

Exhibit No.:  
Issue: Policy  
Witness: Jon R. Empson  
Sponsoring Party: UtiliCorp United Inc.  
Case No.: EM-2000-369  
Date Prepared: August 23, 2000

MISSOURI PUBLIC SERVICE COMMISSION  
Case No. EM-2000-369

Surrebuttal Testimony

of

Jon R. Empson

Jefferson City, Missouri

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI  
SURREBUTTAL TESTIMONY OF JON R. EMPSON  
ON BEHALF OF UTILICORP UNITED INC.**

**CASE NO. EM-2000-369**

1 Q. What is your name and position?

2 A. Jon R. Empson. I am Senior Vice President of UtiliCorp United Inc.  
3 (“UtiliCorp”), responsible for Regulatory, Legislative and Environmental  
4 Services.

5 Q. What role did you have in the application which seeks approval of the merger of  
6 UtiliCorp with The Empire District Electric Company (“Empire”)?

7 A. While having overall responsibility for UtiliCorp’s regulatory filings, I  
8 specifically had the responsibility in this case for ensuring UtiliCorp’s Senior  
9 Management that the merger application contained plans that would provide  
10 UtiliCorp shareholders with the opportunity to earn a fair return on investment  
11 and provide a net benefit to customers.

12 Q. What is the purpose of your surrebuttal testimony?

13 A. My primary purpose is to provide a simplified explanation of the regulatory plan  
14 that will help evaporate the cloud of confusion the Commission Staff (“Staff”)  
15 and the Office of the Public Counsel (“OPC”) have cast over this case through  
16 their rebuttal testimony.

17 Q. Please explain.

18 A. Having listened to the evidentiary hearing in the UtiliCorp merger case involving  
19 St. Joseph Light and Power Company (“SJLP”) and having read the rebuttal

1 testimony in this proceeding, I am frustrated by the attempts to characterize  
2 UtiliCorp's regulatory plan as unique or complex and shifting the risk to the  
3 customers to pay for the acquisition premium. Clearly, the shareholders of  
4 UtiliCorp are bearing the risk of the Empire transaction (as well as the SJLP  
5 transaction) and while the regulatory plan has several elements, it is based on  
6 simple, basic principles.

7 Q. Can you provide some specific references in Staff and OPC testimony that  
8 highlight your concerns?

9 A. Yes, I can. There are numerous references that could be cited but a few  
10 representative statements are:

11 ① OPC witness, Ryan Kind, states on p. 36, lines 4-5: "UtiliCorp's proposed  
12 regulatory plan, which would require ratepayers to fund a large position of the  
13 acquisition premium, ..."

14 ② Staff witness, Cary Featherstone, states on p. 113, lines 16-17 and 21-22:  
15 "UtiliCorp's regulatory plan is developed to capture all the savings for UtiliCorp  
16 and pass the costs of the merger back to its customers."

17 "The shareholders benefit from retaining savings while forcing customers to pay  
18 for the mergers."

19 ③ Witness Featherstone also states on p. 114, lines 9-10: "These plans shift the  
20 risks of both of these mergers to the three UtiliCorp Missouri divisions' respective  
21 customers."

1           ④ Witness Featherstone also states on p. 41, lines 11-12: "Allowing recovery of  
2 positive acquisition adjustments in rates does not provide sufficient incentive for  
3 the acquiring utility to negotiate the best possible price for the acquired firm."

4           ⑤ Witness Featherstone also states on p. 32, lines 1-5: "UtiliCorp's regulatory  
5 plan includes unique regulatory proposals, such as using Empire's pre-merger  
6 capital structure in future Empire rate proceedings and excluding savings in the  
7 administrative and general (A&G) cost categories for the MPS division from  
8 inclusion in rates in future rate proceedings."

9           ⑥ OPC witness Robertson makes comparable statements about customers  
10 bearing the costs on p. 57, lines 13-14 and p. 69, line 3-5.

11   Q.    How would you describe the Empire transaction?

12   A.    First, I want to state that I am not an accountant. My explanation will focus on  
13 the concepts behind the transaction.

14   Q.    Please proceed.

15   A.    UtiliCorp shareholders, through the actions of its Board of Directors, have agreed  
16 to invest approximately \$900 million to acquire ownership of Empire. Basically,  
17 the total price consists of \$620 million to acquire the assets at net book value and  
18 \$280 million to create the opportunity for the transaction to occur. This latter  
19 amount has been called the "acquisition premium." It is important to understand  
20 that if UtiliCorp shareholders had not been willing to pay a premium to create the

1 opportunity for this transaction and put their money at risk, this transaction would  
2 not occur. The payment of the premium is a precondition for the transaction.

