

**REBUTTAL TESTIMONY**

**OF**

**RYAN KIND**

**AQUILA, INC.**

**CASE NO. ER-2004-0034**

1 **Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.**

2 A. Ryan Kind, Chief Energy Economist, Office of the Public Counsel, P.O. Box 2230,  
3 Jefferson City, Missouri 65102.

4 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL AND EMPLOYMENT BACKGROUND.**

5 A. I have a B.S.B.A. in Economics and a M.A. in Economics from the University of  
6 Missouri-Columbia (UMC). While I was a graduate student at UMC, I was employed as  
7 a Teaching Assistant with the Department of Economics, and taught classes in  
8 Introductory Economics, and Money and Banking, in which I served as a Lab Instructor  
9 for Discussion Sections.

10 My previous work experience includes three and one-half years of employment with the  
11 Missouri Division of Transportation as a Financial Analyst. My responsibilities at the  
12 Division of Transportation included preparing transportation rate proposals and testimony  
13 for rate cases involving various segments of the trucking industry. I have been employed  
14 as an economist at the Office of the Public Counsel (Public Counsel or OPC) since April  
15 1991.

16 **Q. HAVE YOU TESTIFIED PREVIOUSLY BEFORE THIS COMMISSION?**

Rebuttal Testimony of  
Ryan Kind

1 A. Yes, prior to this case I submitted written testimony in numerous gas rate cases, several  
2 electric rate design cases and rate cases, as well as other miscellaneous gas, water,  
3 electric, and telephone cases.

4 **Q. HAVE YOU PROVIDED COMMENTS OR TESTIMONY TO OTHER REGULATORY OR**  
5 **LEGISLATIVE BODIES ON THE SUBJECT OF ELECTRIC UTILITY REGULATION AND**  
6 **RESTRUCTURING?**

7 A. Yes, I have provided comments and testimony to the Federal Energy Regulatory  
8 Commission (FERC), the Missouri House of Representatives Utility Regulation  
9 Committee, the Missouri Senate's Commerce & Environment Committee and the  
10 Missouri Legislature's Joint Interim Committee on Telecommunications and Energy.

11 **Q. HAVE YOU BEEN A MEMBER OF, OR PARTICIPANT IN, ANY WORK GROUPS,**  
12 **COMMITTEES, OR OTHER GROUPS THAT HAVE ADRESSED ELECTRIC UTILITY**  
13 **REGULATION AND RESTRUCTURING ISSUES?**

14 A. Yes. I was a member of the Missouri Public Service Commission's (the Commission's)  
15 Stranded Cost Working Group and participated extensively in the Commission's Market  
16 Structure Work Group. I am currently a member of the Missouri Department of Natural  
17 Resources Weatherization Policy Advisory Committee, the National Association of State  
18 Consumer Advocates (NASUCA) Electric Committee, and both the Operating  
19 Committee and the Standards Authorization Committee of the North American Electric  
20 Reliability Council (NERC). I have served as the public consumer group representative  
21 to the Midwest ISO's (MISO's) Advisory Committee. During the early 1990s, I served as  
22 a Staff Liaison to the Energy and Transportation Task Force of the President's Council on  
23 Sustainable Development.

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**I. INTRODUCTION**

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. My testimony will address the proposal of Aquila, Inc. (Aquila or the Company) for the indirect recovery of St. Joseph Light & Power (SJLP) merger costs in its cost of service by including imaginary costs that the Company refers to as merger savings retention costs.

**Q. IS AQUILA SEEKING TO HAVE THIS COMMISSION APPROVE A REVENUE REQUIREMENT FOR RATEMAKING PURPOSES THAT EXCEEDS THE ACTUAL LEVEL OF COSTS INCURRED IN THE TEST YEAR?**

A. Yes. In his direct testimony, Aquila witness Vern Siemek states at line 21 on page 2 that his testimony is intended to “support Aquila retaining 50% of the acquisition-related savings to benefit shareholders for creating those savings.” The mechanism for “retaining savings” that the Company is proposing is for this Commission to include some level of “imaginary” or “make believe” costs in the future rates of MPS electric customers. These “retained savings” are costs that do not actually exist but the Aquila is nonetheless requesting that the Commission pretend that they are real when determining the revenue requirement in this case.

**Q. PLEASE EXPLAIN WHY PUBLIC COUNSEL BELIEVES THAT THE VAST MAJORITY OF THE SJLP MERGER COSTS, INCLUDING THE MERGER ACQUISITION PREMIUM, SHOULD BE CONSIDERED COSTS THAT WERE INCURRED TO SUPPORT AQUILA’S NON-REGULATED OPERATIONS.**

A. Public Counsel believes that Aquila’s decision to merge with SJLP was entirely driven by the Company’s expectation that the merger would benefit shareholders by providing

1 additional opportunities for non-regulated earnings. In the testimony that follows, I will  
2 show what motivated Aquila's business decisions, including the decision to merge with  
3 SJLP, and demonstrate how SJLP fit into Aquila's plans for enhancing its non-regulated  
4 earnings.

5 **Q. PLEASE OUTLINE THE MAJOR TOPICS THAT YOU COVER WHICH ARE RELATED TO**  
6 **AQUILA'S REQUEST FOR INDIRECT RECOVERY OF THE SJLP MERGER COSTS.**

7 A. My testimony focuses primarily on two major areas associated with Aquila's request for  
8 recovery of the SJLP merger costs via its merger savings retention proposal. First, this  
9 testimony examines the major factors that have motivated Aquila to acquire SJLP. These  
10 factors included the desire of Aquila's senior management and Board of Directors to  
11 enhance the value of its shareholder's investment by furthering its strategic objectives of:  
12 (1) expanding its mid-continent footprint, (2) acquiring low cost generation assets and  
13 purchase power contracts that can either be spun off and sold for a profit (monetized) or  
14 used to support Aquila's power marketing activities in the future, and (3) acquiring assets  
15 that can be used or leveraged to support telecommunications ventures.

16 Second, this testimony addresses the reasonableness of Aquila's request to recover the  
17 SJLP merger costs from ratepayers. Within this area, my testimony discusses and  
18 provides support for the following points:

- 19 • The fairly high acquisition premium that Aquila paid for the assets of SJLP was  
20 primarily due to the future non-regulated earnings potential of SJLP's generation  
21 assets due to the negative stranded costs associated with these assets.
- 22 • A large portion of the synergies that Aquila identified at the time of the merger  
23 were in the area of generation and almost any conceivable restructuring legislation  
24 in Missouri was expected to transfer the benefits from all of these synergies to

Rebuttal Testimony of  
Ryan Kind

1                   Aquila. Restructuring was still considered likely in Missouri at the time of the  
2                   merger since the California energy crisis had not yet reached its peak and because  
3                   the Enron bankruptcy had not yet occurred.

- 4                   • If generation became deregulated at the retail level (as was expected at the time of  
5                   the merger), Aquila could achieve synergies that accrued solely to the benefit of  
6                   shareholders by selling the output from SJLP's supply portfolio at market prices  
7                   that exceed its cost of production and keeping 100% of this profit margin for its  
8                   shareholders. Alternatively, Aquila could sell these assets for a price that vastly  
9                   exceeds their book value and keep 100% of the gains for its shareholders. In its  
10                  merger testimony in Case No. EM-2000-292, Aquila was silent about the prospect  
11                  for future non-regulated earnings in this area and this silence greatly understated  
12                  the non-regulated earnings potential that Aquila's management expected to result  
13                  from the SJLP merger.

- 14                  • Aquila also expected substantial non-regulated synergies from planned future  
15                  telephony and cable projects which would benefit from synergies between the  
16                  telephony assets and utility right of ways of SJLP and Aquila. In its merger  
17                  testimony, Aquila was also silent about the prospect for future non-regulated  
18                  earnings in this area and this silence also greatly understated the non-regulated  
19                  earnings potential that Aquila's management expected to result from the SJLP  
20                  merger.

21                  **Q.        SOME OF YOUR ATTACHMENTS HAVE REFERENCES TO UTILICORP UNITED, INC.**  
22                  **PLEASE EXPLAIN THE RELATIONSHIP OF AQUILA TO UTILICORP UNITED, INC.**

1 A. UtiliCorp United, Inc. is the former name of the corporation now known as Aquila, Inc.  
2 Aquila changed its name from UtiliCorp United, Inc. to Aquila subsequent to the  
3 Company's merger with SJLP.

