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Witness: Cary G. Featherstone  
Sponsoring Party: MoPSC Staff  
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**MISSOURI PUBLIC SERVICE COMMISSION  
UTILITY SERVICES DIVISION**

**REBUTTAL TESTIMONY**

**OF**

**CARY G. FEATHERSTONE**

**FILED<sup>3</sup>**

JUN 21 2004

Missouri Public  
Service Commission

**AQUILA, INC. d/b/a AQUILA NETWORKS-MPS (Natural Gas)**

**AND AQUILA NETWORKS-L&P (Natural Gas)**

**CASE NO. GR-2004-0072**

*Jefferson City, Missouri  
February 2004*

Exhibit No. 32  
Date 3-30-04 Case No. GR-2004-0072  
Reporter KP

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

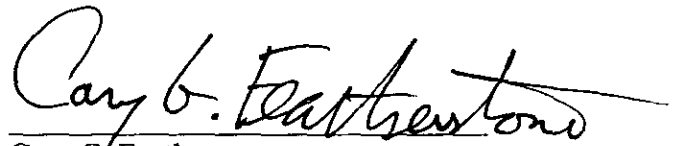
In the Matter of Aquila, Inc. d/b/a Aquila )  
Networks-MPS and Aquila Networks-L&P, )  
Natural Gas General Rate Increase )

Case No. GR-2004-0072

**AFFIDAVIT OF CARY G. FEATHERSTONE**

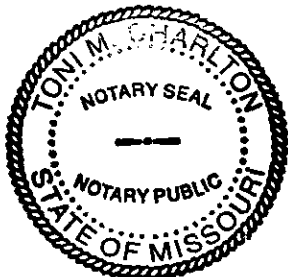
STATE OF MISSOURI     )  
                                  )     ss.  
COUNTY OF COLE     )

Cary G. Featherstone, being of lawful age, on his oath states: that he has participated in the preparation of the following Rebuttal Testimony in question and answer form, consisting of 48 pages to be presented in the above case; that the answers in the following Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

  
Cary G. Featherstone

Subscribed and sworn to before me this 9th day of February 2004.

  
Notary



**TONI M. CHARLTON**  
NOTARY PUBLIC STATE OF MISSOURI  
COUNTY OF COLE  
My Commission Expires December 28, 2004

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**CARY G. FEATHERSTONE**

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**REBUTTAL TESTIMONY**

**OF**

**CARY G. FEATHERSTONE**

**AQUILA, INC., d/b/a AQUILA NETWORKS-MPS (NATURAL GAS) and**

**AQUILA NETWORKS-L&P (NATURAL GAS)**

**CASE NO. GR-2004-0072**

Q. Please state your name and business address.

A. Cary G. Featherstone, 3675 Noland Road, Independence, Missouri.

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

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

Q. Are you the same Cary G. Featherstone who has previously filed direct testimony in this proceeding?

A. Yes, I am. I filed direct testimony in this case on January 6, 2004 on the areas of cost of removal / salvage.

Q. What is the purpose of this rebuttal testimony?

A. The purpose of this rebuttal testimony is to address the direct testimony filed by Aquila, Inc. (Aquila or Company; formerly known as UtiliCorp United, Inc.) witness Vern J. Siemek, Financial Manager for Aquila Networks--Nebraska, relating to aspects of the merger between Aquila and St. Joseph Light & Power Company (SJLP). Specifically, Mr. Siemek states at page 3, line 1 that Aquila is seeking to retain "50% of the acquisition-related savings to benefit shareholders for creating those savings..."

Rebuttal Testimony of  
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1 In particular, I will address the following points relating to Aquila and the St. Joseph  
2 Light & Power merger (collectively the St. Joseph merger):

- 3 • The proposal by Aquila to share in the savings is to take Aquila  
4 Networks-MPS (MPS) and Aquila Networks-L&P (L&P) off of cost-  
5 based rates.
- 6 • Merger savings have benefited and been realized by Aquila's  
7 shareholders
- 8 • Rejection of the merger savings sharing proposal will not be a  
9 disincentive to Company's future merger activities.

10 Q. Please describe how you are referring to Aquila, its divisions and affiliates in this  
11 rebuttal testimony?

12 A. When referring to the current Aquila corporate structure, I will be referring to  
13 Aquila Inc. the parent company of all of Aquila, Inc. including its operations regulated by this  
14 Commission: Aquila Networks-MPS and Aquila Networks-Light & Power. Aquila, Inc. was  
15 formerly named UtiliCorp United, Inc. I refer to the operating division Aquila Networks-MPS  
16 as MPS and I refer to the operating division Aquila Networks-L&P as Light & Power or L&P.

17 In 2000 Aquila (then called UtiliCorp) and St. Joseph Light & Power Company merged.  
18 I refer to that event as the St. Joseph merger. When referring to the former St. Joseph Light &  
19 Power Company I will call it SJLP.

20 Q. When did the merger between Aquila and SJLP take place?

21 A. The merger was completed between Aquila and SJLP on December 31, 2000.

22 **MERGER BETWEEN AQUILA, INC. AND ST. JOSEPH LIGHT & POWER**  
23 **COMPANY**

24 Q. Did you participate in the merger case filed by Aquila (UtiliCorp), and  
25 St. Joseph Light & Power Company, in Case No. EM-2000-292?

Rebuttal Testimony of  
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1           A.    Yes. I filed rebuttal testimony in that case on the areas of merger premium,  
2 acquisition adjustment and tracking of merger savings.

3           Q.    What specific areas will your rebuttal address regarding the St. Joseph merger?

4           A.    This rebuttal testimony will respond to the direct testimony of Aquila witness  
5 Vern J. Siemek regarding the regulatory treatment of merger savings resulting from the  
6 merger with SJLP. In this rebuttal, I will provide testimony concerning cost based rates,  
7 Aquila exclusively realizing benefits from the St. Joseph merger, a general review of the  
8 regulation of utility merger and acquisition activity in the state of Missouri and Aquila's  
9 assertion that the Commission's denial of the Company's merger savings sharing proposal  
10 will affect future merger activity in the state of Missouri. Other Staff members will be  
11 addressing the Aquila merger savings proposal as well. Staff witnesses Mark L.  
12 Oligschlaeger, Janis E. Fischer and Steve M. Traxler will provide rebuttal on this issue.

13          Q.    How have you organized your rebuttal testimony on the merger savings  
14 sharing proposal Aquila has presented in its direct testimony filed in this case?

15          A.    The following indicates the structure of the testimony relating to Aquila's  
16 merger saving proposal based on its merger with SJLP:

- 17               1.    Mergers and Acquisition Background
- 18               2.    Background of the SJLP Merger with Aquila
- 19               3.    Disallowance of Merger Premiums in Rates does not Affect
- 20               Mergers being Completed in Missouri
- 21               4.    Merger Tracking
- 22               5.    Customers are Entitled to Savings Resulting from either
- 23               Merger or Nonmerger Events
- 24               6.    Summary and Conclusions for Merger Savings Proposal

1 **MERGERS AND ACQUISITIONS BACKGROUND**

2 Q. What has been your past experience relating to other mergers and  
3 acquisitions?

4 A. I have been involved in Staff's review of several merger and acquisition  
5 applications filed with the Commission. Attached to this rebuttal testimony as Schedule 1 is  
6 a listing of the various merger and acquisition applications and reviews I have participated in  
7 during my employment with the Commission.

8 **BACKGROUND OF THE ST. JOSEPH LIGHT & POWER COMPANY MERGER**  
9 **WITH AQUILA INC.**

10 Q. Did SJLP provide utility services within the state of Missouri prior to its  
11 merger with Aquila?

12 A. Yes. SJLP provided electric, natural gas and industrial steam utility service to  
13 customers in the northwest part of the state of Missouri.

14 Q. Would you provide a brief history of SJLP?

15 A. Attached as Schedule 2 to this rebuttal testimony is a detailed background of  
16 the merger between Aquila and SJLP which includes a history of SJLP.

17 **COST BASED RATES**

18 Q. Does Aquila's proposal to retain half of the merger related savings as  
19 advocated by Mr. Siemek in his direct testimony take the Company off of cost based rates?

20 A. Yes. Mr. Siemek is supporting in his direct testimony adding adjustments, for  
21 merger savings that Aquila has identified, to the costs it is proposing to include in rates in  
22 this case. The adjustments are being made so Aquila will be able to retain, for shareholders,  
23 merger savings from the synergies occurring as a result of the St. Joseph merger.

Rebuttal Testimony of  
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1 Q. Why is this proposal necessary for Aquila?

2 A. If Aquila did not file a rate case, the Company's shareholders would continue  
3 to benefit exclusively from the purported merger savings, just as they have done since the  
4 closing of the merger on December 31, 2000. This situation would change with the filing of  
5 a rate case. Thus, Aquila has proposed in its rate case a sharing savings adjustment to keep  
6 some of the merger savings for its shareholders.

7 Since rates are based on historical costs that are normalized and annualized in a rate  
8 case, any merger savings that have occurred to date through the end of the known and  
9 measurable period, September 30, 2003, would be reflected in rates when approved by the  
10 Commission. Aquila's merger savings sharing proposal is a mechanism devised by the  
11 Company to allow retention of a portion of the merger savings for its shareholders. This  
12 "sharing" proposal, in essence, is a mechanism that allows the Company to keep the  
13 customers from fully benefiting from the St. Joseph merger. This merger savings sharing  
14 proposal takes Aquila off of rates based on actual costs.

15 Q. Are merger savings any different than other costs reductions that occur as  
16 result of utility decisions?

17 A. No. Over time, there are opportunities to reduce costs as technology brings  
18 about efficiencies. In addition, utilities engaged in employee reductions during much of the  
19 1980s and 1990s as companies sought to cut costs, especially those that planned to avoid  
20 filing rate cases. To the extent that there were cost decreases, the companies maintained the  
21 savings for as long as their rates were not changed to reflect the reductions. Aggressive  
22 companies negotiated fuel contracts and rail freight agreements that resulted in reductions in  
23 fuel costs. These cost reductions also directly benefited shareholders as long as the company



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1 did not have its rates changed to reflect the costs declines. At the time of rate cases, or in  
2 some instances, excess revenue complaint cases, the costs savings were reflected in rates so  
3 that the company's customers could receive benefits from efficiencies and economies from  
4 technology, re-negotiated fuel contracts, or other events and developments. These types of  
5 cost reductions generally were not identified for cost sharing, i.e., half of the savings were  
6 proposed to be "added" back to companies' cost of service calculations so the shareholders  
7 could continue to reap benefits from the costs savings.

8 Just as it would be inappropriate for ratepayers to "share" in costs reductions from  
9 re-negotiated fuel contracts allowing shareholders to retain the savings permanently, it is  
10 equally inappropriate to expect customers to not receive at some point the savings in costs  
11 resulting from a merger. Companies retain the savings that result from, for example,  
12 restructurings or reorganizations that result in employee reductions, until those savings are  
13 provided rate treatment through a rate case or excess revenue complaint case. Merger  
14 savings should also be reflected in rates at some point as well.

15 Q. Will adopting Aquila's proposal to keep half the merger savings for  
16 shareholders result in permanent savings to the Company?

17 A. Just as the Company has reaped 100% of any merger savings since the close  
18 of the St. Joseph merger (December 31, 2000), if the proposal identified by Mr. Siemek in his  
19 direct testimony is approved by the Commission, Aquila will be permitted to keep half of  
20 what is identified as the merger savings generated to date to at least the next rate case. If this  
21 proposal is allowed to continue, the Company will benefit by retaining half the merger  
22 savings until such time as the Commission discontinues such practice.

23 Q. How does the Company's proposal affect cost based rates?

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1           A.     Generally, prudent and reasonable costs are reflected in a revenue requirement  
2 calculation. When rates are determined in a rate case or excess revenue complaint case, the  
3 reasonable and prudent costs of providing utility service are included in the cost structure and  
4 the company is allowed to recover these costs in the rates it charges its customers; thus, rates  
5 are determined using actual costs that are deemed to be reasonable and prudent. While costs  
6 are *normalized and annualized for a particular period*, they are based on actual historical  
7 costs incurred by the utility.

