, so that a nominal amount of merger savings can be "guaranteed" to ratepayers. For this reason, the estimated merger savings are the key to the regulatory plan. If it doesn't accept UtiliCorp's "guarantee" that estimated merger savings exceed the merger-related costs embodied in the regulatory plan, the Commission is left to conclude that recovery of the ratepayers' portion of the acquisition premium would be clearly a detriment to Missouri customers.

ESTIMATED SAVINGS/TRANSITION TEAMS

Q. Are the estimated merger savings presented in the Joint Applicants' filing the savings that are likely to be realized from the UtiliCorp/Empire merger?

A. No. The savings amounts are nothing more than estimates. They can change with additional analysis, and have through time since the initial due diligence savings estimates were made.

Q. Please describe the first attempt made by UtiliCorp to estimate the merger savings that would result from the acquisition of Empire.

A. UtiliCorp developed an initial estimate of merger savings during the due diligence phase of the merger negotiation process. Empire provided UtiliCorp with detailed employee counts and budgets by area, according to Mr. Siemek in his May 30, 2000 transcribed interview. (Tr. 28-30.)

Q. Did the Joint Applicants later perform additional analysis of estimated merger savings?

A. Yes. Once the Merger Agreement was completed, UtiliCorp and Empire started working on identifying and quantifying estimation of merger savings on a joint basis using what are known as "transition teams." The transition teams, among other assigned tasks, "validated" the initial due diligence estimated merger savings. There were a total of seven teams formed: Human Resources, Finance/Accounting, Regulatory/Legislative Services, Distribution, Transmission, Supply/Generation and Information Technology. According to Schedule VMH-1, "Integration Planning Timeline," attached to the direct testimony of the Joint Applicants' witness Vicki M. Heider, the teams began meeting in September of 1999 and presented final transition team recommendations to the Steering Committee on March 14, 2000. Since that time the teams have met less frequently. The transition teams' analyses led to the merger savings estimates included in Mr. Siemek's direct testimony. Mr. Siemek, in his transcribed interview of May 30, 2000, stated that adjustments will be made to UtiliCorp's response to Staff Data Request No. 1 prior to hearing. (Siemek May 30, 2000 Tr. 10-12) These changes will be based upon Steering Committee approval.

Q. What do you mean when you say the transition teams were assigned to "validate the due diligence estimated merger savings"?

A. The transition teams were to determine if the due diligence estimates were reasonable. The analyses of the transition teams were used to support the due diligence estimates and also to identify any major discrepancies. Particularly if the estimated savings had been overestimated, the teams were to notify management.

Q. Is the work of the transition teams ongoing?

A. The transition teams presented their recommendations to the Steering Committee on March 14, 2000. Without the final approval of these reports, which is not expected until August, the Staff does not have a completed analysis from UtiliCorp and Empire of the estimated savings or the integration process. The transition teams will continue to work towards a smooth merger transition from an operational viewpoint.

Q. Does the Proxy Statement of the Empire District Electric Company and the Prospectus of UtiliCorp United Incorporated (Proxy) dated July 29, 1999 contain any disclaimers as to the accuracy of the Companies' forecasts?

A. Yes, it does. On page 13 of the Proxy, Empire District Electric Company and UtiliCorp United Incorporated state:

> In this document, UtiliCorp and Empire each have made forward-looking statements that are subject to risks and uncertainties. Forward-looking statements include statements concerning possible or assumed future results of operations set forth...Various risks and uncertainties may cause actual results to differ materially from the results that these statements express or imply...Please do not place undue reliance on these forward-looking statements, which speak only as of the date of this proxy statement/prospectus.

Q. Was there a detailed description of the estimated merger savings included in the Proxy?

A. No. UtiliCorp/Empire did not include any specific language or schedule to describe the estimated savings that they anticipate will occur as a result of the merger in the Proxy. Neither the estimation of merger savings determined during the due diligence phase nor any other estimate of merger savings was included in the Proxy. The transition teams performed their due diligence synergy validation after the Proxy was issued.

Q. Have the employee reductions used in calculating the estimated merger savings been determined by the Joint Applicants?

A. No. Actual personnel reductions will not be determined until after closing, according to timelines reviewed with transition team documents included in the Companies' Response to Staff Data Request No. 103.

Q. Have other public utility commissions raised concerns over the achieving of merger savings?

A. Yes. Utility regulators in other jurisdictions in which electric utility mergers have occurred have also raised concerns about estimated merger savings. I have included two excerpts from commission orders and have additional related examples later in my testimony. In Docket No. 98–7023, before the Public Utilities Commission of Nevada (Nevada PUC), in the Reapplication of Nevada Power Co., Sierra Pacific Power Co. and Sierra Pacific Resources for Approval of Agreement and Plan of Merger, a Compliance Order was issued by the Nevada PUC:

> The joint application includes a multi-part regulatory rate plan described by the Joint Applicants as being designed to hold utility customers harmless from any adverse impact on rates associated with the costs of the merger and <u>a proposal for an incentive mechanism through which net merger and related benefits are to be shared between customers and investors.</u>

> ...The Commission finds that the merger savings are estimates...merger cost savings can neither be precisely quantified nor accurately tracked and that <u>the Commission should not rely upon the estimates of merger savings provided by the Joint Applicants.</u> [Emphasis added]

The Board of Public Utilities (BPU) for the state of New Jersey, Docket No. EM98070433, in the Orange & Rockland Utilities (RECo) and Consolidated Edison, Inc. (CEI) merger stated their concern about estimated merger savings:

> We <u>HEREBY DIRECT</u> that RECo file an appropriate Cost Allocation Manual by January 1, 2000 for the Board's consideration.
>
> <u>The primary area of controversy in this proceeding is the estimate of the net merger savings and the method and timing of the sharing of said savings with RECo's ratepayers.</u> In deciding this issue, the Board is mindful of the similarities of the characteristics of this issue in this case and the recently concluded Conectiv merger case. Both mergers produce merger savings primarily via labor reductions and the streamlining of utility operations. The net-savings are estimated over 10-year periods in both cases and similar categories of costs to achieve the merger were identified. We are however mindful in the instant proceeding of the substantial windfall which will accrue to O&R shareholders by reason of a 38.5% appreciation in the value of their investment traceable directly to the consummation of this merger resulting in an approximate $200 million premium, which situation is unique to the instant merger vis a vis Conectiv.
> [Emphasis added]

Public utility commissions in other jurisdictions have questioned the validity of estimated merger savings because they are merely estimates and can't be relied upon for setting rates. As this Commission is well aware, traditional ratemaking relies upon recent historical data to determine a utility's revenue requirement and then set rates appropriately to permit the utility the opportunity to recover from its customers this determined revenue requirement. Since utilities tie premium recovery to merger savings, commissions realize that tracking and differentiating merger savings from non-merger savings is crucial.

Q. Does the Staff have any other concerns about the estimated merger savings?

A. Yes.

- UtiliCorp has not analyzed the effects of a three-way merger on the estimated merger savings.
- The estimated savings have not been scrutinized even to the level of annual budgets. If budgets cannot be relied upon for rate making, neither can estimated savings.
- The estimated labor savings have several flaws: vacancies due to the merger should not be included in estimated merger savings, vacancies due to normal attrition should not be included in estimated merger savings, non-merger labor reductions will not be identifiable from estimated merger savings.
- A net present value calculation must be included for estimated merger savings.

Q. Please explain the Staff's concerns related to specific areas of the estimated merger savings.

A. I will address Staff's concerns about several areas identified in Mr. Siemek's direct testimony in the following sections of my rebuttal testimony.

EFFECTS OF THREE-WAY MERGER

Q. Accepting the fact that the estimates are purely speculative; does the Staff have additional concerns about omissions from the Companies' analysis of projected merger savings?

A. Yes. As stated earlier in my testimony, UtiliCorp has failed to provide sufficient information as to what result a combined three-way merger of UtiliCorp, Empire and St. Joseph will have on estimated savings. Without this information, the Commission is placed in a position of having to make its decision of approving the mergers based solely on speculation of the impacts these two mergers will have on each other.

Q. Do UtiliCorp's estimated merger savings assume a three-way combination of UtiliCorp, Empire and St. Joseph?

A. Only in relationship to generation/joint dispatch projected savings, environmental compliance joint options and in the allocated corporate cost scenarios. Both Mr. Siemek (Tr. 36-40; March 2, 2000) and UtiliCorp witness Jerry D. Myers (Tr. 68-69) commented in transcribed interviews with the Staff that they had not combined the three companies together for any of the other merger savings calculations. Ms. Heider also stated in an interview with Staff on January 25, 2000 that the transition teams were distinctly separate for Empire and St. Joseph and that the teams had not performed a combined three-company analysis.

Q. Does the Staff believe that an examination of merger savings for the Empire transaction should include impacts from the proposed St. Joseph merger?

A. Yes. In reviewing the two mergers and the impact of merger savings, at least one scenario should assume that both mergers will be completed. Certainly, any concurrent UtiliCorp merger with St. Joseph will affect the degree of the merger savings of the Empire merger.

Q. What influence does the Staff believe the three-way combination will have on the savings that may accrue through the merger of UtiliCorp, Empire and St. Joseph?

A. The Staff believes that there is a possibility that additional economies of scale may be generated when the three companies are merged. The separate stand-alone analyses performed for UtiliCorp/Empire and UtiliCorp/St. Joseph did not include an analysis of the three companies combined except as mentioned earlier. Without that analysis, it is unknown whether the combined mergers will create additional savings or additional costs. The Staff does believe that the combined mergers will have an effect upon the actual merger savings that will be realized. The estimated merger savings purported by Mr. Siemek in his direct testimony may actually be understated or overstated as they relate to Empire.

Q. What types of additional savings could be realized from the three-way merger?

A. Any savings that arises from an economy of scale; for example, purchasing larger quantities, sharing project costs for Missouri specific activities, sharing personnel instead of outsourcing, etc. Without an analysis of the three-way merger, the likelihood of additional savings being realized is unknown.

Q. What changes in labor requirements could the analysis of the combined merger of UtiliCorp, Empire and St. Joseph have uncovered?

A. The duties that UtiliCorp personnel will assume when their counterparts at Empire and St. Joseph are terminated may not be manageable without the addition of additional supervisory personnel. An example would be the elimination of employees (including a supervisor) from the accounts payable function of both Empire and St. Joseph. When combined, the additional employees might require an additional supervisor that would not have been identified when analyzing the impact of the Empire or St. Joseph transactions separately. It is not known at this time what effects on merger savings two concurrent mergers may have. There could be more savings, or there could be less as a result. Without a thorough analysis on the impact of a three-way merger, the Commission can only guess the effects the combined merger of UtiliCorp, Empire and St. Joseph will have on labor savings or costs.

BUDGET DEVELOPMENT VS. ESTIMATED SAVINGS

Q. Do UtiliCorp and Empire place importance on the development of their annual budgets and meeting or "besting" annual budgets?

A. Yes, UtiliCorp does. Employees are indirectly rewarded for their performance relative to the budget. In response to Staff Data Request No. 154 in Case No. EM-2000-292, UtiliCorp witness Robert B. Browning explained that "Ultimately, managing the budget becomes an important step in achieving earnings per share targets." While employees are not directly rewarded for performance against budget, all employees are rewarded for the company achieving or exceeding its earnings per share goal for each year. Mr. Browning also stated that management does not plan to establish goals for achieving expected merger savings.

Empire's incentive compensation for its five senior officers includes electric O&M expense control. Compensation is given to motivate reduction in controllable costs. Individual goals have also included achieving budget estimates.

Q. Do employees of UtiliCorp devote considerable time developing budgets?

A. Yes they do. UtiliCorp's response to Staff Data Request 149 in Case No. EM-2000-292 provided information pertaining to the budget process. The management of UtiliCorp devotes a considerable amount of time to develop budgets that are used to forecast earnings. Attaining budgeted revenues and holding expenses to budgeted amounts enhances the financial position of UtiliCorp. According to Mr. Myers transcribed interview (Tr. 46-49), each project manager is responsible for the coding of expenses and the outcome of the project. (A "project" could be any number of activities so defined and under the direction of an assigned manager.) Managers devote time in analyzing the expense requirements and the revenue projections for their projects/departments. The process of developing the budget is time consuming and input from many individuals bring the final budget numbers together. Changes in actual activity to the budgeted estimated revenues and expenses are measured monthly.

Q. Do employees of Empire also devote considerable time in developing budgets?

A. Yes. Empire, in response to Staff Data Request No. 125, explained the annual capital and operating budget process:

> The capital budget is prepared on a functional basis. Each functional area determines the capital needs for their area of responsibility. Reviews are then held with functional area management, including the respective Vice-President, and approvals are obtained. The Budget Coordinator gathers all the information from the different functional areas and combines the information into one review book. The book summarizes the information into a high level functional view. The book is then distributed to all Officers and functional area personnel for review.
>
> A meeting with the Officers and functional area personnel is held to review the proposed projects. This meeting includes a review of the current and future financial picture of the Company as well as other business and technical issues. Projects are challenged and defended in the meeting and if necessary changes are made and additional meetings held. The final budget is submitted to the Board of Directors for approval at the July board meeting.
>
> The O&M budget is prepared at the department level. The Officers determine the guidelines for wages and the inflation

> factors. A Budget notebook is developed and provided to all departments. This notebook contains all of the guidelines, schedules and other information needed by the departments. Department management reviews the information, send it to the Budget Coordinator. Once all department information is received, the information is summarized into both a department level view and a corporate level income statement. This information is then provided to the Officers.
>
> The Officers then meet to review the proposed budget in light of the current and future financial picture of the Company. The Vice Presidents meet with their respective directors to discuss any necessary changes. Once all changes are completed, the information is resubmitted to the Budget Coordinator. The previous department and corporate level views are updated to reflect the changes. This new information is then provided to the Officers for review and additional meetings if necessary. Once the Officers have approved the final budget, the Budget Coordinator will process the information into finalized reports for management use.
>
> Both capital and O&M budgets are "bottom-up" driven. In both cases department managers and employees initially determine projects and departmental O&M needs. The process requires defense of the proposed projects and O&M needs at the department, vice-president and total officer level with final approval at the senior officer level.

Q. Has the Commission previously allowed rates to be set based on budgets, forecasts or estimates?

A. No. The Commission generally requires that rates be set on known and measurable costs, not based upon budgeted amounts. Budgets, forecasts and estimates all have a place in planning future expected results for companies and are used to manage the operations of the company. Companies prepare budgets based on expected events and past historical data. Budgets are made for the next year and are used as a planning tool and as performance measurements. Operating budgets typically do not extend out in time past one year. Capital budget forecasts may go out for periods of five years. Companies often revise budget and forecast projections annually and sometimes even monthly as circumstances change. Companies monitor budget-to-actual variances in the short term to monitor performance. While a great deal of effort goes into the development of budgets, they remain just that – budgets. They are appropriate tools for cost control, but they do not provide precise information that can or should be relied on to use in the ratemaking process.

Q. Are the estimated merger savings comparable to annual budgets in their level of detail?

A. No. The merger estimates that UtiliCorp is asking the Commission to rely on are based on an analysis that was not even as detailed as the budget process followed by UtiliCorp or Empire. The estimated merger savings are similar to budgets in one way. They are based upon expected events. They are not similar to budgets in another way. There is no past historical data that defines the unique company that the merger will create.

More importantly, the merger savings estimates are for a period of time that is much longer and much further out in the future than the typical budget is attempting to monitor. Budgeted projections that extend out one year are not relied upon for rate purposes, let alone projections that extend out ten years into the future. The Staff does not believe that the Commission should rely on projected estimates of savings to substantiate the inclusion of fifty percent of the acquisition premium into rate base for the customers of Empire to pay. The estimated merger savings are merely speculative.

The estimated merger savings are also very largely dependent upon application of an escalation factor that artificially increases the merger savings estimates throughout the last nine years of the regulatory plan. The analysis that is applied by UtiliCorp or Empire to the annual budget process would have to be re-done each year of the ten-year regulatory plan in order to be as detailed.

To summarize, budgets have not been used in the rate process in Missouri because of their inherent lack of reliability. Yet, it is striking that the merger savings estimates the Joint Applicants propose to set future rates on are much less detailed and concrete than even UtiliCorp's and Empire's annual budgets. The Commission should decline the Joint Applicants' invitation to set rates based on preliminary estimates of merger savings before the fact.

