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Purchase Power Agreement/
Aries Combined Cycle Unit-in
service;
St. Joseph Light & Power Merger
Premium/Acquisition Adjustment;
Merger Tracking*

Witness: Cary G. Featherstone

Sponsoring Party: MoPSC Staff

Type of Exhibit: Rebuttal Testimony

Case No.: ER-2001-672

Date Testimony Prepared: January 8, 2002

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

CARY G. FEATHERSTONE

**UTILICORP UNITED INC.
d/b/a MISSOURI PUBLIC SERVICE**

CASE NO. ER-2001-672

*Jefferson City, Missouri
January 2002*

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REBUTTAL TESTIMONY

OF

CARY G. FEATHERSTONE

MISSOURI PUBLIC SERVICE

A DIVISION OF UTILICORP UNITED INC

CASE NO. ER-2001-672

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 a Verified Statement and direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of this rebuttal testimony?

A. The purpose of this testimony is to address the direct testimony filed by UtiliCorp United Inc's (UtiliCorp or UCU) witness Stephen L. Ferry relating to off-system sales made on the interchange market and the Greenwood Generating Facilities; UtiliCorp witness Gary L. Clemens relating to the true-up and the in-service criteria of the Aries Combined Cycle Unit; and UtiliCorp witnesses Clemens and Vern J. Siemek, relating to the "rate recovery [of] the merger transition and transaction costs and a portion of the merger premium..." (page 5, line 1 of UtiliCorp witness Clemens' direct testimony) for the merger of St. Joseph Light &

Power Company (St. Joseph or SJLP) and UtiliCorp on December 31, 2000. In particular, I will address the following points:

- UtiliCorp's position of advocating a 50/50 sharing split of off-system sales between shareholders and customers.
- Greenwood Generating Facilities lease payments.
- The need for in-service criteria for the Aries Combined Cycle Unit.
- The purported need by UtiliCorp to seek recovery of the acquisition adjustment, as part of what commonly was referred to in the merger case, as "the regulatory plan."
- Merger savings tracking.

OFF-SYSTEM SALES

Q. What is UtiliCorp's position relating to off-system sales?

A. UtiliCorp witness Stephen L. Ferry addresses the Company's position relating to off-system sales at pages 22 to 24 of his direct testimony filed with the Commission on June 8, 2001. Mr. Ferry states at page 22, line 8 that, in UtiliCorp's case, off-system:

margins were equally shared between the ratepayer and UtiliCorp's shareholders. In other words, 50% of the margins were imputed to expense to reduce the cost of service to MPS' ratepayers, and 50% were allocated to UtiliCorp's shareholders as an incentive for MPS to increase the use of its supply resources. As [UtiliCorp] previously discussed in [direct] testimony, MPS's supply resources consist of both owned generation and capacity purchases. Off-system sales increase the benefits provided by these resources.

Q. What are off-system sales?

A. Off-system sales relate to sales of electricity made at times when utilities have met all obligations to serve their native load customers and have excess energy to sell to other

1 utilities. The off-system sale transactions occur between utilities and result in profits (net
2 margin) to the selling entity, in this case, UtiliCorp.

3 Q. Did Staff include off-system sales in the revenue requirement determination
4 when it filed its direct case on December 6, 2001?

5 A. Yes. Off-system sales were included in Staff's case, just as they were in
6 UtiliCorp's filing. The difference between the Company's filing and Staff's filing is that
7 UtiliCorp is "sharing" the margins or level of off-system sales profits in its case between
8 shareholders and customers on a 50/50 basis, whereas Staff is not making such an adjustment.

9 Q. What level of off-system sales did Staff include in its case?

10 A. Staff included the total amount of off-system sales that UtiliCorp experienced
11 during the 12 months ended December 31, 2000 (the test year used in this case).

12 Q. What level of off-system sales did UtiliCorp include in its direct case?

13 A. In its June 8, 2001 direct filing, UtiliCorp included the level of off-system sales
14 recorded for the 12 months ending June 30, 2000. UtiliCorp used a test year of June 30, 2000 in
15 its direct filing and its testimony and exhibits were developed to support this test year. In the
16 direct testimony of UtiliCorp witness Clemens (page 5), he indicates that the Company "used
17 the historical test-year ending June 30, 2000 for purposes of its filing in this case." However, on
18 page 6 of that same testimony, UtiliCorp recommended that "the Commission use a historical
19 test year ending December 31, 2000 properly adjusted and further adjusted and updated for
20 known and measurable changes through September 30, 2001."

21 Q. Did the Commission order the use of the test year that UtiliCorp recommended?

22 A. Yes. The Commission authorized the use of the year ending December 31, 2000
23 as the test year in its Order issued on August 14, 2001 entitled "Order Concerning Test Year and

1 True-up, Resetting Evidentiary and True-up Hearings, Adopting Procedural Schedule, and
2 Concerning Local Public Hearings.” The Staff filed a pleading with the Commission on July
3 25, 2001 supporting the use of a test year ending December 31, 2000 in this case.

4 Q. What levels of off-system sales is UtiliCorp using in its case currently?

5 A. While the Company based its direct-filed case on the test year levels of June 30,
6 2000 for off-system sales, Staff is uncertain as to the levels of off-system sales UtiliCorp is now
7 proposing to be used. UtiliCorp has provided no testimony supporting any changes from its
8 original filed position of using 12-months ending June 30, 2000 (the original test year the
9 Company filed its direct case on) levels for off-system sales.

10 Q. What is the effect of UtiliCorp’s sharing adjustment to reduce the level of off-
11 system sales by splitting the amounts between shareholders and customers?

12 A. UtiliCorp’s proposal to eliminate half the off-system sales levels has the effect of
13 increasing the overall revenue requirement in this case. This proposal has the same impact as if
14 the Company had made an adjustment that eliminated half the revenue levels it received from its
15 customers in any other revenue category. By reducing the level of off-system sales levels by
16 half -- a 50% sharing to the shareholders -- the Company is increasing the overall revenue
17 requirement in this case by a corresponding amount.

18 Q. Why does this proposal to “share” in off-system sales result in increased tariffed
19 rates paid by customers?

20 A. The off-system sales levels are treated like any other utility revenues and
21 expenses in the calculation of rates. The off-system sales margins (revenues less fuel and
22 purchased power expenses) provide a positive contribution to UtiliCorp’s utility operations in
23 this state. Since these margins are positive (revenue levels are greater than expenses), rates are

1 lower than they otherwise would be if off-system sales margins were not included in the revenue
2 requirement calculation.

3 Q. UtiliCorp witness Ferry states at page 23, line 8 of his direct testimony that
4 "transacting off-system sales imparts risks to both parties [shareholders and customers] that
5 otherwise wouldn't exist if off-system sales were not made." Is the off-system sales
6 (interchange) market risky?

7 A. It is no more risky than any other retail market UtiliCorp operates in. Utility
8 companies' sales are always at risk, just like those of other businesses. The economy affects the
9 levels of sales by a utility just like other businesses. Weather affects the sales levels by electric
10 utilities, probably more than it does many other businesses. Utilities status as monopoly
11 providers of utility services does not insulate them from downturns in the economy and other
12 events that cause sales levels to be at "risk." Nothing is certain in the utility business, just like
13 any other industry sector, private or public. To use the excuse that there are "risks" in the
14 interchange market to justify reducing the off-system sales levels thereby, increasing rates to
15 utility customers, is not appropriate in Staff's view.

16 Q. What rationale does UtiliCorp use for its belief that off-system sales are risky?

17 A. Mr. Ferry identifies at page 23, line 13 of his direct testimony the nature of the
18 risks he believes are part of transacting off-system sales:

19 Because of the de-regulated nature of the wholesale energy market, sales
20 today are seldom made on a cost plus basis as they were when the
21 wholesale markets were regulated. Today, the seller is generally
22 obligated to guarantee a price in order to make a sale. If the supply for
23 that sale should be lost, an example being the loss of the generator being
24 used to supply the sale, then the cost of supply would increase.
25 Increasing the cost of supply on a price guarantee sale will, at a
26 minimum, decrease the seller's margin, and may result in a net loss on
27 the transaction. In a market where the price of energy is high, the loss
28 could be significant.

1
2 Q. Has UtiliCorp experienced "significant" losses in the off-system sales market?

3 A. No. Staff asked the Company specifically to identify losses that it had incurred
4 in the off-system sales transactions made by Missouri Public Service. UtiliCorp only had one
5 off-system sales transaction where it had experienced a loss, and that transaction was immaterial
6 in amount. The response to Data Request No. 258 (updated) identified one off-system sale
7 transaction occurring on December 31, 2000 that resulted in margin loss of \$1,392 (revenue of
8 \$3,879 less expense of \$5,271). In year 2000, UtiliCorp experienced \$16,974,510 in off-system
9 sales; thus the loss of \$1,392 was by no means significant in amount. This lone loss transaction
10 clearly does not support UtiliCorp's claim that the interchange market is sufficiently risky that
11 the Commission should adopt a highly unusual and non-traditional ratemaking approach such as
12 the one proposed by UtiliCorp in this case.

13 Q. Has this loss resulting from the off-system sales margin identified by UtiliCorp
14 been reflected in Staff's case?

15 A. Yes. To the extent this loss, or any other loss in off-system sales margin,
16 occurred in the test year ending 2000, it would have been reflected in the test year levels
17 included in this case. The effect of including losses in off-system sales margin would be to
18 reduce the overall level of off-system sales in the case. In this instance, off-system sales margin
19 for the test year would be reduced by the margin loss of \$1,392 since the transaction occurred
20 December 31, 2000, the last day of the test year.

21 Q Has UtiliCorp ever experienced any month in which its off-system sales
22 transactions resulted in losses?

1 A. No. In a supplemental response to Data Request No. 258, the Company
2 indicated that there was no month in which it experienced an overall loss from off-system sales
3 transactions. UtiliCorp stated in the data request response:

4 Analysis of off-system sales results by month from 1996 to the present
5 shows no negative margins on a monthly basis. (September 1999
6 showed a net loss for the month due to a prior period adjustment
7 recorded in September business.) Off-system sales activity prior to 1996
8 was limited and all transactions were done on a cost-plus basis so there
9 were no losses.

10
11 Thus, in every month and in every year, off-system sales transactions resulted in positive
12 contributions to UtiliCorp's Missouri operations.

13 Q. Why is it appropriate to include off-system sales in the development of the
14 overall revenue requirement?

15 A. I explain this at page 8 of my direct testimony. Essentially, the reason that off-
16 system sales are included as jurisdictional sales, and therefore made part of the revenue
17 requirement calculation, is that these transactions are nothing more than a continuation of utility
18 operations as provided in this state by Missouri Public Service. The same generating facilities,
19 equipment and employee/personnel that are necessary to provide service to Missouri retail
20 electric customers are also needed to make off-system sales. UtiliCorp customers are paying all
21 the costs associated with the facilities that are used to produce and transport the energy sold in
22 off-system sales. Under these circumstances, then it is only fair and appropriate that UtiliCorp's
23 customers receive the benefits produced by these facilities.

24 Q. Does UtiliCorp shareholders receive benefits from off-system sales margins?

25 A. Yes. To the extent that off-system sales increase over time, the shareholders get
26 the direct benefit of any levels above those in rates. Thus, under the traditional approach of

1 including all off-system sales margins in the revenue requirement determination, both customers
2 and shareholders benefit.

3 Q. Are wholesale jurisdictional revenues included in the revenue requirement
4 calculation?

5 A. No. The wholesale jurisdictional revenues are not included in the determination
6 of retail rates, neither are the costs of the plant facilities, depreciation of this plant (return of
7 investment), return on the investment or any other costs incurred to serve wholesale customers.
8 Thus, none of these revenues and none of these costs associated with wholesale non-
9 jurisdictional transactions are included in the determination of Missouri retail electric rates. All
10 costs that are required to provide wholesale service are assigned or allocated to that customer
11 category. The Federal Energy Regulatory Commission (FERC) regulates the wholesale market
12 for electricity.

13 Q. Are all the costs of the plant investment and costs to provide off-system sales
14 within the Missouri jurisdiction assigned or allocated to an electric utility's Missouri retail
15 customers?

16 A. Yes. All these costs are included in the overall revenue requirement calculation.
17 Return of and on plant investment and equipment, material and supplies and prepayments, costs
18 of fuel, payroll and payroll benefit costs, training and employee development costs to operate
19 the power production and transmission facilities; all costs relating to the production and
20 transmission dispatch centers including the building (office) costs, payroll and payroll benefit
21 costs, employee development and training costs, computer and software costs are all assigned
22 and allocated to the Missouri retail jurisdiction. This Commission regulates those rates.

1 Q. Has UtiliCorp proposed this same 50/50 "sharing" adjustment for off-system
2 sales in any other case?

3 A. Yes. The Company made this exact same proposal in Case No. ER-97-394, its
4 previous Missouri rate proceeding. The Commission did not adopt this proposal in that case. I
5 identified the Commission's basis for rejecting this "sharing" approach in that case at page 8 of
6 my direct testimony.

7 Q. Has UtiliCorp proposed this "sharing" approach in any other state where it
8 provides retail electric services?

9 A. Yes. In a UtiliCorp rate application filed in Kansas on December 8, 2000, its
10 West Plains Energy Kansas (West Plains) division proposed the same 50/50 "sharing"
11 mechanism for off-system sales before the State Corporation Commission of the State of Kansas
12 (KCC) in Docket No. 01-WPEE-473-RTS. The KCC rejected this proposal stating:

13 **F. Sharing of Off-System Sales Margins**

14 30. West Plains asks the Commission to reconsider its decision in
15 Docket No. 99-WPEE-818-RTS to not allow West Plains to share in off-
16 system sales margins. The [Kansas] Commission's decision was
17 affirmed by the Kansas Court of Appeals in *UtiliCorp United, Inc. d/b/a*
18 *West Plains Energy Kansas v. KCC*, slip op.85,716 (Kan.App.December
19 15, 2000). As discussed in Order Nos. 10 and 13 in Docket No.
20 99-WPEE-818-RTS, **the cost of off-system sales are borne entirely by**
21 **the ratepayers, while the Applicant has enjoyed all of the benefits of**
22 **the increased revenue.** If all of the costs are borne by the ratepayers,
23 then **all of the benefits of increased revenues should be enjoyed by**
24 **the ratepayers. The full measure of revenues and costs related to**
25 **these sales should be reflected in the cost of service at test year levels.**

26
27 31. West Plains again asserts its proposed sharing mechanism
28 provides incentive for West Plains to engage in off-system sales and
29 compete in the marketplace. [Keith, Rebuttal at 17]. West Plains
30 submits its proposed sharing mechanism is similar to the sharing
31 mechanism allowed in another Commission proceeding, Docket No.
32 190,061-U. [Keith, Rebuttal at 17]. These arguments are the same
33 arguments made by West Plains in Docket No. 99-WPEE-818-RTS.

1 Consistent with the decision in Docket No. 99-WPEE-818-RTS, Staff
2 made an adjustment to add back 50 percent of the sales margins that had
3 been removed in the schedules filed by West Plains with its rate
4 application.

5
6 **32. The Commission remains concerned about any sharing**
7 **mechanism that allocates the sales margins where 100 percent of the**
8 **costs are borne by the customers.** The Commission has not accepted a
9 sharing mechanism, as proposed by West Plains, for any other electric
10 public utility. **The Applicant has an incentive to continue making off-**
11 **system sales because the Applicant would retain all profits exceeding**
12 **the normalized level reflected in the Applicant's overall revenue**
13 **requirement. The Commission finds no compelling argument has**
14 **been advanced by the Applicant to justify the Commission's**
15 **departure from the prior decision and adoption of a new policy**
16 **regarding off-system sales. Staff's adjustment to off-system sales**
17 **revenues is accepted.**
18

19 [August 15, 2001 Order of KCC in Docket No. 01-WPEE-473-RTS,
20 page 13-14; emphasis added]
21

22 Thus, UtiliCorp proposed this 50/50 "sharing" mechanism in Kansas on two occasions and the
23 KCC rejected the proposal in both instances.

24 Q. Have off-system sales been reflected in the overall revenue requirement used to
25 set rates in other electric utility rate cases in Missouri?

26 A. Yes. I have been involved in numerous electric rate cases over the past two
27 decades, and off-system sales have consistency been used to determine the overall revenue
28 requirement in every case. I have personally been involved in numerous Kansas City Power &
29 Light Company (KCPL) rate cases and earnings reviews, The Empire District Electric Company
30 (Empire) rate cases, St. Joseph Light & Power Company rate cases and earnings reviews and
31 UtiliCorp and Missouri Public Service rate cases and earnings reviews from 1980 to the present.
32 I am also aware of the rate treatment afforded off-system sales in Union Electric Company
33 (AmerenUE) rate cases and earnings reviews. In all instances, off-system sales have been used
34 to calculate the overall revenue requirement levels in this state.

1 Q. Are off-system sales a part of the true-up process in this case?

2 A. Yes. In the August 31, 2001 "Joint List of True-up Accounts, Agreement that
3 the True-up Accounts Encompass More than the MEP Pleasant Hill Power Plant, and
4 Suggestions of Local Public Hearing Sites," the parties agreed to a list of true-up items. Item (7)
5 of the list for Income Statement items, reflects an agreement to true up "Fuel and purchased
6 power expense to reflect fuel prices, purchased power prices, margin from off-system sales and
7 net system load (i.e., re-run production cost model)." The agreed true-up period in this case is
8 through January 31, 2002.

9 Q. Is there an agreement between the parties as to the proper levels of off-system
10 sales that should be included in the true-up revenue requirement calculation?

11 A. No. There is no agreement among the parties on the proper level of off-system
12 sales that should be reflected in the true-up and, ultimately in rates. Off-system sales margins—
13 revenues less expenses—will be examined in the context of the true-up audit for the period
14 ending January 31, 2002. Staff will evaluate the levels of actual off-system sales and expenses
15 for this true-up period to see if representative levels exist upon that to set rates in this case. To
16 the extent that such levels do not exist as of January 31, 2002, Staff will recommend using test
17 year December 31, 2000 levels, which are the levels currently in the Staff's direct filing made
18 on December 6, 2001.