8           Aquila's merger savings sharing proposal being sponsored by Mr. Siemek, seeks to  
9 "impute" costs savings to the cost structure. These "imputed" cost savings are not actual  
10 costs yet they are "added" back to the actual costs of the Company to determine the rates to  
11 charge its customers. While there is a basis for reflecting the recovery of actual costs in  
12 rates, there is no basis for reflecting the merger savings. Using merger savings in rates takes  
13 the Company off of cost-based ratemaking.

14           These merger savings can be thought of as arising from hypothetical expenses that no  
15 longer exist for purposes of rate determination. The merger savings do not represent actual  
16 costs incurred in providing utility service yet the Company proposal "adjusts" cost of service  
17 expenses by adding back a portion of these savings as an adjustment to increase expenses,  
18 thus providing a credit to the shareholders by not allowing the savings to "flow" to  
19 customers. Because the Company's cost structure will not represent actual costs if this  
20 proposal is adopted, rates to be determined in this case will not be cost based. The  
21 Company's proposal for purported merger savings increases expenses and causes rates to be  
22 higher than they otherwise would be. Apparently, Aquila's position with regard to the

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1 merger savings is that the Company is entitled to charge customers higher rates based on  
2 higher than actual costs to provide electric and steam service.

3 Q. Have other utilities in Missouri demonstrated experience in cost reductions?

4 A. Yes. Kansas City Power & Light and Union Electric have experienced cost  
5 reductions for which their shareholders reaped the benefits until rates were changed.

6 Q. Has the Commission approved experimental alternative regulation plans for  
7 ratemaking purposes?

8 A. Yes. The Commission approved in two instances experimental alternative  
9 regulation plans for Southwestern Bell Telephone Company (Southwestern Bell or SWBT) in  
10 Case No. TC-89-14 and Union Electric in Case Nos. EO-96-14 and EM-96-149. Both of  
11 these companies were in declining cost situations for their operations. At the time the  
12 Commission entered into these experimental alternative regulation plans, rates were set  
13 through an excess revenue/overearnings reviews that led to rate reductions. In both  
14 instances, there were rate moratoriums associated with the experimental alternative  
15 regulation plans.

16 Q. Is Aquila's merger savings sharing plan similar to the Southwestern Bell or  
17 Union Electric plans?

18 A. Yes. However, it does not have the safeguards associated with the other plans  
19 that the Commission approved in the past. There is no mechanism in place to allow for a  
20 review of earnings so that the Company does not continue to earn above a prescribed level  
21 without a "sharing" of earnings review. While these plans, from the Staff's perspective, were  
22 intended to generally look at all of the regulated costs of the two companies, Aquila's merger  
23 savings sharing proposal only looks at what it defines as "merger savings" and seeks to treat

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1 these cost reductions in a unique manner. Aquila's proposal does not provide for a rate  
2 moratorium, unlike the experimental alternative regulation plans for Southwestern Bell and  
3 Union Electric that prevented general rate increases. While maintaining the protection of  
4 filing rate increases for its increasing costs, Aquila seeks "alternative regulation" for those  
5 isolated costs that have purportedly declined as result of the St. Joseph merger. Unlike  
6 Aquila, Southwestern Bell and Union Electric both gave up the opportunity for general rate  
7 increases through rate moratoriums in return for experimental alternative regulation. Neither  
8 Southwestern Bell nor Union Electric had any general rate increases while these plans were  
9 in effect. With the savings sharing proposal, Aquila seeks a best-of-both-worlds approach in  
10 which it retains the ability to increase rates for its generally increasing costs, but employs  
11 "alternative regulation" for its identified declining costs.

12 Q. Are there other differences between the experimental alternative regulation  
13 plans used by Southwestern Bell and Union Electric and Aquila's merger savings sharing  
14 proposal?

15 A. Yes. The Southwestern Bell and Union Electric experimental alternative  
16 regulation plans also were for specified periods of time, unlike Aquila's savings sharing  
17 proposal.

18 Q. Was there an oversight function attached as part of the Southwestern Bell and  
19 Union Electric plans?

20 A. Yes. Unlike Aquila's proposal, for each year of the experimental alternative  
21 regulation plans, the Staff and the Office of the Public Counsel monitored the earnings levels  
22 of Southwestern Bell and Union Electric to determine the amount of sharing credits, if any,

1 which were to be credited to customers. There is no similar oversight function reflected with  
2 Aquila's savings sharing proposal.

3 **AQUILA HAS REALIZED MERGER SAVINGS TO THE BENEFIT OF ITS**  
4 **SHAREHOLDERS**

5 Q. Mr. Siemek states at page 17, line 7 of his direct testimony that "Aquila has  
6 realized little, if any, benefit from those merger savings to date." Does Staff agree with this  
7 assessment?

8 A. No. The St. Joseph merger was completed December 31, 2000. The  
9 integration of the two systems, now MPS and L&P, started immediately. Aquila realized  
10 merger savings from payroll and payroll-related benefits reductions, fuel and purchased  
11 power savings from joint dispatch, insurance savings along with other cost reductions. MPS  
12 benefited from the change in allocations of corporate costs that reduced its expenses.

13 Q. At page 17, line 17 of his direct testimony, Mr. Siemek claims that "the first  
14 year of integration resulted in relatively few savings" from the merger. When did MPS start  
15 to enjoy the benefits of reduced corporate costs through the allocation process?

16 A. Immediately upon the close of the merger, the amount of corporate costs  
17 allocated to MPS was reduced to reflect the addition of L&P into the allocation mix.

18 Q. Has the Company realized significant savings from the St. Joseph merger?

19 A. Since the very beginning of the merger, both MPS and L&P have benefited  
20 directly from merger savings. The merger closed on December 31, 2000 and since that time  
21 both of these operating divisions started to integrate their two businesses into one another. In  
22 fact, the integration process started prior to the close of the merger when both Companies  
23 started to plan for when the merger would become a reality.

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1 Mr. Siemek contends that significant savings have resulted from the St. Joseph  
2 merger. He states starting at page 20, line 21 of his direct testimony that "Aquila's  
3 acquisition has created significant savings to MPS from economies of scale for support  
4 costs." Aquila has directly benefited from these "significant savings" and since Aquila is  
5 seeking to significantly increase rates, as such, it is time that the customers of these two  
6 operating divisions start to benefit from these merger savings also.

7 Q. When will MPS and L&P rates change?

8 A. Aquila filed on August 1, 2003, this case to change natural gas rates. The  
9 Commission suspended the tariffs filed in this case. Absent further Commission action, July  
10 2004 is the earliest time that customers will receive any benefit from the St. Joseph merger.

11 Q. Were natural gas rates changed in the Company's last general rate case?

12 A. No. The Company only filed to increase electric rates for its MPS division in  
13 Case No. ER-2001-672. No rate change has occurred for MPS natural gas operations since  
14 1993, the last time Aquila filed for a rate increase for those operations in Case  
15 No. GR-93-172. Thus, no merger savings have been realized by MPS natural gas customers.

16 Rates have not changed for the former SJLP, now L&P electric system, since 1999 in  
17 Case Nos. ER-99-247 and EC-98-573, when the parties entered into a Stipulation And  
18 Agreement to decrease rates and the Commission approved. SJLP also filed steam and gas  
19 rate increase cases, Case Nos. HR-99-245 and GR-99-246, in 1999. Those cases settled with  
20 a small decrease in steam rates and no change in gas rates.

21 Q. Will merger savings continue to be created?

22 A. Yes. To the extent that Aquila continues to integrate the two systems  
23 together, savings will be created. Any merger savings beyond those already created will be

1 retained by Aquila for the benefit of its shareholders until such time as rates are changed  
2 again.

3 **THE REJECTION OF AQUILA'S MERGER SAVINGS PROPOSAL WILL NOT**  
4 **AFFECT MERGERS BEING COMPLETED IN MISSOURI AND ACT AS A**  
5 **DISINCENTIVE TO FUTURE MERGERS**

6 Q. At page 18, line 11 of his direct testimony, Mr. Siemek states that if  
7 "shareholders do not retain some portion of merger savings, companies will be less likely to  
8 pursue mergers that could ultimately benefit customers by lowering their costs." Does Staff  
9 agree with this concern of Aquila?

10 A. No. Mr. Siemek further addresses this point at page 3, line 20 of his direct  
11 testimony wherein he states "sharing in the savings created by the merger provides an  
12 incentive for companies to create such savings for customers by encouraging future  
13 mergers." Utilities have been proposing mergers for many years, and have continued to do  
14 so even if the Commission has never adopted direct recovery of merger costs and premiums  
15 or the indirect recovery of merger costs and premiums through the adoption of a merger  
16 saving sharing proposal.

17 Q. Will the rejection of the merger savings sharing proposal result in mergers and  
18 acquisitions not being proposed and effectuated in Missouri and actually create disincentives  
19 for utilities to acquire other utilities in Missouri?

20 A. No, that does not appear to be the case at all in Missouri. The experience in  
21 Missouri appears to be that if the utility considering an acquisition believes that it is in its  
22 economic as well as its business interest, it will acquire the other company regardless of any  
23 approval of any merger savings sharing proposal or direct recovery of an acquisition  
24 adjustment from ratepayers. There have been numerous mergers and acquisitions that have

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1 occurred over the years that were negotiated with merger premiums. No utility to date has  
2 received recovery in rates in Missouri of a sharing of merger savings such as the mechanism  
3 that Aquila is proposing in this case or a direct recovery of a merger premium through an  
4 acquisition adjustment, but that has not stopped mergers from being proposed or any of the  
5 mergers from being completed.

6 Utilities have combined with other utilities in Missouri independent of receiving  
7 recovery of the merger premium directly from customers. There have been numerous mergers  
8 announced and completed, all with the knowledge that this Commission has never adopted a  
9 merger savings proposal like the one contemplated by Aquila in this case. Nor has the  
10 Commission ever included a merger premium in rates.

11 Q. Did the merger between St. Joseph merger result in an acquisition adjustment?

12 A. Yes. Aquila will have to record on its books, for a period of 40 years, the  
13 acquisition adjustment that results from the merger premium paid to SJLP shareholders.

14 Q. What was the actual merger premium that Aquila incurred for the acquisition  
15 of SJLP?

16 A. The actual total value of the acquisition adjustment is approximately \$117  
17 million (Data Request No. 518 in Case No. ER-2004-0034). This amount compares to the  
18 \$92.8 million amount estimated at the time of the merger application filed in Case No.  
19 EM-2000-292, referenced in Aquila's witness Siemek's direct testimony, Schedule VJS-2 in  
20 Case No. EM-2000-292 and \$108.7 million in Case No. ER-2001-672 (Data Request No. 381  
21 in Case No. ER-2001-672).

22 Q. What is an acquisition adjustment?



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1           A.     An acquisition adjustment results when utility property is purchased or acquired  
2 for an amount either in excess of or below net book value. Net book value relates to the value  
3 placed on utility property and recorded on the Company's books and records at the time the  
4 utility property is first placed in public service, adjusted for depreciation and amortization. This  
5 assessment of value is commonly referred to as the property's "original cost." The acquisition  
6 adjustment is made up of two components, the merger premium and the transaction costs. The  
7 transaction costs are pre-merger costs to close or complete the merger.

8           Q.     What is "original cost?"

9           A.     The term "original cost," as defined by the Gas Plant Instruction Section of the  
10 FERC Uniform System of Accounts (USOA), relates to:

11                     All amounts included in the accounts for gas plant acquired as an  
12                     operating unit or system, except as otherwise provided in the texts of the  
13                     intangible plant accounts, shall be stated at the cost incurred by the  
14                     person who first devoted the property to utility service. (Paragraph  
15                     20,042 of USOA).

16           Depreciation and amortization of the utility property from the previous owner must be  
17 deducted from the original cost, which results in a net original cost figure to be recorded on the  
18 purchaser's books and records. The acquired property is valued at the same value the seller  
19 placed on it, hence the concept of "original cost when first devoted to public service," adjusted  
20 for depreciation and amortization.

21           Q.     Is use of net original cost for valuing rate base still the predominant form of  
22 regulation?

23           A.     Yes. In the state of Missouri, the use of original cost less depreciation and  
24 amortization, i.e., net original cost, to set rates is not only the predominant form of  
25 regulation, but to my knowledge, the only form that has been employed by this Commission.