4 **II. AQUILA'S REQUEST FOR THE INDIRECT RECOVERY OF MERGER**  
5 **COSTS.**

6 **Q. HAS AQUILA REQUESTED EITHER DIRECT OR INDIRECT RECOVERY OF ITS SJLP**  
7 **MERGER COSTS IN THIS CASE?**

8 A. Yes. The indirect recovery of the SJLP merger costs has been requested in the  
9 testimonies of Aquila witnesses Keith Stamm and Vern Siemek. The Company is seeking  
10 to indirectly recover its SJLP merger costs through its merger-related savings retention  
11 proposal. On page 2 of his testimony at line 21, Mr. Siemek states that "my testimony  
12 will also support Aquila retaining 50% of the acquisition-related savings to benefit  
13 shareholders for creating those savings." According to the figures provided in Aquila's  
14 response to OPC DR No. 525, the approval of this proposal would cause millions of  
15 dollars to be included in rates for costs that do not exist at this time.

16 **Q. WHAT HAS THE COMPANY PRESENTED AS ITS RATIONALE FOR INCLUDING NON-**  
17 **EXISTANT OR IMAGINARY COSTS IN THE RATES THAT CUSTOMERS PAY FOR ELECTRIC**  
18 **SERVICE?**

19 A. The rationale in the Company's testimony to support its recommendation for including  
20 imaginary costs in its future rates is spelled out in the following statements that Mr.  
21 Siemek made on pages 2 and 3 of his direct testimony:

22 My testimony will also support Aquila retaining 50% of the acquisition-  
23 related savings to benefit shareholders for creating those savings.

24 ...

Rebuttal Testimony of  
Ryan Kind

1 It is equitable for Aquila to retain 50% of those benefits both as an  
2 incentive for creating the savings in lieu of recovering the costs of  
3 creating the acquisition that are not now reflected in MPS or L&P costs.

4 ...

5 Sharing in the savings created by the merger provides an incentive for  
6 companies to create such savings for customers by encouraging future  
7 mergers.

8 **Q. PLEASE ADDRESS THE THIRD STATEMENT THAT YOU LISTED ABOVE. DO YOU BELIEVE**  
9 **IT IS APPROPRIATE FOR THIS COMMISSION TO PROVIDE INCENTIVES FOR MISSOURI**  
10 **UTILITIES TO MERGE WITH OTHER COMPANIES?**

11 A. Definitely not. The Commission should be neutral in this area. If a merger makes sense to  
12 a utility's management based on its overall financial and strategic objectives and on the  
13 savings that it may be able to retain through regulatory lag, then a utility should seek to  
14 consummate a merger. If a utility wants some type of extraordinary ratemaking treatment,  
15 like the merger savings retention proposal that appears in this rate case, then the utility  
16 should seek to negotiate some kind of arrangement (e.g. a temporary rate moratorium)  
17 with other parties at the time it is seeking approval of its merger.

18 **Q. WHAT DO YOU THINK MR. SIEMEK IS REFERRING TO IN THE SECOND STATEMENT**  
19 **LISTED ABOVE WHEN HE REFERS TO ALLOWING AQUILA TO RETAIN "50% OF THE**  
20 **BENEFITS [SAVINGS] ...IN LIEU OF RECOVERING THE COSTS OF CREATING THE**  
21 **ACQUISITION..."?**

22 A. Mr. Siemek appears to be making the argument that it is appropriate to permit the  
23 Company to indirectly recover the acquisition costs associated with the MPS/SJLP  
24 merger via the savings retention mechanism that Aquila has proposed in this case.

1       **Q.     DOES PUBLIC COUNSEL BELIEVE THAT IT WOULD BE APPROPRIATE FOR THE**  
2       **COMMISSION TO PERMIT THE COMPANY TO INDIRECTLY RECOVER THE ACQUISITION**  
3       **COSTS ASSOCIATED WITH THE MPS/SJLP MERGER VIA THE SAVINGS RETENTION**  
4       **MECHANISM THAT AQUILA HAS PROPOSED IN THIS CASE?**

5       A.     No. This testimony will show that the decision of Aquila’s management to acquire SJLP  
6       was based on the expectation that the non-regulated synergies (both cost reductions and  
7       revenue enhancements) resulting from the merger would provide substantial financial and  
8       strategic benefits to the Company’s management and shareholders. This expectation was  
9       the primary motive behind Aquila’s decision to merger with SJLP.

10      **Q.     GIVEN YOUR BELIEF THAT AQUILA’S DECISION TO PURSUE THE MPS/SJLP MERGER**  
11      **WAS NOT BASED ON ANY BENEFITS THAT MIGHT ACCRUE TO THE REGULATED**  
12      **PORTION OF ITS BUSINESS, HOW DO YOU EXPLAIN THE COMPANY’S EFFORTS IN THIS**  
13      **CASE TO PERSUADE THE COMMISSION TO INCLUDE AN IMMAGINARY LEVEL OF COSTS**  
14      **IN RATES FOR THE PURPOSE OF HAVING CUSTOMERS INDIRECTLY FUND THE MERGER**  
15      **ACQUISITION COSTS?**

16      A.     The Company appears to see customers as a “safety net” that will protect Aquila’s  
17      investors from the poor management decision that led to the merger. If the Company can  
18      rely on customers as a “safety net” for poor management decisions that are driven by the  
19      pursuit of non-regulated earnings opportunities, then there will be no incentive for the  
20      Company to avoid repeating its mistakes in the future.

21      **Q.     AT LINE 6 ON PAGE 14 OF HIS TESTIMONY, MR. SIEMEK STATES THAT “THE**  
22      **ACQUISITION ULTIMATELY NEEDS TO PROVIDE SHAREHOLDER BENEFITS IN ORDER TO**  
23      **BE SUCESSFUL.” WHAT QUANTITATIVE MEASURE IS COMMONLY USED TO DETERMINE**



1           **THE SUCCESS OR FAILURE OF A MERGER OR ACQUISITION FROM AN INVESTOR**  
2           **PERSPECTIVE?**

3           A.     Company's that are trying to persuade investors to be supportive of merger or acquisition  
4           proposals usually do so by asserting that financial projections show a merger to be  
5           accretive to earnings (or at least not dilutive) within a very short time period (generally  
6           one to three years). In other words, investors are expected to view a merger or  
7           acquisition as being successful if it is contributing to higher earnings per share (EPS)  
8           within a couple of years after the merger is consummated. In order for a merger or  
9           acquisition to be accretive, it needs to generate earnings that are sufficient to offset the  
10          negative impacts on earnings (including offsetting the amortized annual merger costs)  
11          resulting from the merger.

12          Of course, from the perspective of investors in the company that is being acquired, the  
13          merger is perceived to be successful once they receive the premium on the stock price of  
14          the acquired company. In the case of SJLP shareholders, those who made the mistake of  
15          retaining Aquila stock after April 2002 when it began its steep decline (from about  
16          \$25/share to about \$2.50/share) will probably never view the merger as being successful.

17          **Q.     PLEASE REFER AGAIN TO MR. SIEMEK'S STATEMENT THAT "THE ACQUISITION**  
18          **ULTIMATELY NEEDS TO PROVIDE SHAREHOLDER BENEFITS IN ORDER TO BE**  
19          **SUCCESSFUL." IS THE SUCCESS OR FAILURE (FROM AN INVESTOR PERSPECTIVE) OF**  
20          **AQUILA'S DECISION TO PURSUE THE SJLP ACQUISITION AN ISSUE IN THIS CASE?**

21          A.     No. Whether shareholders received benefits from the decision to acquire SJLP is  
22          irrelevant to the Commission's determination in this case of the proper level of costs that  
23          should be reflected in Aquila's future rates. Aquila chose to acquire SJLP based on  
24          strategic and financial considerations related to its non-regulated business. Almost all

Rebuttal Testimony of  
Ryan Kind

1 business decisions involve some level of risk. When business opportunities don't provide  
2 expected benefits, no one should be completely surprised unless it was expected to be a  
3 risk free opportunity.

4 At the time Aquila decided to pursue the MPS/SJLP merger, it had shown the investment  
5 community a track record of earnings per share (EPS) growth of 8 – 10% for a couple of  
6 years and was hoping to continue that into the future. Not many investors are foolish  
7 enough to think that they can invest in a company like Aquila that was encouraging  
8 investors to believe that it could maintain this kind of earnings growth without taking on  
9 the risk that high profits could turn into high losses.