MERGER SAVINGS–LABOR

Q. What comments do you have concerning the Joint Applicants' estimated labor savings resulting from the merger?

A. I have several points I would like to discuss related to the estimated labor savings resulting from the merger:

- The proposed baseline of the 1999 Empire budget includes non-merger related vacant positions. The costs associated with these vacant positions, when measured against future labor expenses, will produce savings that appear to be merger related.
- Labor reductions have occurred at UtiliCorp and Empire on a stand-alone basis and probably would continue to in the future.
- These non-merger labor savings will be increasingly hard to distinguish from merger labor savings.

Q. Please describe the Companies' analysis of alleged merger savings related to labor.

A. The Joint Applicants provided workpapers and reports issued by the transition teams in response to Staff Data Request Nos. 1 and 103. Each of the seven transition teams was responsible for review of a portion of the Empire 1999 budget during the due diligence validation process. The analyses concentrated on the labor expenses of Empire. Some teams started with the Empire budget and then deducted positions that they believed would duplicate existing UtiliCorp positions. Other teams took the approach of starting at zero dollars and then adding back positions that would be needed. The teams looked at Empire direct labor costs associated with their specific team's departmental functions.

Q. Do projected labor reductions account for a large portion of the estimated merger savings?

A. Yes. A large portion of the alleged savings created by the merger come from reductions in Empire personnel. Mr. Siemek describes these types of estimated savings in his direct testimony starting on page 11. Many of the reductions in direct costs to Empire arise from the fact that the positions and job duties to be eliminated are duplicative of positions and job duties already being performed by personnel at UtiliCorp; i.e., supervisory and management positions. Empire positions that are considered as overhead will be eliminated with those job duties absorbed by UtiliCorp. This will lead to some additional positions at UtiliCorp. In turn, the post-merger Empire operating unit will be allocated a portion of UtiliCorp's corporate overheads, through the ESF and IBU allocations. In the case of the Empire merger, most of the incremental support costs assigned to Empire will be payroll in nature. The Joint Applicants' witness Robert B. Fancher estimated that approximately 270 Empire employees' positions will be eliminated as a result of the merger. Approximately 60 positions will be added to UtiliCorp for a net reduction of 210 employees (Tr. 25).

Q. Did the transition teams provide details to support their labor reductions?

A. Unfortunately, the transition team workpapers contain few concrete explanations to explain position reductions in the various departments. Most of the workpapers, especially in the areas of transmission and distribution, contain only the results of decisions reached regarding the numbers of positions to be reduced and no documentation of why each reduction is thought to be reasonable.

Q. Were all positions eliminated based on similar analyses?

A. No. In some cases, teams were subjective in their decisions and made assumptions that tended to increase the number of positions to be eliminated. Both Mr. Myers and Mr. Siemek supported this "conservative" view keeping the addition of personnel at the UtiliCorp corporate level as low as possible. In his March 2, 2000 transcribed interview (Tr. 43), when asked about the elimination of positions, Mr. Siemek gave an example of personnel in the Accounts Payable department being able to process 10,000 invoices per person:

> So, in my case, and the example that I used, we started with, I think, 36,000 combined invoices from the two companies, which would have been three-and-a-half people at UtiliCorp. And we ended up adding three, and assuming that some of those 36,000 would go away. And I think that was generally the approach that was taken by each of the transition teams...<u>we were fairly conservative in trying to decide what additional staff we needed to add.</u> [Emphasis added]

Q. Please explain the Staff's concerns about the projected merger savings generated from reductions in labor costs.

A. The Staff has two concerns with the projected labor savings. One concern is that the structure of the combined three utilities (UtiliCorp, Empire and St. Joseph) and the effect the combination will have on labor is not known. UtiliCorp has not looked at a three-way combination as it pertains to most areas of labor savings.

In addition, the Staff believes some of the labor savings included in the Companies' proposed merger savings are actually attainable by the Companies without the merger, so attributing the savings solely to the merger is misleading. The distinction between vacancies that are attributable to the merger and those normal vacancies that occur at any point in time for every company also needs to be made.

NON-MERGER NORMAL ATTRITION

Q. Are there positions included in the budget of Empire that are vacant because of non-merger circumstances?

A. Yes. According to the transcribed interview of Mr. Fancher, there are approximately sixty positions currently vacant at Empire. Mr. Fancher stated that forty of the vacant positions are believed to be related to the merger, with the other twenty due to normal attrition (Tr. 20-21). All 60 of these positions have been included in the 1999 Empire budget that the transition teams utilized in estimating merger savings. The inclusion of the normal vacancies in the 1999 budget would therefore be reflected in the synergy analysis and would be included in the savings that ultimately are used to calculate merger savings for the test-year in the post-moratorium rate case proposed in the UtiliCorp regulatory plan. An adjustment has been made to the estimated merger savings supported in Schedule VJS-1, which is reflected in Staff witness Traxler's Schedule SMT-5. I have attached Schedule 1 supporting this adjustment.

Q. How would the Staff propose that labor positions be counted for the estimated merger savings?

A. The Staff would propose that savings estimates should start with actual position levels similar to the approach used in rate case proceedings. Vacant positions are not included in rate cases when determining employee levels. Costs that are not reflected in rates in the first place cannot be considered true merger savings from a customer perspective if they are "eliminated" because of a merger. In determining the estimated expenses that would be representative of the loaded labor costs for twenty positions, I reviewed the 1999 Empire FERC Form 1, for total payroll expenses and divided by the number of employees. To determine the employee count, I reviewed the employee count in the 1998 FERC Form 1 also. Part-time employee counts were divided by two and then added to the full-time employee count for 1998 and 1999. I then took an average from the 1998 and 1999 employee totals. I also reviewed the estimated merger labor savings from UtiliCorp's response to Staff Data Request No. 1, divided by the number of positions to be eliminated. My third approach to estimate the average labor expense was a review of the transition team March 14, 2000 report to the Steering Committee. These three calculations are detailed in Schedule 1. To be conservative, I have used the lowest estimate for the adjustment to the UtiliCorp estimated merger savings.

<u>NON-MERGER LABOR REDUCTIONS</u>

Q. Have both Companies been successful at reducing employee levels and/or labor costs in the past?

A. Yes. UtiliCorp and Empire have both been able to reduce employee levels through reorganizations and downsizing. UtiliCorp's response to Staff Data Request No. 26 in Case No. EM-2000-292 (see attached Schedule 2) illustrates prior personnel reductions related to "re-engineering" effects. The Staff believes some of the labor savings included in the Companies' proposed merger savings are actually attainable by the Companies without the merger, so attributing the savings solely to the merger is misleading. The distinction between vacancies that are attributable to the merger and those normal vacancies that occur at any point in time for every company also needs to be made.

Q. Did Empire recently have a re-engineering project that reduced staffing levels and in effect generate stand-alone savings?

A. Yes. During 1995 and 1996, Empire went through a massive reorganization of its operations. Empire called it the Competitive Positioning Process (CPP). According to comments made by UtiliCorp witness Myron W. McKinney in his transcribed interview:

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> ____
> ____
> ____
> ____
> ____
> ____**
> [Transcript, page 22]

Q. What is the relationship between Empire's and UtiliCorp's past employee reductions and this Merger Application?

A. The Companies allege that labor savings through employee reductions are a merger benefit and are predicated on the assumption that a merger triggers these savings. However, both UtiliCorp and Empire have been able to attain employee reductions on a stand-alone basis through re-engineering at UtiliCorp and through the

CPP at Empire. The Staff believes that these types of reductions would likely continue absent the merger. It is in the best interest of both companies for management to continually strive for efficiencies to reduce employee positions and thus reduce expenses of utility operations. The Staff believes that both UtiliCorp and Empire would still have opportunities to reduce employee counts on a stand-alone basis through additional efficiencies. However, the Staff also believes that the proposed merger between Empire and UtiliCorp allows some additional labor savings that would not have occurred absent the merger.

Q. Are there opportunities today for Empire to reduce employee counts and/or labor costs on a stand-alone basis?

A. Yes. Transition team documents included in the March 14, 2000 report to the Steering Committee included efficiencies from the merger. **________________

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_____** (See attached Highly Confidential Schedule 3.) The centralization of the Empire Call Center in 1995 was an example of a similar employee reduction done earlier on a stand-alone basis.

<u>MERGER SAVINGS – DISCOUNTED PRESENT VALUE</u>

Q. Please explain why a present value adjustment should be made to the estimated merger savings.

A. The costs to achieve the merger are largely current costs, while the estimated savings are projected to occur out into the future over the next ten years and beyond. Dollar inflows and outflows that occur at significantly different dates cannot

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simply be aggregated in a meaningful way. Instead, they must be restated at a common date to take into account the time value of money, i.e., the present value of future dollars must be determined and then aggregated. Recognizing that all cost savings estimates have been "escalated" for assumed inflation for all future years, it would be appropriate to discount the estimates to a common point in time to derive a present value of estimated savings. The Company does not address in its filing the issue of present value for the savings that are projected out to the year 2010.

Q. One of the Companies' merger savings assumptions is the use of a 2.5% escalation rate. Why is this assumption important to the Staff's analysis?

A. The initial (Year 1) estimate of merger savings is multiplied by a 2.5% escalation factor in the Companies' savings analysis. The use of an escalation factor to inflate the merger savings over the next ten-years inherently creates a favorable comparison of merger savings to merger costs. The Staff's position of the appropriateness of the 2.5% escalation rate is discussed in the testimony of Staff witness Traxler.

Q. How does the present value adjustment that the Staff is proposing compare to the escalation factors proposed by UtiliCorp/Empire?

A. While the use of an escalation factor when projecting the estimated merger savings out into the future tends to inflate the savings, the use of a present value adjustment to bring future merger savings in line with current dollar values would discount the merger savings. To include the escalation factor, and not present value adjustments, skews merger savings estimates so that they cannot be compared to current dollar merger costs.

Q. Have you completed a present value analysis of the UtiliCorp/Empire estimated merger savings?

A. Yes. I have completed a present value analysis of the UtiliCorp/Empire estimated merger savings that uses a weighted cost of capital interest rate and extends through the year 2010. "Present value" is the current value of a sum of future dollars discounted back from a specified future date to the present date at a given rate of compound interest, the weighted cost of capital.

Q. Why did you choose to use UtiliCorp's weighted cost of capital interest rate in your present value analysis?

A. The weighted cost of capital for UtiliCorp is an appropriate rate of compound interest to use in the present value computation of the value of estimated future merger savings. If savings are generated from the merger, the resulting cash flow will be available for UtiliCorp to use and will allow them possibly to avoid financing through the debt and equity markets. The weighted cost of capital represents the cost of money that UtiliCorp would be required to pay if they financed through the debt and equity markets.

Q. How did you determine the weighted cost of capital to use in your present value analysis?

A. I reviewed several sources to determine the appropriate interest rate for this analysis. The 11.37% rate is an estimate of UtiliCorp's pre-tax cost of capital as determined by UtiliCorp and provided to Staff in response to Data Request No. 1 from the UtiliCorp St. Joseph merger case. Staff witness David P. Broadwater has also developed a pre-tax cost of capital for UtiliCorp from its last rate case No. ER-97-394, of

11.99%. In addition, I used a 13.1% pre-tax cost of capital, reflected in the Stipulation and Agreement from the last Empire rate case, No. ER-97-81, in my calculation of present value. Since the purpose of my analysis is to demonstrate that the merger savings are overstated without a present value adjustment, use of the most conservative interest rate (11.37%) is adequate to demonstrate my point.

Q. What were the results of your present value analysis?

A. My calculations of net present value computed the present value of the savings at a discount rate of 11.37% for the savings each year out from 2001 through 2010. I did not apply a discount rate to 2000. The net present value of estimated total merger savings from 2001 through 2010 at an 11.37% discount rate is $213.5 million, compared to UtiliCorp/Empire's total merger savings of $383.6 million. (See attached Schedule 4 for the complete calculation.) In addition, Schedule 4 shows that the net present value of the total estimated savings to be provided to customers in Years 6-10 is only $6.4 million in total. This is approximately 3.0% of the total estimated savings on a net present value basis of $213.5 million.

The Staff's position is that the merger savings estimated by UCU/EDE are overstated because they have not been discounted to current 2000 dollars. The use of a discount rate of 11.37% shows that the merger savings are overstated by at least $170 million.

MERGER SAVINGS – TRACKING

Q. Please summarize the Staff's position on the "tracking" of merger savings.

A. The Staff's position is that "tracking" of merger savings is a nearly impossible task and certainly not practical to do. The Commission should not rely on UtiliCorp's "tracking" to justify the recovery of the acquisition premium because:

- There is difficulty in establishing a proper baseline and in distinguishing merger and non-merger related impacts on earnings.
- Human intervention is required to subjectively determine how transactions are identified.
- Tracking has not been successfully done in Missouri.
- UtiliCorp has not provided a detailed or a concrete proposal.
- Empire and UtiliCorp ceased to exist as stand-alone companies the day the merger was announced. It is impossible to identify what would have been a non-merger versus merger savings.
- The merged companies will continue to seek/achieve non-merger savings.
- The sophistication of UtiliCorp's accounting system is not relevant to the success of tracking.
- The attempt to track merger savings will be further complicated by any future merger and acquisition activity of UtiliCorp.
- The attempt to track merger savings will be further complicated by any future restructuring of the electric utility industry in the state of Missouri.

Q. What is meant by merger savings "tracking"?

A. Tracking is a post-merger process where it is asserted that specific events relating to the merger can be identified, verified and the amount quantified so that a determination can be made if the merger is successful from a savings/synergies perspective. The differences between these post-merger transactions when compared to the pre-merger baseline of the stand-alone pre-merger companies represent the "purported" merger savings. Systems purportedly capable of tracking merger savings are generally proposed as part of a regulatory plan to allow for "special treatment" of merger savings (i.e., to allow for either direct or indirect recovery of acquisition adjustments).

In essence, most tracking methods can be defined as an attempt to compare actual merged results of the combined company to the costs that would have been incurred by the companies if they had remained on a stand-alone basis. Determining both parts of this equation is problematic at best.

COMPONENTS OF THE TRACKING EQUATION

Q. What exactly is to be "tracked" in a utility merger?

A. In the case of the utility merger, the post-merger expenses will be "tracked" and compared to a "baseline" (also called a "base year") of pre-merger expenses, with the difference assumed by default to be merger savings. The difficulty of separating merger savings from non-merger savings arises. Whether a savings is in fact created because of the merger or could have been created by one or both of the companies on a stand-alone basis becomes a further complication to an already error prone equation.

Q. What is the Staff's position in regard to the "tracking" of merger savings?

A. The Staff believes that the "tracking" of merger savings is inherently difficult if not impossible because of the difficulty of determining the components that go into the tracking process or equation. A closer analysis of the "tracking" equation demonstrates this.

Q. Why is establishing a baseline for savings tracking purposes so important to the "tracking" equation?

A. The pre-merger baseline is a critical component of the equation and its accuracy as a reflection of stand-alone expense levels in turn influences the accuracy of the merger savings in total. The baseline concept is comparable in some ways to the test-year concept in a rate case. In a rate case proceeding, the Staff would determine the test-year based on the most current actual (known and measurable) expenses. In this Application, the Joint Applicants have proposed that the Empire 1999 budget serve as the baseline for merger savings tracking purposes. However, actual savings levels for a given however small period can also be used as the baseline.

Q. Has the Commission found problems with the concept of using budgets for baselines in determining expense levels in rate cases?

A. Yes. The Commission does not typically allow budgeted, projected or estimated expenses to be used in the determination of expenses for cost of service. An inherent problem with budgets is that management tends to have biases when setting budgeted amounts. Because of the inability of companies to project into the future, a budget is potentially inaccurate. The actual expense results may be very different from the budget projections because of circumstances that cannot be predicted because of their unusual nature.

Q. Are there also problems with using actual expense levels as a baseline?

A. Yes. The use of actual expense levels for a twelve-month period (test-year) also has the intrinsic problem of potential inclusion of unusual and/or nonrecurring expenses that require normalization. These expenses need to be identified and removed from the period so the adjusted test year expenses reflect normal expenses for the company in question. The Staff spends audit time in the field for each utility rate case investigating reasons and causes of abnormal occurrences and events to determine the normal amount for each expense category in a test year that should be used in determining cost of service. The "tracking" equation would also require that the baseline, similar to a test year in a rate case proceeding, be based upon actual normalized expenses. (The need to remove abnormal or unusual expense amounts may also be a problem when budgets are used for baseline purposes.) Another process used in determining adjusted test year amounts in a rate case is the annualization process. This process examines costs to determine if adjustments are necessary to properly reflect expense levels for a full year. An example of a cost that might need adjustment would be payroll.