26           Q.     How does an acquisition adjustment result from a utility merger or acquisition?

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1           A.     Utility property is recorded on the company's books and records at net original  
2 cost. A utility must account for any difference between the acquisition cost or purchase price of  
3 property and the net original cost; i.e., the amount paid to the original owner (the seller) for  
4 utility property being first placed into service and the recorded net original cost amount. This  
5 *difference in purchase price is recorded in USOA Account 114, Gas Plant Acquisition*  
6 *Adjustments.* The amortization of the acquisition adjustment is made to Account 406,  
7 *Amortization of Gas Plant Acquisition Adjustments,* if authorization is granted to include the  
8 adjustment in cost of service for ratemaking purposes (above-the-line treatment). If no  
9 authorization is given to include an amortization for ratemaking purposes (i.e., below-the-line  
10 treatment occurs), then Account No. 425, *Miscellaneous Amortization,* must be used.

11           The USOA description of Account 114 states:

12                         A. This account shall include the difference between (a) the cost to the  
13                         accounting utility of gas plant acquired as an operating unit or system by  
14                         purchase, merger, consolidation, liquidation, or otherwise, and (b) the  
15                         original cost, estimated, if not known, of such property, less the amount  
16                         or amounts credited by the accounting utility at the time of acquisition to  
17                         accumulated provisions for depreciation, depletion, and amortization and  
18                         contributions in aid of construction with respect to such property.  
19

20   .....  
21

22                         C. Debit amounts recorded in this account related to plant and land  
23                         acquisition may be amortized to account 425, *Miscellaneous*  
24                         *Amortization,* over a period not longer than the estimated remaining life  
25                         of the properties to which such amounts relate. Amounts related to the  
26                         acquisition of land only may be amortized to account 425 over a period  
27                         of not more than 15 years. Should a utility wish to account for debit  
28                         amounts in this account in any other manner, it shall petition the  
29                         Commission for authority to do so. Credit amounts recorded in this  
30                         account shall be accounted for as directed by the Commission.  
31

32           The USOA description of Account 406 states:

33                         This account shall be debited or credited, as the case may be, with  
34                         amounts includible in operating expenses, pursuant to approval or order  
35

1 of the Commission, for the purpose of providing for the extinguishment  
2 of the amount in account 114, Gas Plant Acquisition Adjustments.  
3

4 The USOA description of Account 425 states:  
5

6 This account shall include amortization charges not includible in other  
7 accounts which are properly deductible in determining the income of the  
8 utility before interest charges. Charges includible herein, if significant in  
9 amount, must be in accordance with an orderly and systematic  
10 amortization program.  
11

12 ITEMS  
13

14 1. Amortization of utility plant acquisition adjustments, or of intangibles  
15 included in utility plant in service when not authorized to be included in  
16 utility operating expenses by the Commission.  
17

18 2. Other miscellaneous amortization charges allowed to be included in  
19 this account by the Commission.

20 Q. Was there an acquisition adjustment relating to the Kansas City Power &  
21 Light Company (KPL) (subsequently known as Western Resources) merger with acquisition  
22 of Kansas Gas & Electric Company (KGE) in Case No. EM-91-213?

23 A. Yes. Western Resources paid an amount for KGE in 1992 which exceeded its  
24 net book value, resulting in an acquisition adjustment identified at the time of the filing in  
25 that case of approximately \$388.7 million, representing approximately a 60 percent merger  
26 premium.

27 Q. Did the Commission ever include any amount of the KGE acquisition  
28 adjustment in rates?

29 A. No. No amount of the KGE acquisition adjustment was ever recovered in  
30 rates from Missouri ratepayers even though some of the merger savings related to KPL's  
31 Missouri natural gas operations. While the Commission authorized KPL to acquire KGE in  
32 Case No. EM-91-213, it did not allow recovery of the acquisition adjustment from KPL's  
33 customers. The Commission also did not adopt a merger savings "tracking" proposal

1 presented by KPL that KPL claimed would have identified, verified and quantified purported  
2 merger savings and shared those savings equally between shareholders and customers. No  
3 part of the KGE acquisition adjustment was ever recovered by KPL from Missouri  
4 customers.

5 Q. Was Staff opposed to the recovery in rates of the acquisition adjustment  
6 relating to the Kansas City Power & Light Company (KCPL) and Western Resources merger  
7 in Case No. EM-97-515?

8 A. Yes. Western Resources initially sought recovery of the acquisition  
9 adjustment in rates in both Missouri and Kansas through an "incentive regulatory plan." To  
10 the extent Western Resources attempted to recover from Missouri customers the acquisition  
11 adjustment resulting from the proposed KCPL merger, Staff took the position that should be  
12 considered a detriment from the proposed merger.

13 Q. Did Western Resources later agree not to include the acquisition adjustment in  
14 rates?

15 A. Yes. In Case No. EM-97-515, Western Resources and KCPL agreed that the  
16 acquisition adjustment would not be recovered in rates. The Stipulation And Agreement in  
17 that case stated the following regarding the recovery of the merger premium:

18 **2. MERGER PREMIUM**

19 The amount of any asserted merger premium (*i.e.*, the amount of the  
20 purchase price above net book value) paid by Western Resources for  
21 KCPL shall be treated below the line for ratemaking purposes in  
22 Missouri and not recovered in rates. The Joint Applicants, including  
23 Westar, shall not seek to recover the amount of any asserted acquisition  
24 premium resulting from this transaction in rates in any Missouri  
25 proceeding and the Joint Application shall be considered as amended in  
26 this regard. The Joint Applicants have currently estimated this amount  
27 as approximately \$870 million. In addition, Westar shall not seek to  
28 recover in Missouri the amount of any asserted acquisition premium in

1           this transaction as being a “stranded cost” regardless of the terms of any  
2           legislation permitting the recovery of stranded costs from ratepayers.

3           [Stipulation And Agreement in Case No. EM-97-515; emphasis added]

4           Q.     Did the Commission approve the Stipulation And Agreement for the KCPL  
5 merger with Western Resources?

6           A.     Yes. On September 2, 1999, the Commission approved the merger along with  
7 the Stipulation and Agreement that contained the “no acquisition adjustment recovery”  
8 language.

9           Q.     Has there been a more recent merger case involving other utilities where the  
10 merging utilities have agreed to merge without recovery of an acquisition adjustment?

11          A.     Recently, April 20, 2000, in Case No. GM-2000-312, the Commission  
12 approved the Stipulation And Agreement requesting the acquisition of the natural gas assets  
13 located in Missouri of Associated Natural Gas Company (Associated), wholly owned by  
14 Arkansas Western Gas Company (Arkansas Western), by Atmos Energy Corporation  
15 (Atmos). Atmos agreed not to seek recovery of the acquisition adjustment from Missouri  
16 customers. Previously, Arkansas Western’s acquisition of Associated was approved by the  
17 Commission in Case No. GM-88-100 on May 13, 1988, at a premium but without recovery  
18 of the acquisition adjustment, and Arkansas Western recently sold the property to Atmos for  
19 a premium. The language in the recent Atmos acquisition – Arkansas Western Stipulation  
20 and Agreement, is almost identical to the language in the Western Resources-KCPL  
21 Stipulation and Agreement. The Unanimous Stipulation and Agreement states, as follows:

22                   **3.     Acquisition Premium**

23                   The amount of any asserted acquisition premium (i.e., the amount of the  
24 total purchase price above net book value), including transaction costs,  
25 paid by Atmos for ANG [Associated Natural Gas] properties or incurred  
26 as a result of the acquisition **shall be treated below the line for**  
27

1           **ratemaking purposes in Missouri and not recovered in rates.** Atmos  
2           shall not seek either direct or indirect rate recovery or recognition of the  
3           acquisition premium, including any and all transaction costs (e.g., legal  
4           fees, consulting fees and accounting fees), in any future ratemaking  
5           proceeding in Missouri. However, Atmos reserves the right to present  
6           evidence regarding any purported Sale-related savings in any rate  
7           complaint proceeding initiated by Staff or Public Counsel. [emphasis  
8           added]

9           Q.     Have other utilities committed to not seek recovery of acquisition premiums in  
10           rates related to property acquired in Missouri?

11           A.     Yes. In an application of Union Electric to merge with CIPSCO filed on  
12           November 7, 1995, Union Electric entered into a Stipulation and Agreement that contained  
13           language that it would not seek recovery of a purported merger premium. The Commission on  
14           February 21, 1997, approved the merger, along with the Stipulation and Agreement. As part of  
15           the Stipulation and Agreement was the language that "UE shall not seek to recover the amount  
16           of any asserted merger premium in rates in any Missouri proceeding. UE has identified this  
17           amount as \$232 million." In addition, alleged merger benefits were discussed in the Stipulation  
18           and Agreement:

19                     UE shall retain the right to state, in future proceedings, alleged benefits  
20                     of the merger but UE **commits to forego any additional specific**  
21                     **adjustments to cost of service related to the merger savings or any**  
22                     **claim to merger savings** other than the adjustments to cost of service  
23                     and claims to merger savings resulting from the Commission's approval  
24                     of this document or the benefits and savings which would occur through  
25                     regular ratemaking treatment or the current Experimental Alternative  
26                     Regulation Plan ("ARP") or the new Experimental Alternative  
27                     Regulation Plan ("the New Plan") effective July 1, 1998 pursuant to this  
28                     document. [emphasis added]

29           In the application to acquire Arkansas Power & Light's (APL's) Missouri properties,  
30           Union Electric also agreed to not seek recovery of the acquisition premium. The parties to this  
31           Joint Application, designated as Case No. EM-91-29, signed a Stipulation and Agreement on

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1 January 25, 1991. As part of the Stipulation and Agreement, Union Electric agreed not to seek  
2 recovery of the acquisition premium in any rate case in the future:

3           The amount of any acquisition premium (i.e., the amount of the purchase  
4           price above net book value) paid by UE to APL for the electric properties  
5           of APL shall be treated below the line for ratemaking purposes in  
6           Missouri and shall not be sought to be recovered by UE in rates in any  
7           Missouri proceeding, and the Joint Application should be considered as  
8           amended in this regard.

9           The Staff performed an earnings audit in Case No. EM-91-29, and in Case No. EO-87-175,  
10           concurrent with the Stipulation And Agreement in Case No. EM-91-29, Union Electric agreed  
11           to absorb a \$30 million decrease in revenue requirement allocated to the Small General Service,  
12           Large General Service and Primary Service customer classes. Re: Union Electric Co., Case  
13           Nos. EM-91-29, et al., Report and Order, 1 Mo.P.S.C. 3d 96, 108 (1991) and Re: Union Electric  
14           Co., Case No. EO-87-175, Report and Order, 30 Mo.P.S.C.(N.S.) 406, 410 (1990).

15           Also, Southern Union, parent of Missouri Gas Energy, agreed in 1993 to not recover  
16           the acquisition premium relating to its purchase of the Missouri properties of Western  
17           Resources. On August 5, 1993, Western Resources and Southern Union filed an application  
18           with the Commission seeking authority from the Commission to make this purchase  
19           transaction in Case No. GM-94-40. The Stipulation and Agreement states as follows:

20           The amount of any acquisition premium (i.e., the amount of the purchase  
21           price above net book value) paid by Southern Union to Western  
22           Resources for the gas properties of Western Resources shall be treated  
23           below the line for ratemaking purposes in Missouri and neither  
24           amortization nor inclusion of the premium in rate base shall be sought to  
25           be recovered by Southern Union in rates in any Missouri proceeding.

26           The Commission approved the Stipulation And Agreement on December 29, 1993.

27           In a case involving the Missouri-American Water Company (Case No. WR-95-205),  
28           the Commission did not allow recovery of the acquisition adjustment from Missouri-  
29           American's customers. The Commission stated in its Report and Order that "[t]he

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1 Commission finds in this case that the Company has failed to justify an allowance for the  
2 acquisition adjustment.” Re: Missouri-American Water Company, Case Nos. WR-95-205  
3 and SR-95-206, Report and Order, 4 Mo.P.S.C. 3d 205, 217 (1995).

4 Utilities operating in this State know the position taken by various usual parties  
5 relating to merger sharing proposals and the recovery of merger premiums/acquisition  
6 adjustments in rates, and the Commission’s consistent position of not allowing rate recovery  
7 of such proposals. Yet, despite no utility having been permitted to date either indirect  
8 recovery through a merger savings sharing proposal or direct recovery of a merger  
9 premium/acquisition adjustment in rates, mergers continue to be pursued and consummated  
10 respecting public utilities operating in Missouri.