19 **GREENWOOD GENERATING FACILITIES**

20 Q. Has UtiliCorp included the lease costs relating to the Greenwood Generating
21 Facilities (Greenwood Units) in its case?

22 A. Yes. UtiliCorp witness Ferry addresses the Greenwood Units at pages 24
23 through 26 of his direct testimony. Mr. Ferry states that there have been changes to the

Greenwood costs and UtiliCorp has reflected these costs in its case. Mr. Ferry states at page 24, line 20 of his direct testimony:

The lease under which MPS was operating for Units 1 and 2 expired in 2000 (Units 1 and 2 are included on the same lease). The lease for Units 3 and 4 will expire respectively in 2002 and 2004. UtiliCorp purchased Units 1 and 2 and leased them back to MPS. This is also planned for Units 3 and 4. The lease costs for Units 3 and 4 will not change until the term of the original leases expire.

Q. Did Staff treat the Greenwood Units in the same way that UtiliCorp treated them?

A. No. Staff has addressed the proper treatment for the Greenwood Units in its direct testimony at pages 9 through 24. Staff has taken a different approach than leasing by rate basing the Greenwood Units 1 and 2. There continues to be a non-affiliated lease in effect for Greenwood Units 3 and 4. The lease payments for these two units have been included in Staff's direct case.

Q. Did Missouri Public Service acquire these generating units?

A. No. Mr. Ferry states at page 25, line 6 of his direct testimony:

During the negotiations with the previous lessors, it became clear that renewing the leases was going to cause a substantial increase in lease costs. The lessors even indicated that they did not have a desire to renew the leases and preferred to sell the property. UtiliCorp, after reviewing the options for this capacity, decided to purchase the four units, place the property in a subsidiary of UtiliCorp and lease the property to MPS at a cost savings for the customer.

Q. Why did UtiliCorp acquire the units and not place them in Missouri Public Service's rate base?

A. That is not clear. A reading of Mr. Ferry's direct testimony does not provide any explanation for Missouri Public Service not acquiring these assets. Staff specifically asked why the Greenwood Units were purchased by a UtiliCorp subsidiary instead of Missouri Public

1 Service. While Staff inquired into that very issue, UtiliCorp did not provide any explanation or
2 insight into its reasoning for placing "the property in a subsidiary of UtiliCorp and [leasing] the
3 property to MPS..."

4 Q. Has Staff recently been given additional information regarding the acquisition
5 costs of the Greenwood Units?

6 A. Yes. On January 3, 2002, UtiliCorp provided additional material regarding the
7 purchase price of the units in a supplemental response to Data Request No. 446. These
8 documents relate to the actual negotiations with the previous owners in December 1999 and are
9 described as "Documents of offers and counter offers for purchase and lease of the Greenwood
10 1 & 2." Also, notes dating back to December 1999 from the Fern Engineering firm used to
11 evaluate the values of the Greenwood units were also provided on January 3, 2002 in a
12 supplemental response to Data Request No. 488. These documents identify, in part, the
13 negotiation process that UtiliCorp used in acquiring the Greenwood Units.

14 Since these documents were only just received a few days prior to the date rebuttal
15 testimony is due to be filed, Staff has not had time to fully review and assess the contents of the
16 material provided. Staff will evaluate the documents and may have to follow-up with additional
17 inquiry. If there are any changes that need to be made to the Staff's position that become necessary
18 as result of this additional information, Staff will so advise the Commission.

19 **ARIES COMBINED CYCLE UNIT/ PURCHASE POWER AGREEMENT**

20 Q. Has UtiliCorp requested a true-up in this case?

21 A. Yes. UtiliCorp witness Clemens identifies the need for a true-up in this case in
22 his direct testimony, at pages 6 through 10. Specifically, Mr. Clemens states that the Company

1 was requesting a true-up through February 1, 2002 (page 9, line 17 of Clemens direct). Also, on
2 page 9 of his direct, Mr. Clemens identifies the items that should be trued-up in this case.

3 Q. Did the Company state the reason for its true-up request?

4 A. Yes. Mr. Clemens indicated in his direct testimony at page 8, lines 4 through 20,
5 two specific reasons for the Company's request. UtiliCorp believed a true-up in this case was
6 necessary because of "a new purchase power capacity contract" it entered into on behalf of
7 Missouri Public Service and "the volatility of the costs of fuel," specifically, the rise in natural
8 gas prices.

9 Q. Why was the February 1, 2002 true-up date requested by UtiliCorp?

10 A. Mr. Clemens stated that the February 1, 2002 date was selected because of the
11 in-service date of the Aries Combined Cycle Unit that is expected to become operational
12 January 1, 2002. With regard to the need for the true-up, Mr. Clemens stated "the primary
13 reason is to insure the Aries power plant is operating and providing the capacity to UtiliCorp.
14 This date will also allow enough time to audit the true-up items before the operational law date
15 of the new tariffs, if a change is authorized by this Commission" (page 9, line 19 of Clemens
16 direct).

17 Q. Did the Commission authorize a true-up in this case?

18 A. Yes. In its August 14, 2001 "Order Concerning Test Year and True-up,
19 Resetting Evidentiary and True-up Hearings, Adopting Procedural Schedule, and Concerning
20 Local Public Hearings" (Order on True-up), the Commission authorized the use of a true-up
21 period through January 31, 2002.

22 Q. Why was the true-up period through January 31, 2002 used by the Commission?

1 A. This January 31, 2002 date was used by the Commission to be essentially the
2 same as the Company's proposed date of February 1, 2002 date and because Staff supported this
3 date. At page 4 of the August 14 Order on True-up, the Commission cited:

4 Staff further stated that it agreed with a true-up cutoff date of January 31,
5 2002, because the MEP Pleasant Hill, L.L.C., power unit is expected to
6 become operational on January 1, 2002.

7 Q. Did UtiliCorp identify all the components to the true-up in its direct testimony?

8 A. No. UtiliCorp identifies that the "primary" requirement for the true-up in this
9 case is to time the true-up "to insure the Aries power plant is operating and providing the
10 capacity to UtiliCorp," presumably to reflect costs of the Aries Combined Cycle Unit through
11 the purchase power agreement. However, UtiliCorp did not provide any details as to what
12 "operating and providing the capacity to UtiliCorp" means. UtiliCorp has not identified what
13 in-service criteria it purposes to use to satisfy itself that the Aries Combined Cycle Unit is
14 "operating and providing the capacity to UtiliCorp."

15 Q. Should UtiliCorp be required to provide the necessary evidence that the Aries
16 Combined Cycle Unit is "fully operational and used for service?"

17 A. Yes. Regardless of the purchased power agreement, UtiliCorp must make a
18 showing at the time of the true-up that the Aries Combined Cycle Unit is "fully operational and
19 used for service" and able to meet all the obligations and terms of the purchased power
20 agreement during the period of the contract. UtiliCorp should identify and demonstrate, through
21 in-service criteria, that the operational capabilities of this generating plant which must be met,
22 have been attained. Verification must occur before any costs associated with the purchased
23 power agreement are allowed in rates.

24 Q. Did Staff address the need to have the Aries Combined Cycle Unit "fully
25 operational and used for service" as part of its true-up recommendation in this case?

1 A. Yes. In Staff's July 25, 2001 pleading filed on test year and true-up
2 recommendations, under Rate Base, Staff stated:

3 Plant in service, including the MEP Pleasant Hill, L.L.C. power unit (the
4 Aries Combined Cycle unit) (a) if determined to be "fully operational
5 and used for service" (Section 393.135 RSMo 2000), which is scheduled
6 to be operational on January 1, 2002, and (b) related items for which
7 MPS has received an invoice, approved and authorized payment,
8 recorded payment in its accounts payable system and are auditable at the
9 time of the true-up audit
10

11 Q. Is the Aries Combined Cycle Unit similar to The Empire District Electric
12 Company's (Empire) State Line Combined Cycle Unit, which was recently placed in service?

13 A. Yes. Both units are Westinghouse combustion turbine units with two heat
14 recovery steam generators (HRSGs) and a steam turbine-generator. The Aries unit is rated at
15 approximately 600-megawatts, while the State Line unit is rated at 500-megawatts.

16 Q. Has the Commission recognized the need to have in-service criteria in past cases
17 when power plants are being newly constructed?

18 A. Yes. Historically, this Commission has reviewed the operational capability of
19 newly constructed power facilities before these costs have been permitted by the Commission to
20 be reflected in rates. The most recent examination was in the Empire rate case, Case No. ER-
21 2001-299. In that case, Empire was required to meet Staff's in-service criteria before its State
22 Line Combined Cycle Unit was included in rate base and, ultimately, in rates.

23 **MERGER BETWEEN UTILICORP UNITED AND ST. JOSEPH LIGHT & POWER**
24

25 Q. Were you involved in the St. Joseph merger case filed by UtiliCorp, and
26 St. Joseph Light & Power Company, in Case No. EM-2000-292?

27 A. Yes. I filed rebuttal testimony in that case on the same merger related issues that
28 I am addressing in this rebuttal testimony in this case—Case No. ER-2001-672.

1 Q. What specific areas will your rebuttal address regarding the merger of
2 UtiliCorp and St. Joseph Light & Power?

3 A. This rebuttal testimony is to respond to the direct testimony of UtiliCorp
4 regarding the regulatory treatment of certain costs resulting from the merger with St. Joseph
5 Light & Power. In this rebuttal, I will provide testimony setting out a general review of the
6 regulation of utility merger and acquisition activity in the state of Missouri. I will present
7 testimony relating to what is commonly referred to as the "acquisition adjustment"
8 (or "merger premium" or "acquisition premium") resulting from the merger. I will also
9 address the issue of rate recovery of this "merger premium" along with Staff Accounting
10 witnesses Mark L. Oligschlaeger, Charles R. Hyneman, Janis E. Fischer and Steve M.
11 Traxler. Staff witness Michael S. Proctor of the Electric Department will also address the
12 acquisition adjustment issue.

13 Q. How does your rebuttal testimony filed in this case compare to the testimony
14 you filed concerning the same issues in the UtiliCorp/St. Joseph Light & Power merger
15 application, Case No. EM-2000-292?

16 A. The testimony is very similar to that which I filed in Case No. EM-2000-292,
17 and in many sections it is identical.

18 Q. How is your testimony on the merger between UtiliCorp and St. Joseph Light
19 & Power organized?

20 A. The following represents the structure of the testimony relating to the
21 St. Joseph merger by areas:

- 22 1. Mergers and Acquisition Background
- 23
- 24 2. Background of the St. Joseph Light & Power merger with
- 25 UtiliCorp United Inc.

3. Acquisition Adjustment
4. Historical Perspective Relating to Acquisition Adjustments
5. Gains on Sale of Utility Property
6. Disallowance of Merger Premiums in Rates does not Affect
Mergers being Completed in Missouri
7. Termination of the KCPL Merger with Western Resources
8. Merger Tracking
9. Customers are Entitled to Savings Generated by Utilities for
either Merger or Nonmerger Events
10. UtiliCorp Commitments Regarding the Acquisition Adjustment
11. Summary and Conclusions

MERGERS AND ACQUISITIONS BACKGROUND

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

A. I have been involved in Staff's review of several merger and acquisition applications filed with the Commission.

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

I filed rebuttal testimony on the proposed merger between Empire District Electric Company (Empire) and UtiliCorp. On December 15, 1999 UtiliCorp, with Empire, filed an application requesting approval of a merger of UtiliCorp with Empire. The Commission approved this merger on December 28, 2000 in Case No. EM-2000-369, but UtiliCorp 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.

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

Staff witnesses Oligschlaeger, Hyneman and I were involved in the Staff review of the proposed merger between Union Electric Company (Union Electric) and CIPSCO Inc. (CIPSCO). This merger was announced in August 1995 and was not completed until December 31, 1997. On November 7, 1995, Union Electric 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

1 with Western Resources, known at the time as the Kansas Power & Light Company (KPL),
2 KCPL withdrew its tender offer on December 13, 1990.

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

5
6 I was also involved in the review of KPL's merger with and acquisition of KGE. On
7 November 21, 1990, KPL filed an application with this Commission docketed as Case
8 No. EM-91-213, requesting authority to acquire all classes of capital stock of KGE, merge
9 with KGE, and issue stock and incur debt obligations relating thereto. That application was a
10 result of a definitive Agreement and Plan of Merger dated October 28, 1990, which was
11 executed by the two companies. The Commission authorized the KPL merger with KGE in a
12 Report And Order dated September 24, 1991. The State Corporation Commission of the
13 State of Kansas (Kansas Commission or KCC), in Consolidated Docket Nos. 172,745-U and
14 174,155-U, approved that same merger on November 15, 1991. After receiving the
15 necessary regulatory approvals, KPL completed the merger with KGE on March 31, 1992.

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

18
19 I was also involved in the Staff's review of the Joint Application filed with the
20 Commission on August 5, 1993 for the authorization to sell, transfer and assign certain assets
21 relating to the provision of natural gas service in Missouri from Western Resources, d/b/a
22 KPL Gas Service to Southern Union Company (Southern Union). This case was docketed as
23 Case No. EM-94-40. The Joint Application was a result of an Agreement for Purchase of
24 Assets dated July 9, 1993, which was executed by the two companies. The Commission
25 approved this purchase transaction on December 29, 1993. Southern Union continues to

1 operate this natural gas distribution system in the western part of Missouri as Missouri Gas
2 Energy (MGE).

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

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

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

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

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

18 Also, I have been involved in examining the impacts of acquisition and merger
19 activities of another utility operating within the state of Missouri. Specifically, I was
20 involved in the supervision of an audit of UtiliCorp's Missouri Public Service (MPS)
21 division in Case No. GR-88-194, wherein the Staff examined UtiliCorp's Corporate Office
22 function, particularly the impacts on cost of service of that utility's acquisition and merger
23 strategy, in the context of a natural gas rate increase case.

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

4 I have reviewed several other applications filed with the Commission relating to
5 acquisitions of utility property, primarily involving UtiliCorp. This review included the
6 acquisition of Peoples Natural Gas Company from InterNorth that was approved by the
7 Commission in 1985 in Case No. EF-86-73. I was also involved in the review of the
8 acquisition of electric properties of Centel by UtiliCorp in the early 1990s.

9 **BACKGROUND OF THE ST. JOSEPH LIGHT & POWER COMPANY MERGER**
10 **WITH UTILICORP UNITED INC.**
11

12 Q. Did St. Joseph Light & Power Company provide utility services within the
13 state of Missouri prior to its merger with UtiliCorp?

14 A. Yes. St. Joseph provided electric, natural gas and industrial steam utility
15 service to customers in the northwest part of the state of Missouri.

16 Q. What was the history of St. Joseph Light & Power Company?

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

20 St. Joseph's corporate headquarters were located in St. Joseph, Missouri. It was an
21 independent investor-owned electric utility that was engaged in the generation, purchase,
22 transmission, distribution and sale of electricity to over 62,000 electric customers in 74 cities,
23 towns and villages, and in a large rural area encompassing 3,200 square miles in northwest
24 Missouri. In 1999 electric revenues represented about 70% of its total revenues. St. Joseph also

1 supplied natural gas to approximately 6,400 customers in Maryville and 14 other communities.

2 St. Joseph provided industrial steam service to six customers in St. Joseph, Missouri.

3 Q. When did UtiliCorp and St. Joseph file its application to merge?

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

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

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

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

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

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

18 A. Under the terms of the merger agreement, UtiliCorp proposed to pay
19 St. Joseph shareholders a fixed value of \$23.00 of its common stock for each share of
20 St. Joseph's common stock. According to the direct testimony (page 6) filed in Case No.
21 EM-2000-292 by UtiliCorp witness Robert K. Green, President and Chief Operating Officer,
22 the total value of the merger transaction was to be \$270 million, of which \$190 million
23 relates to the purchase of approximately 8.2 million shares of St. Joseph's common stock and

1 the assumption of an expected \$80 million in liabilities. That estimate represented a \$92
2 million or approximately 36 percent merger premium to the book value of St. Joseph. The
3 UtiliCorp common stock was to be based on the average trading price for UtiliCorp's
4 common stock during the 20 trading days ending on the fifth trading day prior to the closing
5 date (Proxy Statement, page 31).

6 Upon the completion of the merger on December 31, 2000, all the operations of
7 St. Joseph were merged with and into the operations of UtiliCorp, and St. Joseph is now
8 being operated as a division of UtiliCorp. UtiliCorp maintained The St. Joseph Light &
9 Power Company name as a trade name within the existing service territory of St. Joseph.
10 The service once provided by St. Joseph Light & Power Company is now being provided by
11 St. Joseph Light & Power, a division of UtiliCorp.

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

13 A. Yes. The Proxy Statement (pages 14 through 16) identifies in detail the
14 process that the Board of Directors of St. Joseph engaged in to conduct a series of analyses
15 relating to its future operations. Also, in the direct testimony of Mr. Terry F. Steinbecker,
16 Chairman of the Board, President and Chief Executive Officer of St. Joseph, (Case No. EM-
17 2000-292 direct, pages 2 through 6) there is similar detail about the merger process that St.
18 Joseph used to determine its future corporate structure. Some of the more important events
19 that occurred during the period of 1995 to the March 4, 1999, the date the merger agreement
20 was executed, are as follows:

- 21 • Prior to 1995, St. Joseph's Board of Directors (Board) studied
22 various strategies for maximizing shareholder value.
- 23 • In 1995, St. Joseph retained a consulting firm, Planmetrics, Inc.,
24 which presented to the Board an analysis in January 1996
25 relating to Strategic Planning of St. Joseph. This presentation
26

1 was used by the Board to make decisions on St. Joseph's
2 diversification program.