Q. Are baseline amounts necessarily valid for future applications?

A. No. A problem with the use of a baseline is the always-changing environment of the utility that makes the normalized and annualized expense amounts reflective only of a point in time. As the utility moves out in time to the future, the baseline become less representative and reflective of properly adjusted expense levels that can be used to establish rates, or in the case of tracking, to establish a measurement of merger savings. One cannot assure that a "baseline" will remain valid as an indication of pre-merger expense levels for long. This is true for any baseline, whether it is based on a budgeted level of expenses, actual expenses or a normalized level of expenses.

The sound business practice in competitive and regulated environments to always strive for improvements and efficiencies in operating the business is widely accepted. The improvements and efficiencies contribute to changes that reduce baseline/test-year over time. Stockholders expect no less from management. Businesses in a competitive environment use these efficiencies to gain market share and improve the company's financial statement bottom line. The regulated environment allows utilities to take advantage of regulatory lag when efficiencies precede rate cases to improve their earnings.

To summarize, use of baseline for a period of ten years out into the future generates increasingly inaccurate results that simply are not credible. The changes in expense activity each year becomes compounded over time, rendering the baseline/test-year unreliable and unrepresentative past the near term, if in fact it is reliable and representative in the near term.

Q. Please discuss the other component of the "tracking" equation.

A. The other component of the "tracking" equation is the amount of actual, post-merger expenses that are identified and then subtracted from the baseline to "determine" the amount of merger savings. To lay out the complications of determining this amount for tracking purposes, first I will discuss the concept of tracking expenses for financial reporting purposes.

Q. Is this component of "tracking" expenses a concept that is used in accounting?

A. Yes. In the direct testimony of Mr. Myers, what he is representing as "tracking" is actually the accounting function that businesses perform to create financial reports. In accounting, actual expenses are "tracked" by account number. The determinations of the account numbers to post transactions to are made based on an analysis of the financial transactions. The transactions are posted based on guidelines and procedures that identify characteristics of accounts and typical transactions to aid someone in the account postings decision. Someone, i.e., a bookkeeper, manager, posting clerk, etc., determines what accounts to post the transactions to. The accuracy of the posting is dependent upon the ability of the person coding the transactions to know what the transactions consist of. Over time, accounting of transactions has become automated as computer software has allowed for more detailed analysis and reporting of accounting functions.

The "tracking" of transactions that affect assets, liabilities, expenses and revenues result in a general ledger that identifies transactions by account number/code and summarizes account transaction activity in the financial statements of the company. The Staff analyzes of the general ledger and financial statements of a utility during each rate case audit. The Staff makes adjustments when it determines that it is necessary during the normal course of the audit process. Company personnel also analyze transactions for accuracy and make initial adjustments prior to financial statements being issued. Company internal auditors routinely analyze transactions and accounts for accuracy. External auditors also are employed annually to attest that the financial statements of the utility present fairly the financial position of the company, through an audit of accounts and transactions that usually includes adjustments/corrections to transaction account entries.

Q. Why are there always corrections and adjustments to be made to the expense entries/coding that comprise the financial transactions of a company?

A. There are always corrections and adjustments because the "tracking" of company expenses becomes subjective when people are required to decide what code to use when posting accounting transactions. The accounting system facilitates the volume of codes and accounts needed to segregate expenses, revenues, liabilities and assets. Yet, human intervention and subjective judgments still create errors that lead to inaccurate coding. Difficulties in distinguishing the correct accounts for posting transactions occurs in rate cases. Accounting policies and procedures aid in the determination of the correct coding but errors will always be made.

Q. Has the Commission recently decided a case involving disputes dealing with disagreements of proper expense levels?

A. Yes. Concerning Union Electric's alternative rate plan, the Commission was asked to decide several issues in a contested proceeding involving disputes and disagreements between the parties relating to expense levels and the interpretation of the overall agreement itself. These disagreements consumed significant resources of the Commission, the Staff, Union Electric and the rest of the parties to the case.

Q. Why will the "tracking" of the merger savings be more difficult than "tracking" standard transactions?

A. Besides the usual problems with people making judgments about events, causing possibly inaccurate coding of transactions, the additional task of determining what savings are specific to the merger and which are not merger related will be a subjective process and will also be prone to error and misstatement. The most sophisticated computer system used for the accounting function of the company cannot prevent the errors. The errors will occur because of the inability to clearly distinguish between what is a merger related transaction and what is a non-merger related transaction. Being able to project back through the rationale and circumstances behind every event, transaction and circumstance that derives a savings from the pre-merger Empire and/or UtiliCorp stand-alone companies will be almost impossible.

Therefore, both parts of the "tracking" equation, the baseline and the identification and quantification of the expense transactions that requires human intervention, proposed by the Joint Applicants are prone to error and cannot be relied upon for determining merger savings for even Year One after the close of the merger. Every day since the announcement of the merger between UtiliCorp and Empire, the business structure of the two companies has been altered further from their pre-merger stand-alone position.

Q. Will UtiliCorp have an incentive to overstate merger savings under its regulatory plan?

A. Yes. With the proposed regulatory plan "guaranteeing" $3 million in merger savings, UtiliCorp personnel will have every incentive to identify as much merger savings as possible, in order to avoid "imputing" merger savings in a future rate case test-year to reach the $3 million "hurdle" level.

DISTINGUISHING BETWEEN MERGER AND NON-MERGER SAVINGS

Q. Please describe the different types of savings that can be generated from a merger.

A. In the merger between KCPL and Western Resources, Case No. EM-97-515, Mr. Thomas J. Flaherty, a partner in the Deloitte & Touche Consulting Group LLC, filed direct testimony on behalf of both companies, which described three types of savings that can arise from a merger:

1. Created savings – These are savings that are related directly to the completion of a merger and can not be obtained absent the merger.

2. Enabled savings – These savings result from the acceleration or unlocking of certain events that can give rise to savings.

> 3. Developed savings – Reductions in cost due to management decisions that could have been made on a stand–alone basis are unrelated to the merger.

The distinction between created, enabled and developed savings can be subjective in many cases. The Staff agrees there will be some created savings and possibly enabled savings from the merger due to duplicative jobs and economies of scale. The Staff would argue though, that there are also developed savings that will occur after the merger that may be "tracked" as merger savings when in fact they are actually non-merger savings.

In Mr. Flaherty's Schedule TJF-2, page 36 of 75, in his direct testimony filed in Case No. EM-97-515, the following was stated concerning estimated merger savings in that case:

> Potential areas of benefit, and subsequently, the resulting cost savings, are determined to be <u>merger-related if they are not attainable by any action that management of either company could practically initiate on an independent basis.</u> For example, management of either company could reduce labor costs by eliminating positions as part of a resource and function analysis. [Emphasis added]

This statement indicates how important it is to identify cost savings between non-merger and merger related events to properly measure the efficiencies of the merger itself. The statement also identifies how subjective an analysis can become. Mr. Flaherty assumes that a resource and function analysis post merger would identify created savings. The Staff would argue that a resource and function analysis completed by either company party to the merger could have identified potential positions to be eliminated or combined on a stand-alone basis. Companies should always be aware of potential non-merger savings that can be developed through efficiencies created by use of enhanced technology, employee productivity increases, and innovative ideas of management and employees.

ATTEMPTS AT "TRACKING" MERGER SAVINGS

Q. Have utility companies in Missouri attempted to track merger savings in the past?

A. Yes, in the Kansas Power and Light Company (KPL) merger with Kansas Gas and Electric Company (KGE), Case No. EM-91-213, KPL requested that the Commission approve the merger and institute a program of sharing merger savings between shareholders and ratepayers with each receiving fifty percent. The Commission's Report and Order in that proceeding stated:

> The Commission is not opposed to the concept of the savings sharing plan provided that only merger-related savings are shared. The Commission does not wish to discourage companies from actions, which produce economies of scale and savings, which can benefit ratepayers and shareholders alike. However, the commission wishes to ensure that savings, which would have been offset against the cost of service without the merger, benefit ratepayers one hundred percent.
>
> That the parties to this case be directed hereby to meet for the purpose of attempting to devise a merger savings tracking plan (MSTP) which will ensure that all non-merger savings can be excluded from the merger savings to be shared between ratepayers and shareholders.

Q. Was KPL successful in tracking merger savings?

A. No. The parties to the case were not able to reach an agreement on how to track the merger savings separately from the non-merger savings. The Commission indicated that if KPL wanted to pursue the tracking system, they could do so in their next rate case.

Q. Did KPL (Western Resources) address the cost tracking system in their next rate case?

A. Yes, they did. In Western Resource's first rate case after the KGE/KPL merger, Case No. GR-93-240, KPL concluded that the cost of maintaining the tracking system out weighed the benefits. For further discussion of this history, please see the testimony of Staff witness Featherstone.

Q. Describe the subsequent Western Resources/KCPL merger savings "tracking" proposal from Case No. EM-97-515 and why it was proposed.

A. Western Resources/KCPL proposed to use the actual 1995 combined expenses of Western Resources and KCPL as a baseline, and then indexing that amount to the year for which the merger savings were being calculated. If the indexed base year expenses were higher than the actual expenses incurred in the post-merger period, the difference would be considered merger savings. The difference for non-production O&M, production O&M, joint-dispatch savings, capital addition savings and other merger savings would be totaled to arrive at the total merger savings for the indexed year. Western Resources proposed to index non-production O&M expenses to adjust for the impacts of inflation, customer growth and productivity. It also removed medical and dental expenses, transmission for others and net nonrecurring expenses from non-production O&M in its proposed savings tracking analysis.

The production O&M indexing formula included only a factor to account for the impact of inflation. For production O&M, Western Resources factored in an inflation adjustment and removed purchased power, fuel, lease expense for the LaCygne 2 generating unit, net non-recurring expenses and Wolf Creek decommissioning and outage expenses.

The reason behind the proposed baseline and adjustments was to identify an amount of merger savings that could be applied to the regulatory plan proposed by Western Resources. That regulatory plan was essentially an incentive plan, which used different levels of savings to determine the amount of "sharing" of earnings between customers and shareholders. The only importance of the level of merger savings related to this incentive plan proposed was that the more savings the formula "proved", the higher the retention of earnings by the Company through the incentive plan.

Q. What was the Staff's position in regard to the tracking system Western Resources/KCPL proposed to use in determining merger savings?

A. The Staff opposed relying on the Western Resources/KCPL method to "measure" merger savings. The Staff believed that the need to determine which adjustments would be necessary to remove non-merger impacts from the actual post-merger results would require some sort of annual audit similar to that of a rate case. A determination of what unusual and nonrecurring events effectively increased or decreased expenses would also need to be made. These events would need to be eliminated so that non-merger activity would not effect the "tracking" of the residual merger savings. Both Western Resources and KCPL recognized that any baseline chosen for tracking purposes must be subject to adjustment to attempt to eliminate non-merger impacts.

Q. Is the tracking of merger savings proposed by UtiliCorp different from the tracking proposed in the Western Resources/KCPL merger?

A. Yes. While the Staff opposed the Western Resource/KCPL tracking proposal, it was proposed in much more detail and in much more concrete terms than UtiliCorp and Empire have put forward to date for their tracking proposal. The UtiliCorp "tracking" proposal has not been explained in detail beyond the statement that it can be done with accounting software. The baseline is not proposed to be adjusted beyond an inflation factor. Mr. Siemek stated in his March 2, 2000 transcribed interview that distinguishing merger from non-merger savings isn't important because of the guaranteed savings. The abbreviated tracking proposal of UtiliCorp is even less acceptable to the Staff than the Western/KCPL proposal.

Q. Did the subsequent Western Resources/KCPL Merger Stipulation and Agreement allow those companies to attempt to track merger savings for that merger?

A. No. The Report and Order in the Western Resources/KCPL merger case, No. EM-97-515, states:

> The parties further agreed that it is unnecessary to develop a post-merger savings quantification tracking mechanism with respect to the instant merger and that none shall be proposed in future proceedings in Missouri.

Q. Is the Staff aware of other attempts by utilities to "track" merger savings?

A. Yes. UtiliCorp attempted to "track" savings in the Kansas utility jurisdiction following its acquisition of West Plains Energy Kansas (West Plains) from Centel in 1991.

Q. Was UtiliCorp successful in its attempt at "tracking" merger savings?

A. No. UtiliCorp did not successfully track these savings. When the issue of documenting the actual merger savings was brought before the Kansas Corporation

Commission (KCC), UtiliCorp attempted to included a multitude of cost savings that the KCC ultimately decided were not merger related.

Q. Please summarize the details of UtiliCorp's acquisition of West Plains.

A. On September 27, 1991, in Docket No. 175,456-U, the KCC allowed UtiliCorp to acquire the electric assets of Centel (West Plains) subject to stipulated conditions. West Plain's assets were transferred to UtiliCorp at or about net book value. However, West Plain's eight-percent ownership interest in Jeffrey Energy Center was transferred to Wilminton Trust and leased back to UtiliCorp. The Stipulation in Docket No. 175,456-U enforced a two-year rate moratorium, a reduction in UtiliCorp's initial rate tariffs, a refund to retail ratepayers within the West Plains service territory and prohibited UtiliCorp from seeking rate recovery of any acquisition premium beyond the level of savings generated by the acquisition. UtiliCorp did not propose a method for identifying and quantify savings in that initial acquisition case. UtiliCorp presented little evidence of cost savings apart from general and administrative cost reductions in its prefiled testimony in that case. The determination of any acquisition premium, the recovery of such costs and the issue of an appropriate measuring mechanism for the merger savings were deferred until the Applicant's next rate case.

Q. What were the merger savings issues in the subsequent KCC rate case, Docket No. 99-WPEE-818-RTS?

A. The following excerpts from the KCC Order on Application, dated January 19, 2000, specifically address the merger savings issues in the West Plains case:

> Page 7, 17. The Applicant identified seven areas of claimed savings to support the recovery of the acquisition premium and submitted that the savings greatly exceeded any acquisition premium paid to Centel. Staff and CURB examined each area of

claimed savings and contended that the Applicant failed to show a nexus between the claimed savings and the Centel acquisition...

Page 8, 18. The largest claimed savings is based upon the position that the Applicant was entirely responsible for the reduced coal costs at the Jeffrey Energy Center... It appears that the primary reason for coal cost savings is Western's motivation to lower its coal costs and that the Applicant benefited from Western's efforts...<u>Moreover, the Applicant failed to carry its burden of proof with respect to these claimed savings and failed to establish that the coal cost savings would not have been created but for the Centel acquisition.</u>

Page 9, 20. ...The third source of claimed savings is a Power Plant Matrix Agreement, which resulted in staff reductions and increasing plant capacity factors... The <u>evidence does not show that these savings would not have been realized but for the Centel acquisition or that the savings related to a sharing of personnel with West Plains</u>... It appears that this type of employee reduction was in line with prudent utility management.

Page 9, 21. The fourth source of claimed merger savings is power plant savings from efficiency programs recently implemented by the Applicant in 1998. Similarly, the Applicant claimed savings in a general work force reduction implemented by the Applicant four years after the Centel assets were acquired. It appears from the evidence that these types of claimed savings are the result of good utility management and consistent with industry standards. <u>The evidence does not establish that these recent corporate changes and restructuring efforts were related to the Centel acquisition.</u>

Page 11, 24. The final claimed cost savings is a general work force reduction implemented by the Applicant starting in 1995. This reduction is said to involve 60 positions and is claimed to reduce costs by over $4.6 million... <u>It appears that the workforce reductions were the result of general economic changes in the electric industry that were forcing all electric utilities to make such work force reductions.</u>

Page 11, 25. ...In addition, <u>the Commission notes that West Plains initially failed to provide adequate evidence and testimony to document their claimed savings and this failure unfortunately complicated and prolonged these proceedings.</u>
[Emphasis added]

Q. What conclusions did you draw from the West Plains merger savings issues in the KCC cases?

A. UtiliCorp did not provide more than general merger savings information in its initial West Plains acquisition case. At the time of the 1999 rate case, UtiliCorp attempted to claim merger related savings for coal contracts and labor savings that the KCC did not accept as merger-related. UtiliCorp's attempt to include non-merger-related savings with merger savings in order to recover the acquisition premium is likely to be replicated in the UtiliCorp/Empire merger. "Tracking" is subjective, and the inherent risk that non-merger savings will be included with merger savings will always exist.