11 Staff does not believe the Commission’s prior decisions on the subject of merger  
12 savings sharing proposals or acquisition adjustments articulated in the above cases in any  
13 way served to “discourage companies from actions which produce economies of scale and  
14 savings which can benefit ratepayers and shareholders alike.” Re: Missouri-American Water  
15 Company, 4 Mo.P.S.C.3d at 216.

16 Q. Are there other cases decided by the Commission where a utility presented  
17 evidence of savings as result of an acquisition, and attempted to justify special rate treatment  
18 of the alleged merger savings?

19 A. Yes. In the Missouri Gas Energy (MGE) 1996 rate increase case,  
20 (Case No. GR-96-285), the Commission rejected a proposal by MGE to allow MGE to retain  
21 purported savings from Southern Union’s acquisition of the Missouri properties of Western  
22 Resources in 1994. As part of the Stipulation And Agreement in Case No. GM-94-40, MGE  
23 could present to the Commission in its rate case purported evidence of savings resulting from



1 the acquisition. The Commission's Report and Order in Case No. GR-96-285 states in part  
2 as follows:

3 MGE contends that the stipulation and agreement allows MGE to  
4 request recovery of the benefits resulting from the acquisition. MGE  
5 contends that an equal sharing of these ongoing savings between  
6 customers and shareholders is a reasonable ratemaking approach and is  
7 consistent with the terms of the stipulation and agreement.

8 . . . .

9  
10 ...Staff recommends that the Commission reject MGE's proposal  
11 because it does not represent appropriate or proper ratemaking policy  
12 because the alleged savings are not adequately quantified by MGE; the  
13 proposal is not fair and equitable; utilities other than MGE have also  
14 downsized without expecting any sharing of related savings; the  
15 alleged cost reductions benefited MGE at least up until any rate  
16 changes resulting from this proceeding; the proposal represents the  
17 equivalent of an incentive plan without any safeguards; the proposal  
18 shifts risks of MGE's cutbacks and related cost reductions to its  
19 customers; the proposal represents an attempted recovery of the  
20 acquisition premium from Case No. GM-94-40; and the proposal  
21 would take MGE off of cost of service ratemaking (cost-based rates).  
22 (Ex. 72, pp. 4-5) The Staff further argues that adoption of MGE's  
23 proposal would reward the Company for providing a lower quality of  
24 service while at the same time requesting ratepayers to pay higher than  
25 cost-based rates.

26  
27 *The Commission finds that MGE's **acquisition savings adjustment***  
28 **should be rejected** in total because adoption of this adjustment would  
29 be contrary to the provision of natural gas service based on the costs of  
30 providing such service and because MGE's experimental gas cost  
31 incentive mechanism already rewards MGE's shareholders for making  
32 financially sound gas procurement decisions.

33  
34 [Re: Missouri Gas Energy, Case No. GR-96-285, Report and Order,  
35 4 Mo.P.S.C. 3d 437, 460-461 (1997)]

36  
37 The Commission decided a merger savings sharing proposal in an even more recent  
38 case involving St. Louis County Water Company. This water company does business in the  
39 state of Missouri as Missouri-American Water Company (Missouri-American). On May 3,  
40 2001, the Commission issued a Report And Order rejecting a proposal to share purported

1 merger savings between customers and shareholders in Case No. WR-2000-844. This  
2 proposal by Missouri-American was exactly the same proposal that Aquila is advocating in  
3 this case.

4 Missouri-American sought to share merger savings it believed came about through a  
5 merger respecting American Water Works' (AWK) acquisition of National Enterprises  
6 (NEI), the former parent company of Missouri-American. The Commission stated at pages  
7 20 and 21 of its Report and Order in the Conclusion of Law section:

8 Regulation is intended to be a substitute for competition. In a  
9 competitive market, a company that achieves gains in efficiencies only  
10 gets to keep the benefit of those gains until its competitors implement  
11 similar efficiencies, and the company is forced to lower its prices to  
12 remain competitive. A regulated company does not get to keep the  
13 benefit of its efficiency gains indefinitely either. If the gains are large  
14 enough and not offset by increased costs elsewhere in its operations, a  
15 utility will get to keep the gains only until a complaint is brought and  
16 resolved. If the gains are offset by increased costs, the utility will only  
17 get to keep them until a rate increase case is filed and resolved. Gains  
18 in efficiency are "captured" in a rate case, and forward-looking rates  
19 are set taking the gains into account.

20  
21 This last situation is the one in which the Company finds itself: it  
22 claims it has achieved gains in efficiency from the merger of NEI and  
23 AWK, but nonetheless has found it necessary to request an increase in  
24 rates. The Company asks to be allowed to share (i.e., keep 50 percent)  
25 of the savings it asserts it has achieved from the AWK/NEI merger.  
26 The Commission, in keeping with regulation's role of simulating  
27 competition, will not approve the shared savings plan.

28  
29 The Company argues that adopting a policy of allowing utilities to  
30 retain some of the savings they achieve will encourage them to pursue  
31 mergers and acquisitions. **The Commission rejects this argument**  
32 **for two reasons.** First, the utility industry, including water utilities,  
33 seems to be pursuing mergers and acquisitions quite willingly without  
34 this Commission approving shared savings plans. In fact, **the**  
35 **Commission has never approved a sharing plan.** Second, the  
36 Commission does not need to allow utilities to keep these benefits to  
37 create an incentive to achieve efficiencies (either through successful  
38 mergers and acquisitions or otherwise); **the lag inherent in the**  
39 **regulatory process provides sufficient incentive.**

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[Case No. WR-2000-844; emphasis added]

Q. Would providing Aquila direct recovery of the acquisition adjustment relating to the St. Joseph merger be fair to all the other utilities which have agreed to not seek in Missouri direct recovery of merger premiums or which have had their merger premium recovery proposals rejected by the Commission?

A. No. Aquila is not unique in the sense that it desires to have customers of L&P and MPS subsidize its acquisition strategies. If a utility can get someone other than shareholders to pay for its merger and acquisition activity, it is likely that merger and acquisition activity (number of merger and acquisition transactions) will increase and prices paid will escalate. In prior cases, the utility, whether it was Union Electric seeking recovery of its asserted merger premium "paid" to CIPSCO shareholders or Western Resources paying KCPL's shareholders a substantial premium to merge, all took the position that the merger savings justified the recovery of the acquisition premium from their customers. As indicated above, either through Commission order, or stipulation and agreement among the parties, none of the utilities received direct recovery of the merger premium and no merger savings sharing proposals were adopted. Aquila's proposal to retain merger-related savings in this case, over and above those already recovered by the Company, would be unfair and unreasonable to all other utilities, which appropriately have had to find other means to "pay" for their growth strategies besides requiring their customers to pay for those activities.

There has been no showing that the St. Joseph merger was necessary other than from the perspective of the shareholders of the companies being "purchased" and the understandable desire to "cash-in" on the opportunity to sell their shares of stock to the highest bidder, Aquila. Customers may or may not ever directly benefit from this merger in

1 the long term, and if there are merger benefits, they may never all be identified and  
2 quantified as all of the merger costs may never all be identified and quantified.

3 The St. Joseph merger benefited the shareholders of that company. Aquila wanted to  
4 acquire SJLP to supplement and promote their "midwest-continent" strategy. SJLP fit into  
5 the growth and acquisition strategy that Aquila aggressively pursued for almost two decades.  
6 Just as the Staff has consistently, in MPS rate cases, raised concerns about MPS customers  
7 subsidizing Aquila's national and international merger growth and acquisition strategies, it  
8 would be unreasonable and inappropriate for the customers of L&P and MPS to provide the  
9 incentive to any future merger plans of the Company by "funding" those mergers through  
10 costs that no longer exist to be imputed in rates as shared merger savings beyond savings  
11 Aquila has already recovered.

12 **MERGER TRACKING**

13 Q. Did Aquila develop a tracking mechanism to identify merger costs and  
14 savings benefits relating to the St. Joseph merger?

15 A. No. While the Company identified costs associated from the merger, it made  
16 no attempt to develop a cost savings and benefits tracking system.

17 Q. Have there been events that have occurred at the Company that have resulted  
18 in cost savings?

19 A. Yes. Since the St. Joseph merger closed on December 31, 2000, Aquila has  
20 experienced several events that have dramatically affected both cost increases and decreases.  
21 In addition, to the merger with SJLP, Aquila announced in November 2001 a restructuring or  
22 reorganization of its regulated utility operations from a centralized organization based on

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1 lines of business such as generation, transmission and distribution to a state-based  
2 organization.

3       Aquila, in 2002, experienced substantial corporate losses from its non-regulated  
4 operations, resulting in significant impacts to corporate earnings causing the Company to get  
5 out of its energy trading business as well as the selling of the majority of its non-regulated  
6 companies. This corporate financial restructuring has resulted in tremendous cuts in the  
7 work force of the Company, primarily in non-regulated operations, but also in corporate  
8 downsizing in general. Aquila announced in 2002 that it intended to exit the trading business  
9 and return to its regulated utility businesses.

10       The Company announced in spring 2002 the cut back of approximately 600  
11 employees, mostly from Aquila's regulated side of the business. This was the result of the  
12 reductions from the state-based reorganization and also from the corporate financial  
13 restructuring. This restructuring continues at present.

14       Q. Do the reductions that Aquila has experienced from the state-based  
15 reorganization and the corporate financial restructuring have anything to do with the  
16 St. Joseph merger?

17       A. Certainly the corporate financial restructuring has nothing to do with the  
18 St. Joseph merger. As indicated, the adverse affect on earnings resulting from the failure of  
19 non-regulated operations caused the decision to return Aquila to regulated utility roots. The  
20 St. Joseph merger may have had some effect on the downsizing from the reorganization to  
21 state-based operations, but much of the reductions in costs related to Aquila's other  
22 previously owned regulated utility operations.

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1 Q. How do the cost reductions from these corporate events affect the merger  
2 savings sharing proposal?

3 A. Regardless of the reasons for costs savings, Aquila and its shareholders have  
4 enjoyed the benefits from these reductions from the time they were made. The Company will  
5 continue to reap the rewards of these reductions until rates are changed as a result of this  
6 case, July 2004. Respecting the state-based reorganization, Aquila will have had the benefit  
7 of any cost reductions from late 2001 to July 2004, over two years. Relating to the St. Joseph  
8 merger, Aquila has enjoyed the benefit of cost reductions from the time reductions took place  
9 until rates change in July 2004. In some instances, Aquila will have these benefits for over  
10 three years.

11 Q. Has Aquila taken into consideration any of the cost savings it experienced  
12 from the corporate events including the merger in its merger savings sharing proposal?

13 A. No. Aquila has not attempted to reflect any of these known reductions in  
14 costs in its proposal to share merger savings. The cost savings from the 600 employee  
15 reductions have benefited the shareholders from the time of the cutbacks but Aquila has not  
16 reflected any of these savings in its merger savings sharing proposal.

17 Q. Did Aquila and SJLP propose to track merger savings in Case  
18 No. EM-2000-292?

19 A. Yes. In the context of that case, Aquila and SJLP, the Joint Applicants,  
20 proposed a regulatory plan that would have allowed the post-merger Aquila to recover the  
21 merger premium through retention of merger and non-merger related savings and through an  
22 amortization of the acquisition adjustment in a rate case for L&P after a five-year rate  
23 moratorium for L&P. Under Aquila's regulatory plan proposal in the merger case, Aquila and

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1 SJLP proposed to “track” all savings, regardless of whether they were merger-related or non-  
2 merger related.

3 Q. What is meant by “tracking” of merger savings?

4 A. “Tracking” of merger savings is the post-merger process for which it is asserted  
5 that the results of specific actions due to the merger are isolated, identified, verified and  
6 quantified. The theory is that the purported results of what would have occurred but for the  
7 merger can be and are isolated, identified, verified and quantified and compared to what has  
8 actually occurred in the aftermath of the St. Joseph merger to determine the merger savings and  
9 the amount of those savings. Tracking is the phenomenon by which post-merger costs, as a  
10 result of the St. Joseph merger, are compared with pre-merger stand-alone costs and what it is  
11 assumed those costs would be if the merger had not occurred.

12 Q. Can merger savings be “tracked”; i.e., isolated, identified, quantified and  
13 verified after-the-fact?

14 A. Tracking merger savings is extremely difficult and, in actuality, it is probably  
15 not possible. It certainly is not practical to track merger savings.