- 3
- 4 • The diversification program resulted in the acquisition of several
- 5 companies by St. Joseph, including Percy Kent, who is a
- 6 manufacturer of small paper bags for food, agricultural,
- 7 chemical, pet food and other consumer packaging companies.
- 8
- 9 • In 1998, St. Joseph retained another consulting firm, Scott,
- 10 Madden & Associates, Inc. (Scott, Madden), which issued a
- 11 confidential report to the Board of Directors on St. Joseph's
- 12 Strategic Planning. Scott, Madden recommended that St. Joseph
- 13 should sell the Company.
- 14
- 15 • On July 15, 1998, the Board approved the retention of Morgan
- 16 Stanley as financial advisor to St. Joseph. Morgan Stanley was
- 17 instructed to develop potential strategic alternatives for
- 18 maximizing shareholder value, including a potential merger or
- 19 strategic alliance.
- 20
- 21 • On October 14, 1998, Morgan Stanley outlined the strategic
- 22 challenges facing St. Joseph and recommended that St. Joseph
- 23 explore a potential business combination with a larger utility
- 24 company as the best means of maximizing long-term value for
- 25 St. Joseph's shareholders.
- 26
- 27 • At the October 14 meeting, the Board instructed Morgan Stanley
- 28 to contact seven companies for the purpose of obtaining
- 29 expressions of interest in a potential business combination.
- 30
- 31 • Between November 27 and December 2, 1998, two of the seven
- 32 potential bidders informed Morgan Stanley of their interest in
- 33 receiving information about St. Joseph. During a December 4
- 34 meeting with the Board, Morgan Stanley informed the Board that
- 35 a third party had indicated an expression of interest.
- 36
- 37 • Between December 16 and 18, 1998, Morgan Stanley received a
- 38 preliminary expression of interest from each of three potential
- 39 bidders. On December 21, Morgan Stanley discussed financial
- 40 and non-financial aspects of the non-binding bids that contained
- 41 preliminary proposed valuations of between \$19.70 and \$22.25
- 42 per share of St. Joseph common stock.
- 43
- 44 • Between January 12 and 21, 1999, the three parties that
- 45 submitted non-binding bids performed due diligence reviews of
- 46 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. UtiliCorp'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 UtiliCorp had the higher and fixed nature of the bid, Morgan Stanley was requested to see if UtiliCorp would increase its offer. Morgan Stanley contacted UtiliCorp and encouraged it to increase its bid. UtiliCorp 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 UtiliCorp'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 UtiliCorp. 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 is fair.
- On March 4, 1999 St. Joseph executed the merger agreement with UtiliCorp based on unanimous approval of the Board.
- On March 5, 1999 the merger was publicly announced.

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

1 Q. Did St. Joseph's Board recommend to its shareholder approval of the merger
2 with UtiliCorp?

3 A. Yes.

4 Q. Did the shareholders approve the merger?

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

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

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

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

- 16 • the merger **consideration offers St. Joseph's shareholders an**
17 **attractive premium** over the recent historical trading prices of
18 St. Joseph's common stock;
- 19 • the merger **offers St. Joseph's shareholders a more liquid market**
20 **for their shares;**
- 21 • as a result of the merger, **St. Joseph's shareholders will most likely**
22 **benefit from UtiliCorp's dividend rate**, which currently is, and in
23 recent years has been, higher than St. Joseph's dividend rate;
- 24 • **St. Joseph's shareholders will benefit by participating in the**
25 **combined economic growth of the service territories** of UtiliCorp
26 and St. Joseph, and from the inherent increase in scale, the market
27 diversification and the resulting increased financial stability and
28 strength of the combined entity;
29
30
31

- 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. As previously noted, in the Proxy Statement, and as stated in Mr. Steinbecker's direct testimony in Case No. EM-2000-292 (pages 2 through 4), the Board made the decision to merge with UtiliCorp based solely on "maximizing shareholder value." The payment of the merger premium to St. Joseph's shareholders and the increased dividends to former St. Joseph shareholders 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.

The reasons cited by the Board in its communication to the shareholders regarding the merger illustrate that the rationale for the St. Joseph merger, like most mergers, is about increasing the overall wealth of Companies' shareholders.

1 Q. Please explain.

2 A. It is necessary for a proposed merger to provide opportunities to shareholders
3 in order for management to be able to pursue the merger. If the merger cannot be presented
4 as advantageous to shareholders, they will not vote for approval. The Proxy Statement
5 identifies several benefits to St. Joseph's shareholders to ensure that they believe that they
6 are being rewarded for giving up control of the company. Maximizing shareholder value is
7 extremely important in the merger process. The board of directors has a special and unique
8 responsibility to the shareholders and other investors of the entity to ensure that the owners
9 of the entity are fully compensated for relinquishing their ownership interest. The payment
10 of the merger premium to St. Joseph's shareholders is the primary benefit to them, along with
11 any opportunity to receive an increase in dividends. Also, typically the opportunity for a
12 smaller company like St. Joseph to access more potential shareholders by trading stock in a
13 larger pool of investors, such as was and is the case for UtiliCorp's stock, is considered a
14 benefit. This allows former St. Joseph stockholders to trade their stock in a more liquid
15 market than was previously available to them. Other potential shareholder benefits resulting
16 from mergers, include the opportunity to be an owner of a larger combined company with
17 greater potential for economic growth, the opportunity as a shareholder to "keep" the
18 preponderance of the purported merger savings, the opportunity to participate in the
19 increasingly competitive market for power, the opportunity to engage in non-regulated and
20 non-utility diversification and the opportunity to realize the benefits of a larger combined
21 company for such things as access to a larger share of the capital markets, procurement of
22 goods and services, etc. These all relate directly to enhancing shareholder value.

1 Q. Does the merger consideration that was paid to St. Joseph's shareholders
2 contain a "control premium?"

3 A. Yes. A portion of the merger consideration of \$92 million, or the approximate
4 36 percent merger premium, relates to what is commonly referred as "control premium."
5 While the actual consideration paid to St. Joseph by UtiliCorp for control of the company is
6 not known, it is common for consideration to be paid in a merger to the seller for
7 relinquishing its control of the company. Mr. Myron McKinney, Empire's President and
8 Chief Executive Officer, stated at page 6 of his direct testimony in Case No. EM-2000-369
9 that consideration had to be made to Empire's shareholders for giving up control when he
10 stated the "financial parameters must be achieved in the merger for the company giving up
11 control...." St. Joseph gave up control of the company to UtiliCorp in the same manner that
12 Empire anticipated, and to that extent, also had to be compensated through the merger
13 premium.

14 Q. Did the merger agreement permit members of St. Joseph's Board of Directors
15 to become members of UtiliCorp's Board of Directors after the merger?

16 A. No. None of St. Joseph's Board members were retained to be on UtiliCorp's
17 Board. In addition, none of St. Joseph's officers were given positions after the merger was
18 completed.

19 For UtiliCorp to control all Board of Directors and officer level positions, an amount
20 had to be included as merger consideration to St. Joseph's shareholders. This control
21 premium allows UtiliCorp to control all aspects of the post-merger entities.

22 For additional discussion of the control premium, see the rebuttal testimony of Staff
23 witness Hyneman.

ACQUISITION ADJUSTMENT

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

A. Yes. UtiliCorp will have to record on its books, for a period of 40 years, the acquisition adjustment that results from the merger premium paid to St. Joseph's shareholders.

Q. Is UtiliCorp proposing to recover the acquisition adjustment in rates in this case?

A. Yes. UtiliCorp has indicated if Staff does not file a stand-alone Missouri Public Service divisional rate case, it will request transaction and transition costs and a portion of the acquisition adjustment from the St. Joseph merger for recovery in rates from Missouri Public Service customers [UtiliCorp witness Clemens, direct testimony, page 5]. Staff's case is not a stand-alone Missouri Public Service divisional rate case.

Q. Did UtiliCorp address the recovery of the acquisition adjustment in the merger application that was filed in Case No. EM-2000-292?

A. Yes. UtiliCorp and St. Joseph, the Joint Applicants in Case No. EM-2000-292, proposed a regulatory plan that would have allowed UtiliCorp to retain a substantial portion of the purported merger savings and future non-merger savings in order to recover the merger premium to be paid to St. Joseph's shareholders. UtiliCorp assumed it would retain 100% of the merger savings in its financial evaluation of the merger with St. Joseph. It has been UtiliCorp's plan all along to retain substantial merger and non-merger related savings so as to fully recover the amount of the merger premium paid to St. Joseph's shareholders for control of that company.

The UtiliCorp regulatory plan proposed to retain both merger and non-merger savings through a series of requests of UtiliCorp. Among these several proposals of UtiliCorp was a 5-

1 year rate moratorium for St. Joseph's rates that allowed for a full retention of the merger and
2 non-merger savings for a period of 5-years. The plan also allowed for the "freezing" of the
3 capital structure for St. Joseph to a pre-merger level and the "freezing" of corporate allocations
4 for Missouri Public Service by not reflecting St. Joseph's operations into the allocation mix.
5 These proposals were designed to provide "indirect" recovery of the merger premium. In
6 addition, UtiliCorp proposed in Case No. EM-2000-292, the direct recovery of half of the
7 merger premium at the end of the 5-year moratorium.

8 Q. Did the Commission adopt UtiliCorp's regulatory plan in Case
9 No. EM-2000-292?

10 A. No. The Commission did not adopt the regulatory plan in the context of the
11 merger application. The Commission further declined to address the recovery of the
12 acquisition adjustment (merger premium) in the merger case [December 14, 2000 Report
13 And Order—pages 40 and 41].

14 Q. What is the amount of the acquisition adjustment related to the merger
15 between UtiliCorp and St. Joseph?

16 A. UtiliCorp identifies the acquisition adjustment as approximately \$93 million
17 (UtiliCorp witness Streek's direct testimony, page 4 in Case No. EM-2000-292). UtiliCorp
18 also incurred additional costs relating to closing or completing the merger, commonly known
19 as transaction costs; i.e., legal, engineering, investment banking (the separate financial
20 advisors used by St. Joseph) and other consultants' fees. Transaction costs are typically
21 incurred prior to the completion of the merger since they are incurred in reaching the
22 agreement to merge and in closing the merger.

UtiliCorp incurred and is still incurring costs referred to as transition costs, commonly referred to as "costs to achieve" the merger; i.e., costs typically incurred after the merger is completed to integrate and implement systems and processes of the two combining companies. Transaction costs and "costs to achieve" the mergers are discussed in the rebuttal testimony of Staff witnesses Fischer and Hyneman. UtiliCorp's estimates of the merger premium, transaction costs and transition costs associated with the St. Joseph merger transaction were as follows at the time of the merger application case (Case No. EM-2000-292):

Merger premium	\$ 92.8 million
Transaction costs	<u>4.575</u> million
(Costs of the merger)	
Total value of acquisition adjustment	<u>\$ 97.375</u> million
Transition Costs	\$ <u>8.673</u> million
(Costs to achieve)	

[Source: UtiliCorp witnesses Streck, page 4, and Vern J. Siemek—
Schedule VJS-2 in Case No. EM-2000-292]

Q. What was the actual merger premium that UtiliCorp incurred for the acquisition of St. Joseph?

A. The actual total value of the acquisition adjustment is approximately \$108.7 million (Data Request No. 381) based on UtiliCorp closing the merger by December 31, 2000. This amount compares to the \$92.8 million amount estimated at the time of the merger application filed in Case No. EM-2000-292, referenced above.

Q. What is a "merger premium?"

1 A. A "merger premium" represents, in general, any portion of the purchase price
2 for a company that reflects a valuation above the current net book value of the acquired
3 company's assets, or market value of the acquired company's stock.

4 For UtiliCorp specifically, the merger premium represents the transfer of shareholder
5 wealth from UtiliCorp to St. Joseph to consummate the merger, measured by the gain in
6 stock price and increase in the number of shares of UtiliCorp stock to be held by St. Joseph
7 shareholders, compared to the market value and the number of shares of pre-merger St.
8 Joseph stock.

9 Q. What is an acquisition adjustment?

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

17 Q. What is "original cost?"

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

20 All amounts included in the accounts for electric plant acquired as an
21 operating unit or system, except as otherwise provided in the texts of the
22 intangible plant accounts, shall be stated at the cost incurred by the
23 person who first devoted the property to utility service. (Paragraph
24 15,052 of USOA).

25 Depreciation and amortization of the utility property from the previous owner must be
26 deducted from the original cost, which results in a net original cost figure to be recorded on the

1 purchaser's books and records. The acquired property is valued at the same value the seller
2 placed on it, hence the concept of "original cost when first devoted to public service," adjusted
3 for depreciation and amortization.

4 Q. Do utilities endorse the net "original cost" concept?

5 A. Yes. In a Joint Submission made by the then KPL and Gas Service Company
6 (Joint Submission By KPL And Gas Service Pursuant To Order Of September 20, 1983;
7 attached hereto as Schedule 2 to my testimony) to the KCC, in Docket No. 138,495-U
8 respecting KPL's request for authority to acquire the Gas Service Company (Gas Service), KPL
9 stated the following:

10 The Commission has the "duty to ascertain the reasonable value of all
11 property of any [regulated public utility] whenever it deems the
12 ascertainment of such value necessary in order to enable the Commission
13 to fix fair and reasonable rates" K.S.A. 66-128. The rate base of a
14 public utility represents the reasonable value of all property which is in
15 service and devoted to the public use. [citation and footnote omitted]
16

17 **Because the value of the corporation's property remains unchanged**
18 **as the corporation's stock is bought and sold, the transfer of a**
19 **utility's stock, the indicia of ownership in a corporate entity whose**
20 **stockholders are separate and distinct from the entity itself, does not**
21 **affect the value of its property in service and devoted to the public**
22 **use. Thus, no recalculation of the utility's property, or rate base, is**
23 **appropriate.**
24

25 The current rate base of Gas Service is derived from the **original cost of**
26 **the property when first dedicated to public use.** The purchase of its
27 stock does not affect original cost. A new stockholder does not purchase
28 the assets of the corporation. Nor does a change in, or substitution of
29 stockholders establish a new business entity. Transfer of ownership of
30 common stock does not affect the ownership of the corporation's
31 property, which still belongs to the corporation. [footnote omitted]
32

33 In a stock transfer, no assets are removed from public service or
34 transferred to another business entity. **The same assets will continue to**
35 **be used to provide the same services to the same ratepayers and the**
36 **assets will remain subject to the same ratemaking jurisdiction of the**

1 **same regulators.** This continuity makes a recalculation of Gas
2 Service's rate base incongruous.

3 [Joint Submission, pp. 2-3; emphasis added]

4 The Joint Submission was requested by the KCC in Docket No. 138,495-U, wherein
5 KPL and Gas Service were directed to provide a legal analysis of whether the Commission
6 should consider adjusting Gas Service's rate base to reflect the purchase price of Gas Service
7 common stock purchased by KPL. It is clear that KPL was arguing for Gas Service's rate base
8 to be valued at net "original cost" even though the "transfer of common stock ownership was
9 effected at approximately 89% of net book value." (Joint Submission, page 1). The Joint
10 Submission was signed by David S. Black, at the time Senior Vice President, Law and
11 subsequently Chairman of the Board, President and Chief Executive Officer of KPL.

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

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

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

18 A. Utility property is recorded on the company's books and records at net original
19 cost. A utility must account for any difference between the acquisition cost or purchase price of
20 property and the net original cost; i.e., the amount paid to the original owner (the seller) for
21 utility property being first placed into service and the recorded net original cost amount. This
22 difference in purchase price is recorded in USOA Account 114, Electric Plant Acquisition
23 Adjustments. The amortization of the acquisition adjustment is made to Account 406,
24 Amortization of Electric Plant Acquisition Adjustments, if authorization is granted to include

1 the adjustment in cost of service for ratemaking purposes (above-the-line treatment). If no
2 authorization is given to include an amortization for ratemaking purposes (i.e., below-the-line
3 treatment occurs), then Account No. 425, Miscellaneous Amortization, must be used.

4 The USOA description of Account 114 states:

5 A. This account shall include the difference between (1) the cost to the
6 accounting utility of electric plant acquired as an operating unit or
7 system by purchase, merger, consolidation, liquidation, or otherwise, and
8 (2) the original cost, estimated, if not known, of such property, less the
9 amount or amounts credited by the accounting utility at the time of
10 acquisition to accumulated provisions for depreciation and amortization
11 and contributions in aid of construction with respect to such property.
12

13

14
15 C. Debit amounts recorded in this account related to plant and land
16 acquisition may be amortized to account 425, Miscellaneous
17 Amortization, over a period not longer than the estimated remaining life
18 of the properties to which such amounts relate. Amounts related to the
19 acquisition of land only may be amortized to account 425 over a period
20 of not more than 15 years. Should a utility wish to account for debit
21 amounts in this account in any other manner, it shall petition the
22 Commission for authority to do so. Credit amounts recorded in this
23 account shall be accounted for as directed by the Commission.
24

25 The USOA description of Account 406 states:

26
27 This account shall be debited or credited, as the case may be, with
28 amounts includible in operating expenses, pursuant to approval or order
29 of the Commission, for the purpose of providing for the extinguishment
30 of the amount in account 114, Electric Plant Acquisition Adjustments.
31

32 The USOA description of Account 425 states:

33
34 This account shall include amortization charges not includible in other
35 accounts which are properly deductible in determining the income of the
36 utility before interest charges. Charges includible herein, if significant in
37 amount, must be in accordance with an orderly and systematic
38 amortization program.
39
40
41
42

ITEMS

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

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

HISTORICAL PERSPECTIVE RELATING TO ACQUISITION ADJUSTMENTS

Q. What is the historical background for the position that net "original cost" should be the basis for setting rates for utility property?

A. Abuses that occurred in the 1920's and 1930's created the need to adopt the original cost concept in setting rates. In the 1920's and 1930's, utilities were acquiring other utility properties for amounts in excess of net book value. This valuation and transfer in excess of book value (i.e., positive acquisition adjustments/merger premiums) created inflated rate bases, which, when included for ratemaking treatment, resulted in higher rates to the then-existing customers. These customers were paying higher rates for the exact same property that had been providing them utility service prior to the merger and acquisition. It was believed that it was not reasonable to charge customers higher rates for the same utility property simply because the utility providing service was acquired by another company. Thus, the practice of using the "original cost" of the property when first devoted to public service became widely accepted. This principle has served to protect ratepayers from utilities selling properties at inflated prices, and then having the purchaser seek revaluation of the properties at higher levels in order to produce greater profits.

Q. Are the concerns that ratepayers will be paying inappropriate higher rates for utility service if the acquisition costs are included in rates just as valid now as they were in the past?

1 A. Yes.

2 Q. Is one of the standards that sometimes has been used to determine the
3 ratemaking treatment of acquisition adjustments whether the purchase of the property was an
4 "arm's length" transaction?

