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Witness: Thomas J. Flaherty
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Sponsoring Party: Union Electric Company
Case: EM-96-149

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EM-96-149

SURREBUTTAL TESTIMONY

OF

THOMAS J. FLAHERTY

****Denotes Highly Confidential Information****

June 3, 1996

Exhibit No. 32
Date 9-5-96 Case No. EM-96-149
Reporter KP

1 **Surrebuttal Testimony of Thomas J. Flaherty**
2 **National Partner - Utilities Consulting**
3 **Deloitte & Touche Consulting Group**
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5 **Missouri Public Service Commission Case # EM-96-149**

6 **Q. WOULD YOU PLEASE STATE YOUR NAME AND BY WHOM YOU ARE**
7 **EMPLOYED?**

8 **A. My name is Thomas J. Flaherty, and I am the National Partner - Utilities**
9 **Consulting and a partner in the Deloitte & Touche Consulting Group, a**
10 **division of Deloitte & Touche LLP. My business address is 2200 Ross**
11 **Avenue, Suite 1600, Dallas, Texas 75201.**

12 **Q. MR. FLAHERTY, ARE YOU THE SAME WITNESS THAT PREVIOUSLY**
13 **FILED TESTIMONY DESCRIBING ESTIMATED COST SAVINGS THAT**
14 **WILL RESULT FROM THE COMBINATION OF UE AND CIPS?**

15 **A. Yes. I previously submitted testimony regarding cost savings that are**
16 **estimated to be achieved through the combination of UE and CIPS.**

17 **Q. MR. FLAHERTY, WHAT IS THE PURPOSE OF YOUR SURREBUTTAL**
18 **TESTIMONY?**

19 **A. My surrebuttal testimony responds to the direct testimony filed by several**
20 **witnesses in this proceeding. First, Mr. Maurice Brubaker has filed direct**
21 **testimony on behalf of the Missouri Industrial Energy Consumers. His**
22 **testimony demonstrates a misunderstanding of the methodology,**

1 procedures and assumptions underlying the development of the UE and
2 CIPS cost savings estimates. To address these misunderstandings, I am
3 providing further clarification of the nature of synergies created from the
4 combination of UE and CIPS. I also will elaborate on descriptions of the
5 bases for quantifying the estimated savings and the process by which
6 savings were derived, reviewed and finalized in conjunction with executive
7 management.

8 In addition, my surrebuttal testimony responds to testimony filed by Mr.
9 Mark Oligschlaeger, regulatory auditor with the Missouri Public Service
10 Commission. Specifically, I will discuss the rationale behind using the
11 synergies study to estimate future benefits that will result from the merger of
12 UE and CIPS.

13 **Q. MR. FLAHERTY, PLEASE SUMMARIZE YOUR TESTIMONY.**

14 **A.** The merger of UE and CIPS will generate significant cost savings that will
15 benefit all interested stakeholders. Using previously tested and accepted
16 methodologies, the Companies have developed reasonable and justifiable
17 estimates of the size of those benefits. The Companies have judiciously
18 undertaken to identify opportunities for merger cost savings, and
19 subsequently provided detailed and comprehensive support for those cost
20 savings estimates. In addition to confirming that the estimated cost savings
21 areas are consistent with those in previously approved utility mergers, the

1 estimates have been through extensive internal review by management both
2 prior to and after the announcement. This review was undertaken to
3 specifically provide for rigorous challenge by management and to improve
4 the quality of the estimate. The reviews have been conducted by those with
5 the most intimate knowledge of respective operations, presumably those
6 best able to judge the achievability of estimates.

7 The savings estimates provide an accurate depiction of benefits that will
8 accrue to all stakeholders. Utilizing savings estimates to determine the
9 beneficial impact of utility mergers is a recognized common practice in
10 numerous jurisdictions, as the events giving rise to cost savings realization
11 have not yet occurred. Based on comparison to preceding transactions
12 included in analyses previously conducted and supplemented by extensive
13 internal analyses, I believe the risk associated with achieving the projected
14 cost savings for this merger is minimal.