16 Q. Are you saying that it is difficult to prove and verify the actual savings that result  
17 from acquisitions and mergers?

18 A. Yes.

19 Q. Why is that so?

20 A. The difficulty in isolating, identifying, verifying and quantifying merger savings,  
21 and merger costs, relates in part to the difficulty in distinguishing between merger and non-  
22 merger events and in part to attempting to identify and quantify what would have occurred had  
23 there not been a merger. Disputes will occur and will have to be resolved by the Commission.

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1 It is difficult to find agreement among the various parties as to what constitutes actual merger  
2 savings and, probably to a lesser extent, merger costs. Certainly, KPL, under its proposal in the  
3 KPL/KGE merger case, Case No. EM-91-213, to share all merger savings on a 50/50 basis, had  
4 real incentives to identify and quantify as much savings as being merger-related as possible,  
5 while ignoring merger costs. The practical effect of KPL's proposal was that the more merger  
6 savings and the less merger costs it identified and quantified, the more dollars it was entitled to  
7 recover by means of the merger premium.

8 Utilities are complex organizations with overlapping activities and functional areas.  
9 They are dynamic organizations that operate in ever-changing environments. They are  
10 constantly organizing and reorganizing functions within their corporate structure to streamline  
11 operations and obtain efficiencies where possible. Various terms have been used to characterize  
12 utility restructuring or reorganizing, such as downsizing, realigning, re-engineering and right-  
13 sizing. Most utilities attempt to achieve efficiencies through the implementation of new  
14 technologies and other productivity gains. In this environment, it is unrealistic to believe that a  
15 tracking system can be put in place to isolate, identify, quantify and verify merger and non-  
16 merger savings. It is very difficult to determine and measure the "cause and effect" relationship  
17 that may exist between taking an action and identifying and measuring the effects of that action  
18 versus not taking an action and identifying and measuring the effects of the nonaction.

19 Any cost savings tracking system would have to be sophisticated so that not only are  
20 necessary and appropriate categories of savings and costs established, but the necessary and  
21 appropriate documentation is established to permit an after-the-fact analysis of the decision-  
22 making and the costs and savings. Disagreements and disputes are certain in the context of an  
23 after-the-fact analysis. While one party may assert that an efficiency is the result of a merger,



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1 another may view it as nothing more than a non-merger related operating efficiency, addressing  
2 a pre-existing condition and an on-going concern that would have been addressed independent  
3 of the merger. Disputes will arise because, among other reasons, there is an incentive for the  
4 utility to identify as much of the savings as merger-related as possible and to capture as much of  
5 the savings as possible for shareholders. There will be an incentive for the utility to identify as  
6 merger-related as many workforce reductions and other cost reductions as possible. This  
7 inherent incentive will make it increasingly difficult to truly identify and quantify merger  
8 savings on a going-forward basis because it will become less possible to objectively evaluate  
9 what would have happened if the merger had not occurred. Needing to justify the inclusion of  
10 "imputed" merger savings in rates, utilities will make every effort to take credit for savings that  
11 may be nothing more than savings it would have realized absent the merger. Moreover, as the  
12 post-merger time increases, the more difficult it will be to isolate, identify, quantify and verify  
13 stand-alone versus merger costs and savings.

14 Q. Can merger savings be tracked?

15 A. Realistically, it is probably impossible to accurately "track" merger savings  
16 because it requires a comparison of cost structures of the entities being merged on a pre-merger  
17 and post-merger basis. If this process is not impossible, it certainly is not practical to accurately  
18 identify merger savings. This tracking process would be extremely difficult at best and to my  
19 knowledge has never been done successfully before. The merged entities lose their identity  
20 post-merger, almost from the first day after the close of the merger. In fact, SJLP lost its pre-  
21 merger corporate identity the day the merger was announced to the public on March 5, 1999.  
22 The pre-merger SJLP entity has not existed since.

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1           Upon the announcement of a merger, the merging companies' stock prices are  
2 immediately affected. On March 4, 1999, the day before the St. Joseph merger announcement  
3 and the date the UtiliCorp-St. Joseph merger agreement was completed, the common stock price  
4 of SJLP was \$16.875 per share. On March 5, 1999, the day of the St. Joseph merger  
5 announcement, SJLP's stock price increased to \$20.375 per share. On March 4, 1999, there  
6 were over 3,000 shares traded and on March 5, 1999, there were over 173,000 shares traded.

7           Every decision made by the merging companies after the merger is agreed to and  
8 announced is affected. Spending levels, human resources decisions, construction projects, etc.  
9 are all impacted. Every corporate decision is subject to the terms and conditions of the merger  
10 agreement; consequently, the corporate entity as it existed prior to the announcement of the  
11 merger no longer exists. While the period during the merger approval process generally results  
12 in significant changes at the entity being acquired entity, certainly after the completion of the  
13 merger, the acquired entity ceases to exist in every sense. To compare an ever-changing pre-  
14 merger stand-alone entity to an ever-changing post-merger announcement being acquired,  
15 presents more than a challenge; it is an incredible task that, to the Staff's knowledge, never has  
16 been truly achieved before.

17           Q.     Why is tracking impracticable?

18           A.     The reasons that "tracking" typically is not used to identify merger costs savings  
19 are:

- 20           • There is difficulty in establishing a proper baseline and in distinguishing  
21 merger and non-merger related impacts on earnings.
- 22
- 23           • Human intervention is required to determine subjectively how future  
24 events and transactions are isolated, identified, verified and quantified.
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- 26           • Tracking has not been successfully done in Missouri.
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- Aquila never developed a detailed merger savings tracking mechanism.
- St. Joseph and Aquila 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 and achieve non-merger savings.
- The sophistication of Aquila's accounting system has not provided assurances that a merger tracking system could be successfully developed.
- Any attempt to track merger savings will be complicated by a prior history of difficulties respecting Aquila providing timely and accurate information and the lack of cooperation from Aquila in prior cases.
- Any attempt to track merger savings will be complicated by any future merger and acquisition activity of Aquila, or its current divesture of previous acquisitions and disposition of other assets.
- Any attempt to track merger savings will be complicated by future reorganizing, restructuring and re-engineering changes that every company experiences.

Q. Is Staff aware of any utility using a "tracking" system to identify merger savings to set rates?

A. No. To the best of Staff's knowledge this has never been accomplished in any jurisdiction.

Q. Has Staff addressed the ability to track merger savings and non-merger savings in prior merger cases?

A. Yes. In all of the major merger applications filed with the Commission, merger savings tracking has been examined. As has been previously noted in the merger between KPL and KGE, Case No. EM-91-213, tracking of savings was a contested issue. Also, tracking was addressed in the Union Electric merger with CIPSCO, Case No. EM-96-149, and the KCPL merger with Western Resources, Case No. EM-97-515. Tracking was addressed in both of

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1 Aquila's merger cases for the St. Joseph merger, Case No. EM-2000-292 and the Empire  
2 merger, Case No. EM-200-369. In all five merger cases, the difficulty to track merger savings  
3 was addressed.

4 Q. Did KPL request recovery of merger savings in Case No. EM-91-213, when it  
5 proposed to merge with KGE?

6 A. Yes. KPL expected to recover the acquisition premium in rates through a  
7 merger savings sharing proposal. In that case, KPL believed there would be sufficient merger  
8 savings that could be used to allow recovery of the acquisition adjustment.

9 KPL proposed, in that case, a unique approach to "share" merger-related savings. The  
10 proposal was intended to allow KPL a partial or a full recovery of the acquisition premium  
11 adjustment.

12 Although KPL never specifically stated that the sharing proposal would allow recovery  
13 of the acquisition premium, this in essence is what would have happened if such a proposal had  
14 been implemented. The only reason that KPL put forth such a proposal was for regulatory  
15 purposes; i.e., to make positive adjustments to test year results in future rate cases. Thus, the  
16 merger savings sharing proposal was nothing more than a ratemaking vehicle to set rates at  
17 higher levels than the actual costs incurred by KPL.

18 Q. Did KPL directly request any recovery of the acquisition adjustment from its  
19 Missouri ratepayers?

20 A. No. KPL stated that its proposed future treatment of merger costs and benefits  
21 was based on a number of considerations, including "the jurisdiction's prior treatment of both  
22 negative and positive acquisition adjustments." KPL was indicating that the reason that it  
23 was not directly proposing to recover the acquisition adjustment in Missouri was because of

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1 the Commission's decision not to recognize a negative acquisition in KPL's purchase of the  
2 Gas Service Company in 1983.

3 Q. Did the Commission adopt KPL's proposal to recover the acquisition premium  
4 through the sharing of the merger savings?

5 A. No. Although the Commission in its Report and Order in Case No. EM-91-213  
6 initially stated its interest in the merger savings sharing concept, no part of the cost savings  
7 tracking system (CSTS) was ever implemented. The Commission stated in its Report and Order  
8 as follows:

9 . . . the Commission will not approve at this time the savings  
10 sharing proposal. Staff has persuasively argued that KPL has a  
11 strong incentive to view savings as merger-related even if they are not  
12 and to classify them in the CSTS so as to increase the pool of savings  
13 subject to the sharing plan. **Staff demonstrated several flaws in the**  
14 **CSTS which could allow nonmerger savings to seep into the pool**  
15 **of savings to be shared.**

16  
17 **The Commission is not opposed to the concept of the savings**  
18 **sharing plan provided that only merger-related savings are**  
19 **shared.** The Commission does not wish to discourage companies  
20 from actions which produce economies of scale and savings which can  
21 benefit ratepayers and shareholders alike. However, **the Commission**  
22 **wishes to ensure that savings which would have been offset against**  
23 **the cost of service without the merger, benefit ratepayers one**  
24 **hundred percent. To avoid any detriment to ratepayers it is**  
25 **imperative that only savings which would not have occurred**  
26 **absent the merger be shared by ratepayers with shareholders.**

27  
28 [Re Kansas Power & Light Co., Case No. EM-91-213, Report and Order,  
29 1 Mo.P.S.C.3d 150, 156-57 (1991); emphasis added.]

30 Q. Was the cost savings tracking system ever implemented by KPL?

31 A. No. The Commission, in its Report and Order in Case No. EM-91-213,  
32 directed "the parties to meet for the purpose of attempting to devise a method for tracking  
33 merger-related savings." 1 Mo.P.S.C.3d at 157. The parties met but no agreement could be  
34 reached to assure the Commission that non-merger-related savings would be excluded from the

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1 cost savings tracking system. The Commission issued a follow-up Order Adopting Staff's  
2 Suggestion And Closing Docket on December 13, 1991, which placed this issue in KPL's next  
3 rate case. This Order stated in part as follows:

4 Based upon these pleadings, the Commission determines that Staff's  
5 suggestion should be adopted, to forego consideration of this issue in  
6 this docket. If KPL wishes to have the possibility of receiving a share  
7 of the merger savings it may use a system it considers appropriate for  
8 excluding nonmerger savings from the pool of savings which might be  
9 shared and present that approach to the Commission in its next rate  
10 case complete with the amounts to be shared. At that time the  
11 Commission will consider whether the device employed by KPL is  
12 sufficiently foolproof to permit sharing of merger savings with  
13 shareholders.

14 Q. Did KPL address the merits of using the cost savings tracking system to identify  
15 merger savings in its next rate case?

16 A. Yes. KPL's next Missouri rate case was Case No. GR-93-240. By that time,  
17 KPL had taken the name Western Resources, Inc. In that case, Western Resources' Controller,  
18 Jerry D. Courington, indicated that Western Resources discontinued the use of the cost savings  
19 tracking system because of "the level of effort necessary to measure the savings and maintain  
20 the tracking system was relatively high when compared to the expected level of merger related  
21 savings in the jurisdictions in which it would be used." (Courington direct testimony,  
22 pages 14-15). Mr. Courington recognized in his direct testimony that merger costs and savings  
23 netted each other out with the Missouri allocated costs being "virtually unaffected in total by the  
24 merger." (Courington direct testimony, page 15). Western Resources made no adjustments in  
25 its rate case to reflect in rates any recovery of the acquisition premium associated with the KGE  
26 merger.