5 A. Yes.

6 Q. If the purchase of utility property is an arm's length transaction, would this
7 guarantee that the lowest purchase price would result?

8 A. No. Simply because an acquisition of utility property would be considered an
9 arm's length transaction (i.e., no affiliation or tie between the negotiating parties), this criterion
10 alone would not guarantee the lowest possible purchase price. This is particularly true if the
11 purchasing utility's management intended that the ratepayers should be required to pay for any
12 premium above net book value. In that circumstance, there certainly would be no guarantee that
13 the purchasing utility would have negotiated the best possible terms or an approximation
14 thereof.

15 Q. If the Commission were to determine that acquisition adjustments should be
16 included in the ratemaking process, would there be a need for the Commission to determine the
17 appropriate price at which utilities should acquire other utilities?

18 A. Yes. Using the Commission's current precedent of not considering acquisition
19 adjustments in the ratemaking process relieves the Commission and its Staff of the burden of
20 determining the appropriate purchase price of acquired utilities. Alternatively, if the
21 Commission were to adopt a position of including acquisition adjustments in rates, this would
22 place the burden of determining the appropriate purchase price of acquired utilities on the
23 Commission and its Staff. Certainly, it is difficult to determine what the "least cost," or

1 otherwise appropriate price, should be for an acquired utility. In order to make that
2 determination, the Commission and its Staff, in essence, would have to place itself in the
3 negotiation process to ascertain if a utility property was being or had been acquired at the lowest
4 possible price. If this were not done, then the Commission could in no way ensure that the
5 public would not be harmed; i.e., that the transaction was not detrimental to the public interest—
6 the standard at which merger applications are evaluated.

7 By maintaining its current position of not authorizing direct or indirect recognition of
8 either positive or negative acquisition adjustments in rates, the Commission can avoid making a
9 determination that the utility property in question was acquired at the lowest possible, or
10 otherwise appropriate, price. The practical effect of authorizing acquisition adjustments in the
11 ratemaking process is in essence to shift the burden or risk from the company to the
12 Commission and its Staff in making determinations regarding the purchase price of acquired
13 utility properties.

14 Q. Why is the Staff opposed to the recovery of acquisition adjustments in rates?

15 A. Allowing recovery of positive acquisition adjustments in rates does not provide
16 sufficient incentive for the acquiring utility to negotiate the best possible price for the acquired
17 firm. If a utility were allowed recovery of acquisition adjustments, it need not be as concerned,
18 or even concerned at all, that it was negotiating the most favorable terms possible in acquiring a
19 property since the ratepayers would provide recovery through rates. Allowing acquisition
20 adjustments in rates sends signals to buyers of utility property that recovery is guaranteed
21 regardless of the purchase price, which may be an inflated amount above the value of the utility
22 property. In fact, if the acquisition adjustment is allowed in rates, both the purchaser and the
23 seller of said property can benefit from inflating the rate base.

1 The adoption of positive acquisition adjustments for ratemaking purposes removes from
2 purchasing utilities (the buyer, which in this case is UtiliCorp) the incentive to negotiate a lower
3 price or terminate negotiations when a seller requests an unreasonable price for the property in
4 question. A policy of giving ratemaking treatment to positive acquisition adjustments would
5 place Missouri regulated utilities at a competitive advantage over unregulated entities, since
6 Missouri jurisdictional utilities then would have in essence a "blank check" for recovery of their
7 acquisition expenditures from ratepayers. This situation does not exist for unregulated entities.
8 Thus, if utility executives knew that there would be recovery from ratepayers of an acquisition
9 adjustment resulting from the purchase of utility property for an amount in excess of net book
10 value, i.e., original cost less depreciation and amortization, this would pose the potential for
11 tainting the negotiation process between the buyer and the seller.

12 Q. How do sellers of utility property benefit from selling above net book value?

13 A. The sale of utility property above net book value benefits the selling party
14 because such a gain is treated below-the-line, and is therefore realized solely by the
15 shareholders. The higher the price that the utility property is sold at, the larger the gain for the
16 seller. Clearly, if the buyer believes there will be a recovery of the acquisition adjustment from
17 ratepayers, there is a greater potential for an inflated rate base, which in turn results in higher
18 utility rates as well as a larger gain to the seller.

19 Q. Do utilities benefit from consistent treatment of acquisition adjustments in the
20 manner advocated by the Staff?

21 A. Yes. Utilities which purchase property below book value, resulting in negative
22 acquisition adjustments, benefit because those utilities receive a return on property valued at its
23 net original cost, not the purchase price. Since these utilities would be receiving a return on the

1 net original cost rate base, their return component would be computed for a rate base greater
2 than that which these utilities actually had invested.

3 The utility industry in Missouri may be in the position of arguing for net original cost
4 ratemaking when negative acquisition adjustments occur, while at the same time advocating that
5 positive acquisition adjustments be treated above net original cost. Under either scenario, the
6 utility would benefit, to the potential detriment of the ratepayers. Western Resources, who once
7 provided natural gas service to customers in western Missouri, took such a position in the past
8 when it purchased the former Gas Service Company in 1983 at below book value.

9 In Case No. GM-84-12, this Commission authorized Western Resources, then KPL, to
10 acquire Gas Service. KPL acquired Gas Service for an amount valued at approximately 89% of
11 net book value. KPL never advocated the use of a negative acquisition adjustment to value Gas
12 Service's rate base in setting rates at any time that it owned the Missouri properties.

13 Q. Had Western Resources previously argued that negative acquisition adjustments
14 should be ignored in the ratemaking process?

15 A. Yes. In a Joint Submission (attached as Schedule 1 hereto) filed in Kansas
16 before the KCC in Docket No. 138,495-U, KPL took the position that a negative acquisition
17 adjustment resulting from the Gas Service merger should not be reflected in the ratemaking
18 process in Kansas. (A portion of the Joint Submission has been previously quoted in this
19 testimony.) In this legal analysis filed before the KCC, KPL maintained that net original cost
20 investment should be used. KPL stated as follows:

21 Aside from the legal issues raised by the Commission's inquiry,
22 revaluation of utility plant measured by the price paid for common
23 stock would produce practical difficulties of potentially significant
24 dimensions. Revaluation, whether on a stock acquisition or purchase
25 of utility assets, would ultimately tend toward higher costs to
26 consumers, since it would provide no incentive to make acquisitions at

1 less than book value. If it is appropriate to write down rate base when
2 stock is purchased below book value, it would be equally correct to
3 write up rate base when the stock is acquired at a premium.
4

5 The Missouri Commission did not recognize the negative acquisition adjustment, but the
6 KCC did. This Commission did not "write down" the assets. Thus, Missouri customers paid
7 higher rates to KPL under original cost theory than they would have if the below book values
8 were used to determine the rate base. Of course, KPL benefited from the use of original cost
9 theory in Missouri for property that, in effect, was overstated because KPL collected higher
10 rates from its Missouri customers.

11 The Joint Submission by KPL further stated:

12 Even if the nature of this transaction could be disregarded and treated
13 as a purchase of the assets of Gas Service, there should be no change
14 in the rate base in recognition of the general rule that the rate base
15 represents the original cost of utility property when dedicated to public
16 use regardless of the price at which it is purchased by another utility.
17 [citations omitted]
18

19 In Kansas the rate base is not recalculated even when the assets are
20 purchased at less than the original cost. [citation omitted] This
21 Commission determined that the reasonable value of property purchased
22 from other utilities was not its purchase price but rather the higher
23 original cost to the first entity which devoted the property to public
24 service. [citation omitted] The Commission accepted Staff's proposed
25 adjustment to increase the utility's rate base from the purchase price of
26 property already devoted to public service to its original cost when first
27 devoted to public service. The Commission considered the increase to
28 be "a traditional adjustment which recognizes for rate-making purposes
29 that the rate base should be the original cost of plant when dedicated to
30 public use regardless of price at a subsequent sale." [citation omitted]
31

32 This carryover of book value is an appropriate valuation method
33 because original cost is an appropriate determinant of reasonable
34 value, and because the purchase price of Gas Service's stock does not
35 accurately reflect the value of its assets. First, even assuming that the
36 purchase price of Gas Service's stock accurately reflected the market
37 value of its assets, there is no sound reason for deviating from the

1 original cost or book value methodology adopted or given great weight
2 in Kansas and most other jurisdictions. [citations omitted]
3

4 Because the market value of assets seldom changes precisely in
5 accordance with depreciation, depreciated original cost is often not an
6 accurate proxy of current fair market value. Nonetheless, **original**
7 **cost accounting is employed to avoid the difficulties of more**
8 **subjective methods of property valuation. The use of the**
9 **depreciated original cost valuation method provides an objective**
10 **method of valuation without the need for independent assessments**
11 **of the fair market value of acquisitions.**
12

13 The unfortunate result of utilizing purchase price in this case would be
14 to encourage the future transfer of properties at a premium above
15 original cost regardless of fair market value. For example, had KPL
16 paid above book value for Gas Service's stock, Gas Service's rate base
17 would have increased, resulting in greater costs to consumers. **One**
18 **reason for the applicability of original cost concept to acquisitions**
19 **was to prevent utilities from artificially inflating their rate bases**
20 **by acquiring properties at unrealistically high prices.** [citation
21 omitted; emphasis added]
22

23
24

25 **This inquiry has confirmed the propriety of Commission [KCC]**
26 **use of original cost as the basis of the value of property devoted to**
27 **utility service.** [emphasis added]
28

29 KPL's position at that time was clear. If the KCC were to consider the negative acquisition
30 adjustment to value Gas Service's rate base, then that position would "logically dictate similar
31 adjustments—up or down—for each utility regulated by the [Kansas] Commission in each rate
32 case." (Joint Submission, Schedule 1).

33 Q. Did the KCC give consideration to the negative acquisition adjustment relating
34 to the KPL/Gas Service merger?

35 A. Yes. In Docket No. 148,312-U, the KCC in its June 13, 1986 Order treated the
36 Gas Service acquisition for rate purposes at below book value. In that Order, it was determined
37 that the effective cost below book value was \$8.4 million on a total company basis. The KCC

1 adopted for ratemaking purposes an amortization of negative goodwill. This has the effect of
2 increasing revenues and thus decreasing the revenue requirement.

3 Q. Are there any cases where this Commission has rejected reflection of a negative
4 acquisition adjustment in rates?

5 A. Yes. In a U.S. Water/Lexington, Missouri, Inc. (U.S. Water) rate case, Case No.
6 WR-88-255, the Commission rejected a negative acquisition adjustment that was proposed by
7 the Office of the Public Counsel (OPC). The negative acquisition adjustment was not used by
8 the Commission to reduce the U.S. Water rate base, or to reflect a negative amortization to the
9 cost of service.

10 If it were inappropriate to use a negative acquisition adjustment to establish rates, then it
11 would be equally inappropriate to use a positive acquisition adjustment. Fairness would dictate
12 that consistent treatment is given for both positive and negative acquisition adjustments.
13 Acceptance of a positive acquisition adjustment would be a reversal of Commission precedent
14 in the U.S. Water rate case. Re U.S. Water/Lexington, Missouri, Inc., Report And Order,
15 29 Mo.P.S.C.(N.S.) 552, (March 10, 1989).

16 As stated in the rebuttal testimony of John C. Dunn, witness for U.S. Water in that
17 proceeding and at one time Chief of Economic Research for the Commission, the Commission
18 has traditionally rejected the use of positive acquisition adjustments in rates. Mr. Dunn stated at
19 page 22 of his rebuttal testimony:

20 Further, the Commission has historically adopted a policy of original
21 cost ratemaking. Regardless of purchase prices, when properties are
22 bought and sold, the Commission has, unless there were compelling
23 circumstances otherwise, regulated on the basis of original cost. There
24 are numerous properties within the state which have been acquired at
25 prices above original costs. **The Commission has routinely rejected**
26 **the use of the purchase price when it is greater than original cost.**
27 It appears to me to be entirely unreasonable for the Commission to

1 now take an asymmetrical position and adopt purchase price as the
2 appropriate standard when the purchase price occurs below original
3 cost. **Either Missouri is original cost ratemaking, or it is not.**
4 [emphasis added]
5

6 Thus, the rebuttal testimony of U.S. Water's witness strongly argued that the appropriate and
7 traditional ratemaking theory relating to acquisition adjustments in Missouri is the use of net
8 original cost.

9 In its initial brief (attached as Schedule 2), the attorneys for U.S. Water argued the
10 concept of "net original cost" rate base. At page 22 of U.S. Water's initial brief, it was stated:

11 ...a negative acquisition adjustment would not be appropriate for general
12 ratemaking principles either. Mr. Drees provided a brief review of the
13 situations which gave rise to the "original cost when first devoted to
14 public service" rules. (Exhibit 6, p. 6) This principle has served to
15 protect ratepayers from utilities selling at inflated prices and then seeking
16 to have the regulators revalue the properties at the higher level, just to
17 produce greater profits. Although there are always exceptions, Mr.
18 Drees **concludes that sales of utility property at higher than net book**
19 **value should be borne by the shareholders. USW is under the**
20 **impression that is the general principle utilized by this Commission,**
21 although there may have been a few exceptions.
22

23 [emphasis added]

24 Q. Does using net original cost valuation for ratemaking purposes give consistent
25 treatment to utilities?

26 A. Yes. Using net original cost to determine rate base valuation for ratemaking
27 purposes provides utilities consistency in establishing their rates. It also provides utilities with
28 the incentive to acquire utility properties of what may be troubled utilities where it would be in
29 the public interest for these troubled utilities to be acquired by another company. Mr. Dunn
30 addressed this view in his rebuttal testimony in U.S. Water case. At page 23 of his rebuttal
31 testimony, Mr. Dunn stated:

1 . . . troubled properties would never be sold. Here, the Commission
2 was confronted with a troubled property and a buyer willing to
3 purchase that troubled property for less than original cost assuming
4 original cost regulation. That difference was part of the incentive in
5 the transaction. Without the incentive associated with this
6 opportunity, the property would have never changed hands and
7 improvements wouldn't even have been contemplated.

8
9 If the Commission adopts an asymmetrical policy in this proceeding
10 where it uses the lower of purchase price or original cost to make rates,
11 no potential buyer would even consider purchasing a troubled property
12 in Missouri.
13

14 Indeed, Mr. Dunn's rebuttal testimony implies that utilities in the state of Missouri have
15 considered and negotiated the acquisition of utility properties with the full knowledge and
16 understanding that Missouri is a net original cost jurisdiction. Utility management in this State
17 has made decisions to acquire utility properties with this belief.

18 Q. Has Mr. Dunn ever represented UtiliCorp?

19 A. Yes. Mr. Dunn has appeared as a witness on numerous occasions in Missouri
20 and other states on behalf of UtiliCorp and Missouri Public Service over the past two decades,
21 and in the last rate case filed by UtiliCorp in Case No. ER-97-394, as its rate of return witness.
22 In fact, Mr. Dunn has filed direct testimony in this case on behalf of UtiliCorp as its rate of
23 return witness.

24 **GAINS ON SALE OF UTILITY PROPERTY**

25 Q. How have gains on sale of utility property been treated for ratemaking purposes?

26 A. Recently, the Commission has not flowed back to ratepayers any of the benefits
27 of the gains on sales. The selling party's shareholders have realized the entire benefit of the
28 gains.

1 The Commission in its Report And Order in KCPL's 1977 general rate increase case,
2 Case No. ER-77-118, found that none of the gains relating to four transactions should be
3 included "above-the-line" and the Staff's adjustment on this issue was disallowed. At
4 Re: Kansas City Power & Light Company, Case No. ER-77-118, Report And Order,
5 21 Mo.P.S.C. 543, 576, (October 20, 1977), the Commission stated:

6 It is the Commission's position that ratepayers do not acquire any
7 right, title and interest to Company's property simply by paying their
8 electric bills. It should be pointed out that Company investors finance
9 Company while Company's ratepayers pay the cost of financing and
10 do not thereby acquire an ownership position. Therefore, the
11 Commission finds that the disposal of Company property at a gain
12 does not entitle its ratepayers to benefit from that gain nor does the
13 disposal of Company property at a loss require that Company's
14 ratepayers absorb that loss.
15

16 Further, in decisions reached by the Commission in rate cases involving Missouri Cities
17 Water Company, Re: Missouri Cities Water Company, Case Nos. WR-83-14, et. al., Report
18 and Order, 26 Mo.P.S.C.(N.S.) 1, 5-6, 10-19 (May 2, 1983) and again respecting KCPL,
19 Re: Kansas City Power & Light Company, Case Nos. EO-85-185, et al., Report and Order,
20 28 MoP.S.C.(S.) 228, 253-56 (April 23, 1986), the Commission found that gains on sale of
21 utility property sold by those utilities would be treated "below-the-line." The Commission has
22 consistently followed this practice of not flowing any gains resulting from sales of utility
23 property to ratepayers. It would be inequitable for the shareholders of a seller of utility property
24 to receive the benefit of any gain therein through below-the-line treatment of the gain, while at
25 the same time, the buyer of utility property is permitted to recover from its ratepayers any
26 "premium," or excess costs above net book value, above-the-line. It would be an unfair
27 approach and disadvantage to the ratepayers, if the seller's gain would be taken below-the-line,
28 while the buyer's premium would be treated above-the-line.

1 Q. Do utilities ever sell properties to other utilities and later reacquire the very same
2 properties?

3 A. Yes, this has happened in the past. In some cases, utilities sell property to
4 another utility and reacquire the sold property back through a merger or acquisition later. This
5 is an instance where the seller's owners reap the profits from any gain and the buying company
6 may request ratemaking treatment for any of the acquisition premium paid for the property.
7 This is a situation where the seller keeps the gains and the buyers' customers are requested to
8 pay for the premiums relating to the acquisition.

9 Q. Has this Commission seen examples of one of the companies under its
10 jurisdiction entering into a transaction to sell property and then reacquiring the very same
11 property later through a merger?

12 A. Yes. On March 12, 1992, Union Electric filed an application with the
13 Commission, docketed as Case No. EM-92-225, to sell its Iowa properties to Iowa Electric
14 Light & Power Company (Iowa Electric). On March 31, 1992, Union Electric also filed an
15 application in Case No. EM-92-253 to sell its northern Illinois properties to CIPSCO. The
16 Commission authorized the sale of these properties in its Report and Order dated
17 December 22, 1992. Re: Union Electric Company, Case Nos. EM-92-225 and EM-92-253,
18 Report and Order, 1 Mo.P.S.C. 3d 501 (1992).