15 **DEVELOPMENT OF MERGER COST SAVINGS ESTIMATES**

16 **Q. HAVE YOU REVIEWED MR. BRUBAKER'S AND MR.**
17 **OLIGSCHLAEGER'S COMMENTS REGARDING THE COMPANIES'**
18 **SUPPORT FOR THEIR ESTIMATES OF MERGER SAVINGS?**

19 **A. Yes. In general, Mr. Brubaker claims that the Companies lack an adequate**
20 **basis for the estimated merger cost savings related to the following**

1 categories: labor, professional services, contract services, procurement and
2 inventory. Likewise, Mr. Oligschlaeger claims in general that the savings
3 estimates are not detailed or supported. However, to the contrary, the
4 estimates of merger cost savings in these areas (as in all areas) were based
5 on substantial, detailed financial and operational data from UE and CIPS,
6 and on sound business assumptions. Deloitte & Touche Consulting Group
7 has been involved in over 70 actual or contemplated mergers. Based on
8 that experience, it is my professional opinion that the merger cost savings
9 estimates set forth by the Companies are sound, achievable, and if
10 anything, conservative.

11 **Q. BEFORE DISCUSSING THE SPECIFIC AREAS ADDRESSED BY MR.**
12 **BRUBAKER, PLEASE GENERALLY DISCUSS THE DEVELOPMENT OF**
13 **THE SAVINGS ESTIMATES.**

14 **A.** A UE and CIPS working group, composed of management personnel from
15 various functions of both companies, exchanged actual financial and
16 operational data, which was then provided to me, to determine the relative
17 expenditure profiles and opportunities available for savings in each cost
18 savings area. Each specific savings category was analyzed independently
19 through a comprehensive process to determine cost savings that will be
20 created due to the combined operations of UE and CIPS. The quantification
21 of savings was an iterative process in which the UE and CIPS working

1 group spent significant hours collecting data, refining assumptions and
2 formulating conclusions about specific cost areas. The assumptions
3 underlying the savings percentages are reasonable, and based on a
4 combination of management's extensive operational experience, and the
5 collective experience of Deloitte & Touche Consulting Group's involvement
6 in previous similar transactions. The savings were then reviewed by
7 executive management to confirm that they are attainable.

8 **Q. MR. BRUBAKER AND MR. OLIGSCHLAEGER SEEM TO SUGGEST**
9 **THAT MANAGEMENT JUDGMENT AND RELATED EXPERIENCE ARE**
10 **NOT ADEQUATE AS BASES FOR THE DEVELOPMENT OF ESTIMATES.**
11 **DO YOU AGREE?**

12 **A. No. The determination of benefits from a merger is an inherently forward-**
13 **looking process as it must deal with events which are yet to occur.**
14 **Management's conclusions are developed from the facts surrounding a**
15 **particular area, such as opportunities for reduction of purchasing levels, and**
16 **supplemented by other factors that can influence management's judgment.**
17 **Mr. Brubaker also seems to suggest that the same level of documentation**
18 **that he is used to obtaining to evaluate rate case adjustments is available**
19 **for estimating merger savings. This is incorrect and unrealistic.**

1 Q. AS A PART OF THE INTEGRATION PLANNING PROCESS, TRANSITION
2 TEAMS FROM UE AND CIPS HAVE COMPLETED A MORE DETAILED
3 STUDY FROM WHICH NEW MERGER COST SAVINGS ESTIMATES
4 WERE PROVIDED. MR. OLIGSCHLAEGER SEEMS TO SUGGEST THAT
5 THE RESULTS FROM THIS STUDY MAY UNDERMINE THE VALIDITY OF
6 THE INITIAL COST SAVINGS STUDY. HAVE YOU HAD A CHANCE TO
7 REVIEW THOSE RESULTS?