10 Managements are successful due to the results they obtain from a series of business  
11 decisions, not a single decision. Substantial turnover in the senior management of a  
12 Company, like that which occurred at Aquila over the last couple of years, is usually an  
13 indication that management is not seen by shareholders and investors to be prudently  
14 managing the business.

15 **Q. BUT WOULDN'T AQUILA'S SHAREHOLDERS FEEL BETTER ABOUT THEIR INVESTMENT IF**  
16 **THIS COMMISSION APPROVED THE COMPANY'S PROPOSAL FOR THE INDIRECT**  
17 **RECOVERY OF MERGER ACQUISITION COSTS?**

18 A. Of course that would make investors feel better about this Company and its management,  
19 but that's not a good rationale for requiring customers to "bail out" Aquila's management  
20 for making poor business decisions. If one believes that utility regulation benefits society  
21 by acting as a surrogate for competition, then the right thing for regulation to do is to let  
22 the company "pay the price" for its poor business decision, just as competitive markets  
23 punish poor business decisions. If, instead of acting as a surrogate for competition,  
24 regulation rewards or provides "safely nets" for bad business decisions, then regulation is

1 directing society's resources towards less socially beneficial uses and failing to fulfill its  
2 role as a surrogate for competition.

3 **Q. AT LINE 17 ON PAGE 9 OF HIS TESTIMONY, AQUILA WITNESS KEITH STAMM STATES**  
4 **THAT "AQUILA'S SENIOR MANAGEMENT ACCEPTS FULL RESPONSIBILITY FOR THE**  
5 **STRATEGIC CHOICES WE MADE AND THE RESULTANT CONSEQUENCES." DO YOU**  
6 **BELIEVE THAT AQUILA'S PROPOSAL IN THIS CASE FOR THE INDIRECT RECOVERY OF**  
7 **MERGER ACQUISITION COSTS IS CONSISTENT WITH MR. STAMM'S STATEMENT THAT**  
8 **"AQUILA'S SENIOR MANAGEMENT ACCEPTS FULL RESPONSIBILITY FOR THE**  
9 **STRATEGIC CHOICES WE MADE AND THE RESULTANT CONSEQUENCES?"**

10 A. No. Rather, I see Aquila's proposal in this case for the indirect recovery of merger  
11 acquisition costs as a clear indication that Aquila's senior management has not yet  
12 accepted full responsibility for the poor strategic choices that it made and the resultant  
13 consequences. As the testimony that follows will demonstrate, Aquila's decision to  
14 acquire SJLP was made to further the Company's non-regulated financial and strategic  
15 interests. The desire to provide cost reductions to customers was not the primary reason  
16 why Aquila chose to acquire SJLP. If Aquila had truly accepted "full responsibility" for  
17 the its poor "strategic choices" then it would not be pursuing its proposal for customers to  
18 "bail out" the Company by paying imaginary costs in rates for a merger that was driven  
19 by non-regulated financial and strategic considerations.

20 **Q. AT LINE 1 ON PAGE 3 OF HIS TESTIMONY, AQUILA WITNESS STAMM STATES THAT**  
21 **"THIS REQUEST FOR RATE RELIEF STANDS ON THE MERITS OF THE NEED OF MISSOURI**  
22 **REGULATED OPERATIONS ALONE, ISOLATED AND INSULATED FROM THE IMPACTS OF**  
23 **OUR NON-REGULATED ACTIVITIES." DO YOU BELIEVE THAT AQUILA'S PROPOSAL IN**  
24 **THIS CASE FOR THE INDIRECT RECOVERY OF MERGER COSTS IS CONSISTENT WITH**

1           **MR. STAMM’S STATEMENT THAT “THIS REQUEST FOR RATE RELIEF STANDS ON THE**  
2           **MERITS OF THE NEED OF MISSOURI REGULATED OPERATIONS ALONE, ISOLATED AND**  
3           **INSULATED FROM THE IMPACTS OF OUR NON-REGULATED ACTIVITIES?”**

4           A.     No. The rate relief for the retention of merger savings that Aquila is seeking in this case  
5           stems entirely from its non-regulated activities. As the testimony that follows will show,  
6           the decision to acquire SJLP was based on the Company’s expectations that this would  
7           lead to improved financial and strategic outcomes for its non-regulated activities. Without  
8           these expectations, the merger would have never occurred. It is not possible to estimate  
9           the cost level that would currently exist at Aquila’s MPS division if the merger had not  
10          occurred since so many speculative assumptions would be involved in creating such an  
11          estimate.

12           **III. FACTORS THAT DROVE THE AQUILA/SJLP MERGER**

13           **A. INDUSTRY TRENDS**

14           **Q.     WAS THE SJLP MERGER PART OF A TREND THAT HAS BEEN TAKING PLACE IN THE**  
15           **ENERGY UTILITY INDUSTRY AT THE TIME AQUILA PROPOSED THE MERGER?**

16           A.     Yes. The American utility industry saw dozens of mergers proposed during the mid to  
17           late 1990s. The energy sector of the utility industry was a major part of this trend. Most  
18           mergers in the energy sector have been between neighboring electric utilities but some  
19           have been between energy and gas utilities and others have been between regulated  
20           utilities and gas or electric marketers.

21           **Q.     WHAT WERE THE MAJOR REASONS FOR THIS RECENT TREND?**

1 A. Utilities were changing the way they did business so they would be ready to take  
2 advantage of the major changes that were occurring in the energy utility industry.  
3 Increases in the amount of wholesale and retail competition in the utility industry led  
4 some utilities to take bold steps like mergers in order to position themselves to take  
5 advantage of expected opportunities for increased earnings in this new environment. In  
6 the new competitive environment, some utilities expected their financial success to  
7 become more dependant upon how well they performed in competitive markets and much  
8 less dependant upon the traditional regulatory process. The perception that utilities may  
9 have opportunities for increased earnings in competitive markets has, however, been less  
10 prominent since the California energy crisis and the Enron bankruptcy. Of course, these  
11 two events were largely unforeseen at the time Aquila's management decided to proceed  
12 with the SJLP merger in order to pursue earnings opportunities in areas outside the  
13 regulated utility industry.

14 **B. MOTIVATING FACTORS FOR SJLP AND AQUILA**

15 **Q. WHAT DOES PUBLIC COUNSEL BELIEVE THE PRINCIPAL FACTORS WERE THAT DROVE**  
16 **THE AQUILA/SJLP MERGER?**

17 A. This merger appears to have been driven by the following factors:

- 18 • SJLP's desire to be acquired by a larger utility so that its shareholders could  
19 receive the acquisition premium windfall that the acquiring utility is expected to  
20 pay for the privilege of taking control of the formerly independent utility's  
21 operations and assets. The SJLP management and Board of Directors recognized  
22 that even though they are a small utility with limited growth potential, an acquirer  
23 would be willing to pay a significant premium to gain control of its low cost  
24 generating assets and purchased power contracts.

Rebuttal Testimony of  
Ryan Kind

- 1                   • Aquila’s desire to further its mid-continent network strategy by increasing the size  
2                   of its distribution service territory footprint, acquiring low cost generation assets,  
3                   and acquiring telecommunications infrastructure and right of ways. This low cost  
4                   generating capacity could either be used to create a significant stream of earnings  
5                   over time, since it could be used to generate power at a cost that is well below  
6                   market prices, or the assets could be sold (monetized) over time to bring earnings  
7                   to the Aquila bottom line as needed to satisfy investor expectations for growth in  
8                   EPS.
- 9                   • Aquila’s desire to further its merchant strategy by acquiring low cost generation  
10                  assets that could be used to (1) support Aquila’s power marketing or (2) sold to  
11                  raise capital that could be used to acquire other generating assets closer to more  
12                  lucrative markets.
- 13                  • Aquila’s desire to prevent its neighboring utilities (Kansas City Power & Light,  
14                  Western Resources, Inc. and others) from expanding their mid-continent footprint  
15                  in Aquila’s backyard by acquiring SJLP or Empire.
- 16                  • Aquila’s desire to better position itself for competition in the mid-continent  
17                  region.