Q. What leads you to believe that UtiliCorp will attempt to include non-merger savings with merger savings in its current "tracking" proposal?

A. My opinion is based on the response of Mr. Siemek in the March 2, 2000 transcribed interview:

> Question of Mr. Siemek: With that kind of adjustments, say, to throw out a cost that would be deemed to be uncontrollable, is that something that should be or would be considered by UtiliCorp and other parties in looking at the bottom-line numbers?
>
> Answer by Mr. Siemek: Well, actually, I think that type of distinction is less important under the regulatory plan that we've proposed. In other proposals that I've seen, it becomes very significant exactly what the merger synergies are, because it sets a return on equity level or determines how much of the premium you can collect or net against the synergies.
>
> In our plan, we've tried to avoid that complexity. And so really the only reason, I think, that we need to quantify the merger, the specific merger-related savings, is to make sure that we reach the threshold or hurdle rate of $1,577,000 in years six through ten. And then it's only important because if we don't reach that hurdle rate, we've guaranteed that—there will be that much of an impact on the customers.

> The distinction between merger synergies and other synergies, or other costs, is not very important, other than that hurdle rate. Because under the scenario and regulatory plan that we've proposed, those synergies or costs get passed through to the customer in that year six through ten, anyway. So if we get out to the year seven and the medical costs are lower than what the projections are, then there are additional synergies, and we've already met the threshold, then the revenue requirements for the customers of St. Joe will be less as a consequence, whether it's merger related or not.
>
> Question: Okay.
>
> Answer: So I think that eliminates a lot of the contention that we've typically seen, for example, in the Western case on the KG and E synergies, where it became very critical whether a synergy was merger related or not. In our case, it doesn't make any difference as long as we meet.
>
> Question: That hurdle--
>
> Answer: --that hurdle rate. And even that makes no difference, to customers because we're already committing to having that guaranteed reduction in the revenue requirements (Tr. 81-83).

This discussion used St. Joseph as the example. The regulatory plan of St. Joseph/UtiliCorp is very similar to the UtiliCorp/Empire regulatory plan with the "hurdle rate" being \$2.967 million (or \$3 million) in the case of the Empire regulatory plan. Mr. Siemek clearly does not see a need to separate merger savings from non-merger savings. This is contrary to the policy the Commission has stated in the past in the previously – discussed Report and Order from Case No. EM-91-213.

<u>JOINT APPLICANTS' PROPOSAL FOR TRACKING</u>

Q. Has the Staff reviewed the savings tracking proposal of the Joint Applicants?

A. Yes, the Staff has read the direct testimony of Company witness Jerry D. Myers who provides testimony to support UtiliCorp's ability to track the synergies resulting from the merger of UtiliCorp and Empire. The Staff participated in a transcribed interview of Mr. Myers to gather additional information related to the savings tracking proposal of UtiliCorp.

Q. How does UtiliCorp propose to "track" the merger savings?

A. Based on UtiliCorp witness Myers' direct testimony, it will attempt to "track" merger savings generated by the acquisition of Empire by using PeopleSoft accounting software. UtiliCorp uses PeopleSoft for its current accounting system. PeopleSoft is an accounting software application used by many utilities to capture the costs and revenues of the operations of the companies specific to the different business units and the different lines of business. UtiliCorp also uses this accounting system to tabulate incremental support costs that are allocated to the operating units through ESF and IBU allocations. In essence, PeopleSoft is nothing more than a sophisticated bookkeeping system. The PeopleSoft system will be addressed again later in this testimony.

Q. Has UtiliCorp presented a detailed proposal for tracking of merger savings in its testimony?

A. No. Mr. Myers goes into some detail to describe the current accounting system utilized by UtiliCorp to "track" business operations. He implies that by having the ability to "track" expenses currently will carryover to the "tracking" of merger savings. The Staff disagrees that this analogy is accurate. This situation is further addressed in the rebuttal testimony of Staff Accounting witness Oligschlaeger.

However, there is no detailed information in Mr. Myers testimony, or elsewhere in the Merger Application, as to the details of how the proposed merger savings tracking system will actually operate.

Q. Did Mr. Myers provide additional information about UtiliCorp's tracking proposal when interviewed to explain the tracking process?

A. Yes, Mr. Myers is familiar with the PeopleSoft software and its capabilities. Starting on page 44 of his transcribed interview (which related to both the SJLP and Empire merger), Mr. Myers explained his understanding of the PeopleSoft accounting system. He provided a document to the Staff during his transcribed interview that illustrates his understanding of how the merger savings will be identified by UtiliCorp (see attached Schedule 5). This schedule was apparently developed for informational purposes to discuss merger savings tracking during the transcribed interview of Mr. Myers.

Q. What does Schedule 5 show?

A. The intent of Schedule 5 is to demonstrate, using a simple model, how the "tracking" process would work conceptually using the PeopleSoft coding. While the interview discussion at times was directed towards St. Joseph, the examples discussed would also apply to the Empire regulatory plan.

Q. Please summarize the contents of Mr. Myers' tracking "document", Schedule 5 of your rebuttal testimony.

A. Mr. Myers' document illustrates the line item components in the merger savings equation: the Empire/St. Joseph and UtiliCorp 1999 budget baselines, and the UtiliCorp incremental costs, all with an inflation (escalation) rate added each year out.

The Empire/St. Joseph 1999 budget baseline represents the expenses that Empire/St. Joseph budgeted for 1999. The UtiliCorp 1999 budget baseline represents the expenses that UtiliCorp budgeted for 1999. The UtiliCorp incremental costs represent the Empire/St. Joseph overhead costs that will become part of UtiliCorp's ESF and IBU allocations that are distributed throughout the UtiliCorp organization.

The UtiliCorp baseline and UtiliCorp incremental line items will be added together. A portion of the sum of the UtiliCorp baseline and incremental amounts will be allocated to Empire/St. Joseph and deducted from the Empire/St. Joseph baseline amount. This difference represents the alleged merger savings. The UtiliCorp baseline and incremental will be coded by UtiliCorp employees using the PeopleSoft accounting system. The Empire/St. Joseph baseline will not be coded to PeopleSoft. The actual savings will not be coded either, since it represents the difference between the uncoded Empire/St. Joseph baseline and Empire/St. Joseph portion of the sum of the UtiliCorp baseline and incremental.

Q. Does Staff believe that the "tracking" method described by Mr. Myers will be able to distinguish between merger and non-merger savings?

A. No. The Staff believes that the Myers document does not support a "tracking" system that is intended to or will be able to distinguish between merger and non-merger savings. Non-merger savings, compared to what was included in the Empire and UtiliCorp 1999 budgets, will not be differentiated from merger savings. The changes in costs as the companies move out in time from when the 1999 budgets were determined will be indistinguishable from merger savings. In essence, the Myers tracking document shows that "merger" savings will be calculated as the difference between an escalated pre-merger Empire budget and post-merger costs allocated to the Empire division. Changes brought about from additional acquisitions, additional technological efficiencies, and increased productivity among employees will impact the total costs allocated by UtiliCorp to the Empire division and will be undistinguishable from true merger savings according to the method outlined in the Myers document. Using this approach, UtiliCorp will be able to take "credit" in its "hurdle rate" calculation for savings that were unrelated to the merger.

Q. Mr. Myers used numbers shown in his tracking document (Schedule 5) for illustration only. Does he have more definitive numbers for the actual merger savings calculations?

A. No. According to Mr. Myers on pages 38 through 41 of the transcribed interview, the percentage of UtiliCorp Baseline and Incremental to be allocated to Empire/St. Joseph has not been calculated. Mr. Myers also did not know if adjustments would be made to the 1999 Empire/St. Joseph Baseline to eliminate nonrecurring expenses and other elements not related to merger savings. He didn't know, when asked about the use of an inflation factor, if UtiliCorp's or Empire's/St. Joseph's actual costs had ever gone down as opposed to always increasing. The following questions were posed to Mr. Myers in the transcribed interview:

> Question to Mr. Myers: What I'm getting at conceptually, I don't understand why you are inflating the baseline year by year from 1999 to the year 2004. I'm just trying to understand conceptually why the company is proposing to do that.
>
> Answer by Mr. Myers: I will tell you my understanding. My understanding is that we're trying to take a snapshot of what the St. Joe operation would have been before the merger, without the merger taking place. Their costs would have been assumed to go up, and I picked three percent for purposes of this illustration.

Question: Do costs ever go down?

Answer: Yes, they do.

Question: Has UtiliCorp's cost ever gone down, actual cost ever gone down?

Answer: I can not answer that (Tr. 40-41).

When asked how the savings to Empire/St. Joseph could be assigned to Empire/St. Joseph specifically for financial reporting purposes, Mr. Myers on pages 69 through 73 of the interview stated that the system could do that, but that he hadn't looked at how it would be done. When asked if Mr. Myers was familiar with the terms "non-merger" and "merger related" savings, he said, "vaguely". When asked how non-merger savings would be distinguished from merger savings in the PeopleSoft system, Mr. Myers stated, "…I would guess from time to time there would have to be reviews made of some of that information."

Individuals would have to make judgments about any adjustments that would be made to the UtiliCorp Baseline and Incremental amounts (lines 4 and 6 on Schedule 5). When asked, "Will it (the PeopleSoft accounting system) be able to and is it planned to be able to track the non-merger related savings and make a distinction between those that are merger related. Has that been discussed?" Mr. Myers responded that it had not been discussed, but the system would have the capability of "tracking" those costs (Tr. 73-75). In other words, if someone could make the distinction between non-merger related and merger related savings and tell PeopleSoft where to capture it, UtiliCorp's accounting system could "track" the savings. Of course, PeopleSoft will not make the distinction. UtiliCorp employees must attempt the monumental task of making those distinctions.

Q. Besides the information contained in Schedule 5, did Mr. Siemek also attempt to explain how UtiliCorp's system for "tracking" of merger savings would occur?

A. Yes. The table below follows the example given by Mr. Siemek in response to Staff Data Request No. 170 from Case No. EM-2000-292, to explain how the synergy analysis of the transition teams will be utilized in the tracking of merger savings for both the St. Joseph/UtiliCorp and UtiliCorp/Empire mergers. The example provided by Mr. Siemek hypothetically explains how the direct labor costs currently expensed to Empire on a stand-alone basis would be eliminated, and become "merger savings." The following is an excerpt from Staff Data Request No. 170 (UtiliCorp/St. Joseph merger case):

> A. Assume a St. Joseph department of 10 positions at a cost of $500,000.
>
> B. The same work can be accomplished by an existing UtiliCorp department of 20 positions costing $1,000,000 by adding 4 staff at a cost of $200,000.
>
> C. The augmented UtiliCorp department of 24 positions at a cost of $1,200,000 is allocated on an established basis that allocates 33% of its costs to the St. Joseph unit at a cost of $400,000.
>
> D. The synergies in this case are $100,000 (the original St. Joseph $500,000 less the post-merger allocation of $400,000). That difference is simple to validate by retaining the original budgets for St. Joseph department (appropriately inflated) to compare to the costs then being charged to St. Joseph.

I have included the following table to demonstrate the example provided by Mr. Siemek in response to Staff Data Request No. 170 (UtiliCorp/St. Joseph merger case):

SJLP Positions	SJLP Dollars	UCU Positions	UCU Dollars
Pre-merger 10	$500,000	Pre-merger 20	$ 1,000,000
Post-merger 0	$ 0	Post-merger 24	$ 1,200,000
Add Allocation	$400,000	Subtract Allocation	- $ 400,000
Total Post-merger	$400,000	Total Post-merger	$ 800,000
Synergies to SJLP	$100,000	Synergies to other UCU Divisions	$ 200,000

[Source: See attached Schedule 6]

Q. Do you have any comments on Mr. Siemek's example?

A. Yes. I have several arguments as to why the example used by Mr. Siemek does not explain how UtiliCorp's "tracking" proposal is to work. The additional $200,000 reduction shown under the column "UCU Dollars" would not be "tracked" as a merger savings because it would be distributed throughout the UtiliCorp allocation process to all divisions that are included in the allocation.

Mr. Siemek's example would work the same for Empire and is very telling in that the direct costs of Empire will be replaced by costs assigned from the allocation pool of UtiliCorp's ESF or IBU. In the example, the amount to be allocated back to the Empire division is less than the direct costs that had previously been expensed, therefore, according to Mr. Siemek, a synergy of $100,000 can be "tracked". The actual amounts that will be "tracked" are the $400,000 of expense allocations that will flow to Empire from UtiliCorp. If the savings were actually being "tracked", the $200,000 flowing to other UCU divisions would also be a merger synergy, included with the $100,000 recognized as the SJLP/Empire "synergy".

The most critical point, however, is that this example does not attempt to explain how non-merger savings factors will affect the savings calculation. Savings that are unrelated to the Empire merger, such as other merger savings, savings generated from past and future re-engineering projects, savings from employee productivity improvements and savings from advances in technology will affect the savings calculation of Mr. Siemek. In particular, all these items would affect the amount of allocated UtiliCorp overhead expenses to the Empire division. The calculation of merger savings will also be affected by any changes in allocations in the ESF and/or IBU, as well as the allocation of regulated and non-regulated business operations. All of these non-merger impacts would effect the calculation of merger savings under the method described in Staff Data Request No. 170 in Case No. EM-2000-292. There would need to be some way of identifying these non-merger impacts and eliminating them from the analysis. However, the Joint Applicants have not proposed any method for distinguishing these amounts, and the Staff does not believe it can be done.

Q. Does the Staff understand that either the Myers tracking system (Schedule 5 to this testimony) or Mr. Siemek's response to Staff Data Request No. 170 from Case No. EM-2000-292 (attached Schedule 6), both previously discussed, constitute a formal proposal for a savings tracking methodology?

A. No. In the absence of such a formal proposal, the Staff is forced to respond in this rebuttal testimony to what little information is available as to UtiliCorp's intentions in this area.

EMPIRE 1999 BUDGET/BASELINE

Q. Has Staff done any comparisons of Empire budgeted costs to actual costs?

A. Yes. The UtiliCorp/Empire response to Staff Data Request No. 147 provided details of the Empire major budget variances for 1999. I have included the 1999 major budget variances as Schedule 7 (see attached) to my rebuttal testimony. The major budget variances demonstrate that the use of the Empire 1999 budget as a baseline will allow non-merger savings to be captured as merger savings. The variances for 1999 show that the budget was overstated for fuel, purchased power, other operating expenses, maintenance and repairs when compared to the actual expenses incurred in 1999. The Staff believes that these budgeted items would appear as savings under Mr. Myers interpretation of how "tracking" will work. The determination of whether the savings are merger or non-merger related would be left to the discretion of a UtiliCorp employee. This analysis shows that the pre-merger Empire, on a stand-alone basis, had variances in all activity areas. If budgeted costs were measured against actuals it would appear that merger savings occurred for some activities and no savings, but additional costs, in others. Budgets are clearly no more than estimates. Using the UtiliCorp tracking format as described in Mr. Myers' Schedule, any reduction in expense compared to the Empire baseline would appear as merger savings.

Q. Do you have any other reservations about the use of 1999 for the baseline?

A. Yes, I do. I believe that there are several reasons why the 1999 budget is not an appropriate choice for the baseline. Any nonrecurring items included in the 1999 Empire budget would require review to determine if adjustments should also be made for the baseline, otherwise future years could show savings because 1999 account amounts were above a true normalized level.

Q. What adjustments to account for nonrecurring events or to normalize expenses have UtiliCorp made to the Empire 1999 budget?

A. When asked by Staff in the May 30, 2000 transcribed interview, Mr. Siemek could only recall one adjustment to the Empire 1999 budget. An expense to convert the Empire computer system to a server was included in the 1999 budget. The transition teams have made an adjustment for this non-recurring expense.

Q. Do you believe that UtiliCorp has taken into consideration all adjustments that would need to be made to the Empire 1999 budget to normalize the amounts contained within and then project it out ten years into the future?

A. No. For example, the Empire response to Staff Data Request No. 154 states that $500,000 of costs were built into the Empire 1999 budget for major maintenance at Iatan which was later postponed until the spring of 2000. This budgeted expense would require an adjustment for tracking purposes to eliminate this cost. No adjustments have been made to the Empire 1999 budget for this planned event that did not occur or for any other unusual or nonrecurring expense that may have been included in the budget.