8 A. Yes. The results of the transition teams' studies confirm the initial estimates
9 and further identify additional areas of opportunity for generating an even
10 greater level of merger cost savings. As I previously stated, I am fully
11 confident that the initial estimates will be at least achieved, and most likely
12 surpassed. The transition teams' conclusions support this statement.
13 Their studies, in which the most experienced personnel from both
14 companies comprehensively examined every operation within the utilities
15 organization, support the conclusion that the merger of UE and CIPS will, at
16 the very least, generate the level of savings initially proposed. The extent
17 of effort put forth during this analysis phase ensures that cost savings
18 estimates have been based on sound business and operational judgment.

1 Q. THE RESULTS OF THE TRANSITION TEAMS' STUDY EXCEED THE
2 INITIAL ESTIMATES FOR MERGER COST SAVINGS. HOW DO YOU
3 ACCOUNT FOR THE DIFFERENTIALS?

4 A. The most substantive differential appears in estimates regarding labor
5 related savings. First, the transition teams' study identified an additional 13
6 positions, which represent a 4% increase in labor savings. The teams
7 identified these positions after gaining a better understanding of respective
8 activities conducted in support of day to day operations. The transition
9 teams concluded that the joint operations could be supported at an
10 equivalent level of service after elimination of these redundant efforts.
11 Additional labor savings will also result from enacting a more accelerated
12 plan to displace redundant positions. Consequently, savings accrue to the
13 new company at an earlier date, therefore increasing the cost savings
14 impact. This change in position reduction achievement accounts for a 25%
15 increase in the initial estimate of labor related savings.

16 Additional, modest cost savings differentials resulted from more detailed
17 analyses in the areas of corporate and administrative programs, purchasing
18 economies, facilities and electric and gas production. These revised
19 savings estimates were relatively close to the initial estimates particularly on
20 an annual basis.

1 Finally, new cost savings opportunities were identified in several areas that
2 were not considered in the initial savings study including load management
3 systems and improved outage control. As expected from a more intimate
4 and detailed study, new opportunities for merger cost savings were
5 uncovered.

6 To reiterate, the results of this study confirm that the merger of UE and
7 CIPS will generate significant benefits for all stakeholders, including
8 customers and shareholders.

9 **Q. MR. OLIGSCHLAEGER GOES ON TO CLAIM THAT A PREFERRED
10 POLICY WOULD BE "TO BASE FUTURE RATE LEVELS ON ACTUAL
11 SAVINGS RESULTS FROM THE MERGER RATHER THAN RELY ON
12 SAVINGS ESTIMATES." [OLIGSCHLAEGER REBUTTAL TESTIMONY,
13 Page 17] DO YOU AGREE?**

14 **A. No. Suggesting the use of actual savings results rather than relying on
15 estimates overlooks a simple point. Regardless of whether you are looking
16 forward or backward, you have to develop an estimate. Utilizing "actual"
17 results would provide a different result, but not necessarily a result that is
18 more reliable than a detailed, forward looking estimate. Using "actual"
19 results requires a comparison of historical data to expected, stand-alone
20 operational data. Regardless of the approach taken - expected results or**

1 actual results - a comparison to an estimate of stand-alone results is
2 required, nonetheless. In addition, actual results potentially will be
3 influenced by other factors unrelated to the merger, making complete and
4 accurate separation of impacts difficult to achieve.

5 **Q. MR. BRUBAKER ASSERTS THAT THE UE/CIPS MERGER RELATED**
6 **LABOR SAVINGS ARE OVERSTATED. IS HE CORRECT?**

7 A. No. Mr. Brubaker suggests that the labor reductions attributed by UE and
8 CIPS to the merger include positions that could be eliminated without the
9 merger. Mr. Brubaker's comments regarding labor savings mischaracterize
10 the nature of the analysis and rationale underlying the identification of
11 estimated position reductions. The position reductions identified through a
12 comprehensive analysis represent those labor resources, and only those
13 labor resources, that become duplicative due to the merger of UE and
14 CIPS's operations.