18                  **Q.     WHY DO YOU BELIEVE AQUILA EXPECTED THE SJLP MERGER TO BETTER POSITION**  
19                  **THE COMPANY FOR COMPETITION?**

20                  A.     The merger was expected to place Aquila in a better position for competition by:

- 21                   • Reducing the prospect of cut-throat competition in regional energy markets by  
22                   keeping low cost generation assets out of the hands of its local competitors.
- 23                   • Lowering the cost structure of Aquila and its affiliates.

- 1                   • Increasing the number of customers to which Aquila has access for selling
- 2                    electricity, natural gas, home security services, telephony, cable TV, internet, and
- 3                    other unregulated services.
  
- 4                   • Increasing the amount of market power that Aquila has in the retail merchant
- 5                    function and in retail and wholesale generation markets.

6                   **C. AQUILA’S VALUE CYCLE PHILOSOPHY**

7                   **Q.     YOU MENTIONED AQUILA’S NETWORK AND MERCHANT STRATEGIES. COULD YOU**

8                   **PLEASE EXPLAIN THOSE STRATEGIES AND HOW THEY RELATED TO THE SJLP**

9                   **MERGER?**

10                  A.     Yes. First, however, I should explain the framework in which Aquila executed its

11                  network and merchant strategies. Aquila referred to this framework as its Value Cycle

12                  Philosophy. According to this philosophy, Aquila sought to: (1) make appropriate

13                  investments, (2) optimize those investments, and (3) monetize those investments. As

14                  Attachment 1 shows, this philosophy was explained in a slide that was part of Aquila’s

15                  presentation in its 1999 Year End Conference Call with investment analysts. The

16                  purpose of this framework for executing its network and merchant strategies was the

17                  creation of value for the corporation and its shareholders.

18                  **Q.     PLEASE EXPLAIN HOW AQUILA’S VALUE CYCLE PHILOSOPHY WAS BROADER THAN**

19                  **THE MORE WIDELY RECOGNIZED UTILITY STRATEGY OF MERGING TO ACQUIRE**

20                  **ADDITIONAL SIZE AND COST ECONOMIES IN ORDER TO PREPARE FOR COMPETITION.**

21                  A.     Aquila’s Value Cycle Philosophy included this more widely recognized strategy but also

22                  considered other options for enhancing shareholder value such as disaggregating the

23                  assets/functions (e.g. generation or telecommunication assets or the retail function) of a

1 newly-acquired vertically integrated utility and either spinning them off or combining  
2 them with the assets of other Aquila affiliates.

3 **Q. DOES AQUILA'S TESTIMONY IN THIS CASE OR IN THE SJLP MERGER CASE DESCRIBE**  
4 **ITS VALUE CYCLE PHILOSOPHY AND ITS NETWORK AND MERCHANT STRATEGIES?**

5 A. No. Aquila's testimony makes no mention of its Value Cycle Philosophy in either case.  
6 The Company's direct testimony in the merger case only described limited aspects of its  
7 network and merchant strategies. Robert Green's testimony in the merger case contained  
8 a brief description of Aquila's network and merchant strategies and Steve Pella's  
9 testimony in that case discussed the cost reduction and customer care aspects of the  
10 network strategies. For a detailed discussion of these strategies and the Value Cycle  
11 Philosophy one must review the presentations that Aquila's senior executives have made  
12 to investment analysts.

13 **Q. WHY IS IT IMPORTANT TO LEARN MORE ABOUT AQUILA'S VALUE CYCLE PHILOSOPHY**  
14 **AND NETWORK AND MERCHANT STRATEGIES IN ORDER TO DETERMINE WHETHER TO**  
15 **APPROVE AQUILA'S PROPOSAL FOR THE INDIRECT RECOVERY OF SJLP MERGER**  
16 **COSTS IN THIS CASE?**

17 A. Unless the SJLP merger is evaluated within the context of Aquila's guiding philosophy  
18 and strategies at the time it chose to merge with SJLP, it is impossible to determine the  
19 reasonableness of Aquila's proposal for the indirect recovery of SJLP merger costs in this  
20 case. Aquila's guiding philosophy and strategies and the way these strategies have been  
21 implemented in the recent past by Aquila shed a substantial amount of light on what  
22 motivated Aquila to choose to acquire SJLP.



1           Aquila stated in its presentations to utility analysts that it may consider selling some of  
2           the SJLP generating assets. In the late 1990s, the Company sold a power plant that was  
3           part of its West Virginia utility operations. Aquila has broken apart some of the  
4           businesses that were a part of its Australian electric utility operations. Aquila has taken  
5           advantage of the telecommunications assets that it acquired as part of its Australian  
6           electric utility operations and turned them into a profit center. These types of merger  
7           synergies and potential windfalls from the sale of low cost generation assets that Aquila  
8           anticipated at the time it chose to merger with SJLP must be taken into account when  
9           evaluating Aquila's request for the indirect recovery of SJLP merger costs in this case.

10       **Q.    YOU STATED THAT AQUILA'S TESTIMONY IN THIS CASE AND THE SJLP MERGER CASE**  
11       **CONTAIN ONLY A BRIEF DESCRIPTION OF ITS MERCHANT AND NETWORK STRATEGIES.**  
12       **WHAT WERE THE MAIN SOURCES OF INFORMATION THAT YOU FOUND ABOUT THESE**  
13       **STRATEGIES?**

14       A.    These strategies, along with Aquila's Value Cycle Philosophy, were described in detail in  
15       a couple of conference calls that Aquila senior executives held with financial analysts in  
16       the first quarter of 2000. On April 15, 2000, Bob Green held a "2000 Conference Call"  
17       (the 2000 Call) with Salomon Smith Barney and on February 8, 2000 Rick Green, Bob  
18       Green, and Peter Lowe (former Aquila CFO) held a "1999 Year End Conference Call"  
19       (the 1999 Call) with investment analysts. The 1999 Aquila Annual Report contains  
20       additional information on these concepts. Transcripts of the conference calls were  
21       available on Aquila's internet web site in the Presentations section of the Investor  
22       Information Area.

23

1 **D. AQUILA'S NETWORK STRATEGY**

2 **Q. PLEASE RETURN TO AQUILA'S NETWORK STRATEGY AND DESCRIBE IT IN DETAIL.**

3 A. Aquila's network strategy was to bring value to its shareholders by investing in energy  
4 networks and production assets. This strategy was implemented in Canada, the U.S.,  
5 New Zealand, and Australia where Aquila has invested in energy networks. In the 2000  
6 Call, Bob Green described recent developments in its network strategy as follows:

7 First of all, our network strategy, where we essentially are taking  
8 advantage of the trend towards privatization and liberalization of energy  
9 markets around the world. We have bought utilities in Australia, New  
10 Zealand and Canada outside the U.S. **We've also acquired two**  
11 **distribution assets here in the U.S., St. Joe Power & Light and**  
12 **Empire District. We believe we can significantly enhance the value of**  
13 **those assets by disaggregating, breaking apart some embedded**  
14 **businesses, and repositioning them.** We've done that in Australia. Since  
15 1995, our IRR in terms of that investment is over 30% and what we've  
16 done is break out the retail energy business and we will joint venture that  
17 with Shell at a value significantly above what we paid for it. **We've built**  
18 **a telecom business leveraging our right-of-way in the power business**  
19 and we have built a back office business that handles the settlement and  
20 billing for other power markets and generators, other participants in the  
21 marketplace. There's an analogy for that business and the telecom  
22 business; companies like Saval Systems you might have heard about and  
23 Cincinnati Bell has a subsidiary that does this. Most of the large  
24 telephone companies don't do their own billing and we believe we can  
25 outsource most of that billing to this unregulated entity which will  
26 ultimately trade at a much higher multiple. So we believe this  
27 international network strategy has the potential to create IRRs well above  
28 20%. In Australia we've achieved 30%, and we will continue to  
29 aggressively pursue that in deregulating markets like Australia, New  
30 Zealand, Alberta, Ontario, and here domestically, as the states  
31 deregulate. (emphasis added).