EXAMPLES OF NON-MERGER SAVINGS

Q. In this section of testimony, what is the Staff attempting to demonstrate?

A. The Staff will show that both UtiliCorp and Empire have implemented expense reduction efforts in the past, and intend to continue to do. The relevance of these points to the proposed tracking system is that the Staff believes that beneficial results of future non-merger cost reduction efforts will be "captured" by the merger savings tracking system, and improperly used to allow UtiliCorp to recover its acquisition adjustment.

Q. Is UtiliCorp aware of the Staff's concern regarding distinguishing merger and non-merger savings in a tracking system?

A. Yes, as my testimony previously indicated in the quotes from Mr. Siemek's transcribed interview (March 2, 2000), based on Mr. Siemek's statements in that transcribed interview, UtiliCorp appears not to have any intention to separate non-merger savings from merger savings. The example presented in his responses to Staff Data Request No. 170 (Schedule 6) certainly supports the Staff's interpretation of UtiliCorp's position on this matter.

Q. Why does it matter whether merger savings are separated from non-merger savings in a tracking system?

A. Ratepayers typically get the benefits of non-merger savings through cost of service reductions that ultimately reduce rates. Applying the regulatory plan proposed by UtiliCorp without separating merger savings from non-merger savings would jeopardize the flow of non-merger savings which, regardless of the merger, should all flow through to the ratepayers. At some point, customers are entitled to the savings provided by prudent utility management. While generally, the utility keeps the savings for a period of time through regulatory lag, customers will eventually enjoy the benefit of those cost reductions. When costs increase, customers are generally asked to pay for those increased costs through increased rates. It is equally expected when costs decrease for customers to receive those reductions in reduced rates. Simply put, regardless of what the appropriate treatment for merger savings is determined to be, customers are entitled to non-merger savings. Accordingly, these savings must be separated from merger related savings under any regulatory plan or tracking system.

Q. Is it important to distinguish between merger and non-merger related savings if recovery of an acquisition adjustment is being requested?

A. Yes. It is even more critical to identify, verify and quantify the merger-related savings from the non-merger-related savings to make a decision on recovery of the acquisition adjustment. This can be thought of as a cost/benefit type of analysis where the costs of the merger, in this example, the acquisition adjustment, must be compared to the benefits, in this example, the merger savings. If all savings are included in this comparative analysis, you would likely get unrealistic and inaccurate results.

Q. How does the business strategy of UtiliCorp contribute to the inability to separate savings related to the merger from non-merger savings?

A. As stated in UtiliCorp's 1993 Annual Shareholders Report "...the company actively seeks expansion opportunities in both the regulated and non-regulated segments of the industry." UtiliCorp is a merger and acquisition company. It has had a growth through acquisitions strategy for almost two decades. The constant influx of change within UtiliCorp contributes to the complexity of the organization and the difficulty in attributing changes in expense levels to one factor (i.e., the Empire merger) as opposed to other factors.

For example, suppose UtiliCorp were to acquire another major domestic utility through a merger transaction this year or next. This hypothetical merger would impact the financial results of UtiliCorp significantly. It would be very difficult, if not impossible, to attribute the amount of the earnings impact from this additional merger separately from the Empire merger, and from other possible influences. Separating out the merger savings and earnings impact of St. Joseph and Empire will be difficult enough. The multiple mergers that are apparently an important part of UtiliCorp's business strategy create layers of merger expenses and merger savings that become increasingly difficult to identify separately.

Q. Has UtiliCorp communicated its philosophy related to generating savings and efficiencies?

A. Yes. An example is a quote from the UtiliCorp 1996 Annual Shareholders Report from Richard C. Green, Jr. to UtiliCorp shareholders:

> Our continual push to improve the efficiency of electric and gas utility operations is having a positive effect on Energy Delivery financial results. This mature business has attained a strong competitive position by controlling costs...Our electric and gas utility operations will benefit...from ongoing efforts to reduce operating expenses.

Q. Can the Staff cite examples of non-merger savings that UtiliCorp anticipates in the next few years?

A. UtiliCorp, in response to Staff Data Request No. 82, from Case No. EM-2000-292 provided **____

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Q. As an example of potential non-merger savings, will use of the PeopleSoft for Human Resources (HR) application by UtiliCorp result in cost savings?

A. Yes, I believe it will. I asked UtiliCorp in Staff Data Request No. 198, Case No. EM-2000-292, to identify any expected/anticipated savings to be realized through the implementation of PeopleWorks Phase III. This is a software package to enhance PeopleSoft applications through additional options. Although UtiliCorp's response stated that PeopleSoft HR was implemented in January 1999, it also stated that no savings would be realized from the implementation of PeopleWorks so that no savings would need to be segregated from savings associated with either merger.

This contradicts PeopleSoft's statement from its web page promotional documents. PeopleSoft illustrates examples of ways cost savings can be generated through efficiencies created by the implementation of its software. For example:

> A Duke Energy PeopleSoft Profile, states that the use of PeopleSoft in its HR function has allowed them to need fewer people creating economies of scale and productivity.
>
> As an other example: Entergy stated in another PeopleSoft Profile that HR allowed them to cut their human resource staffing by 30%.

These savings will be available to UtiliCorp when the Employee Service Station is implemented. The self-service functionality of the HR software allows employees access to their personnel data through a HR home page.

UtiliCorp also stated in response to Staff Data Request No. 198 from the UtiliCorp/St. Joseph merger case that the basis for approval of the PeopleWorks Phase III wasn't cost savings. However, when these savings occur, they will flow through the allocations associated with Human Resources functions and be distributed to all divisions of UtiliCorp that received allocations from HR. Empire will receive an allocation from HR. Under the Staff's understanding of the proposed tracking system, these non-merger UtiliCorp savings will be passed through to Empire with the allocation process and become "merger savings" related to Empire.

Q. Are there any examples of non-merger cost savings implemented by Empire that may be reflected as merger savings in the future?

A. Yes. Empire upgraded its computer software with PeopleSoft in 1998. The 1998 Annual Shareholders Report states on page 14:

> New financial software. In preparation for a restructured market-place, adaptable financial software is critical. In late 1997, after a careful review of available alternatives, the Company committed to the purchase and implementation of integrated financial and human resources software from PeopleSoft, Inc., a leading vendor in its field. Financial modules include: general ledger, budgets, purchasing, inventory, accounts payable, asset management, and projects tracking. Human resources modules include: human resources records, payroll, benefits administration, and time and labor.

Empire on a stand-alone basis implemented PeopleSoft software and attained a non-merger savings for the same technology benefits that will now be counted as merger related savings through UtiliCorp allocations. Empire has been able to demonstrate that it can attain efficiencies and cost savings on a stand-alone basis.

Q. Has the Staff identified any additional potential stand–alone savings for Empire?

A. Yes. **____

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NON-MERGER SAVINGS – RE-ENGINEERING PROJECTS

Q. Do UtiliCorp's past savings resulting from reorganization/re-engineering mimic those projected from the merger?

A. Yes, in some cases they do. UtiliCorp provided information about its reorganization and strategic planning effort in response to Staff Data Request Nos. 26 and 192 from Case Number EM-2000-292. Several excerpts from the response to Staff Data Request No. 26 demonstrate that re-engineering savings were approached in much the same way as merger savings:

> The focus in this area was on reduction of redundancy and in gaining of efficiencies.
>
> Based on the findings of the "Recommended State" study, significant savings could be expected. O&M savings (exclusive) of transition costs would be $35-40 million or roughly 20%. Much of these savings would result from a decrease in personnel, which is estimated to be approximately 840 employees.

UtiliCorp recognized that there are opportunities within the UtiliCorp organization on a stand-alone basis to create savings absent mergers.

Q. Can you cite examples from the UCU re-engineering effort of non-merger savings?

A. Yes, I can. The Companies' response to Staff Data Request No. 192 in Case No. EM-2000-292 included a copy of <u>Project BTU, Building Tomorrow's UtiliCorp</u>, Business Case, August 26, 1996. (Project BTU was the name of the UtiliCorp re-engineering process.) The following savings were referenced with the report:

- Improve efficiency of UtiliCorp's labor and material resources in design, construction and maintenance of the distribution network, allowing for lower operating costs
- The initiative of Project BTU will significantly reduce costs of operations
- BTU will reduce the time it takes to execute basic business activities
- Line and service crew productivity will increase through enhanced planning and scheduling capabilities
- The business focus of the Customer Service Center is to create the most efficient and standardized customer service/sales call center environment in the industry.
- In 1995, the estimated cost per call for call centers in Michigan and Missouri was $1.85. The improvements in the system are expected to contribute to meeting the future team goal of $1.18. This would represent a 36% decrease.

Assuming similar cost-saving efficiencies will be employed in the future, it will be difficult or nearly impossible to differentiate these types of non-merger savings from merger savings as they extend out in time. Where re-engineering non-merger savings end and merger savings begin will be nearly impossible to separate, let alone "track".

Q. Does UtiliCorp continue to benefit through cost savings today as a result of the re-engineering which began in 1994?

A. Yes. Most of the benefits didn't occur until late 1997. Some of the re-engineering projects have only recently been implemented. The Missouri Customer Information System (CIS) has just been put into place within the last few months. The benefits from changes in CIS will potentially contribute to non-merger savings for years to come. The rebuttal testimony of Staff witness Traxler in this case has a further discussion of the details of the re-engineering plan and its relationship to this merger.

Q. Has Empire also implemented management efforts to reorganize its business and reduce costs?

A. Empire has made numerous management decisions in recent years to reduce expenses as documented in its Annual Shareholder Reports to Shareholders. In 1995, Empire began the previously mentioned CPP to maximize its efficiencies and effectiveness. Empire also offered an enhanced voluntary early retirement program to 52 eligible employees, of which 49 accepted the program. **____________________

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____________________________________** (Tr. 62-63.) In 1995, Empire opened a centralized call center, consolidating those operations by closing several of its business offices resulting in efficiencies.

In 1997, Empire completed technology upgrades to assets, allegedly improving performance, efficiency, and safely while reducing maintenance costs. During 1998 and 1999, Empire employees replaced all the computer systems of the company. An excerpt from page 20 of the <u>1999 Annual Shareholders Report</u> states:

> Empire saved about $5 million in out-of-pocket expenses by developing its own Customer Information System, and cut the annual Information Services budget by about $500,000 a year, or 30%, with the switch from mainframe to client/server technology. Manpower savings for the PeopleSoft installation totaled an impressive 63% below the normal installation average for internal staffing, 57% below for internal man-hours, and 51% below for consultant's time.

Empire is representative of other utilities in that making comparisons from one year's budgeted or actual expenses to the next year's budgeted or actual expenses is complicated by continual efficiency, technological and productivity changes brought about by management decisions. No one can say with any certainty what stand-alone entities would have continued to do to increase efficiencies, productivity or what managerial decisions would have been made. Over time the changes are compounded and the ability to rely on an indexed baseline or the "tracking" of merger savings become less likely.

Q. Why are re-engineering programs implemented and how do they generate savings?

A. Re-engineering programs are implemented for a variety of reasons. Some of the reasons are improvements in coordination, systems reliability, performance standards and reductions in costs. Re–engineering is a process in which an organization reanalyzes their operations to determine where efficiencies can be created. The organization reviews benchmarks and sets goals to incorporate changes to improve its competitive position within the industry. Costs savings are often realized from re-engineering programs.

Q. Has Empire completed any re-engineering projects?

A. Yes. As mentioned earlier in my testimony, Empire implemented the CPP during 1995. In response to Staff Data Request No. 179 Company witness Myron McKinney stated that:

> CPP was not initiated as a cost reduction program. CPP was intended to establish an organizational structure which would allow the Company to be as competitive and responsive as possible looking toward a deregulated environment, with the primary focus on driving decision making further down into the organization and removing communication barriers.

It has also been stated earlier that the CPP process did generate savings through labor expense reductions.

Q. Are you aware of any other examples of recent expense reductions achieved by Empire?

A. Yes. Another example of a non-merger savings that will be commingled with merger savings is the fuel savings at Empire's Iatan plant. Staff Accounting witness V. William Harris will also address Iatan fuel stand-alone savings as it relates to the merger savings issue.

Q. Does the Staff believe that merger savings can be segregated from savings generated from re–engineering or other cost saving methods employed by the companies on a stand–alone basis?

A. No. The Staff believes that there is no mechanism available to truly separate these savings. The UtiliCorp/Empire merger savings tracking "proposal" cannot be relied upon because the estimates contain savings generated from re-engineering and other cost saving methods.

ACCOUNTING SYSTEMS AND TRACKING

Q. Please describe the PeopleSoft system that will be used by UtiliCorp in an attempt to "track" merger savings.

A. PeopleSoft's web page provides promotional information describing the benefits and capabilities of the system. PeopleSoft has a specialized software package to aid utilities in measuring performance. The software is part of the financial system designed to enhance decision-making and organizational performance. It is also an activity based costing system, which allows companies to analyze costs, revenues and determine profitability. PeopleSoft touts itself to be an accounting system that can help utilities in a deregulated world. The system is designed for deregulated functions.

UtiliCorp has been using PeopleSoft since September 1997 and has incorporated its use into the Company's analysis of business unit costs and revenues for all United States domestic business operations.

Q. Does the PeopleSoft accounting system make the decision where costs should be booked and how costs are accounted for?

A. No. UtiliCorp employees make those decisions. PeopleSoft provides a means to categorize expenses to very specific cost centers. Individuals within UtiliCorp that are responsible for projects or groups of activities have the authority to code transaction expenses to specific accounts. Individuals must be relied upon to create the codes for each specific project and identify the proper coding for each invoice/source document so the flow of expenses to the proper project occurs. A review process ensures that proper codes are used.

Q. Did UtiliCorp have an accounting system before PeopleSoft?

A. Yes. An accounting system was used to tabulate expenses and revenues into an income statement, and assets and liabilities in a balance sheet. Additional reports could be generated based on the coding of transactions. Accounting systems of this type have been developed over the years as automation/computerization have improved.

Q. Have utilities always had some type of accounting systems?

A. Yes. For as long as utilities have been supplying utility services to customers they have had some type of accounting system in place to keep an accounting of revenues and expenses, and assets and liabilities. The accounting systems of the past and the accounting system of the present all have one thing in common, they all require human intervention to properly quantify and identify where costs should be booked and how these costs should be treated. PeopleSoft is no different.

Q. Is UtiliCorp attempting to portray that it has a mechanism to "track" merger related savings?

A. Yes. That is exactly how UtiliCorp is attempting to portray PeopleSoft. UtiliCorp wants the Commission to believe that it has a system in place that can "track" merger savings.

Mr. Myers stated in his transcribed interview (Tr. 53) that the PeopleSoft accounting system was capable of "tracking" merger savings because the system is very complex and sophisticated. PeopleSoft may be a sophisticated accounting system but it will not be able to "track" merger savings. In fact, neither this accounting system nor any other can actually "track" merger savings. UtiliCorp personnel must tell the accounting system through the coding process what the merger savings will be and then PeopleSoft will capture the costs once personnel determine what categories and where the costs savings should be identified. It is the subjective human component of the "tracking" that will prevent the system from accurately distinguishing merger savings from non-merger savings. PeopleSoft is not the problem. The problem is inherent to the human intervention required for the coding of every possible merger and non-merger related transaction.

Q. Does Mr. Myers admit to this?

A. Yes. During the transcribed interview (Tr. 60 and 65-67), Mr. Myers stated that the coding process involved human intervention.

Q. Did the Staff obtain from the Joint Applicants any other information concerning information systems and savings tracking processes gathered by the Staff?

A. Yes, during the March 2, 2000 transcribed interview of Mr. Siemek, the following discussion took place:

> Question by Staff: Referring again to Mr. Myers' document (see attached Schedule 5) he gave us yesterday, the last number reflects a calculation of merger savings which is derived from the lines above it.
>
> Answer by Siemek: Yes.
>
> Question: And I guess my question to you is: Is it intended that this process will produce a number automatically that should be viewed as a merger savings amount for a particular 12 –month period, or will human judgement still have to be entered into it to say, "Is this a reasonable amount? Does this need further adjustments? This expense change has nothing to do with the merger, so let's take it out," and so on. I know that's a pretty long question.
>
> Answer: Well, I believe the intent is that the merger synergies will have to be calculated from pieces from different systems. Again, we had the three different types of costs that each would have different baseline numbers. So I believe that you would have to manually compile those or put them together to see what the resulting merger savings are. To that extent, I don't think there is one system that you can press a button and it will automatically derive. There are very few systems like that that I'm aware of, anyway. So I'm not sure that's even a possibility (Tr. 80-81).