15 The labor analysis combined the UE and CIPS working group's intimate
16 knowledge of the respective organizations, and Deloitte & Touche
17 Consulting Group's extensive experience related to numerous merger
18 analyses and operational studies to accurately estimate the merger related
19 position reductions.

1 The detailed analysis aligned all positions within the respective
2 organizations according to job functions, specifications and defined
3 responsibilities. Following the detailed alignment of positions, the UE and
4 CIPS working group, together with Deloitte & Touche Consulting Group,
5 identified duplicate efforts and redundant positions. The identified position
6 reductions were provided to UE and CIPS executive management for their
7 review and concurrence. These positions represent the merger related
8 labor savings.

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18 The labor analysis focused solely on identifying redundant positions
19 and did not identify or include in the savings estimates any labor savings
20 opportunities that would be associated with internal, nonmerger related

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1 operational improvements. Because the labor analysis only identified
2 overlapping labor resources associated with redundant efforts, none of the
3 identified position reductions could be achieved absent the merger of UE
4 and CIPS operations.

5 **Q. MR. BRUBAKER ASSERTS THAT INDUSTRY BENCHMARKS INDICATE**
6 **THAT THE IDENTIFIED POSITION REDUCTIONS COULD BE ACHIEVED**
7 **ABSENT THE MERGER. PLEASE RESPOND.**

8 A. Mr. Brubaker's contention indicates a misunderstanding surrounding the
9 industry benchmarks and methodology used to identify position reductions.
10 The information regarding the industry benchmarks was not used to any
11 extent in determination of potential position reductions. The industry
12 benchmarks provide nothing more than a directional indication of where the
13 combined company might rank relative to peers given various operational
14 and financial metrics. Due to the multitude of factors underlying various
15 companies' operational and financial statistics, the type of conclusions
16 regarding staffing levels reached by Mr. Brubaker cannot reasonably be
17 drawn from the benchmarking data. Without appropriate normalization of
18 the raw data, the relative size of customer bases or density of service
19 territories, and other numerous like factors, skew the results of
20 benchmarking analyses. The benchmarking information by itself does not
21 suggest that a single position could be eliminated. The industry

1 benchmarks connote no information related to the impact of consolidating
2 UE and CIPS operations.

3 **Q. MR. BRUBAKER CONTENDS THAT ESTIMATED SAVINGS IN THE**
4 **AREAS OF PROCUREMENT AND INVENTORY WERE NOT BASED ON**
5 **ANY DETAILED ANALYSIS. PLEASE RESPOND.**

6 **A.** Procurement savings will be achieved via the new company's ability to
7 increase bulk commodity orders, secure volume discounts and bring about
8 purchasing efficiencies from suppliers and vendors. Some examples will
9 illustrate the type of savings that can be generated from changes in
10 purchasing and inventory management practices.

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Merged requirements also will allow the combined company to contract for increased production runs at substantial unit cost savings. These savings result from spreading the fixed cost associated with design, pilots and setup across a larger base of units, thereby reducing the total cost per unit.

Furthermore, merged purchasing will increase the ability of the combined organization to strengthen relationships with the best manufacturers and distributors, and subsequently influence improved joint purchasing practices. For example, the increased purchasing activity of the combined company may entice a supplier to invest in EDI technology in support of improved transaction processing, which subsequently will lead to decreased transaction costs.³

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³ Electronic Data Interchange is a company-to-company mechanism for electronically transmitting electronic transactions.

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These are but a few examples of the types of savings that will be achieved through the combined operations of UE and CIPS. Cost savings in these areas will be achieved through effective negotiation with various vendors and standardization of purchasing practices and items. Accordingly, management judgment based on its extensive, operational experience, coupled with my substantial experience with these types of transactions provide a reasonable basis for determining the synergies impact of combining operations, and subsequently the assumed savings percentages. UE and CIPS management used these bases to develop the specific assumptions used to estimate cost savings levels.