32 **E. PAST IMPLEMENTATION OF THE NETWORK STRATEGY**

33 **Q. HAVE YOU REVIEWED AQUILA DOCUMENTS THAT DESCRIBE HOW THE COMPANY HAS**  
34 **APPLIED ITS VALUE CYCLE PHILISOPHY AS IT IMPLEMENTS ITS NETWORK STRATEGY?**

35 A. Yes. In the 1999 Call, Rick Green described the value cycle as follows:

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Ryan Kind

1 The other key component of being successful with our mission and  
2 vision, on top of taking advantage of open markets, it's to constantly  
3 build value. And that is described here in the value cycle. This is a value  
4 cycle that you've heard us talk about through the year as to how we  
5 invest in opportunities, and immediately they get pushed into optimizing.  
6 Whether that means putting our operational template on them, cut costs,  
7 enhance revenues, look for emerging opportunities.

8 Whatever that is, we do that very quickly; **and then you have the option**  
9 **to monetize. Grab that value and push it to the bottom line.** It  
10 consistently over time gives you another whole stream of earnings  
11 besides your existing business, your operational activities. (emphasis  
12 added)

13 This has been going on at Aquila for a number of years, starting back  
14 with our cornerstone shareholdings down in New Zealand with WEL.  
15 And we were able to position from those initial investments now to one  
16 of the larger investments in Aquila and 30% market share in New  
17 Zealand. In '95, we moved to Australia, optimizing the value there by  
18 taking the electric company, United Energy, public, and realizing that  
19 value before the regulators start to take it back away and reset returns,  
20 which will happen in January of '01.

21 And currently in '99, we continue this value cycle. The West Virginia  
22 sale, for example. We were not interested in that sale just because we  
23 got a profit on the assets. It was the strategic relationship we were able to  
24 develop with Allegheny, and the long-term gas contract that we got for  
25 Aquila, that made that a real good value proposition for us. And the  
26 Aries plant, our merchant plant that we're developing in Missouri.

27 Here again bringing in Calpine as a partner allowed us to monetize and  
28 bring some of that value to the bottom line. So the consistent building of  
29 value is a very important measure, we think, going forward. **So when**  
30 **you take advantage of opening markets, and when you constantly**  
31 **focus on building value, it gives you a very nice earnings track**  
32 **record, again with the ability to move that up to 8% and even start**  
33 **to talk and focus on 10%.** (emphasis added)

34  
35 The Aquila 1999 Annual Report also describes the value cycle and gives numerous  
36 examples of how it has followed this cycle all the way through to the monetization stage  
37 for some of its network investments. As Aquila states in its 1999 Annual Report,

38 ...“the Value Cycle. We invest, then optimize and monetize.

39 This means that as we manage properties, whether acquired recently or a  
40 long time ago, we are constantly enhancing revenues, cutting costs or  
41 applying our operational model to add value. We realize that value by

1 bringing in a partner, asking the public to invest, or developing some  
2 other strategic relationship.

3 Later in its 1999 Annual Report, Aquila gives the following examples of network  
4 investments that it has recently or will soon have monetized in order to “realize the  
5 appreciated value that we have created”:

- 6 • Aquila realized a gain on a power plant that it sold in its West Virginia Power  
7 service territory and stated that “for us, this was another value cycle opportunity.”
- 8 • Aquila says it will likely sell part of its United Networks investment in New  
9 Zealand as “the next step in the value cycle.”
- 10 • In January of 2000, Aquila sold a 50% interest in its new combined cycle plant  
11 that is currently under construction at Pleasant Hill, Missouri in what it  
12 characterizes as another application of its value cycle concept.

13 The 1999 Call contains more details about the success Aquila has had in executing its  
14 value cycle philosophy and monetizing its investment in the Pleasant Hill (Aries) plant  
15 where Bob Green states that:

16 The Aries plant is another good example. We identified an opportunity to  
17 build a 600-megawatt plant. We executed a purchase power agreement  
18 with our affiliated network business, got it approved by the Commission.  
19 We've already sold half that plant before we have a piece of steel on site,  
20 for a value of \$34 million more than we'd have to put in it. So we created  
21 \$34 million of value in a combined cycle plant. We expect that to grow  
22 over time. And we've already monetized half of it.

23 **F. NETWORK STRATEGY TELECOM SYNERGIES IN AUSTRALIA**

24 **Q. DO YOU HAVE ANY FURTHER COMMENTS ABOUT AQUILA’S NETWORK STRATEGY?**

25 A. Yes, developing telecommunications networks was a big part of Aquila’s network  
26 strategy. Bob Green emphasized this in the 1999 Call where he stated “as we look at

1 buying network assets, the telecom overlay will be a key part of the value proposition."

2 Mr. Green also indicated in the 1999 Call that Aquila intended to implement its telecom  
3 strategy in conjunction with its purchase of the SJLP and Empire network assets.

4 **Q. DID AQUILA EXECUTE ITS TELEPHONE STRATEGY IN ANY OF THE PLACES WHERE IT**  
5 **OWNED ENERGY NETWORKS?**

6 A. Yes. In the following passage from the 1999 Call, Bob Green describes the telecom  
7 business that Aquila has developed in Australia and its intention to pursue a similar  
8 strategy in Missouri by acquiring SJLP and Empire:

9 The biggest upside coming out of Australia is our telecom business,  
10 UECOM. Some of you might remember a gentleman by the name of  
11 Harvey Parker, whom we hired from Telstra, to run United Energy. He  
12 left after about a year, but he had initiated a teleco strategy for United.  
13 We have refocused that strategy, and it has been quite successful.

14 Today we have about 500 miles of fiber. We're building rings around  
15 Melbourne, Sydney and Brisbane. It started out as dark fiber, providing  
16 services to the 50 data centers in the United Energy service territory. It  
17 has grown from there.

18 We expect to offer voice services this year. And it really is our biggest  
19 venture into telecom. And it is a strategy we think we can replicate. We  
20 think we can replicate it in a place like Calgary, taking advantage of our  
21 power distribution position. We think we can replicate it in Missouri.  
22 Empire has 300 miles of fiber. We think we can implement this strategy  
23 in the Empire service territory. We think we can implement it in and  
24 around Kansas City. And we're developing the business plan and  
25 identifying the right partners to make this strategy most successful in  
26 these different markets. But as we look at buying network assets, the  
27 telecom overlay will be a key part of the value proposition.

28 And the business in Australia, just to give you a sense, you've got 500  
29 miles laid; we're only using 30% of the capacity. So in terms of  
30 incremental business, there's very little capital cost associated with it, and  
31 we expect the EBIT to more than double this year. And it almost tripled  
32 in '99. So there is some talk of a potential float of that business. We  
33 haven't made any decisions. We're going to look at how we derive the  
34 best value in the long run.

1 In the 2000 Call, Rick Green gives further insights into Aquila's apparent successful  
2 implementation of its network and telecom strategies in Australia where he states that "in  
3 Australia...[w]e've built a telecom business leveraging our right of way in the power  
4 business."

5 **G. AQUILA'S ENERGY MERCHANT STRATEGY**

6 **Q. LET'S TURN NOW TO A DISCUSSION OF AQUILA'S MERCHANT STRATEGY. PLEASE**  
7 **EXPLAIN THIS STRATEGY.**

8 A. Aquila's merchant strategy was intended to bring value to its shareholders by becoming a  
9 leading energy merchant in wholesale gas and electric markets. This strategy was  
10 primarily focused in the U.S. where Aquila became one of the leading marketers of gas  
11 and electricity and Aquila had also begun pursuing this strategy more aggressively in  
12 Europe. Aquila's 1999 Annual Report stresses the importance of Aquila's recent  
13 initiative to acquire mid-stream assets such as power plants and gas storage facilities to  
14 give it the resources that it needed to support its trading business as the wholesale energy  
15 market became more competitive. Aquila's investment in the Pleasant Hill plant fit in  
16 with this initiative. The acquisition of SJLP's low cost generating assets was also be  
17 expected to be useful in supporting this initiative in the future once the expected  
18 restructuring of Missouri electric markets took place.

19 **Q. DID ROBERT GREEN COMMENT ON AQUILA'S MERCHANT STRATEGY IN HIS DIRECT**  
20 **TESTIMONY IN THE SJLP MERGER CASE?**

21 A. Yes, on page 4 of his testimony, he stated that:

22 our focus on domestic acquisitions has become basically two fold: first,  
23 we are interested in utilities that are in the mid-continent region where  
24 we currently own and operate utilities and have the platform to realize  
25 economies of scale, and second, we are interested in assets that enhance

1 our ability to become a leading energy merchant such as the Katy  
2 Storage facility in Texas and the electric combined cycle generation plant  
3 now under construction in Cass County, Missouri by Aquila's Aquila  
4 Merchant Energy Partner business.