27 Q. Is it difficult to "track" merger savings for the post-merger Aquila?

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1           A.     Yes.  Aquila had a very aggressive growth strategy through mergers and  
2 acquisitions.  Because of its recent financial difficulties, Aquila is now engaged in a divesture of  
3 many of its properties, i.e., disposition of much of its non-United States and non-public utility  
4 assets it acquired during its high growth period.  The constant changes resulting from acquiring  
5 new properties, and now the disposition of those properties, makes it even more difficult to  
6 isolate, identify, verify and quantify the actual merger savings from any one transaction.

7           Q.     Did the Commission specifically address the need to distinguish merger savings  
8 between merger and non-merger in the KPL Order?

9           A.     Yes.  The Commission in the September 24, 1991 Report and Order approving  
10 the KPL and KGE merger, clearly set out the "standard" that merger savings had to be  
11 separated from non-merger related savings.  During the St. Joseph merger case, Aquila  
12 indicated this separation was not necessary.  In a transcribed interview conducted in Case  
13 No. EM-2000-292, held on March 2, 2000, with Staff and Public Counsel, Aquila witness  
14 Siemek related that:

15                     the distinction between merger synergies and other synergies, or other  
16                     costs, is not very important, other than that hurdle rate [of \$1.577 in  
17                     years six through ten.]...in our case, it doesn't make any difference as  
18                     long as...[we make] that hurdle rate.  And even that makes no  
19                     difference, because we've already committed to having that  
20                     guaranteed reduction in the revenue requirement.

21                       
22                     [Source: Siemek Transcript- pages 82-83]

23           The "hurdle rate" Mr. Siemek was referring to meant that Aquila did not need to distinguish  
24 between merger synergies and other synergies as long as the minimum savings were achieved.  
25 Based on this discussion, Staff never believed that Aquila had any intention of attempting to  
26 track merger savings separately from non-merger savings.  This is the very basis that forms the  
27 assessment as to the success or failure of the merger itself from a regulatory point of view, in

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1 particular if the company is requesting ratemaking treatment of retention of merger savings  
2 through a sharing mechanism.

3 Q. Why did the Commission want to ensure merger savings were separated from  
4 non-merger savings?

5 A. When KPL was unable to devise a "tracking" system which would separate  
6 the merger savings from the non-merger savings, the Commission issued its December 13,  
7 1991 Order indicating that the savings sharing proposal would be rejected. The  
8 Commission's reason for requiring this separation is that it wanted to ensure that all the non-  
9 merger related savings experienced by KPL would be flowed to customers in rates. The  
10 Order stated "the Commission wishes to ensure that savings which would have been offset  
11 against the cost of service without the merger, benefit ratepayers one hundred percent."

12 The Commission made it very clear in the KPL/KGE merger Report and Order that  
13 savings had to be identified between merger and non-merger related savings as a condition of  
14 the initial approval of the savings tracking proposal presented by KPL in that merger request.  
15 KPL was unable to demonstrate the ability to track costs; i.e., isolate, identify, verify and  
16 quantify savings between merger and non-merger related. Because of its inability to  
17 distinguish between the types of savings, the tracking proposal presented by KPL was  
18 rejected.

19 Q. Are merger and non-merger related savings different?

20 A. Yes. While they are both "savings," they are two very different types of  
21 savings. Merger related savings are those savings that can only occur as a result of the  
22 combining of the entities that were previously operating as separate and distinct from one  
23 another. Once the combination of the entities occurs there will be savings that will exist over



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1 time from the elimination of duplication and economies of scale that are effectuated or occur  
2 through system and process improvements throughout the organization. An example of  
3 elimination of duplication would be the position of corporate president. There is a need for  
4 only one president of the company. One of the two prior positions can be, and is, eliminated  
5 once the merger takes place. System improvements may result in the combining of activities  
6 such as the consolidation of customer call centers. Instead of operating two separate call  
7 centers because both pre-merger companies had the need to operate their own call centers,  
8 the merger can result in savings from the elimination of one of the call centers that is no  
9 longer needed. Process improvements would be the automation of certain functions such as  
10 in the areas of purchasing, accounting or human resource functions that may enable savings  
11 to occur as the direct result of the merger.

12 Non-merger related savings are those savings that occur over time as a result of  
13 improvements in technology and efficiencies achieved by experience and a better-trained and  
14 skilled work force. An example would be savings from reorganizations and re-engineering  
15 that occur periodically such as the recently implemented state based reorganization of  
16 Aquila's regulated operations or any cost reductions occurring as result of the Company's  
17 corporate financial restructuring. These types of savings also result from negotiating  
18 improved contract terms such as those relating to fuel supply, building leases and health and  
19 medical benefits. Reductions in cost of capital and tax rates, which occurred with the Tax  
20 Reform Act of 1986, can result in savings that having nothing to do with merger and  
21 acquisition activities. System and process improvements can take place absent a merger and  
22 result in non-merger related savings. Non-merger related savings result on an on-going basis  
23 and can occur as labor becomes more efficient and productive.

1           These two types of savings are viewed differently and are generally afforded different  
2 treatment in merger applications. Non-merger related savings are considered as occurring  
3 regardless of the merger. There is a widely accepted view that customers are entitled to these  
4 savings. An example would be the \$17 million rate reduction for Aquila's MPS division in  
5 1997 (Case No. ER-97-394). Another example of reflecting non-merger related savings  
6 through a reduction in rates is the \$15 million rate decrease passed on to KCPL's customers  
7 in 1999 (Case No. ER-99-313). In both of these cases, the companies experienced cost  
8 reductions and revenue growth over a period of time, not related to mergers. The  
9 shareholders of both companies enjoyed the benefits of these cost reductions through  
10 regulatory lag, until the rates were changed.

11           Q.     Did these companies voluntarily reduce rates?

12           A.     In the case of KCPL, it did. Staff performed an earnings audit of KCPL and  
13 the parties, KCPL, OPC and Staff, reached an agreement on the dollar amount of the  
14 reduction. In the case of Aquila's MPS divisions' rates, Staff had to file an excess revenues  
15 complaint case to reduce the MPS rates. After Staff filed its complaint case, designated as  
16 Case No. EC-97-362, Aquila filed a rate increase case designated as Case No. ER-97-394,  
17 which sought a \$25 million increase to MPS's electric rates. Staff's initial complaint case  
18 was dismissed but Staff subsequently filed another excess revenues complaint case against  
19 MPS, Case No. EC-98-126, which was consolidated with Case No. ER-97-394. The  
20 Commission ultimately reduced MPS's electric rates by \$17 million in its Report and Order  
21 dated March 6, 1998. The filing of the rate increase case by Aquila is a commonly used  
22 strategy by utilities to counter an excess revenue complaint case and keep overearning for as  
23 long as possible.

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1           The Staff started reviewing Aquila's rates, MPS division, in the spring of 1996 as part  
2 of its examination of the merger application filed by Aquila and KCPL as Case No.  
3 EM-96-248. After the merger between KCPL and Aquila failed, Staff continued its review  
4 of Aquila's rates and filed a complaint case on March 3, 1997 to reduce rates by \$23 million  
5 designated as Case No. EC-97-362. From the time Staff started its review of the electric  
6 rates of MPS to the date the rate reduction was implemented, March 6, 1998, it took two  
7 years.

8           SJLP employed the exact same approach in Staff's 1998 excess revenues complaint  
9 case, Case No. EC-98-573. SJLP filed a rate increase case docketed as Case No. ER-99-247.  
10 These two cases ultimately resulted in a \$2.5 million rate reduction by Stipulation And  
11 Agreement in 1999. Once a utility increases rates, it generally resists any attempt to reduce  
12 rates, regardless of reductions in costs or revenue growth that may have occurred since the  
13 last rate rebasing.

14           Q.    Has the Commission had concerns that indicated the importance of  
15 maintaining a distinction between merger-related events and non-merger-related events?

16           A.    Yes. In the KPL merger with KGE (Case No. EM-91-213), the Commission  
17 wanted to be certain that no merger-related costs would be passed to customers. The  
18 Commission stated the following relating to the segregation of merger and non-merger costs:

19                   The Commission has also found that there is the potential for a  
20 detrimental effect on Missouri ratepayers from the merger through  
21 increased A&G and capital costs. Therefore, the Commission, in order  
22 to shield Missouri ratepayers from such detriment, has made it clear to  
23 KPL that such costs will be carefully scrutinized in any future,  
24 postmerger rate case to assure that no such detriment is suffered by  
25 Missouri ratepayers.

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27                   [Commission Report and Order in Case No. EM-91-213, 1 Mo.P.S.C.3d at  
28 159]

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The Commission will direct its Staff to carefully audit KPL in future rate cases to screen out costs caused by the merger and to suggest methods, if necessary in future rate cases, such as those recommended herein, which might be used to shield Missouri ratepayers from costs arising from the merger.

The Commission will also direct KPL to keep its books so that costs associated with the merger are clearly segregated. Abnormal increases in A&G expenses will be carefully scrutinized and, unless persuasively explained as not related to the merger, will be associated with the merger.

[Commission Report and Order in Case No. EM-91-213, 1 Mo.P.S.C.3d at 157]

In addition, from prior Commission decisions respecting its rate cases, Aquila is aware of the importance that the Commission has given to the distinction between merger and non-merger related activities. In Aquila's 1990 rate case, Case No. ER-90-101, involving its MPS division, the Commission issued its Report and Order stating the importance of segregating Aquila's merger and acquisition costs so those costs would be excluded from rates.

These Aquila merger and acquisition activities have been examined in each of Aquila's rate increase cases and Staff's excess revenues complaint cases, and were specifically identified as an issue in Case No. ER-90-101 where the Commission found as follows:

*The evidence indicates that the Company has removed from its A&G costs most of the known expenses associated with M&A activities. The Commission believes that UtiliCorp's expenses for M&A activities should be removed from the expenses reflected in MPS' rates. When UtiliCorp was formed, Company assured the Commission that the ratepayers would suffer no detriment from UtiliCorp's activities but would experience the benefits associated with UtiliCorp's activities. The Commission believes that it is inconsistent with this pledge to include M&A costs in the expenses reflected in MPS' rates. The Commission is of the opinion that it is inappropriate for MPS' ratepayers to pay for these activities which have little to do with MPS' goal of providing safe and adequate electric service in Missouri. Therefore, the Commission finds that the \$70,280 of additional costs for M&A activities should be excluded from the cost*

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1 of service. Finally, the Commission is concerned that Company has  
2 not been accounting for these costs separately. Accordingly, the  
3 Commission will direct Company to account for M&A costs  
4 separately so that they can be readily excluded in future rate cases  
5 from A&G costs reflected in MPS' rates.  
6

7 [Commission Report and Order in Case No. ER-90-101, 30 Mo.P.S.C. (N.S.) 320,  
8 350-351; emphasis added]

9 In addition, in Aquila's 1997 rate case (Case Nos. ER-97-394, ET-98-103 and  
10 EC-98-126) the Commission adopted the Staff's adjustments to assign costs to Aquila's three  
11 major non-regulated activities of mergers and acquisitions, international operations and new  
12 product development. The March 6, 1998 Report and Order states that "the Commission  
13 finds substantial evidence supports the position of the Staff. The Commission finds the  
14 proposed adjustment to be reasonable in light of the poor timekeeping and inadequate records  
15 offered by UtiliCorp." Re: Missouri Public Service, Case No. ER-97-394, et al., Report and  
16 Order, 7 Mo.P.S.C.3d 178, 209 (1998). In this Report and Order, the Commission affirmed  
17 its prior decision to exclude from rates costs relating to the merger and acquisition strategy of  
18 Aquila.

19 Q. Does Staff believe that Aquila's accounting is able to "track" merger savings?

20 A. No. Aquila's accounting system, just like any other bookkeeping system is  
21 able to categorize costs, and identify those costs to specific accounts when the system  
22 identifies through a "coding" process where those costs should go. This same process is  
23 expected by Aquila to be used to "track" merger savings. The accounting system still will  
24 require individuals to isolate, identify, verify and quantify the savings, and separate those  
25 savings between merger and non-merger related events. Aquila personnel will have to be  
26 able to determine what the pre-merger SJLP operations were, if they are to compare these  
27 costs to the costs of the post-merger L&P operations. Those individuals making the "coding"

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1 decisions will have to make judgments and decisions about, among other things, assumptions  
2 and costs respecting how the merger affected the post-merger L&P operations. During an  
3 interview on March 1, 2000, in Case No. EM-2000-292, Mr. Jerry Myers, then UtiliCorp's  
4 Director of Corporate Accounting and Reporting, indicated that coding would have to be  
5 completed by individuals to enter into the accounting system. [Transcript, pages 19-26].  
6 While Aquila and SJLP did not explained in detail how they intended to implement tracking  
7 procedures, it was apparent that Aquila was not going to distinguish between merger savings  
8 and non-merger savings to the level that was envisioned in the KPL/KGE cost savings  
9 tracking system.