The information gathered by the Staff repeatedly points to the fact that human intervention will be required to track merger savings. The subjective task of identifying what is merger related and what is a stand-alone non-merger transaction will be monumental, if not impossible.

ACQUISITION ADJUSTMENTS

Q. Have you read the direct testimony of Joint Applicant witness John McKinney?

A. Yes, I have.

Q. Do you have any comments to make in reference to his testimony?

A. Yes, I do. Mr. McKinney has included as "Figure 2", on page 23 of his direct testimony, a map attributed to the NAWC Sourcebook, Updated 6/23/97. This map shows the United States with the states shaded where commissions purportedly have approved a recovery of acquisition adjustments. In actuality, the Staff believes the map presented by Mr. John McKinney represents states where acquisition adjustments were approved for water utilities.

The original map in the June 23, 1997 NAWC Sourcebook is included in my testimony as Schedule 8. The appearance of the map is somewhat different from the one presented by Mr. John McKinney. The NAWC Sourcebook map is shaded black for states that have approved acquisition adjustments for water mergers/acquisitions and shaded gray for states that allow a limited acquisition adjustment for water mergers/acquisitions. Of the twenty-six states shaded, fifteen have only allowed *acquisition adjustments on a limited basis.*

Q. What was the purpose of the NAWC Sourcebook update?

A. The purpose of the sourcebook for which the full title is Sourcebook of Regulatory Techniques for Water Utilities, is explained by Ms. Janice A. Beecher, Ph.D. Indiana University, who compiled the update for the Rates and Revenue Committee of the National Association of Water Companies. In the introduction to the Sourcebook, Ms. Beecher states:

> The purpose of this Sourcebook of Regulatory Techniques for Water Utilities is to provide water industry and regulatory professionals with a comprehensive and current compilation of regulatory policies and practices. The Sourcebook describes each approach and its use. The purpose of the Sourcebook is not to emphasize or advocate any particular approach, but to provide information resources. The Sourcebook is designed to aid research and promote dialog on a wide range of alternative regulatory techniques.

Q. What sources of information did Ms. Beecher rely on for the compilation?

A. In the introduction, Ms. Beecher stated the following regarding her sources:

> The Sourcebook relies extensively on a 1996 survey of commission staff members...The survey includes all forty-five commissions that regulate water utilities... The survey data should be used for general information purposes only. In keeping with the goal of comprehensiveness, the survey is broad in scope but not highly detailed. Commission staff members provided a very general impression of regulatory policy in their respective states based on a very simple survey instrument. Within specific areas of policy, many variations in interpretation are likely. While much effort was devoted to ensuring the accuracy of the survey, the results should not be taken as a definitive statement of commission policy.

The survey used to compile the Sourcebook data had very general questions and state regulators that responded were given latitude to convey as much or as little information as they chose.

Q. Did you review the Missouri response to the NAWC survey?

A. Yes. It was answered from a water regulatory perspective only.

Q. Were there further details that accompanied the Sourcebook map that were not included with the "figure 2" map in Mr. John McKinney's testimony?

A. Yes. There were survey notes that described in greater detail the circumstances in which acquisition adjustments were allowed for water utility merger cases. The survey notes included specific information to further explain the state survey responses (see attached Schedule 9).

Q. What additional information did the Staff gain from the NAWC Sourcebook?

A. Some jurisdictions have treated acquisition adjustments for water and wastewater merger/acquisitions somewhat differently than those resulting from electric and natural gas mergers. Pennsylvania and New York are two states that have enacted policies to allow acquisition adjustments, both positive and negative, for small water utilities. These policies have been implemented because the quality of water and the financial viability of small utilities is a concern to state regulators. These concerns, along with needs for customer service improvements have spurred the approval of acquisition adjustments for certain water utilities in these jurisdictions.

While some states have realized the need to allow acquisition adjustments for troubled water systems and in some cases for wastewater systems also, the circumstances that lead to the mergers and acquisition of electric and natural gas utilities are obviously quite different.

Q. Does the Staff believe the NAWC survey's relevant to the issue of recovery of electric acquisition adjustments?

A. The NAWC survey results are not relevant to the acquisition adjustment issue as it relates to electric utility mergers. Just the fact that a state is shaded on Mr. John McKinney's Schedule 2 does not necessarily mean that jurisdiction has approved recovery of electric acquisition adjustments.

Q. What circumstances have led to increased merger activity in both electric and natural gas utilities in recent years?

A. I believe that there are several contributing factors to the increase in merger activity in the electric and natural gas industries. The first contributing factor is that restructuring of the electric industry has led to the increased merger activity. An article describing electric restructuring activities in Florida taken from the Florida Public Service Commission web page, States' Electric Restructuring Activities Update-Florida Public Service Commission, summarizes some of the main reasons why restructuring is occurring and in turn, why increased merger activity is occurring:

> A number of states are exploring retail restructuring as a way of achieving lower rates and greater customer satisfaction. Higher than average electric rates appear to be the primary driver in these states. Electric restructuring generally describes a movement from regulated monopoly electric utility services to market-based competitive electric services. A lot of different terms are being used to describe what is happening at the federal level and in other states in the transition to electric competition. Phrases such as restructuring, deregulation, competition, retail wheeling, retail access, and customer choice have all been used to describe a broad-based, national movement away from traditional rate base regulation of vertically integrated, monopoly public utilities.
>
> California, New Hampshire, New York and Massachusetts were among the first states to move toward retail access. The average residential rate in these states is approximately 12 cents per kilowatt-hour. Because of these high rates, economic development appears to have suffered with the loss of jobs and the relocation of industry. In many high-cost states, large commercial and industrial customers have been the most active in encouraging a move

> toward competition. At present, a total of twenty-two states have enacted legislation or implemented regulations requiring retail restructuring, although the legal basis is being challenged in several states... Small-use residential and commercial customers are less likely to have meaningful alternative generation supply choices in a competitive market and may be left paying higher costs.

The second contributing factor, I believe, is the realization by utilities that they must grow larger in order to survive. In reviewing documents related to the Western Resources/KCPL merger, the UtiliCorp/St. Joseph merger and the UtiliCorp/Empire merger, it is noted that utilities perceive that they must become part of a larger utility. The industry provides numerous examples of utilities joining together to become larger entities.

The third contributing factor to increased merger activity is that there is a window of opportunity for utility systems to grow. The finite number of utility systems that exist limits the availability of smaller utilities that can be purchased. As the largest global utilities acquire additional utility systems to become even larger, those utilities that aren't merging become in relative terms, smaller, and become targets for acquisition themselves.

These factors that contribute to the increased merger activity of electric utilities focus on the utilities' needs to be competitive, not on the reliability of the systems or the need for improved service to customers. Regulators should approach these mergers quite differently than mergers of water or sewer utility mergers where customer safety and service are often the main issues.

Q. Why have some state regulators become more likely to pass on acquisition adjustments in electric and natural gas utility mergers to ratepayers in recent years?

A. The pressure continues to be exerted upon regulators in states where utility costs are considered to be significantly above the national average to promote activities, whether mergers, divestitures of generation assets or deregulation initiatives, to lower utility rates. On the federal level, the philosophy of the Federal Energy Regulatory Commission (FERC) supports mergers that purport to enhance economic development, build stronger/larger companies that can survive deregulation/ restructuring and cut costs through economies of scale.

It is yet to be seen if deregulation/restructuring will reduce rates for the majority of Americans. It is unlikely that the customers in low cost energy states, like Missouri, would want their state regulators to endorse the exact same philosophy as those of the high cost energy states. The utility environment of each state and the circumstances of each merger play a role in the decision that the state commissions make. While the decisions reached by commissions in other states provide examples and UtiliCorp would suggest that this merger meets the criteria for recovery of an acquisition premium in some other states the, Staff believes that this Commission's prior decisions in merger cases reflect an approach that is appropriate for this merger.

Q. Have you read the direct testimony of UtiliCorp witness Robert K. Green?

A. Yes, I have.

Q. Do you have any comments about his testimony?

A. Yes, I do. On page 19, he cites Massachusetts as an example of a public service commission that has addressed acquisition premium recovery:

> After years of denying the cost of acquisition premiums, in 1994 the Massachusetts Department of Telecommunications and Energy changed its long-standing policy and now will allow recovery of the premium on a case by case basis when denying recovery of that

> premium would prevent consummation of a merger that would otherwise be in the public interest.

I don't believe Mr. Green went far enough in explaining the Massachusetts Department of Telecommunications and Energy (DTE) view on acquisition premiums. I will provide some excerpts from the Massachusetts Department of Public Utilities (DPU) (the predecessor to the DTE) <u>Guidelines and Standards for Acquisitions and Mergers of Utilities</u> (Guidelines) dated August 3, 1994 and then comment on why Massachusetts changed its policy to allow utilities the opportunity to recover acquisition adjustments:

> ...<u>In light of concerns over high utility rates</u> which in part may be the result of duplicative facilities, functions, and services among Massachusetts utilities, the <u>Department has sought to reexamine its current policy towards mergers or acquisitions</u> and determine whether the public interest may better be served by specific policy changes that enhance efficient delivery of utility services in Massachusetts.
>
> ...The <u>Department believes that cost-effective mergers are one of several means by which utilities may be able to reduce their cost</u> of service, improve service reliability, and enhance their financial strength.
> [Emphasis added]

Massachusetts is a high cost per kilowatt-hour state. I believe high cost states are more likely to consider modifications to prior policy to reduce rates and improve economic development opportunities in their states. These excerpts from the Massachusetts Guidelines support my position. In his testimony, Mr. Green did not explain what led to the policy change or why Massachusetts is not necessarily comparable to Missouri.

Q. Did the Massachusetts DPU provide reasons in the 1994 Guidelines for its change in policy?

A. The following excerpts from the Guidelines explain why the DPU had not felt compelled prior to 1994 to allow acquisition adjustments:

> ...Most mergers or acquisitions that have occurred in Massachusetts have involved affiliated companies where assets and liabilities were combined into a single entity. In these cases, consolidations were achieved either by a sale of assets at a price equal to book value or by exchange of stock. Because these transactions did not result in a difference between purchase price and original book value, no acquisition premium was realized.
>
> ...A merger or consolidation may also occur through a pooling of interests by two or more utilities...some involved an acquisition price that differed from the net book value of the assets of the acquired utility, thus producing an acquisition premium...however, <u>in each of these cases, the acquiring company specifically pledged that it would not include the premium in rate base, and would not propose cost of service treatment for amortization.</u>
> [Emphasis added]

Again, Mr. Green in his direct testimony did not provide an explanation to why acquisition premiums were not approved in Massachusetts prior to 1994. It is clear through the explanation included in the guidelines that, historically, acquisition premiums had not been an issue. Companies had either purchased systems at book value, employed the pooling of interests accounting treatment, which recognizes no acquisition premium or had decided not to seek recovery of an acquisition premium from ratepayers. The guideline cites at least twenty cases where premiums were not an issue in prior acquisitions.

Q. Did Mr. John McKinney also reference Massachusetts DPU policies?

A. Yes, he did. On page 23 *of his direct testimony* Mr. McKinney *states:*

> The Massachusetts Department of Public Utilities ("Department") set forth generic guidelines and standards for acquisitions and mergers of utilities. Prior to the generic investigation, the Department maintained a policy of disallowing acquisition adjustments. Importantly, after the generic hearings, the Department determined that where potential benefits for customers exist, it is not in the interest of the customers, the shareholders, or the state to maintain a barrier against mergers.

Q. Do you have any comments about his testimony?

A. Yes. I don't believe Mr. John McKinney went far enough in explaining the Massachusetts DTE's present view on acquisition premiums in the above statement, either. I would like to emphasize the requirements set out in the Guidelines that the Massachusetts DTE would consider various factors in order to determine if the merger is consistent with the public interest.

These factors were set forth in the guidelines:

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

The DTE stated, "This list is illustrative and not 'exhaustive,' and the Department may consider other factors when evaluating a §96 proposal." (Section 96 permits companies subject to Chapter 164 to engage in merger or acquisition under the preconditions there stated.) While Missouri may not have requirements set in place, Staff does take into consideration many of the same factors when analyzing a merger transaction.

The Massachusetts DTE, when allowing acquisition premiums, must be satisfied that companies demonstrated more than "potential benefits for customers exist," which is what Mr. John McKinney states in his testimony. A paragraph in the Guidelines points this out explicitly:

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

The Massachusetts DTE does not guarantee the recovery of acquisition premiums. Whether an acquisition premium will be allowed recovery and to what extent will be determined on a case-by-case basis. While the Massachusetts DTE may allow premiums, they have much latitude in determining how to approach mergers so that no harm comes to ratepayers or the public interest.

Q. Has the Massachusetts DTE used its guidelines in merger cases?

A. Yes. Massachusetts has used its guidelines in four utility mergers to date. In the Eastern Enterprises (Eastern) pooling of interests acquisition of Essex County Gas Company (Essex), D.T.E. 98-27, the applicants estimated a $47.1 million acquisition premium related to earnings dilution would be experienced by Eastern shareholders. Staff witness Hyneman addresses issues related to the differences in accounting treatment (pooling of interest versus purchase) of mergers in his rebuttal testimony.

Q. What led the DTE to approve an acquisition premium in the Eastern - Essex merger case?

A. The DTE considered the factors listed in the Guidelines. Essex is a small gas local distribution company at the end of an interstate pipeline system. The DTE stated in its analysis and findings that Essex would be increasingly challenged to respond to a competitive market dominated by larger utilities and that, ultimately, the ratepayers would be losers if the merger did not take place. With respect to effect on rates, the DTE stated:

> The resulting net savings, and alternatives to the merger, the Department found that approval of a 10-year freeze of base rates will yield benefits to Essex's ratepayers and results in just and reasonable rates. Further, the Department recognized that the proposed merger would provide Essex's ratepayers with guaranteed savings in gas costs that would be unavailable absent the merger. Based on our evaluation of the Rate Plan, the Department also concludes that the five percent rate reduction and 10-year rate freeze, in conjunction with the opportunity for Eastern's shareholders to recover the costs associated with the merger, represents a fair allocation of the benefits between shareholders and ratepayers.

A condition of the approval was finding the Eastern/Essex transaction to be "consistent with the public interest" or a "no net harm" standard. Under the Guidelines, the extent to which recovery of the acquisition premium is permitted depends on the "no net harm" analysis.

Q. What did the DTE decide in the other natural gas merger case?

A. The Northern Indiana Public Service Company (NIPSCO) acquisition of Bay State Gas Company (Bay State), D.T.E. 98-31, was treated for accounting purposes as a purchase rather than a pooling of interests. The applicants estimated a merger premium of $315 million, including estimated transaction costs of $5 million. NIPSCO proposed a Rate Plan consisting of two components: (1) a base rate freeze; and (2) an earnings sharing mechanism (ESM). The DTE approved a five-year rate freeze but did not approve the ESM. The focus of this case was growth of NIPSCO and the anticipated merger savings benefits were not quantified. The DTE allowed Bay State to seek recovery of the acquisition premium in future rate proceedings. The recovery of the premium would be dependent upon quantifying savings and proving that the savings are the result of the merger. Merger-related savings must be equal to or greater than any portion of the acquisition premium proposed to be included in base rates.

Q. Have there been other Massachusetts merger cases where the Guidelines were applied?

A. Yes. In another DTE merger case between Boston Edison Company (BEC) and Commonwealth Energy, DTE 99-19, the Massachusetts Guidelines were applied. In this case, BEC was asking for recovery of an acquisition premium of $502 million under the purchase accounting merger method. The DTE approved the merger with a four-year rate freeze and allowed recovery of the premium. The DTE relied on a finding of projected merger savings of $632.5 million over the first ten years following the merger close. Costs over the same time would be $205 million in amortization of the premium and $135 million after tax transaction costs.

The DTE approved the recovery because of the significant amount of projected savings that would exceed the acquisition premium and be passed on to ratepayers. Even with inclusion of the amortization of the acquisition premium over an additional 30 years beyond the initial ten years that merger savings originally had been projected, the projected merger savings still significantly exceeded costs. With all the excess of projected merger savings over merger costs all going to customers, made it easier for the DTE to approve the recovery of the acquisition premium. The DTE could feel more confident that the merger would result in "no net harm" because of the size of the projected merger savings.