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1 Q. CAN YOU PROVIDE FURTHER INFORMATION REGARDING
2 ESTIMATED SAVINGS IN THE AREA OF CONTRACT AND
3 PROFESSIONAL SERVICES?

4 A. Savings for contract and professional services will be achieved through
5 improved buying power due to the consolidation of common service
6 providers, and increased scope of services of other providers. Some
7 examples will illustrate the type of savings generated from changes in
8 procuring contracts for services.

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The assumed savings percentages represent reasonable estimates based on sound business judgment and experience from previous transactions.

The underlying assumptions for all savings areas were developed through

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1 the combined efforts of the UE and CIPS management group, the members
2 of which have extensive operational experience, with the assistance of
3 Deloitte & Touche Consulting Group. I am fully confident that the cited
4 savings are attainable.

5 **Q. IN SUPPORT OF HIS CONTENTION THAT THE PREPARED**
6 **WORKPAPERS DO NOT SUPPORT THE PROJECTED SAVINGS, DOES**
7 **MR. BRUBAKER OFFER ANY ALTERNATIVES FOR ESTIMATING**
8 **SAVINGS?**

9 **A. No. Mr. Brubaker simply argues that the workpapers for the identified**
10 **savings areas do not provide the type of support which he believes is**
11 **necessary to establish the estimated savings. He failed to offer any**
12 **suggested alternative or adjustment to these estimated merger related**
13 **savings, although he acknowledged in response to a data request that**
14 **"some savings should be achievable." However, the detailed workpapers**
15 **and related testimony prepared by the Companies fully support the**
16 **estimated savings and provide reasonable estimates based on the specific**
17 **facts of this business combination, and establish that these savings**
18 **estimates are consistent with other merger and acquisition experience.**
19 **Furthermore, the basic cost savings rationale is consistent with the**

1 approach applied before, and accepted by, numerous other jurisdictions in
2 connection with other business combinations.

3 **USE OF MERGER COST SAVINGS**

4 **Q. MR. OLIGSCHLAEGER CONTENDS THAT THE MERGER COST**
5 **SAVINGS ESTIMATES FAIL TO OFFER ADEQUATE SUPPORT FOR**
6 **DETERMINING THE LEVEL OF BENEFITS THAT WILL RESULT FROM**
7 **THE MERGER OF UE AND CIPS. DO YOU AGREE?**

8 No. The synergies study was conducted by the Companies for the primary
9 purpose of determining reasonable estimates of the total benefits that will
10 accrue to stakeholders as a result of the merger between UE and CIPS.

11 The resulting conclusions conservatively indicated that the merger between
12 UE and CIPS will generate at least \$590 million in cost savings over the first
13 ten years of operations. Based on my experience, these estimates provide
14 reasonable determinations of the size of benefits that will accrue to
15 stakeholders in the future.

16 In a similar manner, traditional rate setting, even through the use of an
17 historical test year implicitly accepts assumptions and expectations
18 regarding future events to establish fair rates for customers and fair returns
19 for shareholders. These rates are not reexamined every year, but carried
20 over a period of time, therefore relying on reasonable estimates about future

1 cost of service. The proposed treatment of merger cost savings by UE and
2 CIPS supports this conceptual framework. Ultimately, actual data for the
3 combined operations can, and will, be influenced by any number of factors
4 unrelated to the merger. The same holds true for conclusions drawn in
5 traditional rate setting cases. The level of data present in a merger filing
6 compared to a rate case does not inherently suggest that merger cost
7 savings estimates will be less accurate.

8 **Q. MR. OLIGSCHLAEGER GOES ON TO DISCUSS THE INORDINATE**
9 **RISKS THAT RATEPAYERS WOULD ASSUME UNDER THE PROPOSED**
10 **SAVINGS SHARING PLAN. PLEASE COMMENT.**

11 **A.** Based on a combination of my experience related to previous transactions,
12 the risk associated with achieving the Companies' projected savings levels
13 is minimal.

14 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

15 **A.** Yes, it does.