10 Q. What is the significance of individuals making the coding decisions to the  
11 accounting system?

12 A. These decisions are made in an after-the-fact fashion about a company that no  
13 longer exists. The many judgments needed to identify and verify the existence of merger-  
14 related savings would undoubtedly cause much disagreement and dispute. Individuals are  
15 making the determinations as the information is entered into the accounting system.  
16 Unfortunately, the review process that takes place so that merger costs, and ultimately,  
17 merger savings, can be "carefully scrutinized," as required by the Commission in the  
18 KPL/KGE merger, takes place well after the decisions are made, i.e., coded, and information  
19 is entered into the accounting system.

1 **CUSTOMERS ARE ENTITLED TO SAVINGS GENERATED BY UTILITIES FOR**  
2 **EITHER MERGER OR NONMERGER EVENTS**

3 Q. Are utility customers entitled to cost savings that occur as a result of mergers  
4 or non-merger events?

5 A. Yes. Historically, customers have enjoyed the benefits of cost reductions, as  
6 well as declines in rate base and growth in revenues. As utilities experience productivity  
7 gains through technology improvements and downsizing of their work forces, cost increases  
8 have been kept in check or mitigated. Through restructuring, reorganizations and re-  
9 engineering programs, utilities have been experiencing cost decreases (or, at least, cost  
10 increases have been moderated, allowing for revenue gains to outpace them) through  
11 improvement in methods and processes which have occurred over time. This is not to say  
12 that decreasing costs are not also the result of developments other than efficiencies, such as  
13 decreasing interest rates and declining inflation rates.

14 Q. Why are customers entitled to benefits from cost savings?

15 A. Through the regulatory process, utilities generally benefit most immediately  
16 from cost reductions and growth in revenues. When significant cost reductions take place over  
17 time, public utility commission staffs or offices of public counsel may perform revenue reviews  
18 to determine the need for possible rate reductions. There are various factors that may warrant  
19 reductions in rates:

- 20 1. Reduction in capital costs is one of the most significant  
21 causes for declining revenue requirements.
- 22 2. Early retirement programs and cost efficiencies have resulted  
23 in steady reductions in employee levels.
- 24 3. Renegotiations and aggressive negotiation of fuel supply  
25 contracts and railroad freight rates have resulted in a steady  
26 decline in actual fuel costs which has contributed  
27 significantly to cost savings.

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1           4.     With reduction in construction programs from the levels of  
2                     the 1970's and 1980's, utilities have experienced declining  
3                     rate base, and thereby decreasing revenue requirements.

4           5.     Shifting allocations involving multi-state utilities can, and  
5                     do, cause declining jurisdictional costs and rate bases when  
6                     growth occurs in other jurisdictions as a result of: (a) adding  
7                     new customers, (b) usage increases and (c) adding service as  
8                     a result of mergers and acquisitions.

9           6.     Reductions in corporate income taxes have had a significant  
10                    impact resulting in declining utility costs.

11           All of these factors can have a substantial impact on costs, causing the need to review  
12           rates periodically.

13           As previously noted, to the extent that merger-related savings occur, these are  
14           typically retained by the utility until a rate case. Through regulatory lag, the utility's  
15           shareholders reap all the benefits of costs reductions, either from the merger or through other  
16           non-merger-related means, until the new cost structure is reflected in rates. Customers  
17           normally wait a period of time before they experience any savings from reorganizations,  
18           restructuring, re-engineering, down-sizing or mergers and acquisitions.

19           Q.     Has Staff included merger related savings in the present case?

20           A.     Yes. The allocations used to assign corporate overhead costs reflect the  
21           inclusion of L & P.

22           Q.     If Staff has considered the impacts of the merger savings in this case, does this  
23           mean Aquila has been able to successfully track merger costs and savings?

24           A.     No. The discussion on merger tracking and the need for such a mechanism  
25           relates to the ability to separate the merger costs and savings from the "normal" non-merger  
26           activities of the Company. As indicated above, the Commission has viewed this as essential



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1 in the past in considering the sharing of merger savings between the customers and  
2 shareholders.

3 Because two cost elements have been identified does not mean the Company has  
4 done a meaningful job of providing sufficient detail to the level expected in segregating the  
5 related merger costs and savings from non-merger events such as the state based  
6 reorganization.

7 The savings resulting from the corporate allocations is an example of savings that  
8 were expected as result of the St. Joseph merger. There were other aspects to the merger that  
9 have not been identified or "tracked" to enable the parties to judge the success of the  
10 St. Joseph merger. Those merger costs and savings have not been segregated out from the  
11 rest of the Aquila operations as required in the previous merger savings sharing proposals.

12 Q. Has Aquila benefited from the savings relating to the corporate allocations?

13 A. Yes. As noted above in my rebuttal testimony, Aquila has enjoyed the  
14 benefits immediately upon completion of the St. Joseph merger in the area of corporate  
15 allocations. When the St. Joseph merger was complete, the factors used to allocate costs to  
16 the divisions of Aquila changed by virtue of SJLP being incorporated into the allocation mix.  
17 Less corporate costs were allocated to MPS simply because the allocator changed with the  
18 inclusion of SJLP.

19 Q. If the Company has created the savings, then why isn't it appropriate to allow  
20 Aquila to "keep" the savings?

21 A. The Company has been allowed to "keep" the savings from the time the  
22 savings occurred until new rates in this case will take place in July 2004. At some point, it is

1 reasonable for customers to benefit from any cost reductions from a merger or from cost  
2 reductions achieved in the normal course of business operations.

3 **SUMMARY AND CONCLUSIONS FOR THE MERGER SAVINGS SHARING**  
4 **PROPOSAL**

5 Q. Please summarize your conclusions relating to Aquila's proposed recovery of  
6 the acquisition adjustment resulting from the St. Joseph merger.

7 A. Aquila chose when to file this case to adjust MPS and L&P natural gas rates.  
8 As a result of its belief that it needed to file this rate case, Aquila developed its merger  
9 savings sharing approach to retain a substantial portion of the merger savings it believes may  
10 have been generated to date from the St. Joseph merger. This proposal by Aquila deviates  
11 from cost-based rates by not reflecting MPS's and L&P's actual cost of service in rates. By  
12 making adjustments in its natural gas case to increase expenses over actual levels, the  
13 Company is not reflecting one-half of the cost savings that may have resulted from the  
14 merger to date. These imputed expenses increase the cost of service of MPS and L&P from  
15 the allocations of corporate costs. Aquila's merger savings sharing proposal deviates from  
16 the standard practice of developing rates based on actual costs.

17 Aquila's shareholders have enjoyed the benefits of the merger since the merger was  
18 closed on December 31, 2000 and will continue to reap those benefits until the present rates are  
19 changed by the Commission—currently this is not expected before July 2004 in this case. Thus,  
20 Aquila will have received full benefit from the merger for three and one-half years. Neither the  
21 customers of MPS nor the customers of L&P have received any savings benefits from the  
22 merger.

Rebuttal Testimony of  
Cary G. Featherstone

1           If Aquila's proposal to retain merger savings through the imputation of cost savings over  
2 actual costs is approved, this will set a precedent for future mergers and rate cases. Adopting a  
3 merger savings sharing mechanism could result in even greater pressure in the future for the  
4 extraction of even greater merger premiums than have been negotiated previously. If utilities  
5 successfully propose that their customers subsidize growth through mergers and acquisitions,  
6 then it can be expected that more and more mergers will take place at greater and greater risk to  
7 customers.

8           Q.     Does this conclude your rebuttal testimony?

9           A.     Yes, it does.

## MERGERS AND ACQUISITIONS BACKGROUND

### UtiliCorp United Inc. Merger with Empire District Electric Company-- Case No. EM-2000-369

I filed rebuttal testimony on the proposed merger between Empire and Aquila, then called UtiliCorp. On December 15, 1999 Aquila, with Empire, filed an application requesting approval of a merger of Aquila with Empire. The Commission approved this merger on December 28, 2000 in Case No. EM-2000-369, but Aquila chose not to complete the merger.

### Kansas City Power & Light Company Merger with Western Resources, Inc.— Case No. EM-97-515

I was project coordinator for Staff's review of Kansas City Power & Light Company's (KCPL) proposed merger with Western Resources, Inc. (Western Resources). On May 30, 1997, KCPL and Western Resources filed their initial application with the Commission requesting approval of a merger between KCPL and Western Resources. This application was designated as Case No. EM-97-515. A Stipulation and Agreement was filed with the Commission on July 20, 1999 and on September 2, 1999, the Commission issued an Order Approving the Stipulation and Agreement. The merger between KCPL and Western Resources ultimately was not completed.

### Union Electric Company Merger with CIPSCO, Inc.—Case No. EM-96-149

Staff witnesses Mark L. Oligschlaeger, Charles R. Hyneman and I, among others, were involved in the Staff review of the proposed merger between Union Electric Company (UE) and CIPSCO Inc. (CIPSCO). This merger was announced in August 1995 and was not completed until December 31, 1997. On November 7, 1995, UE filed an application with the Commission requesting authority to merge, designated as Case No. EM-96-149. The

Commission conditionally approved this merger in a Report And Order issued on February 21, 1997.

**Kansas City Power & Light Company Merger with Kansas Gas & Electric Company—  
Case No. EM-91-16**

Along with other members of the Staff, I was involved in the review of the hostile tender offer to Kansas Gas & Electric Company (KGE) shareholders made by KCPL. On July 16, 1990, KCPL filed an application with this Commission to acquire and merge with KGE, which was docketed as Case No. EM-91-16. After KGE signed a merger agreement with Western Resources, known at the time as Kansas Power & Light Company (KPL), KCPL withdrew its tender offer on December 13, 1990.

**Kansas Power & Light Company Merger with Kansas Gas & Electric Company—  
Case No. EM-91-213**

I was also involved in the review of KPL's merger with and acquisition of KGE. On November 21, 1990, KPL filed an application with this Commission docketed as Case No. EM-91-213, requesting authority to acquire all classes of capital stock of KGE, merge with KGE, and issue stock and incur debt obligations relating thereto. That application was a result of a definitive Agreement and Plan of Merger dated October 28, 1990, which was executed by the two companies. The Commission authorized the KPL merger with KGE in a Report And Order dated September 24, 1991. The State Corporation Commission of the State of Kansas (Kansas Commission or KCC), in Consolidated Docket Nos. 172,745-U and 174,155-U, approved that same merger on November 15, 1991. After receiving the necessary regulatory approvals, KPL completed the merger with KGE on March 31, 1992.

**Southern Union Company Acquisition of Missouri Properties of Western Resources, Inc., d/b/a Gas Service—Case No. GM-94-40**

I was also involved in the Staff's review of the Joint Application filed with the Commission on August 5, 1993 for the authorization to sell, transfer and assign certain assets relating to the provision of natural gas service in Missouri from Western Resources, d/b/a KPL Gas Service to Southern Union Company (Southern Union). This case was docketed as Case No. EM-94-40. The Joint Application was a result of an Agreement for Purchase of Assets dated July 9, 1993, which was executed by the two companies. The Commission approved this purchase transaction on December 29, 1993. Southern Union continues to operate this natural gas distribution system in the western part of Missouri as Missouri Gas Energy (MGE).

I was one of the witnesses who addressed a proposal made by MGE in its 1996 rate case (Case No. GR-96-285) to share in purported savings relating to the acquisition.

Q. What other experience do you have regarding mergers and acquisitions?

A. I was involved in discussions with other Staff members who were reviewing the Union Electric acquisition of Arkansas Power & Light Company's (APL) Missouri properties, docketed as Case No. EM-91-29. This application was filed on August 2, 1990 and was approved in a Report And Order issued on September 19, 1991.

I have been involved in several other merger and acquisition applications filed with the Commission. Included among these applications was the application of United Cities Gas Company (United Cities) to acquire Monarch Gas Company, docketed as Case No. GM-96-180. This application was filed on November 29, 1995 and was approved by the Commission on March 22, 1996.