However, the DTE's decisions regarding acquisition adjustment recovery and estimated merger savings in the BEC/Commonwealth Energy case are being challenged. The Case has been appealed to the State Supreme Court by the Attorney General and a group of large volume customers. They contend the rate plan is not in the public interest, and the fact that merger savings estimates were heavily relied on by the DTE leads to uncertainties about how much consumers will actually save in reality.

Q. What is the last case in which the guidelines have been required?

A. The guidelines have also been used in the Eastern and Colonial Gas Company (Colonial) case, D.T.E. 98-128, where Eastern proposed a Rate Plan consisting of two components: (1) a ten-year base rate freeze and (2) a 2.2 percent reduction in the burner-tip price of gas for Colonial ratepayers. Eastern/Colonial also developed and filed a tracking mechanism that purported to "track" merger savings. Eastern/Colonial began with a 1997 test year and adjusted it in an attempt to approximate a 1999 test year. The baseline proposed by Eastern/Colonial was complicated and led to lengthy discussion about every detail of the baseline. The acquisition premium totaled $199.2 million. The tracking mechanism approved by the D.T.E. included inflation and productivity factors for the ten-year rate freeze. The D.T.E. determined that a 1.5% productivity offset would be used for the purpose of determining the savings to be achieved by avoidance of rate cases during the ten-year period of the rate freeze. The savings to Colonial ratepayers is calculated to be $112.2 million over the ten years of the rate freeze.

Q. Did Mr. John McKinney provide examples from other state public utility commissions in his direct testimony?

A. Yes, he did. Mr. McKinney listed Oklahoma Corporation Commission (OCC) "criteria" from an OCC case that he believes the UtiliCorp/Empire transaction meets.

Q. Have you reviewed the case Mr. John McKinney referenced in his direct testimony that set out the "criteria"?

A. Yes, I have. In a case involving Oklahoma Gas & Electric Company (OG&E), the OCC established a standard test for rate base treatment of acquisition premiums with four points for consideration. These were stated in Mr. McKinney's direct testimony at page 24. The OG&E case, Cause Nos. PUD900000898, PUD910001055, PUD900001005, Order No. 380443, 150PUR 4th 33, February 25, 1994, involved the rates being charged by Enogex, a wholly owned subsidiary of OG&E, in its pipeline transportation charges to OG&E. The OCC decided to pass 50% of the acquisition premium cost in transportation charges to OG&E through the Fuel

Adjustment Clause being charged by Enogex. The decision was based on evidence for allocation of the transportation and processing segments of OG&E. The OCC found that in this OG&E case that the transaction substantially met the four criteria recognized in the treatise, Accounting for Public Utilities. (This document is addressed in Mr. John McKinney's direct testimony at pages 23-24.) The OCC went on to state:

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

Q. Should the Commission accept the OCC standards in determining if the UtiliCorp/Empire merger should be approved?

A. No. Each state commission should follow its own statutes, policies, standards, etc. in determining approval of mergers and rate treatment appropriate for each service territory included in the merger. While the OCC standards appear on the surface to be reasonable and UtiliCorp believes their Empire merger transaction meets these standards, these standards are not specific to Missouri.

Q. In reference to the four OCC "standards", does the Staff believe that the UtiliCorp/Empire acquisition adjustment meets all four standards for recovery?

A. No. In particular, the Staff questions whether the Joint Applicants have demonstrated that total merger savings will exceed the merger premium in this case. Please see the testimony of Staff witnesses Oligschlaeger and Traxler on this point.

Q. Have you reviewed merger cases in other state jurisdictions besides those mentioned by Mr. John McKinney and Mr. Robert Green?

A. Yes. I have reviewed merger cases in several other jurisdictions and have found that state commissions have a variety of approaches to approving mergers. Companies don't necessarily ask for recovery of acquisition premium from ratepayers. Commissions, even when asked to allow recovery of acquisition premiums, don't always allow recovery. Commissions may postpone deciding the recovery issue until savings can be proven in subsequent rate case proceedings. Upfront rate reductions for customers may be agreed to or ordered concurrent with closing of the merger. The status of deregulation in the state often influences the approach the commission takes in deciding how much recovery, how long to extend rate freezes, savings sharing mechanisms, etc.

Q. What are the issues regarding how acquisition adjustments should be treated?

A. There are two basic accounting/rate issues related to acquisition adjustments. The first is the appropriate treatment of the acquisition adjustment in rate base. The second is the appropriate cost of service treatment of the amortization of the acquisition adjustment. In my research of merger cases in other jurisdictions, one pivotal consideration that must be met in deciding whether to allow partial or total recovery of the acquisition premium is proof that the merger creates sufficient savings so that customer rates are not increased. Regulators are provided arguments based on the unique circumstances of each merger and must weigh the options available to them based on the statutes (laws) and circumstances (facts) within their jurisdictions.

Q. Do you have some specific examples?

A. Yes. I reviewed the California Public Utilities Commission's (CPUC) opinion in the merger of Pacific Enterprises and Enova Corporation (Enova), D.98-03-073. California implemented electric industry restructuring in January 1998. Pacific Enterprises and Enova wanted a ten year sharing period to recover fifty-percent of an estimated $1.1 billion in savings. In the Opinion, the CPUC commented on problems with the ten-year plan in conjunction with an electric rate freeze and a price based rate (PBR) mechanism, which anticipated a cost of service review in 2003:

> It will be difficult and artificial to conduct this cost of service review with a merger savings overlay. If the utilities true up forecast merger savings to actual savings, they would have an incentive to change from a narrow view of merger savings now to an expansive view of merger savings later. If the utilities lock in merger savings now, any future cost-of-service review will be artificial. We will have to add non-existent costs back into the utility system to develop a cost-of-service review for stand-alone utility operations and redesign earnings sharing mechanisms.

I believe this statement points to problems in proposals to track merger savings because companies have incentives to combine merger and non-merger savings. This will also likely be a problem in the UtiliCorp/Empire merger under the Joint Applicants' tracking proposal.

Q. Do you have another example of how other jurisdictions have ruled in merger cases?

A. Yes. The PacifiCorp and Scottish Power merger was completed November 30, 1999. The combined utility is now one of the top ten investor-owned U.S. electric utilities. The PacifiCorp and Scottish Power merger was approved in several states: Utah, Idaho, Oregon, Wyoming and Washington. I chose to review merger cases in the states of Wyoming and Idaho to examine the main issues in those jurisdictions. Denise K. Parrish, Supervisor of the Rates and Pricing Section of the Wyoming Public Service Commission, testified as a member of the Consumer Advocate Staff in that jurisdiction's proceedings. She advised the Wyoming Public Service Commission as follows:

> You have to look at each state on an individual basis and see where they are. For instance, the Idaho staff thinks that PacifiCorp may be over earning. We heard Mr. O'Brien indicate that they are probably under earning in Idaho. Utah has just had a rate case. Oregon has an alternative form of regulation in place where some increases are coming about on a quasi-automatic basis. So I don't think it's fair to compare Wyoming to those other states when there are different regulatory schemes in place.

Each state has taken a position that addresses their specific situation based on current rates, customers service concerns, and the status of deregulation in that state in addition to the requirements of the laws governing the regulation of utilities in that state.

Q. Did ScottishPower make concessions to the state of Wyoming as part of its regulatory plan?

A. Graham Morris, Head of Finance for Manweb (a regional electric company in England and Wales), testified for ScottishPower, in the Wyoming merger application case regarding the nature of the merger transaction:

> All transaction costs would be excluded from PacifiCorp utility accounts. He stated the result of this exclusion. We have ensured

> that the costs associated with the transaction will not be passed on to customers. The companies are bearing these costs and the acquisition premium, which ScottishPower is paying for PacifiCorp.
> [Emphasis added]

Alan V. Richardson, Executive Director and member of ScottishPower Board of Directors, testified:

> ScottishPower would share its transition plan with the Commission within six months after closing of the merger. The plan will identify how ScottishPower expects to achieve cost savings and the expected costs and benefits of these initiatives. Additionally, ScottishPower committed to submit an informational filing in June 2001 to show how planned cost savings will be promptly reflected in Wyoming results of operations.

Q. What did the Commission decide in the Wyoming ScottishPower/ PacifiCorp merger?

A. On November 17, 1999 the Wyoming Commission ordered in Docket No. 20000-EA-98-141 approval of the reorganization under the terms and conditions of the Stipulation and its Amendment. Condition 4 of the stipulated case as amended states that:

> The 2001 informational filing will include a full description, calculation and dollar identification of merger savings. The filing will include in the adjusted revenue requirement calculation, any such merger savings. The Wyoming allocated share of merger-related savings shall be no less than $4 million per annum, rather than the approximately $1.5 million previously discussed and agreed upon by them. If the savings are higher than $4 million, the higher figure will be used for the 2001 informational filing; and the higher figure will be reflected in the next general rate case filed on or after January 1, 2001. If the full $4 million is not demonstrated, the parties agree that it may be imputed for ratemaking purposes.
> [Emphasis added]

ScottishPower presented a position to the Wyoming Commission that did not include substantial risk to the ratepayers. By not seeking recovery of the acquisition premium and the costs of the transaction, the company removed many of the barriers for approval of the merger. At the same time, the company also agreed to reflect merger savings in rates.

Q. Did ScottishPower make concessions in Idaho as part of its regulatory plan?

A. ScottishPower, following the conclusion of the technical hearings in Idaho, filed with the Commission a Notice of Merger Credit Commitment that was incorporated in to the Commission's Order, which stated the following:

> Pursuant to that offer, ScottishPower and PacifiCorp shall provide guaranteed merger-related cost of service reductions for four years through an annual merger credit on customers' bills. The amount of the credit shall be $3 million per year for the years 2000, 2001, 2002, and 2003. The total credit in years 2000 through 2003 will be $6.4 million. For each of the years 2002 and 2003, ScottishPower and PacifiCorp may reduce or offset the $3 million merger credit to the extent that cost reductions related to the merger are reflected in rates.

The Order also states in regard to transaction costs and the estimated savings as follows:

> <u>ScottishPower and PacifiCorp will exclude all costs of the transaction from PacifiCorp's utility accounts</u>...ScottishPower originally guaranteed operating efficiencies of at least $10 million annually on a system basis. If the minimum $10 million annual reduction is not achieved by the end of the third year, an amount equal to the difference between the $10 million and efficiencies actually achieved must be moved below the line to be absorbed by shareholders.
>
> Annual report of efficiencies achieved must be provided to the Commission Staff to verify the savings along with an annual

> commission basis earnings report. ScottishPower has committed to provide these reports in a format similar to that currently used by the Company in the UK. The actual report format can be modified for additional information following the merger if the Commission so desires.
>
> Moreover, Staff will audit the annual commission basis earnings report and file an audit report with the Commission. The results of this report can be used to determine if the efficiencies have been achieved. If not, the procedure and actual adjusting entries can then be determined.
> [Emphasis added]

Q. What does Staff want the Commission to note from reading these excerpts from the ScottishPower merger cases?

A. There are several points Staff would like to comment on. Mergers are taking place still today where acquisition adjustments are not recovered. Companies enter into mergers without threatening to cancel the merger if regulators don't allow recovery of acquisition adjustments. States approach mergers from their specific perspectives. It becomes a balancing act between shareholders and customers with the commissions deciding how much of the savings should be kept by ratepayers and how much should be applied to recovery of the acquisition premium. Regulators must weigh the benefits and costs to determine the best approach for each specific merger case. Various sharing mechanisms including rate reductions, rate freezes, savings sharing and the opportunity to seek recovery in future rate case treatment of acquisition adjustments have all been implemented in mergers.

Q. Can you cite other examples from various states as to how regulatory commissions determine an acceptable treatment of acquisition adjustments?

A. In the state of Florida, generally, the Florida Public Service Commission (PSC) looks for quantifiable merger benefits, which will offset the acquisition adjustment. In fact, the Commission allowed an acquisition adjustment associated with the consolidation of Central Florida Gas Company and Chesapeake Utilities Corporation. In FPSC Order No. 18716, the PSC reserved the right to review the actual savings in a future rate case. And, in the next rate review, the PSC noted that the savings, which were predicted to occur as a result of the acquisition, never, materialized. To the contrary, the company experienced an increase in its revenue requirements since the acquisition. With the absence of savings from which to recover the premium, the Commission removed the acquisition adjustment from rate base (FPSC Order No. 23166).

SUMMARY/CONCLUSIONS

Q. Please summarize your conclusions and position.

A. My conclusions and position are the following:

- The Staff's position is that the estimated merger savings presented by UtiliCorp/Empire should not be relied upon.
- Tracking merger savings is very difficult to accomplish. The tracking mechanism discussed by UtiliCorp/Empire does not appear to be able to distinguish stand–alone savings from merger savings.
- In their direct testimony, the Joint Applicants have provided only one side of the acquisition adjustment argument. The Staff has tried to balance the argument by providing cites to cases in other jurisdictions that may aid the Commission in their decision in this case

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 JANIS E. FISCHER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Janis E. Fischer, is, of lawful age, and on her oath states: that she has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 93 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Janis E. Fischer

Janis E. Fischer

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

UtiliCorp/Empire Merger
Case No. EM-2000-369
Analysis of Labor Reductions
From 3/14/00 Transition Team Report to Steering Committee
DR 1 and DR 144 used to compile numbers

Transition Team	Eliminated Positions	Synergies	20% Loading	Synergies Total
Supply/Generation	9.0	455,518	91,104	546,621
Finance/Accounting	29.7	1,210,851	242,170	1,453,021
Distribution	28.5	1,209,932	241,986	1,451,918
From DR 144	15.0	695,854	139,171	835,025
From DR 144	71.0	3,062,813	612,563	3,675,376
Regulatory/Legislative	2.3	111,539	22,308	133,847
Environmental	1.7	95,454	19,091	114,545
Transmission	16.0	751,684	150,337	902,021
Information Technology	19.0	1,017,749	203,550	1,221,299
Human Resources	5.5	466,230	93,246	559,476
	197.7	9,077,623	1,815,525	10,893,148
Average per employee		45,916	9,183	55,099
DR 1 Total Labor Savings	204.5	7,906,866	1,581,373	9,488,239
Average per employee		38,664	7,733	46,397

From FERC Form 1 1999 & 1998	1999	1998	Avg
Total Number of Employees-Full-Time	630	638	
Part-Time and Temporary Employees	42	32	
	651	654	652.5

Average Payroll Expense per Employee 50,978
$33,263,034/652.5
Assume fully loaded

Normal Vacancy Levels

5% Inflation Factor Applied for Years 2002 - 2010

Synergy Value of 20 Employees	2001	2002	2003	2004	2005	2001 - 2005 Subtotal	2006	2007	2008	2009	2006 - 2010 Subtotal	10 Year Totals
Based on 1999 Numbers												
FERC Version - all benefits included	1,019,560	1,070,538	1,124,065	1,180,268	1,239,282	5,633,713	1,301,246	1,366,308	1,434,623	1,506,354	7,190,204	12,823,916
DR 1 Version - Loading @ 20%	**927,940**	**974,337**	**1,023,054**	**1,074,207**	**1,127,917**	**5,127,454**	**1,184,313**	**1,243,528**	**1,305,705**	**1,370,990**	**6,544,075**	**11,671,530**
Transition Teams - Loading @ 20%	1,101,980	1,157,079	1,214,933	1,275,680	1,339,464	6,089,135	1,406,437	1,476,759	1,550,597	1,628,126	7,771,451	13,860,586