19 Q. Please identify the properties sold to Iowa Electric and CIPSCO.

20 A. Union Electric's Iowa properties were located in the southeastern part of the
21 state having a service area of 566 square miles and serving approximately 17,000 customers.
22 The northern Illinois service area was located just east of the Iowa service area and had

1 approximately 4,200 customers. [Source: Union Electric witness Gary L. Rainwater, Direct
2 Testimony, pp. 6 and 7, Case Nos. EM-92-225 and EM-92-253].

3 Q. When were these properties sold?

4 A. These properties were sold on December 31, 1992.

5 Q. Did Union Electric sell these properties for a gain?

6 A. Yes. The gains Union Electric realized on the Iowa and northern Illinois
7 properties totaled \$34 million. Case Nos. EM-92-225 and EM-92-253, 1 MoPSC 3d 501,
8 503 Report and Order (1992).

9 The gain associated with the northern Illinois property was approximately
10 \$4.8 million. The remaining portion of the gain, or \$29.2 million, relates to the Iowa service
11 area (\$34 million - \$4.8 million).

12 Q. How was the sale of these properties recorded on the books and records of
13 Union Electric?

14 A. Union Electric recorded these transactions by removing the properties from
15 plant in service and from accumulated provisions for depreciation. It also recorded the cash
16 received from Iowa Electric and CIPSCO and reflected the gains from the sale.

17 Q. How did CIPSCO record the purchase transaction?

18 A. CIPSCO recorded the purchase of the northern Illinois service area and
19 facilities as an increase to plant in service on the "original cost" basis. It recorded the same
20 amount on its books for plant as Union Electric had on its books.

21 CIPSCO debited the plant account for \$8,882,092 and credited accumulated
22 depreciation for \$5,168,022. Union Electric credited the plant account and debited the

1 accumulated depreciation account for the exact same amounts. Iowa Electric would have
2 recorded amounts on its books in a similar fashion.

3 Q. Did CIPSCO identify an amount for an acquisition adjustment?

4 A. Yes. CIPSCO established an acquisition adjustment of approximately
5 \$4.9 million for the property sold to it by Union Electric. Union Electric recorded a gain to
6 Account 421.1, Gain on Disposition of Property, of approximately the same value
7 (the amounts differ slightly for the recording of salaries and other sales expenses recorded by
8 Union Electric).

9 Q. How did Union Electric treat the gain?

10 A. The gains from the disposition of the Iowa and northern Illinois properties
11 were treated below-the-line for ratemaking purposes; i.e., the profit from the sale of these
12 properties was flowed back exclusively to the shareholders.

13 Q. Did CIPSCO still own the property it purchased from Union Electric at the
14 time of the merger between Union Electric and CIPSCO?

15 A. Yes.

16 Q. How did the merger between Union Electric and CIPSCO affect this property?

17 A. The merger had the effect of bringing the property back to Union Electric
18 shareholders, who became AmerenUE shareholders after the Union Electric/CIPSCO merger.
19 The acquisition created from the sale of the northern Illinois property that was formerly
20 owned by Union Electric and re-acquired as a result of the Union Electric/CIPSCO merger, is
21 now reflected in the accounts of Ameren once again through Ameren CIPS (as an operating
22 company of Ameren).

1 The property Union Electric sold in 1992 for a gain is reflected on Ameren's
2 consolidated financial statements as an acquisition adjustment. Union Electric shareholders
3 received the full benefit to earnings for this gain, and with the merger, these shareholders
4 received the property back.

5 Q. How do gains on sale of property relate to the booking of acquisition
6 adjustments?

7 A. The amount a selling utility books as a gain on sale will equal the amount a
8 buying utility books as an acquisition adjustment.

9 Q. How did the application for the Union Electric merger with CIPSCO relate to
10 the previous Union Electric sale dockets, Case Nos. EM-92-225 and EM-92-253?

11 A. In the sale dockets, Union Electric sold certain property to CIPSCO at a gain.
12 This gain was booked below-the-line by Union Electric and was provided to its shareholders.
13 In the Union Electric and CIPSCO merger Application, Union Electric, through Ameren,
14 reacquired the property it earlier sold to CIPSCO that was at issue in Case Nos. EM-92-225
15 and EM-92-253. However, through Union Electric's proposed regulatory plan for the
16 CIPSCO merger filed as part of Case No. EM-96-149, it sought to charge the additional cost
17 of the merger premium related, in part, to that specific property to its customers. This would
18 have been clearly inconsistent with the treatment afforded the earlier gain on sale. As will be
19 discussed, Union Electric later abandoned its attempt to recover the merger premium
20 associated with the CIPSCO transaction by entering into a stipulation and agreement.

21 **DISALLOWANCE OF MERGER PREMIUMS IN RATES DOES NOT AFFECT**
22 **MERGERS BEING COMPLETED IN MISSOURI**
23

24 Q. Will disallowances of recovery of acquisition adjustments in rates create
25 disincentives for utilities to acquire other utilities?

1 A. No, that does not appear to be the case at all in Missouri. The experience in
2 Missouri appears to be that if the utility considering an acquisition believes that it is in its
3 economic as well as its business interest, it will acquire the other company regardless of any
4 recovery of an acquisition adjustment from ratepayers. There have been numerous mergers and
5 acquisitions that have occurred over the years that were negotiated with merger premiums. No
6 utility to date has received recovery in rates in Missouri for an acquisition adjustment, but that
7 has not stopped any of the mergers from being completed.

8 Utilities have combined with other utilities independent of receiving recovery of the
9 merger premium directly from their customers. There have been numerous mergers announced
10 and completed in the past, all with the knowledge that this Commission has not ever included a
11 merger premium in rates.

12 Q. Was there an acquisition adjustment relating to the KPL merger with KGE in
13 Case No. EM-91-213?

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

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

19 A. No. No amount of the KGE acquisition adjustment was ever
20 recovered in rates from Missouri ratepayers even though some of the merger savings related
21 to KPL's Missouri natural gas operations. While the Commission authorized KPL to acquire
22 KGE in Case No. EM-91-213, it did not allow recovery of the acquisition adjustment from
23 KPL's 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 of the acquisition adjustment relating to the
6 KCPL and Western Resources merger in rates in Case No. EM-97-515?

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

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

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

17 **2. MERGER PREMIUM**

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

30 [Stipulation and Agreement in Case No. EM-97-515; emphasis added]

1 Q. Did the Commission approve the Stipulation and Agreement for the KCPL
2 merger with Western Resources?

3 A. Yes. On September 2, 1999, the Commission approved the merger along with
4 the Stipulation and Agreement that contained the "no acquisition adjustment recovery"
5 language.

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

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

19 **3. Acquisition Premium**

20
21 The amount of any asserted acquisition premium (i.e., the amount of the
22 total purchase price above net book value), including transaction costs,
23 paid by Atmos for ANG [Associated Natural Gas] properties or incurred
24 as a result of the acquisition **shall be treated below the line for**
25 **ratemaking purposes in Missouri and not recovered in rates.** Atmos
26 shall not seek either direct or indirect rate recovery or recognition of the
27 acquisition premium, including any and all transaction costs (e.g., legal
28 fees, consulting fees and accounting fees), in any future ratemaking

1 proceeding in Missouri. However, Atmos reserves the right to present
2 evidence regarding any purported Sale-related savings in any rate
3 complaint proceeding initiated by Staff or Public Counsel. [emphasis
4 added]
5

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

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

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

27 In the application to acquire APL's Missouri properties, Union Electric also agreed to
28 not seek recovery of the acquisition premium. The parties to this Joint Application, designated
29 as Case No. EM-91-29, signed a Stipulation and Agreement on January 25, 1991. As part of the
30 Stipulation and Agreement, Union Electric agreed not to seek recovery of the acquisition
31 premium in any rate case in the future:

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

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

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

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

25 The Commission approved the Stipulation and Agreement on December 29, 1993.

26 In a more recent case involving the Missouri-American Water Company case (Case
27 No. WR-95-205), the Commission did not allow recovery of the acquisition adjustment from
28 Missouri-American's customers. The Commission stated in its Report and Order that "[t]he
29 Commission finds in this case that the Company has failed to justify an allowance for the

1 acquisition adjustment.” Re: Missouri-American Water Company, Case Nos. WR-95-205
2 and SR-95-206, Report and Order, 4 Mo.P.S.C. 3d 205, 217 (1995).

3 Utilities operating in this State know the position taken by various parties relating to
4 the non-recovery of merger premiums/acquisition adjustments in rates and the Commission’s
5 approval of this. Yet, despite no utility being permitted direct recovery of a merger
6 premium/acquisition adjustment in rates, mergers continue to be pursued and consummated.
7 Other examples of this situation exist.

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

12 Q. Is there another case decided by the Commission where a utility presented
13 evidence of savings as result of an acquisition, and attempted to justify special rate treatment
14 of the alleged merger savings?

15 A. Yes. In the Missouri Gas Energy (MGE) 1996 rate increase case,
16 (Case No. GR-96-285), the Commission rejected a proposal by MGE to allow MGE to retain
17 purported savings from Southern Union’s acquisition of the Missouri properties of Western
18 Resources in 1994. As part of the Stipulation and Agreement in Case No. GM-94-40, MGE
19 could present to the Commission in its rate case purported evidence of savings resulting from
20 the acquisition. The Commission’s Report and Order in Case No. GR-96-285 states in part
21 as follows:

22 MGE contends that the stipulation and agreement allows MGE to
23 request recovery of the benefits resulting from the acquisition. MGE
24 contends that an equal sharing of these ongoing savings between

customers and shareholders is a reasonable ratemaking approach and is consistent with the terms of the stipulation and agreement.

....

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

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

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

Q. Would providing UtiliCorp 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 direct recovery of merger premiums or which have had their merger premium recovery proposals rejected by the Commission?

A. No. UtiliCorp is not unique in the sense that it desires to have customers of St. Joseph and Missouri Public Service subsidize their acquisition strategies. If one can get someone else to pay for purchases, it is likely the purchases (number of merger transactions) will increase and prices paid will also escalate. In prior cases, the utility, whether it was

1 Union Electric seeking recovery of its asserted merger premium "paid" to CIPSCO
2 shareholders or Western Resources paying KCPL's shareholders a substantial premium to
3 merge, all took the position that their mergers justified the recovery of the acquisition
4 premium from their customers. As indicated above, either through Commission order, or
5 stipulation and agreement among the parties, none of the utilities received direct recovery of
6 the merger premium. Under UtiliCorp's proposal to seek recovery of the merger premium
7 and transaction costs in this case, the ultimate recovery of the acquisition adjustment directly
8 from the customers of St. Joseph and Missouri Public Service would be unfair and
9 unreasonable to all other utilities, which have had to find other means to "pay" for their
10 growth strategies besides requiring their customers to pay for those activities.

11 There has been no showing that the St. Joseph merger was necessary other than from
12 the perspective of the shareholders of the companies being "purchased" and the
13 understandable desire to "cash-in" on the opportunity to sell their shares of stock to the
14 highest bidder, UtiliCorp. Customers may or may not ever directly benefit from this merger,
15 and if there are merger benefits, we may never be able to identify and quantify all of them. It
16 is abundantly clear that the St. Joseph merger benefited the shareholders of that company. It
17 is equally clear that UtiliCorp wanted St. Joseph to supplement and promote their "midwest-
18 continent" strategy. St. Joseph fit into the growth and acquisition strategy that UtiliCorp has
19 actively pursued for almost two decades. Just as the Staff has consistently, in Missouri
20 Public Service rate cases, raised concerns about Missouri Public Service customers
21 subsidizing UtiliCorp's national and international growth and acquisition strategies, it would
22 be unreasonable and inappropriate for the customers of St. Joseph and Missouri Public
23 Service to provide the funding for this merger through their rates.

TERMINATION OF THE KCPL MERGER WITH WESTERN RESOURCES

Q. Did the KCPL merger with Western Resources ever close?

A. No. KCPL terminated the merger after a nearly three-year attempt for those two companies to merge. On January 3, 2000, KCPL announced that it was exercising its rights as identified in the KCPL and Western Resources' merger agreement to terminate the merger.

Q. Do you believe the KCPL merger was terminated because the Commission approved the merger without the direct recovery of the merger premium?

A. No. KCPL terminated the merger with Western Resources because of Western Resources' non-regulated activities, specifically Western's 85% ownership interest in Protection One, a security alarm system business. The non-regulated company experienced substantial operational and regulatory problems that caused the stock price of Western Resources to deteriorate. The termination of that merger did not occur because of the Stipulation and Agreement that Western Resources-KCPL voluntarily entered into with the Staff, Public Counsel and others.

Q. Do you know why KCPL decided not to merge with Western Resources?

A. KCPL indicated that the stock price of Western Resources was significantly below the level negotiated between the two companies, which would have resulted in a material decrease in the value that the KCPL shareholders would have received if the merger had been closed.

Q. Did the merger settlements approved by the KCC and the Missouri Commission have anything to do with the collapse of the merger between Western Resources and KCPL?

1 A. No. All the information I have seen regarding the reason for KCPL terminating
2 the merger related solely to the declining value of the merger to KCPL's stockholders resulting
3 from the substantial reduction in Western Resources common stock price. KCPL's
4 stockholders, who initially approved the merger, would have received far less for their shares
5 than they originally would have received at the time of the shareholder vote on July 30, 1998.
6 The merger agreement between Western Resources and KCPL allowed KCPL to terminate the
7 merger if Western Resources' common stock price fell below \$29.78 or if the merger was not
8 completed by December 31, 1999. (Amended And Restated Agreement And Plan Of Merger
9 between KCPL and Western Resources dated March 18, 1998, Article XI-Termination,
10 Amendment and Waiver—Section 11.1 Termination (c) and (f).)

11 Q. Has KCPL explained the reason for the termination of the merger with
12 Western Resources?

13 A. KCPL has stated it was because of the problems with Western Resources
14 stock price caused by the non-regulated operations of Protection One. In KCPL's
15 Form 10-K405 filing with the SEC on February 10, 2000, KCPL identified the reason its
16 Board of Directors voted unanimously on January 2, 2000 for the termination of the merger
17 as follows:

18 A key factor in the KCPL's Board's action was problems at Western
19 Resources' Protection One subsidiary and their impact on Western
20 Resources as a whole. **These problems and the related decline in**
21 **Western Resources' stock price since the signing of the Merger**
22 **Agreement had a direct bearing on the value of the contemplated**
23 **transaction to KCPL's shareholders,** as well as the future prospects
24 of Western Resources and its affiliated companies assuming such
25 transaction was consummated. Western Resources' common stock,
26 which closed at \$43.13 per share on March 18, 1998, closed at \$16.94
27 per share on December 31, 1999.
28

Also critical among the KCPL Board's reasons for their decision was the fact that KCPL's financial advisor, Merrill Lynch & Co., was unable to provide an opinion that the contemplated transaction was fair to KCPL shareholders from a financial point of view.

[Source: KCPL's Form: 10-K405 filing date: February 10, 2000]

In a letter dated January 3, 2000 sent to Western Resources, KCPL's Chairman of the Board and Chief Executive Officer, A. Drue Jennings cited the reasons KCPL was terminating the merger. Mr. Jennings stated the following in his letter to Mr. David Wittig of Western Resources:

Our Board took this action reluctantly and only after giving extensive consideration to all of the relevant facts and circumstances surrounding the transaction. As you know, our Board has held a number of meetings during the past several months to review and consider the status of the transaction. These meetings included a special meeting on October 28, 1999, at which you addressed the Board concerning the financial condition and future prospects and business plan of Western Resources, Inc. ("Western"), **and in particular, the current problems facing your Protection One subsidiary...**

....

*At these meetings, as well as in other communications between our respective companies and their representatives, **we have expressed our deep concern with the problems facing Protection One and their impact on Western as a whole...***

....

While we and our advisors have given careful consideration to the information you conveyed to us in these meetings, I regret to say that our Board has concluded that the transaction contemplated by the Merger Agreement is no longer in the best interests of KCPL and its shareholders. Critical among the Board's reasons for reaching this conclusion was the fact that Merrill Lynch advised that it could not opine that the transaction is fair to KCPL shareholders from a financial point of view. In addition, one of the principal reasons that our Board recommended that KCPL shareholders approve the transaction was that it would provide them with an opportunity to participate, "through their ownership of Western Resources Common Stock, in the growth

1 of a larger, more diversified and strategically positioned holding
2 company," which growth was "expected to derive from diversification
3 into unregulated businesses, including Western Resources' investment
4 in Protection One...." (Joint Proxy Statement of KCPL and Western
5 dated June 9, 1998, at page 42.) **In light of the continuing problems**
6 **at Protection One, this important strategic rationale for the**
7 **proposed merger no longer appears to exist.** Finally, we have heard
8 from numerous KCPL shareholders in recent months – both large
9 institutional holders and small individual holders – who, in increasing
10 numbers, have expressed their opposition to the transaction and have
11 strongly urged that we terminate the Merger Agreement.

12
13 [Source: Letter dated January 3, 2000 from A. Drue Jennings to David
14 Wittig of Western Resources]
15

16 In an article that appeared in The Kansas City Star on March 9, 2000, Mr. Jennings
17 said, "doubts about the merger began to rise in the second quarter of 1999 because of
18 problems at Protection One Inc., the monitored-security firm that is 85 percent owned by
19 Western. The continuing decline of Western's stock, which affected what would be paid to
20 KCP&L shareholders, sealed the deal." Another article in the January 4, 2000 edition of the
21 Topeka Capital-Journal, cited the original value of the merger at \$2.1 billion at the time of
22 the March 18, 1998 merger agreement was worth approximately \$1.4 billion at the time of
23 the termination because of the steep decline in Western Resources' stock price.

24 Without question the reason KCPL terminated the merger with Western Resources
25 was because of the adverse impact Protection One had on the Western Resources' stock
26 price, which in turn made the value of the merger to KCPL and its shareholders substantially
27 less than when the Board of Directors approved the Merger Agreement on March 18, 1998
28 and when the shareholders approved the merger on July 30, 1998.