5 From Mr. Green's statement, its apparent that SJLP's low cost generating assets could  
6 easily become a part of Aquila's merchant strategy, if retail generation markets are  
7 deregulated in Missouri. Of course, the expectations of whether and when retail  
8 generation markets may be deregulated in Missouri have changed substantially since the  
9 time that Aquila decided to acquire SJLP.

## 10 **H. AQUILA'S GROWTH STRATEGY**

11 **Q. HAVE YOU REVIEWED OTHER DOCUMENTS THAT SHOW AQUILA'S FORMER**  
12 **STRATEGIES FOR GROWING ITS EARNINGS AS THE ENERGY INDUSTRY IN THE U.S. AND**  
13 **WORLD WIDE CONTINUED TO EVOLVE?**

14 A. Yes. There is one other document that I would like to describe and comment on before  
15 turning to a discussion of how Aquila's growth and "value cycle" strategies apply to its  
16 acquisition of SJLP. The other document that I will discuss is attached to this testimony  
17 as Attachment 2. This document was introduced as Exhibit 204 HC in the Aquila/Empire  
18 merger hearing (Case. No. EM-00-369). This document is entitled UtiliCorp United  
19 Strategic Plan, 1996 – 2000, Corporate Development (UtiliCorp 1996 – 2000 Strategic  
20 Plan). I believe this document is important to bring to the Commission's attention  
21 because it covers the time frame of the SJLP merger and because it acknowledges that

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**Q. PLEASE REVIEW THOSE ASPECTS OF UTILICORP 1996 – 2000 STRATEGIC PLAN THAT ARE RELEVANT TO AQUILA’S REQUEST FOR INDIRECT RECOVERY OF SJLP MERGER COSTS.**

**A.** \*\* \_\_\_\_\_

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**IV. RELATIONSHIP BETWEEN FORMER AQUILA CORPORATE STRATEGIES, THE SJLP ACQUISITION, AND MERGER COST RECOVERY IN RATES**

**A. OVERVIEW**

**Q. PLEASE EXPLAIN WHY YOU BELIEVE IT IS VERY IMPORTANT FOR THE COMMISSION TO CONSIDER AQUILA’S CORPORATE STRATEGIES AND THE SPECIFIC CHARACTERISTICS OF SJLP WHEN DECIDING WHETHER TO APPROVE AQUILA’S PROPOSAL FOR THE INDIRECT RECOVERY OF ITS SJLP MERGER COSTS.**

A. When the Commission considers the Aquila proposal for the indirect recovery of its SJLP merger costs, it should be cognizant of potential shareholder benefits that Aquila



1 expected would be brought about by the opportunities that this merger would give to  
2 Aquila for bringing non-regulated earnings directly to its bottom line. At the time Aquila  
3 decided to proceed with the SJLP merger, the Company believed these opportunities  
4 existed in many areas, almost none of which were acknowledged by Aquila in its merger  
5 application. The closest that Aquila came to acknowledging these shareholder benefits in  
6 any of its filings in the merger case was the statement on page six of its application that  
7 “the merger will strengthen the competitive position of Aquila, including its MPS and  
8 SJLP operations, not only in Missouri, but also in the surrounding region in the  
9 Midwest.”

10 Aquila chose to merge with SJLP for a number of factors. Many of these factors are  
11 related to Aquila’s value cycle philosophy, network strategy, and merchant strategy that  
12 were described earlier in this testimony. SJLP had characteristics that made it an  
13 attractive candidate for use in the pursuit of these strategies. These characteristics  
14 included, its proximity to Aquila’s other Missouri service territories (providing  
15 transmission and off-system sales synergies), its low cost generating supplies, and its  
16 telecommunications assets.

## 17 **B. SJLP’S LOW COST GENERATING PORTFOLIO**

18 **Q. WHAT MATERIALS HAVE YOU REVIEWED THAT ILLUSTRATE AQUILA’S APPRECIATION**  
19 **OF THE VALUE OF THE LOW COST GENERATING ASSETS THAT SJLP EITHER OWNED**  
20 **OR TO WHICH IT HAD ACCESS?**

21 A. Aquila has acknowledged the value in the SJLP low cost generation assets that it obtained  
22 through the merger in: its 1999 Annual Report, in presentations to investment analysts,  
23 and internal documents that analyzed the benefits of a potential acquisition of SJLP. In  
24 its 1999 Annual Report, Aquila stated that:

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Empire District and Light and Power, among the longest operating [sic] in Missouri, also bring low cost generation assets and cost-effective distribution operations.

In the "1999 Year End Conference Call" (the 1999 Call) with investment analysts, Bob Green stated:

But take a look at the mid-continent footprint that we're building on the network side of the business. With the St. Joe and the Empire acquisition, we've brought together some very attractive low-cost generation assets, and we have added some contiguous distribution networks that afford us a significant opportunity for synergies and efficiencies. 75% of those benefits are going to come from the supply side.

Presentations at two Aquila Board of Directors (BOD) meetings that took place shortly before Aquila presented its final bid to SJLP included comments about SJLP's generating assets. The presentation at the 2/3/99 BOD meeting noted that SJLP is \*\* \_\_\_\_\_

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**Q. HAVE YOU REVIEWED ANY MATERIALS THAT HAVE QUANTIFIED THE VALUE OF SJLP'S LOW COST GENERATING SUPPLIES EITHER IN TERMS OF MARKET VALUE, OR IN TERMS OF ITS POTENTIAL CONTRIBUTION TO NON-REGULATED EARNINGS STREAMS, IF GENERATION IS DEREGULATED AT THE RETAIL LEVEL IN MISSOURI?**

A. \*\* \_\_\_\_\_  
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Attachment 3).

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**Q. IS THERE A GENERALLY ACCEPTED APPROACH TO DETERMINING THE MARKET VALUE OF GENERATION ASSETS?**

A. Yes. The market value is generally determined by calculating the contribution to annual earnings that each generating plant is expected to make over the life of the plant and then discounting this stream of future annual earnings to determine the present value of the earnings stream. \*\* \_\_\_\_\_  
\_\_\_\_\_\*\*

**Q. PLEASE DISCUSS IN MORE DETAIL THE \*\* \_\_\_\_\_  
\_\_\_\_\_\*\* ANALYSIS AND THE CONCLUSIONS THAT WERE DRAWN, BASED ON THAT ANALYSIS.**

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**C. GENERATION SUPPLY SYNERGIES**

**Q. DID AQUILA'S MISSOURI PSC SJLP MERGER FILING DESCRIBE THE VALUE THAT THE COMPANY EXPECTED ITS SHAREHOLDERS TO RECEIVE IN THE FUTURE FROM ACQUIRING SJLP'S LOW COST GENERATION ASSETS?**

A. No. The Company did, however, \*\* \_\_\_\_\_  
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**D. AQUILA’S EXPECTED OPTIONS TO DERIVE NON-REGULATED EARNINGS FROM SJLP’S LOW COST GENERATING PORTFOLIO**

**Q. DID AQUILA’S TESTIMONY IN THE SJLP MERGER CASE OR ITS RESPONSES TO DATA REQUESTS IN THAT CASE DESCRIBE ITS POTENTIAL TO ACHIVE SYNERGIES THAT WOULD ACCRUE SOLEY TO THE BENEFIT OF ITS SHAREHOLDERS?**

A. No. Its testimony was completely silent with respect to this issue. Its responses to data requests specifically on this issue (Staff DR Nos. 152 and 228) stated that Aquila has not performed any studies of the potential for merger synergies in the non-regulated area. The Company’s response to DR No. 152 even implies that Aquila has not observed any potential for merger synergies in the non-regulated area.

**Q. DO YOU BELIEVE THESE DR RESPONSES WERE ACCURATE?**

A. No. I don’t believe Aquila’s response was accurate when it stated that no analysis has been performed by or on behalf of Aquila that contains “estimates of merger savings/synergies applicable to non-regulated business operations after a combination.” I also do not believe that Aquila’s response to sub-part 3 of Staff DR No. 152 was accurate when it implied that Aquila has not observed any potential for merger synergies in the non-regulated area.