I presented testimony in Case No. GR-90-152 on the proper ratemaking treatment of the acquisition adjustment resulting from the acquisition of Associated Natural Gas Company by Arkansas Western Gas Company.

Also, I have been involved in examining the effects of the acquisition and merger activities of Aquila's Missouri Public Service (MPS) division. Specifically, I was involved in the supervision of an audit of in Case No. GR-88-194, wherein the Staff examined Aquila's Corporate Office function, particularly the effects on cost of service of that utility's acquisition and merger strategy, in the context of a natural gas rate increase case.

In addition, I was the principal Staff witness on the Corporate Office costs issue in Aquila's 1990 electric rate increase case, Case No. ER-90-101 respecting the MPS division's electric operations.

I have reviewed several other applications filed with the Commission relating to acquisitions of utility property. Most of those other cases involved Aquila, including the acquisition of Peoples Natural Gas Company from InterNorth that was approved by the Commission in 1985 in Case No. EF-86-73, and the acquisition of the electric properties of Centel by Aquila in the early 1990s.

**BACKGROUND OF THE ST. JOSEPH LIGHT & POWER COMPANY MERGER**  
**WITH AQUILA, INC.**

Q. What was the history of St. Joseph prior to its merger with Aquila?

A. According to St. Joseph's 1998 Annual Report to Shareholders, St. Joseph "has been in the public utility business since 1883. It became an independent, investor-owned business in 1950." It was incorporated in the state of Missouri in 1895.

St. Joseph's corporate headquarters were located in St. Joseph, Missouri. It was an independent investor-owned electric utility that was engaged in the generation, purchase, transmission, distribution and sale of electricity to over 62,000 electric customers in 74 cities, towns and villages, and in a large rural area encompassing 3,200 square miles in northwest Missouri. In 1999 electric revenues represented about 70% of its total revenues. St. Joseph also supplied natural gas service to approximately 6,400 customers in Maryville and 14 other communities, and provided industrial steam service to six customers in St. Joseph, Missouri.

Q. When did Aquila and St. Joseph file their application to merge?

A. On October 19, 1999, Aquila filed an application with the Commission requesting approval of a merger between Aquila and St. Joseph pursuant to the "Agreement and Plan of Merger" (Merger Agreement) dated March 4, 1999. Under terms of this Merger Agreement, St. Joseph merged with and into Aquila, then called UtiliCorp. The merger was publicly announced on March 5, 1999.

Q. Did this Commission approve the merger between Aquila and St. Joseph?

A. Yes. On December 14, 2000, the Commission approved the merger in Case No. EM-2000-292. All other regulatory approvals were received by Aquila and St. Joseph, and the merger was completed by December 31, 2000.



Q. How did Aquila approach St. Joseph to bring about this merger proposal?

A. Aquila submitted a proposal to merge with St. Joseph in a bidding process to acquire all the common stock of SJLP. This bidding process was initiated by St. Joseph through its financial advisor, Morgan Stanley Dean Witter (Morgan Stanley) in late 1998.

Q. What was the purchase price offered by Aquila for St. Joseph?

A. Under the terms of the merger agreement, Aquila proposed to pay St. Joseph shareholders a fixed value of \$23.00 of its common stock for each share of St. Joseph's common stock. According to the direct testimony (page 6) filed in Case No. EM-2000-292 by Aquila witness Robert K. Green, President and Chief Operating Officer, the total value of the merger transaction was to be \$270 million, of which \$190 million relates to the purchase of approximately 8.2 million shares of St. Joseph's common stock and the assumption of an expected \$80 million in liabilities. That estimate represented a \$92 million or approximately 36 percent merger premium to the book value of St. Joseph. The Aquila common stock was to be based on the average trading price for Aquila's common stock during the 20 trading days ending on the fifth trading day prior to the closing date (Proxy Statement, page 31).

Upon the completion of the merger on December 31, 2000, all the operations of St. Joseph were merged with and into the operations of, Aquila, and St. Joseph is now being operated as a division of Aquila. Aquila maintained the St. Joseph Light & Power Company name as a trade name within the existing service territory of St. Joseph. The service once provided by St. Joseph is now being provided by Aquila Networks-L&P, a division of Aquila.

Q. Did St. Joseph seek a buyer for its utility property?

A. Yes. The Proxy Statement (pages 14 through 16) identified in detail the process that the Board of Directors of St. Joseph engaged in to conduct a series of analyses relating to its future operations. Also, in the direct testimony of Mr. Terry F. Steinbecker, Chairman of the Board, President and Chief Executive Officer of St. Joseph, (Case No. EM-2000-292, direct, pages 2 through 6) there is similar detail about the merger process that St. Joseph used to determine its future corporate structure. Some of the more important events that occurred during the period of 1995 to the March 4, 1999, the date the merger agreement was executed, are as follows:

- Prior to 1995, St. Joseph's Board of Directors (Board) studied various strategies for maximizing shareholder value.
- In 1995, St. Joseph retained a consulting firm, Planmetrics, Inc., which presented to the Board an analysis in January 1996 relating to Strategic Planning of St. Joseph. This presentation was used by the Board to make decisions on St. Joseph's diversification program.
- The diversification program resulted in the acquisition of several companies by St. Joseph, including Percy Kent, who is a manufacturer of small paper bags for food, agricultural, chemical, pet food and other consumer packaging companies.
- In 1998, St. Joseph retained another consulting firm, Scott, Madden & Associates, Inc. (Scott, Madden), which issued a confidential report to the Board of Directors on Strategic Planning. Scott, Madden recommended that St. Joseph should sell the Company.
- On July 15, 1998, the Board approved the retention of Morgan Stanley as financial advisor to St. Joseph. Morgan Stanley was instructed to develop potential strategic alternatives for maximizing shareholder value, including a potential merger or strategic alliance.
- On October 14, 1998, Morgan Stanley outlined the strategic challenges facing St. Joseph and recommended that St. Joseph explore a potential business combination with a larger utility

company as the best means of maximizing long-term value for St. Joseph's shareholders.

- At the October 14 meeting, the Board instructed Morgan Stanley to contact seven companies for the purpose of obtaining expressions of interest in a potential business combination.
- Between November 27 and December 2, 1998, two of the seven potential bidders informed Morgan Stanley of their interest in receiving information about St. Joseph. During a December 4 meeting with the Board, Morgan Stanley informed the Board that a third party had indicated an expression of interest.
- Between December 16 and 18, 1998, Morgan Stanley received a preliminary expression of interest from each of three potential bidders. On December 21, Morgan Stanley discussed financial and non-financial aspects of the non-binding bids that contained preliminary proposed valuations of between \$19.70 and \$22.25 per share of SJLP common stock.
- Between January 12 and 21, 1999, the three parties that submitted non-binding bids performed due diligence reviews of St. Joseph.
- Between January 7 and February 17, 1999, St. Joseph's management conducted a due diligence review of the three interested parties.
- On February 16, 1999, St. Joseph received final binding proposals from two of the three interested parties. Aquila's proposal was a fixed value of \$22.50 per share of St. Joseph common stock. The second proposal was an all stock transaction at a value of \$21.28 per share of St. Joseph common stock, with a downward price adjustment in the event of a reduction in the bidder's share price. The third interested party had informed Morgan Stanley it did not intend to submit a final binding proposal.
- On February 19, 1999 the Board met to review and compare the two binding bids. Because Aquila had the higher and a fixed bid, the Board requested Morgan Stanley to see if Aquila would increase its offer. Morgan Stanley contacted Aquila and encouraged it to increase its bid. Aquila raised its bid to \$23.00 per share of St. Joseph common stock.

- Based upon the increase in price to \$23.00 per share and the more favorable structure of Aquila's bid, on February 22, 1999 the Board of Directors authorized management and St. Joseph's legal advisors to negotiate a definitive merger agreement with Aquila. This occurred over the next ten days.
- Sometime after February 22, 1999 and prior to March 4, Morgan Stanley contacted the financial advisor of the other bidder, which did not augment its proposal as a result of that conversation.
- On March 4, 1999 Morgan Stanley presented an opinion to St. Joseph's Board that the merger consideration was fair.
- On March 4, 1999 St. Joseph executed the merger agreement with Aquila based on unanimous approval of the Board.
- On March 5, 1999 the merger was publicly announced.

The St. Joseph Board unanimously approved the merger with Aquila, and Morgan Stanley presented its fairness opinion in accordance with the investment banking firm's responsibilities to the shareholders of St. Joseph.

Q. Did the shareholders approve the merger?

A. Yes. At a special meeting held on June 16, 1999, St. Joseph's shareholders approved the merger by greater than the necessary two-thirds approval with 68.6 percentage participation. This vote comprised a 96.3 percent approval of those shares that voted.

Q. What reasons did the Board state for recommending shareholder approval of the merger?

A. The Proxy Statement (pages 16 and 17) identified reasons the Board approved the merger. The overwhelming majority of reasons the Board approved and recommended shareholder approval dealt with St. Joseph's ownership issues. Very little mention is given to St. Joseph's customers or employees.

The reasons the Board believed the shareholders should approve the merger with Aquila are identified in the Proxy Statement as follows:

- the merger **consideration offers St. Joseph's shareholders an attractive premium** over the recent historical trading prices of St. Joseph's common stock;
- the merger **offers St. Joseph's shareholders a more liquid market** for their shares;
- as a result of the merger, **St. Joseph's shareholders will most likely benefit from UtiliCorp's dividend rate**, which then was, and in recent years had been, higher than St. Joseph's dividend rate;
- **St. Joseph's shareholders will benefit by participating in the combined economic growth of the service territories** of UtiliCorp and St. Joseph, and from the inherent increase in scale, the market diversification and the resulting increased financial stability and strength of the combined entity;
- the merger **will result in cost savings from decreased electric production and gas supply costs, a reduction in operating and maintenance expenses** and other factors;
- the combined enterprise **can more effectively participate in the increasingly competitive market** for the generation of power;
- UtiliCorp has significant non-utility operations and, as a larger and stronger financial entity following the merger, should be able to **manage and pursue further non-utility diversification activities** more efficiently and effectively than St. Joseph as a stand-alone entity; and
- the merger and various provisions of the merger agreement **offer St. Joseph's shareholders, customers and employees** and the St. Joseph community a unique **opportunity to realize the benefits** created by combining the two companies.

[emphasis added]

The reasons cited by the Board in its communication to the shareholders regarding the merger clearly illustrates that the merger was about increasing the overall wealth of St. Joseph's shareholders. The Proxy Statement and Mr. Steinbecker's direct testimony in Case No.

EM-2000-292 (pages 2 through 4), indicate that the Board made the decision to merge with Aquila based solely on "maximizing shareholder value." The payment of the merger premium to St. Joseph's shareholders and the increased dividends on an ongoing basis to former St. Joseph shareholders taking UtiliCorp stock relate directly to "maximizing shareholder value." To that end, the merger process engaged in by St. Joseph was a success. St. Joseph ensured that the interest of its shareholders was first and foremost in the merger analyses. The customers' interests were secondary in all respects.

Q. Was the basis for the SJLP merger with Aquila increasing the overall wealth of shareholders?

A. Yes. It is necessary for a proposed merger to provide opportunities to shareholders in order for management to be able to pursue the merger. If the merger cannot be presented as advantageous to shareholders, they will not vote for approval. The Proxy Statement identifies several benefits to St. Joseph's shareholders to ensure that they believe that they are being rewarded for giving up control of the company. Maximizing shareholder value is extremely important in the merger process. The board of directors has a special and unique responsibility to the shareholders and other investors of the entity to ensure that the owners of the entity are fully compensated for relinquishing their ownership interest. The payment of the merger premium to St. Joseph's shareholders is the primary benefit to them, along with any opportunity to receive an increase in dividends. Also, typically the opportunity for a smaller company like St. Joseph to access more potential shareholders by trading stock in a larger pool of investors, such as was and is the case for Aquila's stock, is considered a benefit. This allowed former St. Joseph stockholders to trade their stock in a more liquid market than was previously available to them. Other potential shareholder

benefits resulting from mergers, include the opportunity to be an owner of a larger combined company with greater potential for economic growth, the opportunity as a shareholder to “keep” the preponderance of the purported merger savings, the opportunity to participate in the increasingly competitive market for power, the opportunity to engage in non-regulated and non-utility diversification and the opportunity to realize the benefits of a larger combined company in the procurement of capital, goods and services, etc. These all relate directly to enhancing shareholder value.