29 The terms of the merger approval by the Missouri Commission and the KCC were not
30 the reason that the Western Resources-KPL merger was not consummated.

1 Q. Why is the Staff addressing in such detail the reasons for the termination of
2 the Western Resources/KCPL merger?

3 A. During the transcribed interviews conducted in Case No. EM-2000-292 of Mr.
4 Robert Green and Mr. Terry Steinbecker, they made statements that the Missouri and Kansas
5 settlements were material factors causing the termination of the merger between KCPL and
6 Western Resources.

7 **MERGER TRACKING**

8 Q. Did UtiliCorp and St. Joseph propose to track merger savings in Case No.
9 EM-2000-292?

10 A. Yes. In the context of that case, the Joint Applicants proposed a regulatory plan
11 that would have allowed the post-merger UtiliCorp to recover the merger premium through
12 retention of merger and non-merger related savings and through direct recovery of the
13 acquisition adjustment through amortization treatment in a rate case after a five-year
14 moratorium. Under their proposal, UtiliCorp and St. Joseph proposed to "track" all savings,
15 regardless if they are merger-related or non-merger related. The Joint Applicants' merger
16 tracking proposed in the merger case is also being addressed in the rebuttal testimonies of Staff
17 witnesses Oligschlaeger and Fischer.

18 Q. What is tracking of merger savings?

19 A. Tracking of merger savings is the post-merger process where it is asserted that
20 the results of specific actions relating to the merger are isolated so they can be and are identified,
21 verified and quantified. The theory is that the purported results of what would have occurred
22 but for the merger can be and are identified, verified and quantified and compared to
23 substantiated non-merger related savings to determine whether there are merger savings and the

1 amount of those savings. Tracking is the phenomenon by which this comparison of post-merger
2 costs with pre-merger stand-alone costs is alleged to be possible.

3 Q. Can merger savings be "tracked"; i.e., quantified and verified after-the-fact?

4 A. Tracking of merger savings is extremely difficult if it can be done at all and, in
5 actuality, it is probably not possible. It certainly is not practical to track merger savings.

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

8 A. Yes.

9 Q. Why is that the case?

10 A. The difficulty in identifying, verifying and quantifying merger savings, as well
11 as merger costs, relates to the difficulty in distinguishing between merger and non-merger
12 events. Disputes will result which most likely will have to be resolved by the Commission. It is
13 difficult to find agreement among the various parties as to what constitutes actual merger
14 savings and, to a lesser extent, merger costs. Certainly, KPL, under the proposal advanced in
15 the KPL/KGE merger case, Case No. EM-91-213, to share all merger savings on a 50/50 basis,
16 had real incentives to identify and quantify as much savings as merger-related as possible, while
17 ignoring merger costs. The more merger savings and the less merger costs KPL could identify
18 and quantify, the more dollars KPL believed it was entitled to recover via the merger premium.

19 Utilities are complex organizations with overlapping activities and functional areas.
20 They are dynamic organizations that operate in ever-changing environments. Generally,
21 utilities are constantly organizing and reorganizing functions within their corporate structure to
22 streamline activities and obtain efficiencies where possible. Various terms have been used to
23 identify the restructuring of today's utility organizations, such as downsizing, realigning,

1 re-engineering and right-sizing. Most utilities should, and do attempt to achieve efficiencies
2 through the implementation of productivity measures. In this environment, it is unrealistic to
3 believe that a tracking system can be put in place to identify and quantify savings and then
4 isolate these savings between merger and non-merger related. It is very difficult to determine
5 and measure the "cause and effect" relationship that may exist between taking an action and
6 identifying and measuring the effects of that action versus not taking an action and identifying
7 and measuring the effects of the nonaction.

8 Any cost savings tracking system would have to be sophisticated enough to not only
9 identify categories of prospective savings and costs, but to create documentation so that an
10 examination can be conducted after-the-fact to recreate the decision-making process
11 surrounding the costs and savings. Disagreements and disputes are certain in the context of an
12 after-the-fact analysis. While one party may assert that an efficiency is the result of a merger,
13 another may view as nothing more than an operating efficiency, addressing a pre-existing
14 condition of an on-going concern. Disputes will arise because companies have an incentive to
15 identify as much of the savings as merger-related as possible, to capture as much of the merger
16 savings as possible for shareholders. As stated previously, there will be an incentive for the
17 utility to identify as merger-related as many workforce reductions and corresponding reductions
18 in costs as possible. This inherent incentive makes it increasingly difficult on a going-forward
19 basis to truly identify and quantify merger savings, as opposed to non-merger cost savings,
20 because it is not possible to objectively evaluate what would have happened if the merger had
21 not occurred. Utilities having to prove the existence and the amount of merger savings to justify
22 the inclusion of the acquisition adjustment in rates, will make every effort to take credit for
23 savings that may in actuality be nothing more than non-merger related.

1 Q. Why is it not possible to "track" merger savings?

2 A. Realistically, it is probably impossible to accurately "track" merger savings
3 because it requires a comparison of cost structures of the entities being merged on a pre-merger
4 and post-merger basis. If this process is not impossible, it certainly is not practical to accurately
5 identify merger savings. This tracking process would be extremely difficult at best and to my
6 knowledge has never been done successfully before. The merged entities lose their complete
7 identity post-merger, almost from the first day after the close of the merger. In fact, St. Joseph
8 Light & Power lost its pre-merger corporate identity the day the merger was announced to the
9 public on March 5, 1999. The pre-merger St. Joseph entity has not existed since.

10 Upon the announcement of a merger, the merging companies' stock prices are
11 immediately affected. On March 4, 1999, the day before the announcement and the date the
12 merger agreement was completed, the common stock price of St. Joseph was \$16.875 per share.
13 On March 5, 1999, the day of the announcement, St. Joseph's stock price increased to
14 \$20.375 per share. On March 4, 1999, there were over 3,000 shares traded and on March 5,
15 1999, there were over 173,000 shares traded.

16 Every decision made by the companies after the merger is agreed to and announced is
17 affected. Spending levels, human resources decisions, construction projects, etc. are all
18 impacted. Every corporate decision is subject to the terms and conditions of the merger
19 agreement; consequently, the corporate entity as it existed prior to the announcement of the
20 merger no longer exists. While the period during the merger approval process generally results
21 in significant changes at the entity being acquired, certainly after the completion of the merger
22 the acquired entity ceases to exist in every sense. To compare an ever-changing pre-merger

1 stand-alone entity to an emerging post-merger entity presents more than a challenge; it is an
2 incredible task that, to the Staff's knowledge, never has been achieved before.

3 Q. Why is tracking impracticable?

4 A. The reasons the Commission should not rely on UtiliCorp's "tracking" to justify
5 the recovery of the acquisition premium are:

- 6 • There is difficulty in establishing a proper baseline and in distinguishing
7 merger and non-merger related impacts on earnings.
- 8
- 9 • Human intervention is required to subjectively determine how future
10 events and transactions are identified, verified and quantified.
- 11
- 12 • Tracking has not been successfully done in Missouri.
- 13
- 14 • UtiliCorp has not provided a detailed or a concrete proposal.
- 15
- 16 • St. Joseph and UtiliCorp ceased to exist as stand-alone companies the
17 day the merger was announced. It is impossible to identify what would
18 have been a non-merger versus merger savings.
- 19
- 20 • The merged companies will continue to seek/achieve non-merger
21 savings.
- 22
- 23 • The sophistication of UtiliCorp's accounting system is not relevant to the
24 success of tracking.
- 25
- 26 • The attempt to track merger savings will be complicated because of prior
27 difficulties in working with UtiliCorp in providing timely and accurate
28 information and the lack of cooperation that has existed in prior cases.
29 This current case certainly has done nothing to change the thinking on
30 this issue.
- 31
- 32 • The attempt to track merger savings will be further complicated by any
33 future merger and acquisition activity of UtiliCorp.
- 34
- 35 • The attempt to track merger savings will be further complicated by future
36 organizational and re-engineering changes that every company
37 experiences.
- 38
- 39 • The attempt to track merger savings will be further complicated by any
40 future restructuring of the electric utility industry in the state of Missouri.
- 41

1 Q. Is Staff aware of anyone using a "tracking" system to identify merger savings to
2 set rates?

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

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

7 A. Yes. In all the major merger applications filed with the Commission, merger
8 savings tracking has been examined. As has been previously identified in the merger between
9 KPL and KGE, Case No. EM-91-213, tracking of savings was a contested issue. Also, tracking
10 was addressed in the Union Electric merger with CIPSCO, Case No. EM-96-149, and the KCPL
11 merger with Western Resources, Case No. EM-97-515. In all three of these merger cases, Staff
12 interviewed a consultant hired by the utilities to identify merger savings. The consultant was
13 Mr. Thomas J. Flaherty, national partner for Deloitte & Touche, LLP., who specializes in merger
14 analyses, especially, merger synergies studies. Mr. Flaherty has been involved in a number of
15 the mergers throughout the United States.

16 Q. Has Staff ever conducted a transcribed interview of Mr. Flaherty in the course of
17 a merger case?

18 A. Yes. Staff conducted a transcribed interview with Mr. Flaherty on February 26,
19 1999 relating to his work on the KCPL/Western Resources merger (Case No. EM-97-515). The
20 transcribed interview process in the Union Electric/CIPSCO merger and the KCPL/Western
21 Resources merger were very similar to the transcribed interviews performed in the St. Joseph
22 merger case (Case No. EM-2000-292).

1 During his February 26, 1999, interview, Mr. Flaherty discussed the difficulty of
2 identifying savings and distinguishing them between merger and non-merger related events. He
3 indicated that he was not aware of any attempt to track merger savings after-the-fact and to use
4 the results to set rates.

5 Portions of his transcribed interview appear as follows:

6 Q. As far as from our perspective, at U.E., there was no such
7 requirement, and there has been no, ... to my knowledge, any attempt
8 made to go back and track the achieved cost versus the estimated or
9 forecasted savings. Is there a reason why that it is not done? Is it too
10 difficult?

11
12 A. If I recall the arguments we had back in the testimony in the
13 KPL/KG&E case probably still apply. It is an administrative burden, I
14 think, on both parties. It is relatively easy to track the changes in
15 staffing. It is less easy to necessarily identify or attribute the reason for
16 the change in every position circumstance. But once a position is gone, it
17 is generally gone forever. But you could track the head count numbers.

18
19 The problem, for example, that a lot of companies have, is that if you
20 offer an early out program of some kind, more people may take it than
21 the actual number of what you were pursuing in the proposed merger
22 reductions. So then you are reduced to sort of sorting out, where did you
23 get those from versus where you thought you got those from.

24
25 Once you get to the non-labor areas, it is a lot tougher to necessarily look
26 at unit cost differences and get all the right factors working together,
27 because companies will redefine certain arrangements. It is like
28 insurance. You could look at the cost per thousand dollars of coverage
29 provided between companies, but people have differences in terms of
30 self-insurance philosophy or the level of coverage and the terms of that
31 coverage and the deductibles and things like that. So people tend to look
32 at an overall package again. Just like redoing all your credit facilities for
33 the new company, as opposed to all the separate ones that used to exist
34 there.

35
36 So it is harder to separate, which is why people I think have shied away
37 from it. Then when you move to something like the production area or
38 dispatch, it is much more harder to do that than any of the other two
39 preceding categories, staff and early corporate programs, simply because
40 you may have a starting point, but that starting point is only good at that
41 instant it existed. All the facts and circumstances externally changed

1 around gas prices and supply and what happened in the region with
2 available capacity, and the number of customers, customer usage and all
3 those things.
4

5 So there were other features that people just sorted to as a more
6 convenient way of getting the sort of the same end of understanding what
7 ultimately happened. An index approach or the reporting requirement
8 after five years or something like that, to revisit rates. It is the
9 administrative burden, I think, and the lack of certainty that necessarily
10 goes with it.
11

12 Q. We got into several of these, what you just mentioned, the
13 KPL/KG&E merger as I recall. And some of the argument was that
14 utilities, they are a dynamic ongoing operational entity that, absent
15 mergers, make changes to their organizations. They will always reflect
16 technological changes. And they will have reductions and increases as
17 well. It is difficult to assign what is merger related. This was caused
18 directly because of consolidation, elimination and duplication, so on, so
19 forth, or that which would have been occurring anyway, stand-alone
20 entities. At least as from our perspective that has happened.
21

22 Is that really what you're saying? It is hard to identify the reasons for the
23 reductions in work force or the reductions for processes?
24

25 A. Well, I think you can get a much better handle on force than you can
26 on cost, in terms of identification, but it is not perfect. You mentioned a
27 number of reasons. It could be more regulatory requirements, which
28 require either additional or a redistribution of existing resources. Or it
29 could be that technology either facilitates the accomplishment of work or
30 adds requirements for work as the nature of the market changes. So now
31 people have a settlement process they have to go through that they didn't
32 before. That just adds work.
33

34 But you can identify raw numbers of head count, easier. But cost
35 information is a lot tougher. So the factors that you're referring to, and
36 that I was referring to, which was really the unit costs are tough to
37 compare. Those reasons are what makes the unit cost tough to compare.
38

39 Q. I guess when you look at, say, we used to pick on the controller. You
40 don't need two controllers, so you can eliminate one controller. That's
41 pretty easy to define. Two dispatch centers are consolidated into one.
42 But as you get down through the ranks, does it just become just a very
43 difficult task as to isolating the process that you go through, in terms of
44 identifying it being the merger itself as opposed to just ongoing
45 operations?
46

1 A. It gets more difficult both as you go down through the pyramid we
2 talked about before, to sort out all the things that happened, like the
3 clerical level, for example.
4

5 Q. You mentioned, I think, as an example a while ago the customer
6 service function. Because there's limited overlap or no overlap, the calls
7 aren't going to change. Isn't that kind of a phenomenon?
8

9 A. Well, that one maybe falls in the middle of things. You can go down
10 through a payables organization and you know that to process the
11 amount of work - - if you started with 20, maybe you only need 15 to
12 process that amount of work. If you ended up with 12, you don't know
13 whether the right number attributable to the merger is the five or it might
14 be six or it might be seven. Because maybe you can do better than what
15 the estimate was in terms of processing the work.
16

17 So it is just harder to wholly attribute each and every individual event. I
18 think you can get a better handle on labor than you can on cost. But even
19 labor is imperfect. The lower you go down the organization, there are
20 more factors that affect the larger base. Then when you bring the
21 overlay in of offering like a separation program, for example, more
22 people may take than what you expect, and it may come from places you
23 didn't even expect it to come from. So that people really sort of - -
24 rather than fight each of the individual issues and the headache that has,
25 to sort of step back and let's work with the total dollars as opposed to the
26 unique dollars.
27

28 Q. I assume the regulatory process may have a bearing also that you are
29 going to get into if we make this claim, someone else may make this
30 claim, or challenge that particular claim. That we're always going to be
31 at odds in terms of interpretation of what is merger related and what's
32 not. Does that come into play, why perhaps we shy away from or simply
33 don't do the savings track?
34

35 A. Which is like that example of moving from the 20 to the 15 to the 12.
36 That maybe everybody agrees that the first five is merger related, but
37 maybe they disagree about that next three in some form.
38

39 Q. Someone comes in and says, you can probably achieve the 12 if you
40 just have a reengineering of your processes instead of a merging and
41 consolidation of two entities?
42

43 A. Well, I mean, that's been argued. Merger savings can be achieved
44 absent the merger. But remember, the merger savings really reflect
45 overlapping duplication not cost reduction opportunity or streamlining
46 opportunity. So...

1
2 Q. It may be hard to identify which is which?
3

4 A. Well, overlapping duplication, at least in my mind, is easier to
5 identify. Reengineering opportunity is something that may go above and
6 beyond that. But just – it is like the two controllers. You don't need to
7 reengineer to figure out you only need one controller. When you look at
8 the rest of the support staff, the amount of that support staff that you
9 need is going to be – the ultimate amount is going to be driven by the
10 level of duplication, and then how you elect to operate the business. And
11 how you elect to operate the business may reflect that you have decided
12 to reengineer certain processes as well.
13

14 [Source: Transcribed Interview in KCPL/Western Resources Merger
15 Application, Case No. EM-97-515, February 26, 1999 Flaherty
16 interview, pages 62-29.]
17

18 Q. Can you explain why you believe that disputes will arise relating to "tracking"
19 merger savings?

20 A. Any after-the-fact analysis will be very contentious. Disagreements will occur at
21 every turn as to the identification, the verification and quantification of any alleged merger
22 savings. Generally, these quantifications are self-serving in that the utility will have every
23 incentive to identify as much merger savings as possible. Their rate structure and earnings
24 levels will depend on it. Not to mention that the utility will have an especially strong desire to
25 demonstrate the achievement of the merger savings because it wants to "prove" to the regulators
26 that the merger was successful so that regulatory plans to "pay" for the merger will be
27 implemented.

28 Q. Did KPL request recovery of an acquisition adjustment when, in Case No. EM-
29 91-213, it proposed to merge with KGE?

30 A. No. However, KPL expected to recover the acquisition premium in rates
31 through a merger savings-sharing proposal. In that case, KPL believed there would be sufficient
32 merger savings that could be used to allow recovery of the acquisition adjustment.

1 KPL proposed, in that case, a unique approach to "share" merger-related savings. The
2 proposal was intended to allow KPL a partial or a full recovery of the acquisition premium; i.e.,
3 acquisition adjustment.

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

10 Q. Why did KPL not directly request any recovery of the acquisition adjustment
11 from the Missouri Commission?

12 A. KPL, in response to Data Request No. 147, Case No. EM-91-213, stated that its
13 proposed future treatment of merger costs and benefits was based on a number of
14 considerations, including "the jurisdiction's prior treatment of both negative and positive
15 acquisition adjustments." KPL was indicating that the reason that it was not directly proposing
16 to recover the acquisition adjustment in Missouri was because of the Commission's prior
17 treatment of acquisition adjustments; i.e., the Missouri Commission's decision not recognizing a
18 negative acquisition in KPL's purchase of Gas Service Company in 1983.