UCU/SJLP Merger Case EM-2000-292
Analysis of Personnel UCU Reengineering

EM-2000-369 Synergies
DR26UCUReengineering
JEF

DR Response #26	6/23/94 dated materials Current Employees	Current Disco	% Dollar Change	Rec State	Rec Disco Employees	Change in Dollars	Change in Employees	New Total
Operations	2,320	$88,706	-26.22%	$65,450	1,575	($23,256)	(745)	2,095
Engineering	77	$3,111	-17.13%	$2,578	48	($533)	(29)	60
Communications	20	$1,684	-28.74%	$1,200	11	($484)	(9)	14
Legal	12	$1,518	-13.37%	$1,315	7	($203)	(5)	8
Regulatory/Legislative	38	$5,976	-15.71%	$5,037	23	($939)	(15)	26
Human Resources	72	$6,078	-32.54%	$4,100	47	($1,978)	(25)	58
Mtrls/Procurement/Fleet Facilities Management	57	$7,432	-7.66%	$6,863	71	($569)	14	103
Internal Audit	19	$1,021	-21.06%	$806	15	($215)	(4)	18
Accounting	180	$9,351	-18.00%	$7,668	143	($1,683)	(37)	179
InformationSystems	121	$11,379	0.00%	$11,379	121	$0	0	144
Call Center	35	$1,050	128.76%	$2,402	77	$1,352	42	95
Marketing/Bus Dev/Econ Dev	120	$7,932	1.20%	$8,027	107	$95	(13)	164
Senior Management	35	$6,293	-26.90%	$4,600	26	($1,693)	(9)	31
General Admin		$3,815	-26.90%	$2,789		($1,026)		
Benefits		$20,420	-26.90%	$14,927		($5,493)		
UCU	20	$10,455	0.00%	$10,455	20	$0	0	32
Risk Management	4	$3,680	-17.36%	$3,041	3	($639)	(1)	7
Total (excluding operations)	810	101,195	-13.84%	$87,187	719	($14,008)	(91)	
Total	3,130	189,901	-19.62%	$152,637	2,294	($37,264)	(836)	3,034

SCHEDULE 3

HAS BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

NP

UtiliCorp/Empire Merger Case
Case No. EM-2000-369
Response to DR #1
Present Value Analysis

	2001	2002	2003	2004	2005	1st 5 yrs. Total	1st 5 yrs. Average	2006	2007	2008	2009	2010	Years 6-10 Total	Years 6-10 Average	Ten Full Years Totals	Ten Full Years Average
Operating Costs																
Dispatching/Generation Savings	10,739	14,755	18,395	20,052	25,705	89,646	17,929	22,966	24,877	22,710	16,244	21,442	108,239	21,648	197,885	19,789
Gen & Admin Savings	6,674	6,840	7,011	7,187	7,366	35,078	7,016	7,551	7,739	7,933	8,131	8,334	39,688	7,938	74,766	7,477
Distribution & Transmission Savings	2,982	5,817	5,963	6,112	6,265	27,139	5,428	6,421	6,582	6,746	6,915	7,088	33,752	6,750	60,891	6,089
UtiliCorp Benefits Conversion	4,262	3,750	4,264	4,525	4,780	21,581	4,316	5,058	5,354	5,670	6,005	6,365	28,452	5,690	50,033	5,003
Total O&M	24,657	31,162	35,633	37,876	44,116	173,444	34,689	41,996	44,552	43,059	37,295	43,229	210,131	42,026	383,575	38,358
Discounted 11.37%	**22,140**	**25,124**	**25,796**	**24,620**	**25,749**	**123,428**	**24,686**	**22,009**	**20,965**	**18,194**	**14,149**	**14,726**	**90,043**	**18,009**	**213,471**	**21,347**
Capital Savings																
Depr Interconnect/SCADA/T&D	(432)	(386)	(288)	(189)	(91)	(1,386)	(277)	7	106	204	302	359	978	196	(408)	(41)
Amort of Transaction/Transition Costs	(2,962)	(2,962)	(2,962)	(2,962)	(2,962)	(14,810)	(2,962)	(2,962)	(2,962)	(2,962)	(2,962)	(2,960)	(14,808)	(2,962)	(29,618)	(2,962)
Return on Interconnect SCADA/T&D	(1,443)	(1,045)	(565)	(97)	360	(2,790)	(558)	807	1,242	1,666	2,078	2,485	8,278	1,656	5,488	549
Return on Transaction/Transition Costs																
Total Capital Savings (Costs)	(4,837)	(4,393)	(3,815)	(3,248)	(2,693)	(18,986)	(3,797)	(2,148)	(1,614)	(1,092)	(582)	(116)	(5,552)	(1,110)	(24,538)	(2,454)
Total Synergies, net of Cost to Achieve	19,820	26,769	31,818	34,628	41,423	154,458	30,892	39,848	42,938	41,967	36,713	43,113	204,579	40,916	359,037	35,904
Discounted 11.37%	**17,797**	**21,582**	**23,034**	**22,509**	**24,177**	**109,098**	**21,820**	**20,883**	**20,205**	**17,732**	**13,929**	**14,687**	**87,436**	**17,487**	**196,534**	**19,653**
Enterprise Support Functions Allocated (In)	4,272	4,379	4,488	4,600	4,715	22,454	4,491	4,833	4,954	5,078	5,205	5,335	25,405	5,081	47,859	4,786
EDE Direct Costs Transferred to ESF	2,485	2,547	2,611	2,676	2,743	13,062	2,612	2,811	2,882	2,954	3,027	3,103	14,777	2,955	27,839	2,784
EDE Direct Costs Transferred to IBU	(23,079)	(23,656)	(24,247)	(24,854)	(25,475)	(121,311)	(24,262)	(26,112)	(26,765)	(27,434)	(28,120)	(28,823)	(137,254)	(27,451)	(258,565)	(25,857)
Support Functions Allocated (In)																
Net Allocations (Costs) Savings to EDE	(16,322)	(16,730)	(17,148)	(17,578)	(18,017)	(85,795)	(17,159)	(18,468)	(18,929)	(19,402)	(19,888)	(20,385)	(97,072)	(19,414)	(182,867)	(18,287)
Total Synergies, net of Costs to Achieve/Alloc Costs	3,498	10,039	14,670	17,050	23,406	68,663	13,733	21,380	24,009	22,565	16,825	22,728	107,507	21,501	176,170	17,617
Discounted 11.37%	**3,141**	**8,094**	**10,620**	**11,083**	**13,661**	**46,599**	**9,320**	**11,205**	**11,298**	**9,534**	**6,383**	**7,742**	**46,163**	**9,233**	**92,761**	**9,276**
Premium Costs																
Return on Premium	(30,978)	(30,184)	(29,389)	(28,595)	(27,801)	(146,947)	(29,389)	(27,006)	(26,212)	(25,418)	(24,623)	(23,829)	(127,088)	(25,418)	(274,035)	(27,404)
Amortization of Premium	(6,988)	(6,988)	(6,988)	(6,988)	(6,988)	(34,940)	(6,988)	(6,988)	(6,988)	(6,988)	(6,988)	(6,988)	(34,940)	(6,988)	(69,880)	(6,988)
Reflect Non-tax Deductibility of Premium	(4,659)	(4,659)	(4,659)	(4,659)	(4,659)	(23,295)	(4,659)	(4,659)	(4,659)	(4,659)	(4,659)	(4,659)	(23,295)	(4,659)	(46,590)	(4,659)
Total Premium Cost	(42,625)	(41,831)	(41,036)	(40,242)	(39,448)	(205,182)	(41,036)	(38,653)	(37,859)	(37,065)	(36,270)	(35,476)	(185,323)	(37,065)	(390,505)	(39,051)
Empire Share of Premium Costs	(21,313)	(20,916)	(20,518)	(20,121)	(19,724)	(102,591)	(20,518)	(19,327)	(18,930)	(18,533)	(18,135)	(17,738)	(92,662)	(18,532)	(195,253)	(19,525)
Synergies, net of 50% of Premium	(17,815)	(10,877)	(5,848)	(3,071)	3,682	(33,928)	(6,786)	2,054	5,080	4,033	(1,310)	4,990	14,846	2,969	(19,083)	(1,908)
Discounted 11.37%	**(15,996)**	**(8,769)**	**(4,234)**	**(1,996)**	**2,149**	**(28,846)**	**(5,769)**	**1,076**	**2,390**	**1,704**	**(497)**	**1,700**	**6,373**	**1,275**	**(22,472)**	**(2,247)**

NPV Total Savings Years 1-10	213,471,185
NPV Total to Customers Years 6-10	6,411,642
Percent to Customers	3.00%

Dept Example

Line No.	Description		1999	2000	2001	2002	2003	2004
1	**SJLP Baseline**							
2	'99 Budget inflated by 3%		1,000	1,030	1,061	1,093	1,126	1,159
3	**UCU Baseline**							
4	'99 Budget inflated by 3%		3000	3,090	3,183	3,278	3,377	3,478
5	**UCU Incremental**							
6	Estimate inflated by 3%		300	309	318	328	338	348
7	Sub Total		3,300	3,399	3,501	3,606	3,714	3,826
8	Portion allocated to SJLP	25%	825	850	875	901	929	956
9	Merger Savings		175	180	186	191	197	203

UTILICORP UNITED
DOCKET NO. EM-2000-292
DATA REQUEST NO. SJLP-170

DATE OF REQUEST: January 31, 2000

DATE RECEIVED: January 31, 2000

DATE DUE: February 19, 2000

REQUESTOR: Janis Fischer

QUESTION:

1. How will the synergy analysis of the Transition Teams be utilized in the tracking of merger savings? Please provide details for each of the Transition Teams.

2. How will UCU demonstrate in year six following the close of the merger, that savings have exceeded costs?

3. How will UCU differentiate between SJLP and EDE savings throughout the years following the merger closings?

4. How is UCU currently measuring merger savings related to the SJLP/UCU and EDE/UCU transactions? Please identify specific examples of savings from the SJLP/UCU and EDE/UCU transactions that can be traced back to the general ledger/financial statements.

RESPONSE: 1 See testimony of Jerry Meyers. The usefulness of the transition reports in tracking is similar for all the teams for the operating and transition cost elements. As a result, a general example covers most of the synergies for the transition teams of Regulatory, Finance/Accounting, Human Resources, Information Technology, Distribution Operations, Transmission, and the O&M portion of Generation. The approved and final reports of those transition teams will be used as a roadmap to ensure that expected costs and savings materialize.

Assume that a report calls for the elimination of an SJLP department with an increase of 4 staff at UtiliCorp. The elimination can be easily verified, along with the severances. The elimination is compared to the allocated costs from UtiliCorp to determine the synergies.

A simple example illustrates the concept:

EXAMPLE:
A. Assume an SJLP department of 10 positions at a cost of $500,000.
B. The same work can be accomplished by an existing UtiliCorp department of 20 positions costing $1,000,000 by adding 4 staff at a cost of $200,000.
C. The augmented UtiliCorp department of 24 positions at a cost of $1,200,000 is allocated on an established basis that allocates 33% of its costs to the SJLP unit at a cost of $400,000.
D. The synergies in this case are $100,000 (the original SJLP $500,000 less the post-merger allocation of $400,000). That difference is simple to validate by retaining the original budgets for SJLP department (appropriately inflated) to compare to the costs then being charged to SJLP.

The operating departments of SJLP should be even clearer, because those departments are still identified with SJLP. The current staffing will be reduced, and the remaining departments identified as SJLP Operations can be compared to the original departments to identify the savings.

The generation synergies not related to operations and maintenance are slightly more complex but have the benefit of using an agreed-to software model that both UtiliCorp and staff have tested and used before.

2. **See Jerry Meyers testimony. And response to 1 above.**
The comparison of synergies can be simply stated as the current costs of SJLP and Empire operations, (each determined separately and appropriately inflated), less the allocated costs from Utilicorp for performing those functions for SJLP and Empire at the 'General Ledger Business Unit' level.

3. The existing departments and their costs are identified for each of the two (SJLP and Empire). Because each will be maintained as a separate entity (a General Ledger Business Unit) in the UtiliCorp accounting system, the offsetting allocations to each entity will also be identified. The net result is the synergies for each entity.

4. The mergers have not been accomplished, nor have intended reorganizations been approved or accomplished. As a result, merger savings or synergies are not being measured.

ATTACHMENTS: None

ANSWERED BY: Vern Siemek

SCHEDULE 7

HAS BEEN DEEMED

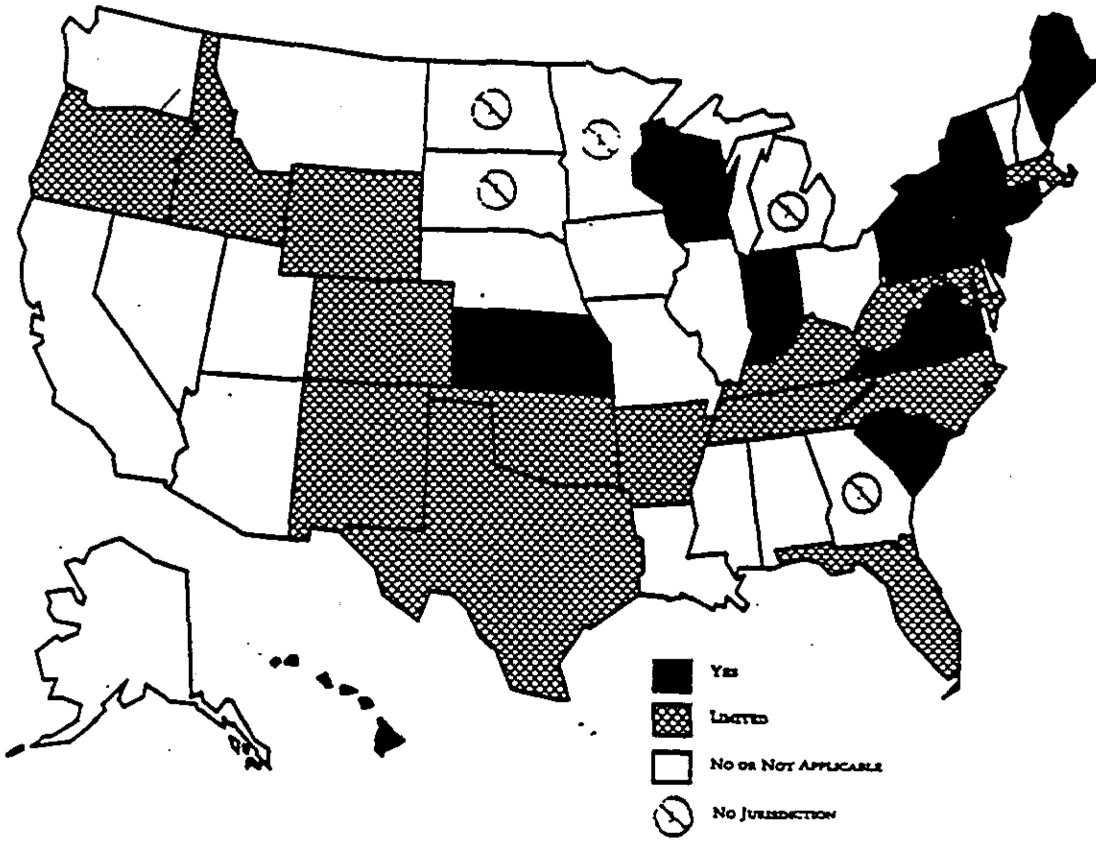
HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

NP

1.2 Commission Policy

Commissions that have Approved Acquisition Adjustments



Arkansas ⅄
Colorado ⅄
Connecticut
Florida ⅄
Hawaii
Idaho ⅄
Indiana
Kansas
Kentucky ⅄
Maine
Maryland ⅄
Massachusetts (1994 ⅄
New Jersey
New Mexico ⅄
New York (1994)
North Carolina ⅄
Oklahoma ⅄
Oregon ⅄
Pennsylvania (1995)
South Carolina
Tennessee ⅄
Texas ⅄
Virginia
West Virginia ⅄
Wisconsin
Wyoming ⅄

( ) Approximate effective date (if available).
⅄ On a limited basis.

Schedule 8

NAWC Sourcebook 6/23/97

The survey notes included specific information to the following states survey responses:

- Colorado. When shown to benefit ratepayers.
- Delaware. Acquisitions at original cost.
- Florida. Positive, negative, and no adjustments have been made.
- Hawaii. Book purposes only.
- Indiana. Case specific.
- Maryland. If purchase is in the public interest.
- Missouri. Acquisition adjustments have never been recognized in rates.
- New York. Policy exists.
- North Carolina. On a case-by-case basis.
- Oregon. Only where a net benefit to customers is shown.
- Rhode Island. Acquisitions above book are generally disallowed.
- Tennessee. If utility can prove that excess price above net book benefits existing and new customers.
- Texas. Case-by-case (no laws or rules).
- Virginia. Adjustment no higher than purchase pricing using net book value.
- West Virginia. Debit balances not reflected in operations; credit balances must be ruled on by the Commission.
- Wisconsin. Rate recovery determined on a case-by-case basis in the utility's rate case.