3 Q. Why do you say that the UtiliCorp shareholders have assumed the risk?

4 A. UtiliCorp's shareholders have invested this money based upon the belief that  
5 UtiliCorp's management will be able to create incremental value by consolidating  
6 operations and creating a more efficient utility and therefore earn a reasonable  
7 return on its investment. Conceptually, this incremental value created by  
8 UtiliCorp management funds the acquisition premium. If UtiliCorp's  
9 management does not create the required incremental value to fund the acquisition  
10 premium, UtiliCorp's shareholders absorb the risk and will not receive an  
11 adequate return on the invested capital. It is important to emphasize that if the  
12 UtiliCorp shareholders had not assumed this risk by paying the premium, the  
13 incremental values could not be created. The payment of the premium triggers the  
14 chain of events.

15 Q. Have the Staff and OPC claimed that the proposed regulatory plan has the  
16 customers assuming the risks and paying the premium?

17 A. Yes, but both the Staff and OPC are decoupling the enabling action – payment of  
18 premium which creates the risk – from the results – creation of incremental value  
19 which funds the risk. On the one hand, they want the shareholders to absorb the  
20 premium cost, the transaction costs, and even some of the transition costs; while  
21 on the other hand they want the customers to receive the incremental value created  
22 by the transaction.

1 Q. Staff Witness Featherstone (p. 41, lines 20-23) has stated that the adoption of  
2 positive acquisition adjustments ... removes from purchasing utilities ... incentive  
3 to negotiate a lower price ...". If the concept of recovering the acquisition  
4 premium as proposed by UtiliCorp is adopted, what constrains the price utilities  
5 will pay for utility properties?

6 A. Basic economics. If any acquiring utility can only recover premium that is funded  
7 by the incremental values created, they will limit the premium paid to make these  
8 economics work. That is the simple concept that UtiliCorp has used in  
9 developing the regulatory plan in this case.

10 Q. How does this concept apply to the regulatory plan in this case?

11 A. UtiliCorp has proposed a five-year rate moratorium, which will initially enable it  
12 to fund some of the costs to create the incremental values. By retaining the  
13 incremental values created during years 1-5, and essentially charging the  
14 shareholders all of the costs and holding the customers unharmed through frozen  
15 rates, UtiliCorp is attempting to make the economics of the transaction work  
16 through the values created. But again, the risk resides with the shareholders since  
17 rates to the customers are frozen.

18 Q. You've explained that the created value has to fund the costs. How does that  
19 occur in year 6 when cost recovery is directly requested for a portion of the  
20 premium and other costs?

21 A. Again, the proposed regulatory plan places all of the risk on UtiliCorp  
22 shareholders. In year 6, UtiliCorp asks to recover up to 50% of the costs (i.e.  
23 premium) but only if the created value at least equals that cost. If, based upon the

1 guidelines developed in this proceeding, UtiliCorp cannot document that the  
2 incremental values created and realized from this transaction are at least equal to  
3 50% of the cost of premium, the shareholders will bear the difference – not the  
4 customers. The incremental values created by the initial premium payment by the  
5 shareholders and invested transaction costs are what fund the recovery of these  
6 costs. Even if UtiliCorp falls short in creating incremental value to fund the  
7 premium, the Empire customers are guaranteed at least a \$3 million reduction in  
8 cost of service and the financial risk for this transaction again rests with the  
9 shareholders.

10 Q. What do you mean by the phrase “guidelines developed in this proceeding”?

11 A. UtiliCorp management must have guidelines established by the Commission in its  
12 order approving the merger in this case which validate the starting point for  
13 synergy categories. For example, the starting point for determining electric off-  
14 system sales, joint dispatch, number of employees, operating costs and normal  
15 cost increases are critical. Then, there must be a recognition in the order that  
16 synergies will be measured against these starting points. Any attempt to speculate  
17 on what Empire might have, could have, or should have achieved during the five-  
18 year rate freeze relating to these synergy categories is irrelevant and a  
19 nonproductive exercise. It would be inappropriate to hold UtiliCorp to a standard  
20 of proving a negative, i.e., Empire could not have achieved these synergies as a  
21 stand-alone entity.

22 Q. As you read Staff rebuttal testimony in this case, what general, overall observation  
23 would you make?

1 A. It would appear that the Staff has attempted to create a great deal of confusion but  
2 in the final consideration I am hopeful that the Commission will be able to sort  
3 things out. The regulatory plan is clearly designed and does in fact place the risk  
4 of recovering the premium on the UtiliCorp shareholders. I cannot think of a  
5 reasonable scenario where the customers of either Empire or UtiliCorp are placed  
6 at risk or detrimentally impacted. The regulatory plan is designed to provide  
7 UtiliCorp shareholders with the opportunity to recover some of its investment  
8 over a period of time. On the other hand, the Staff apparently does not want to  
9 recognize the upfront investment made by UtiliCorp shareholders that creates the  
10 opportunity for Empire customers to receive a \$3 million reduction in the cost of  
11 service in year 6.