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

21 A. No. Although the Commission in its Report and Order in Case No. EM-91-213
22 initially stated its interest in the merger savings sharing concept, no part of the cost savings
23 tracking system (CSTS) was ever implemented. The Commission stated at page 9 of that order:

1 . . . the Commission will not approve at this time the savings
2 sharing proposal. Staff has persuasively argued that KPL has a
3 strong incentive to view savings as merger-related even if they are not
4 and to classify them in the CSTS so as to increase the pool of savings
5 subject to the sharing plan. Staff demonstrated several flaws in the
6 CSTS which could allow nonmerger savings to seep into the pool
7 of savings to be shared.
8

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

20 [Re Kansas Power & Light Co., Case No. EM-91-213, Report and Order, 1
21 Mo.P.S.C. 3d 150, 156-57 (1991); emphasis added.]
22

23 Q. Why was the cost savings tracking system never implemented?

24 A. The Commission, in its Report and Order in Case No. EM-91-213, directed "the
25 parties to meet for the purpose of attempting to devise a method for tracking merger-related
26 savings." 1 Mo.P.S.C. 3d at 157. No agreement could be reached among the parties to assure
27 the Commission that nonmerger-related savings would be excluded from the cost savings
28 tracking system. The Commission issued a follow-up Order Adopting Staff's Suggestion And
29 Closing Docket on December 13, 1991, which placed this issue in KPL's next rate case. This
30 two page Order stated in part as follows:

31 Based upon these pleadings, the Commission determines that Staff's
32 suggestion should be adopted, to forego consideration of this issue in
33 this docket. If KPL wishes to have the possibility of receiving a share
34 of the merger savings it may use a system it considers appropriate for
35 excluding nonmerger savings from the pool of savings which might be
36 shared and present that approach to the Commission in its next rate
37 case complete with the amounts to be shared. At that time the

Commission will consider whether the device employed by KPL is sufficiently foolproof to permit sharing of merger savings with shareholders.

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

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

Q. Will it be difficult to "track" merger savings for the post-merger UtiliCorp?

A. Yes. UtiliCorp, not unlike many utilities today, has in the past, and continues at present, to engage in a very aggressive growth strategy through mergers and acquisitions. The constant changes resulting from acquiring new properties, in the situation of UtiliCorp, makes it even more difficult to identify, verify and quantify merger savings from any one transaction.

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

1 A. Yes. The Commission in the September 24, 1991 Order approving the KPL
2 and KGE merger, clearly set out the "standard" that merger savings had to be segregated
3 from non-merger related savings. UtiliCorp has indicated this separation was not necessary.
4 In a transcribed interview conducted in Case No. EM-2000-292, held on March 2, 2000 with
5 Staff and Public Counsel, UtiliCorp witness Siemek indicated that:

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

12
13 [Source: Siemek Transcript-- pages 82-83]

14 Based on this discussion, Staff does not believe that UtiliCorp has any intention of attempting to
15 track merger savings separately from non-merger savings. This is the very basis that forms the
16 assessment as to the success or failure of the merger itself from a regulatory point of view, in
17 particular if the company is requesting ratemaking treatment of an acquisition adjustment, either
18 through direct recovery or through some sort of indirect recovery mechanism.

19 Q. Why did the Commission want to ensure merger savings were segregated from
20 non-merger savings?

21 A. In its Order in Case No. EM-91-213, the Commission was explicit that there
22 must be a segregation of merger and non-merger related savings. In fact, when KPL was
23 unable to devise a "tracking" system which would separate the merger savings from the non-
24 merger savings, the Commission issued its December 13, 1991 Order indicating that the
25 savings sharing proposal would be rejected.

26 The Commission's reason for requiring this separation is that it wanted to ensure that
27 all the non-merger related savings generated by the company would be fully passed on to

1 customers in rates. The Order stated "the Commission wishes to ensure that savings which
2 would have been offset against the cost of service without the merger, benefit ratepayers one
3 hundred percent."

4 The Commission made it very clear in the KPL/KGE merger Order that savings had
5 to be identified between merger and non-merger related savings as a condition of the initial
6 approval of the savings tracking proposal presented by KPL in that merger request. KPL was
7 unable to demonstrate the ability to track costs; i.e., identify, verify and quantify savings
8 between merger and non-merger related. Because of this inability to distinguish between the
9 types of savings, the tracking proposal presented by KPL was rejected.

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

11 A. Yes. While they are both "savings," they are two very different types of
12 savings. Merger related savings are those savings that can only occur as a result of the
13 combining of two or more separate entities that were previously operating as separate and
14 distinct from one another. Once the combination of the entities occurs there will be savings
15 that will exist over time from the elimination of duplication and the economies of scale that
16 happen through system and process improvements throughout the organization. An example
17 of elimination of duplication would be the position of corporate president. There is need for
18 only one president of the company. One of the two prior positions can be eliminated once
19 the merger takes place. System improvements may result in the combining of activities such
20 as the consolidation of customer call centers. Instead of operating two separate call centers
21 because both pre-merger companies had the need to operate their own call centers, the
22 merger can result in savings from the elimination of one of the call centers that is no longer
23 needed. Process improvements would be the automation of certain functions such as in the

1 areas of purchasing, accounting or human resource functions that may enable savings to
2 occur as the direct result of the merger.

3 Non-merger related savings are those savings that occur over time as a result of
4 improvements in the technology and the efficiencies from a better-trained and skilled work
5 force. An example would be savings from reorganizations and re-engineering that occur
6 periodically. These types of savings also result from negotiating improved contract terms
7 such as those relating to fuel supply, building leases and health and medical benefits.
8 Reductions in cost of capital and tax rates can result in savings that having nothing to do with
9 merger and acquisition activities. System and process improvements can take place absent a
10 merger and would result in non-merger related savings. Non-merger related savings result on
11 an on-going basis and occur, as labor becomes more efficient and productive. These types of
12 savings occur absent mergers.

13 These two types of savings are viewed differently and are generally afforded different
14 treatment in merger applications. Non-merger related savings are considered outside the
15 scope of the merger. There is a widely accepted view that customers are entitled to these
16 savings and that cost savings will eventually be provided to customers in the form of rate
17 reductions. An example of reflecting non-merger related savings through a reduction in rates
18 is the recent \$15 million rate decrease passed on to KCPL's customers in 1999 (Case No.
19 ER-99-313). Another example would be the \$17 million rate reduction for UtiliCorp's
20 Missouri Public Service division in 1997 (Case No. ER-97-394). In both of these cases, the
21 companies experienced cost reductions and revenue growth over a period of time, not related
22 at all to mergers. Both companies enjoyed the benefits of these cost reductions, known as
23 regulatory lag, until the rates were changed.

1 Q. Did these companies voluntarily reduce rates?

2 A. In the case of KCPL, it did. Staff performed an earnings audit of KCPL and
3 the parties, KCPL, OPC and Staff, reached an agreement on the dollar amount of reduction.
4 In the case of UtiliCorp's Missouri Public Service division's rates, Staff had to file an excess
5 earnings complaint case to reduce rates. After Staff filed its complaint case, designated as
6 Case No. EC-97-362, UtiliCorp filed a rate increase case designated as Case No. ER-97-394,
7 which sought a \$25 million increase to Missouri Public Service's electric rates. Staff's initial
8 complaint case was dismissed but subsequently filed another excess earnings complaint case
9 against Missouri Public Service, Case No. EC-98-126, which was consolidated with Case
10 No. ER-97-394. The Commission ultimately reduced Missouri Public Service's electric rates
11 by \$17 million in its Report and Order dated March 6, 1998. The filing of the rate increase
12 case by UtiliCorp is a commonly used strategy by utilities to counter Staff's excess earnings
13 case and keep over-earning for as long as possible.

14 The Staff started reviewing UtiliCorp's rates in the spring of 1996 as part of its
15 examination of the merger application filed by UtiliCorp and KCPL as Case No. EM-96-248.
16 After the merger between KCPL and UtiliCorp failed, Staff continued its review of
17 UtiliCorp's rates and filed a complaint case on March 3, 1997 to reduce rates by \$23 million
18 designated as Case No. EC-97-362. From the time Staff started its review of the electric
19 rates of Missouri Public Service division, to the date the rate reduction was implemented,
20 took two years.

21 St. Joseph employed the exact same approach in Staff's 1999 complaint case (Case
22 Nos. EC-98-573 and ER-99-247) that ultimately resulted in a \$2.5 million rate reduction by
23 Stipulation And Agreement. Once a utility increases rates, it generally resists any attempt to

1 reduce rates, regardless of reductions in costs or revenue growth that may have occurred
2 since the last rate rebasing.

3 Q. What has been UtiliCorp's view on flowing through savings to its customers?

4 A. UtiliCorp has sought to retain declines in revenue requirements for its
5 shareholders and generally has not been in favor of passing those savings to customers.
6 UtiliCorp has acknowledged that it has been the beneficiary of regulatory lag in the past.
7 Mr. Richard C. Green acknowledged the benefits of regulatory lag in statements dating back
8 to the latter part of the 1980's. Mr. Green made the following comments at UtiliCorp's 1987
9 Officers Conference held in Chicago on October 6, 1987:

10 ...As you all know, the scenario of how a utility is operated has gone
11 through a number of changes. The 60's was the growth area, the 70's
12 was inflation and consumerism, the 80's the problems are starting to
13 go away. We have less rising costs. They are not going up, so
14 managing a utility is a lot easier. Regulatory lag is in our favor, as
15 Missouri Public Service learned so well in having to give back \$15
16 million because that lag gave us some very good profits there.
17

18 Mr. Green also addressed the need to manage UtiliCorp's regulated divisions and the
19 earnings of its subsidiaries at another Officers Conference held in Toronto in 1988. He
20 continued to emphasize the importance of each regulated division and subsidiary knowing
21 where its costs were going to fall and when the dollars were going to come in so that the
22 earnings level could be managed.

23 Mr. Green indicated further at the 1987 Officers Conference the importance not of not
24 earning excessive returns, which would bring regulatory focus on rates. He stated the
25 following:

26 The other point that has become painfully obvious this year, is that the
27 goal in the regulated utility business is not to try to earn the highest
28 return you can. The goal in the regulated utility business is to earn that
29 allowed return and maybe a hair above it, but don't get carried away

1 and start pulling in all kinds of money because you create a hell of a
2 problem for us. Now, Missouri Public Service has had this nice
3 problem since about 1983, and we spent a lot of time managing it then.
4 Then they went through rate decreases and they still have the problem.
5 What you see here is a focus on that problem which is that if we don't
6 manage those earnings, if we don't prudently spend it where it needs
7 to be spent for the integrity of the system, if we let those returns get
8 too carried away, then we're going to be right down there in Jefferson
9 City going through a rate reduction which is not going to be good for
10 anybody to go through. So you look at that and you have to talk about
11 how that return can come down. . . The bulk of the reason that that has
12 come down is because we have exercised, or MPS has exercised,
13 options on expenses that they can take care of this year as opposed to
14 next year, or whatever the formula might be, so that in effect, they
15 show a decreasing return for the balance of the year as they report
16 monthly to the regulatory people. Now, I think that's a smart way to
17 do business. I think it's the way we're going to continue to do
18 business, and it really surprisingly distinguishes us from a lot of other
19 utilities. A lot of the properties that we come into do not have this
20 sense of regulatory understanding.

21
22 [emphasis added.]

23
24 From these comments, it would appear that Mr. Green is advocating managing
25 discretionary expenses so as to control earnings from one period to the next. This discussion
26 indicates that UtiliCorp has wanted to ensure that there is not an appearance of excessive
27 earnings that regulators may want to use to reduce rates.

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

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

33 The Commission had also found that there is the potential for a
34 detrimental effect on Missouri ratepayers from the merger through
35 increased A&G and capital costs. Therefore, the Commission, in order
36 to shield Missouri ratepayers from such detriment, has made it clear to
37 KPL that such costs will be carefully scrutinized in any future,

1 postmerger rate case to assure that no such detriment is suffered by
2 Missouri ratepayers.

3

4
5 The Commission will direct its Staff to carefully audit KPL in future
6 rate cases to screen out costs caused by the merger and to suggest
7 methods, if necessary in future rate cases, such as those recommended
8 herein, which might be used to shield Missouri ratepayers from costs
9 arising from the merger.

10
11 The Commission will also direct KPL to keep its books so that costs
12 associated with the merger are clearly segregated. Abnormal increases
13 in A&G expenses will be carefully scrutinized and, unless persuasively
14 explained as not related to the merger, will be associated with the
15 merger.

16
17 [Commission Order in Case No. EM-91-213, pages 10 and 13]

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

24 These UtiliCorp merger and acquisition activities have been examined in each of
25 UtiliCorp's rate increase cases and Staff's excess earnings audits, and were specifically
26 identified as an issue in Case No. ER-90-101. In that case, the Commission found as follows:

27 The evidence indicates that the Company has removed from its A&G
28 costs most of the known expenses associated with M&A activities.
29 The Commission believes that UtiliCorp's expenses for M&A
30 activities should be removed from the expenses reflected in MPS'
31 rates. When UtiliCorp was formed, Company assured the Commission
32 that the ratepayers would suffer no detriment from UtiliCorp's
33 activities but would experience the benefits associated with
34 UtiliCorp's activities. The Commission believes that it is inconsistent
35 with this pledge to include M&A costs in the expenses reflected in
36 MPS' rates. The Commission is of the opinion that it is inappropriate

1 for MPS' ratepayers to pay for these activities which have little to do
2 with MPS' goal of providing safe and adequate electric service in
3 Missouri. Therefore, the Commission finds that the \$70,280 of
4 additional costs for M&A activities should be excluded from the cost
5 of service. Finally, the Commission is concerned that Company has
6 not been accounting for these costs separately. Accordingly, the
7 Commission will direct Company to account for M&A costs
8 separately so that they can be readily excluded in future rate cases
9 from A&G costs reflected in MPS' rates.

10
11 [Source: 30 Mo.P.S.C. (N.S.) 320, 350; emphasis added]

12 In addition, in UtiliCorp's 1997 rate case (Case No. ER-97-394) the Commission
13 adopted Staff's adjustments to assign costs to UtiliCorp's non-regulated activities of mergers
14 and acquisitions, international operations and new product development. Pages 50-51 of the
15 March 6, 1998 Report and Order states that "the Commission finds substantial evidence
16 supports the position of the Staff. The Commission finds the proposed adjustment to be
17 reasonable in light of the poor timekeeping and inadequate records offered by UtiliCorp." In
18 this Report and Order, the Commission affirmed its prior decision to exclude from rates costs
19 relating to the merger and acquisition strategy of UtiliCorp.

20 Q. Does Staff believe that UtiliCorp's accounting is able to "track" merger
21 savings?

22 A. No. UtiliCorp's accounting system, just like any other bookkeeping system is
23 able to categorize costs, and identify those costs to specific accounts when the system is told
24 through a coding process where those costs should go. This same process is expected to be
25 used to "track" merger savings. The accounting system still will require individuals to
26 identity, verify and quantify the savings, segregating those savings between merger and non-
27 merger related events. UtiliCorp personnel will have to be able to determine what the pre-
28 merger St. Joseph operations were, if they are to compare the costs of the post-merger

1 St. Joseph operations. Those individuals making the "coding" decisions will have to make
2 all kinds of judgments and decisions about assumptions and costs on how the impacts of the
3 merger affected the post-merger St. Joseph's operations. During an interview on March 1,
4 2000 in Case No. EM-2000-292, with Mr. Jerry Myers, UtiliCorp's Director of Corporate
5 Accounting and Reporting, he indicated that coding would have to be completed by
6 individuals to enter into the accounting system. [Transcript, pages 19-26]. While UtiliCorp
7 and St. Joseph have not fully explained in detail how they intend to implement the tracking
8 procedures, it is apparent that UtiliCorp is not going to distinguish between merger savings
9 and non-merger savings to the level that was envisioned in the KPL/KGE cost savings
10 tracking system.

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

13 A. These decisions are made in an after-the-fact fashion about a company that no
14 longer will exist. The many judgements that have to be made to identity and verify the
15 existence of merger related savings would undoubtedly cause much disagreement and
16 dispute. That would be the case as individuals are making the determinations as the
17 information is entered into the accounting system. Unfortunately, the review process that
18 takes place so that merger costs, and ultimately, merger savings, can be "carefully
19 scrutinized" as required by the Commission in the KPL/KGE merger, takes place well after
20 the decisions are made (coded) and information is entered into the accounting system.

21 Q. Has UtiliCorp ever requested approval an alternative regulation plan?

1 A. Yes. In Case No. ER-97-394, UtiliCorp requested such a plan for its Missouri
2 Public Service division. UtiliCorp called its incentive plan an "Efficiency Earnings Model"
3 (EEM).

4 Q. Did the Commission approve the UtiliCorp alternative regulation plan
5 proposal?

6 A. No. The Commission rejected UtiliCorp's proposal, in part, because of
7 discovery problems and lack of cooperation. At page 68 of the Commission's Report and
8 Order in that case, the Commission identified the reasons it believed the alternative
9 regulation plan could not be adopted:

10 First, the Commission finds that the sharing grid, as proposed by
11 UtiliCorp, is not in the interest of the MPS ratepayers and is neither
12 fair nor reasonable.

13
14 Second, the Commission notes the concerns of both the Staff and OPC
15 in regard to the long-term problems encountered in this litigation in
16 regard to discovery and cooperation between the parties. The
17 Commission will not assign fault in this matter but states that a
18 successful incentive regulation plan requires proper and accurate
19 accounting and other record keeping, and substantial cooperation
20 between the parties.

21
22 Third, the Commission agrees with Jackson County to the extent that
23 the approved Incentive Plans to date have all been experimental and
24 have had a fixed expiration date.

25
26 Therefore, for the above reasons, the Commission will reject the
27 proposed incentive regulation plan.

28
29 Q. Has UtiliCorp shown a willingness to provide timely and accurate information
30 during the course of this rate case?

31 A. No. Staff had to file for a three-week extension for time in this case, largely
32 because of problems in obtaining data from UtiliCorp. Three witnesses including myself had
33 to submit Verified Statements addressing the discovery problems encountered in this case.

UtiliCorp's responsiveness to the timely provision of information has been very slow and the ability to get accurate information is very difficult, at best. Staff witness Traxler addresses the discovery problems Staff had with UtiliCorp in this case in his direct testimony.