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**Q. HAVE YOU REVIEWED ANY ANALYSIS OTHER THAN THAT CONTAINED IN THE \*\* \_\_\_\_\_  
\_\_\_\_\_ \*\* WHICH INDICATES THAT AQUILA IS CONSIDERING OPTIONS  
FOR DERIVING NON-REGULATED SYNERGIES FROM SJLP'S LOW COST GENERATING  
PORTFOLIO?**

A. Yes. The discussion earlier in this testimony where I describe Aquila's Value Cycle Philosophy and its Network and Merchant strategies shows how Aquila's strategic intent regarding investments like the Company's acquisition of SJLP may be applied to SJLP in the future. In fact, both the 1999 Call and the 2000 Call that were discussed earlier contain specific statements regarding future options that Aquila may pursue with its SJLP investment and explains how those options fit into the Company's Value Cycle Philosophy and its Network and Merchant strategies.

**Q. PLEASE QUOTE THE SPECIFIC STATEMENTS REGARDING FUTURE OPTIONS THAT  
AQUILA MAY PURSUE WITH ITS SJLP INVESTMENT THAT WERE MADE IN THE 1999  
AND 2000 CALLS AND PROVIDE ANY NECESSARY EXPLANATIONS.**

A. In the 2000 Call, Bob Green makes the following statement:

First of all, our network strategy, where we essentially are taking advantage of the trend towards privatization and liberalization of energy markets around the world. We have bought utilities in Australia, New Zealand and Canada outside the U.S. **We've also acquired two distribution assets here in the U.S., St. Joe Power & Light and Empire District. We believe we can significantly enhance the value of those assets by disaggregating, breaking apart some embedded businesses, and repositioning them.** We've done that in Australia. Since 1995, our IRR in terms of that investment is over 30% and what we've done is break out the retail energy business and we will joint venture that with Shell at a value significantly above what we paid for it. We've built



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1 a telecom business leveraging our right-of-way in the power  
2 business...(emphasis added)

3 In the 2000 Call, Bob Green makes the following statement:

4 But take a look at the mid-continent footprint that we're building on the  
5 network side of the business. With the St. Joe and the Empire  
6 acquisition, we've brought together some very attractive low-cost  
7 generation assets, and we have added some contiguous distribution  
8 networks that afford us a significant opportunity for synergies and  
9 efficiencies. 75% of those benefits are going to come from the supply  
10 side.

11 **And over time, we will look to restructure the supply-side assets and**  
12 **potentially take them out of rate base and provide more of an upside.**  
13 **It might be that the easiest path is to sell some of those assets** so we  
14 can establish a market value and avoid a stranded cost to base with the  
15 regulator; and then redeploy that capital strategically on the energy grid  
16 in other generation assets or other growth investments. (emphasis added)

17 **And again, this just highlights the service territories that we've**  
18 **acquired with St. Joe and Empire.**

19 It seems quite clear from the above statements by the most senior Aquila witness in the  
20 SJLP merger case, that Aquila was considering the full range of options, including the  
21 sale (monetization) of some of its soon to be acquired SJLP generating assets, in order to  
22 bring significant unregulated earnings to the bottom line for its shareholders.

23 **Q. HAVE YOU SEEN ANY INFORMATION SUBSEQUENT TO THE COMPLETION OF THE SJLP**  
24 **MERGER THAT INDICATES AQUILA ANTICIPATED TREATING ITS SJLP INVESTMENT**  
25 **JUST LIKE ANY OTHER INVESTMENT THAT IS SUBJECT TO THE VALUE CYCLE**  
26 **PHILOSOPHY OF AQUILA?**

27 A. Yes, Aquila's President and Chief Operating Officer, Robert Green made the following  
28 statement in a presentation to the Edison Electric Institute (EEI) Financial Conference on  
29 October 30, 2001:

30 **We have talked about the value cycle and as we invest in assets on**  
31 **the energy grid or energy infrastructure we don't have a buy and**  
32 **hold mentality like a traditional utility, we have a shareholder**



1                   **mentality.** We have a capability to manage, rationalize, optimize these  
2 investments. And as we do, we harvest the capital and re-deploy it. And  
3 by doing so we've been able to drive significantly higher returns,  
4 because once we've optimized the assets, the distribution asset in  
5 particular, a network asset the upside is limited. So we look to monetize  
6 the asset and invest in another asset where we see greater upside. We did  
7 that in Australia with the float of United Energy at a value significantly  
8 above what we paid for the asset, I think we bought that asset for \$1.1  
9 billion U.S. and we floated it at \$2 billion. So that's the kind of upside  
10 that we try to realize. And you've probably heard about our latest  
11 investment in the U.K. in the form of Midlands, again it is the same  
12 strategy that we developed in Australia, executed in New Zealand,  
13 executed in Canada, and now will execute in the U.K. and on the  
14 continent as we find assets that we believe we can, um, a significant  
15 opportunity to optimize it and then monetize that value.       (emphasis  
16 added)

17                   The above quote from one of Aquila's senior executives shows that this Company's  
18 strategy towards making investments that can contribute to non-regulated earnings  
19 through execution of its "value cycle" strategy was still in place in late 2001, after the  
20 SJLP merger was completed. One of the slides (See Attachment 6) that accompanied Mr.  
21 Green's presentation at the EEI Financial Conference specifically identified SJLP as one  
22 of the recent investments to which Aquila is applying its "value cycle philosophy."

23                   **E.     AQUILA'S EXPECTED NON-REGULATED EARNINGS IN THE**  
24                   **TELECOM/CABLE TV AREA**

25                   **Q.     EARLIER IN THIS TESTIMONY, WHEN YOU WERE DISCUSSING AQUILA'S VALUE CYCLE**  
26                   **PHILOSOPHY, NETWORK STRATEGY, AND MERCHANT STRATEGY, YOU DISCUSSED THE**  
27                   **RELATIONSHIP BETWEEN THE COMPANY'S NETWORK STRATEGY AND ITS**  
28                   **TELECOMMUNICATIONS AND CABLE TV INITIATIVES. HOW DID AQUILA PERCEIVE A**  
29                   **LINK BETWEEN THE TWO?**

30                   A.     Bob Green described this link in the 1999 Call where he stated "as we look at buying  
31 network assets, the telecom overlay will be a key part of the value proposition" and in the

1           2000 Call where he stated “we’ve built a telecom business leveraging our right-of-way in  
2           the power business.”

3           **Q.    HAVE YOU SEEN ANY INFORMATION THAT PROVIDES AN ADDITIONAL INDICATION**  
4           **THAT THE “TELECOM OVERLAY” WAS PART OF WHAT MOTIVATED AQUILA TO**  
5           **ACQUIRE SJLP?**

6           A.    Yes, a number of the statements made by Aquila’s senior management indicate that the  
7           non-regulated synergies associated with the SJLP merger were a major factor in deciding  
8           to pay the premiums necessary to acquire SJLP. I’ll start with the comments that Bob  
9           Green made in the 2000 Call where he stated that:

10                       Second, in terms of a near-term upside is our telecom business that's  
11                       emerging first in Australia. We expect to float a telecom business at a  
12                       valuation close to the initial investment value in United Energy, the  
13                       power company we bought back in 1995. We think that should have a  
14                       big impact on Aquila's share price. **As well, we are aggressively**  
15                       **pursuing that telecom strategy here domestically.** (Emphasis added)

16           A significant amount of additional detail about Aquila’s domestic telecom strategy was  
17           revealed by Bob Green in the 1999 call where he made the following statements:

18                       The biggest upside coming out of Australia is our telecom business,  
19                       Secom. Some of you might remember a gentleman by the name of  
20                       Harvey Parker, whom we hired from Telstra, to run United Energy. He  
21                       left after about a year, but he had initiated a telecom strategy for United.  
22                       We have refocused that strategy, and it has been quite successful.

23                       Today we have about 500 miles of fiber. We're building rings around  
24                       Melbourne, Sydney and Brisbane. It started out as dark fiber, providing  
25                       services to the 50 data centers in the United Energy service territory. It  
26                       has grown from there.

27                       We expect to offer voice services this year. And it really is our biggest  
28                       venture into telecom. And it is a strategy we think we can replicate. We  
29                       think we can replicate it in a place like Calgary, taking advantage of our  
30                       power distribution position. **We think we can replicate it in Missouri.**  
31                       Empire has 300 miles of fiber. (Emphasis added)

32                       We think we can implement this strategy in the Empire service territory.  
33                       **We think we can implement it in and around Kansas City. And**

1                    **we're developing the business plan and identifying the right partners**  
2                    **to make this strategy most successful in these different markets. But**  
3                    **as we look at buying network assets, the telecom overlay will be a**  
4                    **key part of the value proposition.** (Emphasis added)

5                    ...

