Pages 9-11, 20-21, 26-27, 47-50

*Exhibit No.:* 713
*Issue:* *Staff Overall Recommendations*
*Witness:* *Mark L. Oligschlaeger*
*Sponsoring Party:* *MoPSC Staff*
*Type of Exhibit:* *Rebuttal Testimony*
*Case No.:* *EM-2000-292*

# MISSOURI PUBLIC SERVICE COMMISSION

## UTILITY SERVICES DIVISION

# REBUTTAL TESTIMONY

## OF

## MARK L. OLIGSCHLAEGER

## UTILICORP UNITED INC. AND ST. JOSEPH LIGHT & POWER COMPANY

## CASE NO. EM-2000-292

*Jefferson City, Missouri*
*May, 2000*

STAFF Exhibit No. 35
Case No(s). EM-2007-0374
Date 12-6-07 Rptr PF

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

- The proposed recovery of the acquisition adjustment, even at the purported 50% level, would require that UCU's Missouri customers inappropriately pay for costs properly assignable to shareholders. A significant driver of the merger premium is perceived benefits to UCU in nonregulated areas. These points are further addressed in this testimony and the testimony of Staff witnesses Featherstone, Charles R. Hyneman, Janis E. Fischer, Michael S. Proctor and David P. Broadwater.
- The proposed regulatory plan will actually result in the Joint Applicants receiving recovery of far more than 50% of the premium, when the impact of "regulatory lag" and the Companies' proposal concerning the "frozen" SJLP capital structure and "frozen" MPS corporate allocators are properly taken into account. This will also be discussed in the rebuttal testimony of Staff witnesses Broadwater, Featherstone and Steve M. Traxler.
- The Joint Applicants' proposal would require customers to pay for merger transaction costs, which should be treated in a similar manner to the acquisition adjustment and be assigned to shareholders in entirety. In addition, the proposed regulatory plan would allow recovery from ratepayers of certain "costs to achieve" (transition costs) that also should be assigned to shareholders, such as executive severance payments ("golden parachutes"). These points are addressed in the rebuttal testimony of Staff witness James M. Russo.

- UCU/SJLP's proposal to use a "frozen" stand-alone SJLP capital structure in rates after the merger is implemented would deny customers any benefit for what should be a major source of savings to them: substitution of a lower-cost UCU capital structure for a higher-cost SJLP capital structure. This issue will be discussed in detail in the testimony of Mr. Broadwater.
- The "guarantee" of the Joint Applicants that SJLP customers will receive a minimum merger benefit in a reduction to the SJLP revenue requirement is based on their assertion that they will have the ability to measure and quantify actual merger savings starting in the fifth year after the closing of the merger. However, the Joint Applicants have failed to present any detailed plan for "tracking" merger savings in their direct testimony, so the purported ability to track merger savings is totally unsupported in actuality and illusory. This situation is addressed in the testimony of Staff witnesses Featherstone and Fischer.
- The Joint Applicants' plan will result in UCU customers in Missouri receiving the benefit of only a very small, insignificant portion of total merger savings during the first ten years after the closing of the merger. The vast majority of the savings will be retained by UCU to pay off the acquisition adjustment or will be offset by the detrimental impact of increased corporate cost allocations from UCU to SJLP customers. This item is addressed in my testimony and that of Staff witness Traxler.
- The regulatory plan is premised upon the ability of UCU to recover from SJLP customers significant amounts of total administrative and general

(A&G) costs compared to SJLP's stand-alone A&G levels. Not only is this recovery from SJLP ratepayers of a significant portion of UCU's A&G expenses counter-intuitive to legitimate expectations of what should result from a merger of two utilities, but the increase in A&G expenses that would be borne by SJLP customers is in no way related to the provision of safe and adequate service at just and reasonable rates. This topic is covered in the rebuttal testimony of Mr. Traxler.

- The proposed plan would result in a disproportionate amount of purported merger savings being assigned to SJLP customers at the expense of MPS customers who have historically paid a portion of the costs associated with the "economies of scale" which in part cause the purported potential savings from this proposed transaction to exist in the first place. In addition, this assignment of purported merger savings will pass most purported merger savings SJLP which under the Joint Applicants' proposal will operate under a rate moratorium, while not assigning any material portion of purported merger savings to MPS which under the proposed plan will seek increases in rates during the next several years. Also, this assignment of purported merger savings will result in most of the savings going to SJLP's customers who already pay significantly lower rates in Missouri than MPS customers who have relatively high rate levels. These issues will be further addressed in my testimony and that of Staff witnesses Philip K. Williams, Traxler and Proctor.

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

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

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

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

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

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

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

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

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

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

Q. Mechanically, how do the Joint Applicants propose to "ensure" receipt by customers of the minimum $1.6 million net merger benefit during Years 6-10?

A. In the rate cases to be filed in Year 5 following the merger, UCU states its intent to measure or "track" merger savings in the test year used in that rate proceeding. If the total merger savings measured at that time are less than the estimated $1.6 million, then UCU's regulatory plan proposal states that it will propose an adjustment to impute the additional merger savings to ensure that customers will receive the benefit in rates of that full amount. By imputing savings into cost of service to reflect expense reductions that have not actually been achieved, the financial impact that will result would be a recovery of less than 50% of the acquisition adjustment. In turn this process, in theory, would place the risk of attaining the Joint Applicants' estimated merger savings on UCU and not on its customers.

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

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

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

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

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

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

A. The short and truthful answer is that the Joint Applicants have not proposed a way to overcome these problems, for the reason that they have made no serious proposal as to how their tracking system would work. While Mr. McKinney devotes several pages of his testimony to a very general discussion of how savings tracking will conceptually work to merger savings in sufficient quantity to allow recovery of acquisition adjustments is equivalent to allowing direct recovery of this item, and is inappropriate for the reasons given in this and other Staff witnesses rebuttal testimony.

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

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

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

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

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

Q. What is "regulatory lag?"

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

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

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

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

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

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

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

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

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

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

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

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

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