Q. In order to have a tracking system work, would there have to be an established level of trust and cooperation between the parties?

A. Absolutely. Based on past problems between UtiliCorp and the other parties relating to discovery disputes, one of the reasons Staff is not in favor of the merger tracking system proposed by UtiliCorp in the merger case is the belief that UtiliCorp will not provide sufficient detail and adequate information in which to fully substantiate the merger and non-merger savings in future post-merger, rate cases.

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

Q. Are utility customers entitled to rate reductions related to cost savings?

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

Q. Why are customers entitled to benefit from savings?

1 A. Through the regulatory process, the utilities generally benefit most immediately
2 from cost reductions and growth in revenues. When significant cost reductions take place over
3 time, public utility commission staffs or offices of consumer advocates may perform earnings
4 reviews to determine the need for possible rate reductions. There are several factors that may
5 cause reductions in rates:

- 6 1. Reduction in capital costs is one of the most significant causes
7 for declining revenue requirements.
- 8 2. Early retirement programs and cost efficiencies have resulted in
9 steady reductions in employee levels.
- 10 3. Renegotiations and aggressive negotiation of fuel supply
11 contracts and railroad freight rates have resulted in a steady
12 decline in actual fuel costs which has contributed significantly to
13 cost savings.
- 14 4. With reduction in construction programs from the levels of the
15 1970's and 1980's, utilities have experienced declining rate base,
16 and thereby decreasing revenue requirements.
- 17 5. Shifting allocations involving multi-state jurisdictions can, and
18 do, cause declining jurisdictional costs and rate bases when
19 growth occurs in other jurisdictions as a result of adding new
20 customers, usage increases and adding service as a result of
21 mergers and acquisitions.
- 22 6. Reductions in corporate income taxes have had a significant
23 impact on utilities' cost declines.

24 All these factors can have a substantial impact on rates, causing the need to review
25 rates periodically.

26 **UTILICORP COMMITMENTS REGARDING THE ACQUISITION ADJUSTMENT**
27

28 Q. Has UtiliCorp committed not to seek recovery of the acquisition adjustment
29 from its customers?

30 A. Yes. In a 1989 speech given by Mr. Richard C. Green, Jr., then UtiliCorp
31 President and Chief Executive Officer, before the National Association of Regulatory Utility

Commissioners (NARUC), he identified the UtiliCorp philosophy regarding its growth strategies. In response to Public Counsel Data Request No. 216 in Case No. ER-90-101, UtiliCorp stated the "overall corporate strategy has been consistently implemented since the inception of the UtiliCorp name change. It is most comprehensively described in a speech before NARUC" as follows:

In 1983, [Mr. Richard C. Green] went to the Missouri Public Service Commission with a plan to add value for the customers and shareholders of my company. A principal component of this plan was to expand through utility acquisitions. Of course, the concern of the Missouri commission was whether this plan would be a detriment to Missouri ratepayers.

The Missouri commission has shown a willingness to allow us to pursue this plan because UtiliCorp made a commitment to flow only benefits to Missouri customers and not to pass on any new problems that may arise. At no time will we jeopardize our own financial integrity. We recognize that it is vitally important not to put Missouri's sound utility infrastructure at risk.

Six years later, this commitment still stands. Our record shows we have lived up to everything we have promised. This process has worked well. By taking a different regulatory approach, the Missouri Commission has allowed us to serve our customers better and build value for our shareholders.

....
UtiliCorp has followed a firm policy of not seeking to recover any of its acquisition-related premiums through rates. We have made a very persuasive case to investors that any premium costs or share dilution they experience will be for the short-term. We believe we can demonstrate that UtiliCorp will financially outperform the industry in the long-term.

[Source: OPC Data Request No. 216, Case No. ER-90-101; emphasis added]

The entire speech before the NARUC is attached as Schedule 3.

In response to a data request submitted in Case No. ER-90-101, UtiliCorp stated in reference to a question regarding commitments to pass on benefits, not problems/costs to Missouri consumers:

Mr. [Richard C.] Green's commitment to the Missouri commission was (1) **that premiums paid for utility acquisitions would not be recovered through Missouri rates**, and (2) that there would be no cross subsidization of the company's various division and subsidiary operations. These commitments have been kept.

Premiums paid for acquired utility properties are amortized by the corporation over varying periods of time and **are not being recovered through rate structures in any of our service jurisdictions**. In addition, each division and subsidiary exists as a stand-alone entity with its own allocated capital structure.

Benefits which have been passed along to Missouri ratepayers include: easier access to capital through lower debt costs and marketable equity securities; economies of scale in such areas as pension and health benefits, centralized purchasing and consolidations of computer and purchase contracts and other areas enumerated in Mr. Green's pre-filed direct testimony in this case.

[Source: Response to Data Request No. 368, Case No. ER-90-101; emphasis added]

Q. Has UtiliCorp understood that its merger and acquisition policies would have to develop without assurances of recovery of the merger premiums?

A. Yes. In March 1987, at an investor analyst meeting in San Francisco, Mr. Richard C. Green, Jr., made a statement regarding the recovery of merger premiums as it related to UtiliCorp's merger and acquisition strategies. Mr. Green stated the following:

No, how do we look at new acquisition properties is the question. No, its more the traditional utility sense because whether you like it or not, you're going to be traditionally regulated. So you've got to play by those rules and when you tack a premium on you got to know you're **not** going to be allowed to earn a return, so you've got to squeeze that out of other places. So you want to look at things differently and be more aggressive, but the realities of life is that that Commission is not there yet and they're going to do it the old traditional way...

[Source: Transcript of video relating to the San Francisco Analyst meeting March 1987 provided by UtiliCorp in response to Data Request No. 476 (Case No. ER-90-101); emphasis added]

Another example of this commitment not to seek recovery of acquisition premiums in rates is a May 21, 1990 interview with Mr. Richard Green by members of the Office of the

Public Counsel and Staff. Mr. Green indicated once again that UtiliCorp would exclude acquisition premium from rates. In the interview, Mr. Green was asked about the discussion he had with the Commissioners in early 1986, wherein he made his commitment to insulate the Missouri customers from the "downside risks" relating to UtiliCorp's merger and acquisition strategy:

In a meeting with the Commissioners and Staff members held at the Commission offices in Jefferson City in late 1985/ early 1986, Green stated that MOPUB's Missouri ratepayers would be insulated from all "downside risks" associated with the corporate M&A strategy. In part, those discussions with the Commission focused on UtiliCorp's need to receive timely financing authorization regarding its acquisition strategy. At that time, Green said he would be coming back before the Commission for additional financing for acquisitions. In the agenda meeting before the Commission, Mr. Green pledged that at no time would Missouri ratepayers be adversely or detrimentally impacted by UtiliCorp's M&A strategy. In the context of needing future financing, Green stated that all benefits would flow to the ratepayers and that they would be insulated from all "downside risks." In that meeting Mr. Green explained this meant that all benefits relating to a larger, less risky consolidated UtiliCorp would flow to Missouri ratepayers while these ratepayers would be insulated from any negative or detrimental impacts.

Green said he concurred with the above assessment of that meeting, and still holds that view today. **He said he has not only made that pledge but has kept it. Green said evidence of this was that at no time has or would UtiliCorp attempt to seek recovery in rate base, premiums (acquisition costs in excess of book value) paid for M&A properties by way of a positive acquisition adjustment.**

Green believed it was reasonable that UCU make this commitment. There is no reason that a problem found elsewhere would provide a reason to seek higher rates from MOPUB's ratepayers. Green believes that the commitment not only can be made, but was, and still is being made.

[Source: Richard Green May 21, 1990 interview in Case No. ER-90-101 – Response to Data Request No. 591; emphasis added]

1 It is clear from the statements made to the Commission and elsewhere in speeches
2 that in order to gain support for UtiliCorp's merger and acquisition growth strategy,
3 UtiliCorp was willing commit to not seek recovery of merger premiums resulting from this
4 growth strategy. While UtiliCorp can certainly change its position and go back on this
5 commitment, as now appears to be the case with the proposed regulatory plan being pursued
6 as outlined in Mr. McKinney's direct testimony, the fact of the matter is that UtiliCorp's
7 merger and acquisition activities have not been questioned by this Commission over the
8 many years that UtiliCorp's "hold harmless" merger and acquisition philosophy has been in
9 place. Mr. Green sought support from the Commission when he needed the financing of
10 UtiliCorp's growth strategy. He made a promise not to seek recovery of the merger
11 premiums that resulted from this growth strategy. The Staff hopes UtiliCorp will reconsider
12 its position relating to the recovery of the acquisition adjustment and other merger costs that
13 it has presented in this case and renew its pledges to not seek recovery of merger premiums
14 from its Missouri customers.

15 UtiliCorp on numerous prior occasions made it clear it would not seek recovery of
16 merger and acquisition premiums from its Missouri customers. Something has evidently
17 happened to cause UtiliCorp to no longer honor its prior commitment it made to the
18 Commission in the past regarding acquisition adjustment recovery. Regardless of the reasons
19 for this change in position, the former position of UtiliCorp whereby it insulated its retail
20 utility customers from the risks of UtiliCorp's merger and acquisition strategy was
21 appropriate, and still is appropriate, if not more so considering all of the non-regulated
22 activities of UtiliCorp as well as the changes occurring as a result of electric restructuring.

1 UtiliCorp's growth strategy is even more pronounced today then it was just even a few years
2 ago.

3 As this growth strategy intensifies, it seems UtiliCorp intends to ask this Commission
4 to provide UtiliCorp assistance in these activities so that UtiliCorp's shareholders will be
5 protected from earnings dilution. The Staff does not believe UtiliCorp's Missouri retail
6 ratepayers should be placed in such a role of subsidizing UtiliCorp's merger and acquisition
7 policies.

8 Q. Was the earlier-referenced May 21, 1990 interview with Mr. Richard Green
9 verified?

10 A. Yes. Staff conducted several interviews of UtiliCorp officials in the 1990 rate
11 case. As part of the process, before court stenographers were used, participants compiled
12 their notes from the meeting and submitted these notes to each person interviewed for
13 verification of accuracy. Mr. Green's interview was submitted for verification in Data
14 Request No. 591 (Case No. ER-90-101), an excerpt from which appears above. The
15 following statement was agreed to by UtiliCorp in order to authenticate the content of the
16 interview write-up: "While not necessarily all-inclusive, the attached summary of the
17 interview of Mr. Richard Green, as amended, is **accurate in all material respects** and
18 represents factual information." [emphasis added]

19 **SUMMARY AND CONCLUSIONS**

20 Q. Please provide a summary of your conclusions relating off-system sales.

21 A. With regard to UtiliCorp's proposed treatment "sharing" off-system sales profits,
22 the Commission should reject this proposal. It is an unusual, unique and unprecedented
23 approach that is nothing more than an attempt to divert legitimate profit margins resulting from

1 the off-system sales transactions from inclusion in the development of rates. If implemented,
2 the ultimate impact of this proposed "sharing" treatment of off-system sales will result in
3 increasing the revenue requirement, causing an increase in customers' rates. UtiliCorp has not
4 proposed any assignment of costs of off-system sales to shareholders, yet they would reap the
5 benefits from the off-system sales transactions under UCU's position. In other words, the
6 customers must bear all the costs associated with off-system sales, and "share" the profits. This
7 is patently unfair and totally unnecessary. The Company's owners already share in the profits
8 from off-system sales transactions through any increases over and above the normalized levels
9 set in rates.

10 Q. Please summarize your conclusion regarding the Aries Combined Cycle Unit
11 and Purchased Power Agreement.

12 A. Staff believes UtiliCorp must demonstrate that at the time of true-up that the
13 Aries Combined Cycle Unit is "fully operational and used for service" and able to meet all the
14 obligations and terms of the purchased power agreement. UtiliCorp should identify and
15 demonstrate through in-service criteria that the operational capabilities of this generating plant
16 which must be met have been attained. Verification must occur before any costs associated with
17 the purchased power agreement are allowed in rates.

18 Q. Please summarize your conclusions relating to UtiliCorp's proposed recovery of
19 the acquisition adjustment resulting from the St. Joseph merger.

20 A. UtiliCorp has requested direct recovery of the St. Joseph acquisition adjustment
21 in this case if the use of a stand-alone Missouri Public Service cost structure is not used to set
22 MPS rates. UtiliCorp chose when to file this case to adjust Missouri Public Service electric
23 rates. It could have waited to file, thus, allowing more opportunity more opportunity for the

1 merger savings to be created. As a result of not waiting to file this rate case, UtiliCorp
2 developed its approach to deviate from cost-based rates by not reflecting Missouri Public
3 Service's actual cost of service in rates. The Company has arbitrarily not reflected in its case
4 any actual cost savings that has occurred during the post-test year period in the form of
5 allocations of corporate costs and fuel costs savings from joint dispatch.

6 UtiliCorp has taken the position in this case that if any party develops cost-based rates,
7 the Company will propose direct recovery of the acquisition adjustment resulting from its
8 merger with St. Joseph. This direct recovery of the merger premium is designed to force the
9 customers of Missouri Public Service and, ultimately of St. Joseph, to subsidize UtiliCorp's
10 growth efforts through its mergers and acquisitions strategy. UtiliCorp is attempting to recover
11 through an acquisition adjustment, the merger premiums it paid to St. Joseph, in addition to
12 other merger costs associated with UtiliCorp's acquisition of St. Joseph. UtiliCorp developed its
13 strategy for recovery of the acquisition adjustment to accomplish two very important goals
14 related to its "customers must pay for the merger" concept.

15 The first of UtiliCorp's goals that it is attempting to achieve in this case is for its
16 shareholders to retain all merger. The direct filing in this case by UtiliCorp reflects a stand-
17 alone case that is the device that, in part, accomplishes the retention of merger. Rate
18 moratoriums typically occur after a merger to enable companies an opportunity to indirectly
19 recover a portion of any merger premium. However, Missouri Public Service chose to file a rate
20 case to address specific cost increases that UtiliCorp believed generate a positive revenue
21 requirement. In filing this case, UtiliCorp believed it needed to increase the rates for Missouri
22 Public Service for the addition of the Aries Combined Cycle Unit through a purchased power
23 agreement, increases in lease payments to an affiliated company for Greenwood generating

1 facilities, and high natural gas costs last year, among other factors. This rate case for Missouri
2 Public Service had to be filed after the St. Joseph merger because of the timing of the in-service
3 date of the Aries Combined Cycle Unit. Thus, UtiliCorp developed an approach to ensure that
4 no savings would be flowed-back to customers, notwithstanding the rate case. In order to do so,
5 UtiliCorp had to propose to deviate from the standard practice of developing rates based on
6 actual costs.

7 The second goal that UtiliCorp is pursuing is to seek direct recovery of the acquisition
8 adjustment from Missouri Public Service, and ultimately, from St. Joseph customers. This
9 feature is certainly the most detrimental to UtiliCorp's Missouri customers, and is the most
10 unique. The direct recovery of the acquisition adjustment in this case, as well as any proposed
11 recovery in future St. Joseph rate cases, would be unprecedented in Missouri public utility
12 regulation.

13 The approach developed by UtiliCorp is unreasonable and inappropriate for customers,
14 the group that has the least say in assessing the merits of the mergers. The proposed stand-alone
15 approach advocated by UtiliCorp keeps savings away from customers. If the stand-alone
16 approach is not used, and a direct recovery of the acquisition adjustment is permitted, then
17 customers are placed in the position of paying for mergers through rates, yet not reaping the
18 rewards of ownership, achieved through gains in asset disposition and dividends. It is clear that
19 customers are not owners of the utility. Therefore, they should not be expected to subsidize
20 utility's growth through mergers and acquisitions approach.

21 If UtiliCorp's proposal to recover the acquisition adjustment is approved, this will set a
22 precedent for future mergers. UtiliCorp is very aggressive in pursuit of its growth through
23 mergers and acquisition strategies. Adopting recovery of the merger premium will result in an

1 even greater pressure to include more acquisition adjustments in the future with even greater
2 merger premiums being negotiated. If utilities can successfully get their customers to subsidize
3 growth through acquisitions strategies, then it can be expected that more and more mergers will
4 take place at greater and greater risks to customers.

5 If acquisition adjustments are allowed to be directly recovered in rates, regulatory bodies
6 will be forced to make determinations as to the value of the merger transaction. This
7 Commission and its Staff will have to review the actual merger transaction and merger
8 consideration to ensure that the buying utility has not paid an excessive amount. This will place
9 a greater burden on the Commission and its Staff to identify the reasons why a merger is
10 beneficial to the public, which is different than ensuring that the customers are not harmed.

11 The Commission and its Staff will have to identify the benefits of the merger relating to
12 shareholder and customer interest, respectively. The acquisition adjustment will have to be
13 allocated among the different ownership costs for the control premium and non-regulated
14 activities. If the Commission adopts UtiliCorp's position, future merger applications and rate
15 proceedings will have to address the many issues that will arise from the expectation that
16 customers should pay for the growth strategies of utilities operating in this State. Staff believes
17 this approach would be detrimental to the public interest and, therefore, the recovery of the
18 acquisition adjustment should be rejected and not adopted by the Commission in this case.

19 Q. Does this conclude your rebuttal testimony?

20 A. Yes, it does.


BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of the Tariff)	
Filing of Missouri Public Service (MPS))	
A Division of UtiliCorp United Inc., to)	Case No. ER-2001-672
Implement a General Rate Increase for Retail)	
Electric Service Provided to Customers in the)	
Missouri Service Area of MPS)	

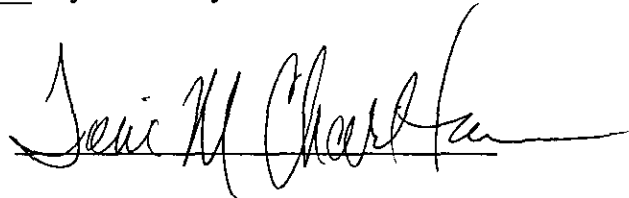
AFFIDAVIT OF CARY G. FEATHERSTONE

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 foregoing Rebuttal Testimony in question and answer form, consisting of 98 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


CARY G. FEATHERSTONE

Subscribed and sworn to before me this 8th day of January 2002.



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