6                    We will continue to pursue this telecom strategy that has emerged out of  
7                    Australia. **There is significant potential with the assets we're**  
8                    **acquiring at Empire and St. Joe to create an Australian-like telecom**  
9                    **play in the mid-continent.** (Emphasis added)

10                  **And as I said, we've got I think 300 miles of fiber at Empire, and a**  
11                  **significant business at St. Jo that we think we can build, based on**  
12                  **our Australian experience, into a real growth vehicle for Aquila.**  
13                  (Emphasis added)

14                  ...

15                  Q: [Investment analyst] I was wondering if you could ballpark for us the  
16                  level of investments you're looking at making in telecom over the next  
17                  two to three years. And then also maybe you could provide us a little bit  
18                  more detail on the New Zealand and Australia regulatory processes and  
19                  how you see yourselves coming out.

20                  A. [Bob Green] In terms of telecom, just to give you an idea, in  
21                  Australia, Peter, I think we've invested like \$15 million? And we've got a  
22                  valuation of \$300 million. So it's not capital-intensive, and we're only  
23                  using 30% of the capacity. So as we look at what we might do in Calgary  
24                  – I mean, **I think that would be an example and then as we look at**  
25                  **what we might do with the assets we've acquired through Empire**  
26                  **and St. Joe, the capital expenditure is not big.** (Emphasis added)

27                  **I mean, in St. Joe I think we're looking at putting \$4 million into the**  
28                  **business to fund their expansion.** (Emphasis added)

29                  **Q.      WHAT KIND OF TELECOM ASSETS DID AQUILA AND SJLP POSSESS AT THE TIME OF**  
30                  **THE SJLP MERGER THAT COULD HAVE BEEN LEVERAGED TO CREATE NON-**  
31                  **REGULATED SYNERGIES?**

32                  A.      At the time of the SJLP merger, Aquila had recently invested in two telecommunications  
33                  companies near Kansas City and the SJLP service territory. Of course, Aquila already  
34                  possessed its own right of way and fiber loops that it had installed for internal

1           communications purposes. In Aquila’s 1999 Annual Report, the Company stated that  
2           SJLP is already in the “telecommunications, data networks” business.

3           **V. SUMMARY OF PUBLIC COUNSEL’S POSITION REGARDING AQUILA’S**  
4           **REQUEST FOR THE INDIRECT RECOVERY OF SJLP MERGER**  
5           **COSTS VIA ITS MERGER SAVINGS RETENTION PROPOSAL**

6           **Q. PLEASE SUMMARIZE OPC’S POSITION REGARDING AQUILA’S REQUEST FOR THE**  
7           **INDIRECT RECOVERY OF SJLP MERGER COSTS.**

8           A. Aquila’s request that this Commission include non-existent costs in the Company’s cost  
9           of service because the Company asserts that “the [SJLP] acquisition ultimately needs to  
10           provide shareholder benefits in order to be successful” should be denied. Aquila freely  
11           chose to enter into a merger agreement with SJLP. Consumers were never consulted  
12           about their views on this merger. The merger applicants were less than forthcoming in  
13           their testimony in the SJLP merger case where they failed to acknowledge the non-  
14           regulated synergies that the Company expected to result from the merger. A large  
15           portion of the expected synergies were in the generation area and, at the time of the  
16           merger, almost any conceivable restructuring legislation in Missouri was expected to  
17           transfer the benefits from all of these generation synergies to Aquila. Such legislation  
18           was widely expected by most industry observers, including Aquila officials, at the time  
19           the Company decided to pursue a merger with SJLP. The management and Board of  
20           Directors of Aquila chose to merge with SJLP because of a broad range of non-regulated  
21           benefits that were expected to result from the merger: These expected non-regulated  
22           benefits included:

- 23           • Reducing the prospect of cut-throat competition in regional energy markets by  
24           keeping low cost generation assets out of the hands of its local competitors.

Rebuttal Testimony of  
Ryan Kind

- 1           • Obtaining a lower cost structure for the generation portion of Aquila’s regulated  
2           operations. All benefits of these reduced costs were expected to flow through to  
3           shareholders if, as expected, retail wheeling was allowed and generation prices  
4           were no longer regulated at the retail level in Missouri.
  
- 5           • Increased market power in wholesale and retail generation markets would enhance  
6           Aquila’s future earnings.
  
- 7           • Revenue enhancements resulting from synergies between the unregulated  
8           operations of SJLP and Aquila and between the unregulated and regulated  
9           operations of SJLP and Aquila. Aquila’s investments in Missouri  
10          telecommunications firms is an example of an attempt to facilitate achieving this  
11          type of synergy.
  
- 12          • Cost reductions resulting from synergies between the unregulated and regulated  
13          operations of SJLP and Aquila.

14          If Aquila’s proposal to include a non-existent costs in its cost of service for the purpose  
15          of indirectly recovering merger costs ever made sense, it was prior to the time when  
16          utilities began diversifying into areas beyond their regulated public utility businesses.  
17          For Aquila, that time has long since passed. Utility mergers in the 1990s were not  
18          prompted by a utility’s desire to minimize the cost of providing regulated service; if this  
19          was the motivation, the mergers would have been proposed decades ago. To the  
20          contrary, these mergers were prompted by the desires of utility managers to pursue non-  
21          regulated earnings opportunities in areas such as: non-regulated generation service,  
22          facilities based telecommunications services, and other value added services. Aquila  
23          cited its earnings potential in these non-regulated areas when it explained the motivation  
24          for the merger to its shareholders. It would be an extreme injustice to see SJLP merger  
25          costs included indirectly in rates (under the guise of retaining merger savings) when the

Rebuttal Testimony of  
Ryan Kind

1           Aquila made the decision to incur merger costs (including the acquisition premium) to  
2           acquire SJLP not for the purpose of lowering costs for ratepayers, but because it believed  
3           the SJLP merger would lead to handsome returns to shareholders from non-regulated  
4           business opportunities.

5           **Q.     DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

6           **A.     YES.**

# TABLE OF CONTENTS

<b>I. INTRODUCTION .....</b>	<b>3</b>
<b>II. AQUILA’S REQUEST FOR THE INDIRECT RECOVERY OF MERGER COSTS.....</b>	<b>6</b>
<b>III. FACTORS THAT DROVE THE AQUILA/SJLP MERGER .....</b>	<b>12</b>
A. INDUSTRY TRENDS .....	12
B. MOTIVATING FACTORS FOR SJLP AND AQUILA .....	13
C. AQUILA’S VALUE CYCLE PHILOSOPHY .....	15
D. AQUILA’S NETWORK STRATEGY.....	18
E. PAST IMPLEMENTATION OF THE NETWORK STRATEGY .....	18
F. NETWORK STRATEGY TELECOM SYNERGIES IN AUSTRALIA .....	20
G. AQUILA’S ENERGY MERCHANT STRATEGY .....	22
H. AQUILA’S GROWTH STRATEGY .....	23
<b>IV. RELATIONSHIP BETWEEN FORMER AQUILA CORPORATE STRATEGIES, THE SJLP ACQUISITION, AND MERGER COST RECOVERY IN RATES .....</b>	<b>25</b>
A. OVERVIEW.....	25
B. SJLP’S LOW COST GENERATING PORTFOLIO.....	26
C. GENERATION SUPPLY SYNERGIES.....	29
D. AQUILA’S EXPECTED OPTIONS TO DERIVE NON-REGULATED EARNINGS FROM SJLP’S LOW COST GENERATING PORTFOLIO .....	29
D. AQUILA’S EXPECTED OPTIONS TO DERIVE NON-REGULATED EARNINGS FROM SJLP’S LOW COST GENERATING PORTFOLIO .....	30
E. AQUILA’S EXPECTED NON-REGULATED EARNINGS IN THE TELECOM/CABLE TV AREA .....	33
<b>V. SUMMARY OF PUBLIC COUNSEL’S POSITION REGARDING AQUILA’S REQUEST FOR THE INDIRECT RECOVERY OF SJLP MERGER COSTS VIA ITS MERGER SAVINGS RETENTION PROPOSAL .....</b>	<b>36</b>