12 Q. Is there an analogy you might offer that represents your understanding of the  
13 Staff's position?

14 A. Yes. Conceptually, I can see two utilities merging that have two offices, but both  
15 offices are too small to hold the combined staffs. However, one of the offices has  
16 additional space available that could be leased. The decision is made to "buy-out"  
17 the other utility's lease (i.e., pay a premium to enable consolidation) so that the  
18 merged utility can consolidate into a single office and gain operational  
19 efficiencies. The analysis developed by the merged utilities shows that the cost  
20 for the "buy-out" is more than offset by the gains in operational efficiencies. In  
21 other words, the premium paid (i.e. buy-out) was necessary for the operational  
22 efficiencies (i.e. synergies) to be achieved.

23 Q. Please continue with your analogy.

1 A. From the utility perspective, the cost of the lease buy-out should be amortized  
2 over the term of the lease and included in rates knowing that the related  
3 efficiencies or cost reductions gained from the consolidation more than offset this  
4 cost so the customer is a net winner. Simply stated, the costs should be matched  
5 with the savings. The merged utility should be held accountable to document  
6 these savings as at least equal to the cost of the "buy-out." It would appear that  
7 the Staff position would be to disallow including the lease buy-out in rates but to  
8 retain the benefits for the customers or use a show cause to "claw" back the  
9 benefits before the buy-out is repaid by the operational efficiencies. In my mind,  
10 both costs – the premium and the lease buy-out – were incurred to create an  
11 opportunity to develop incremental value that benefits customers and both would  
12 be legitimate, reasonable utility expenses.

13 Q. Why has UtiliCorp recommended freezing the Empire capital structure as part of  
14 the merger regulatory plan?

15 A. There are two reasons. First, there is no detriment to the Empire customers by  
16 maintaining Empire's or a comparable company approach in setting rates. That is  
17 the basis for rates today and how UtiliCorp itself will assign capital requirements  
18 to Empire in the future. Staff has taken a comparable company approach in  
19 testimony in other cases involving companies like SJLP so the concept is not  
20 foreign to the Staff.

21 Second, UtiliCorp has always managed and funded its operations on a comparable  
22 company approach. As UtiliCorp grew its business portfolio and changed its risk  
23 profile from a utility to a more diversified energy company, it was important to

1 internally maintain books and records that reflected the proper business profiles.

2 The proposal to adopt Empire's capital structure is consistent with UtiliCorp's  
3 current operational and regulatory practice.

4 Q. Why does the regulatory plan exclude the impact of Empire in determining  
5 corporate allocations to UtiliCorp's Missouri Public Service ("MPS") operating  
6 division?

7 A. Staff and OPC have consistently challenged UtiliCorp's growth strategy. Even in  
8 this proceeding, Staff goes back almost 20 years to quote UtiliCorp Chairman,  
9 Rick Green about the implementation of the growth strategy.

10 Bob Green explains in his surrebuttal testimony in this case the intent of Rick  
11 Green's comments from the 1980's. UtiliCorp has not sought to recover from its  
12 Missouri customers merger and acquisition expenses or premiums associated with  
13 its non-Missouri acquisitions. As we designed the regulatory plan in this case, we  
14 felt it was important to maintain this "independent" approach. That is, MPS  
15 customers should not bear the costs of the merger transaction. Therefore, all of  
16 the premium was assigned to Empire and the allocation factors were neutralized  
17 so that the benefits of reduced factors also did not go to MPS customers. An  
18 option would have been to assign prorata costs of the transaction to MPS that  
19 create the benefit (lower allocations).

20 Q. Why didn't UtiliCorp choose this alternative?

21 A. The alternative raised a new policy issue for the Commission that was better  
22 addressed directly by our proposal. The new issue was whether we should be  
23 adding costs to MPS customers in all acquisitions that reduce corporate

1 allocations to MPS customers. We concluded it was best for this merger to isolate  
2 the premium and benefits as much as practical with Empire. This was also  
3 consistent with Rick Green's commitment that MPS customers would be  
4 protected from downside risks associated with UtiliCorp's M&A strategy.

5 Q. Do you have any concluding comments?

6 A. Yes. The regulatory plan was specifically designed to ensure that Missouri  
7 customers of both Empire and MPS would not be exposed to any downside risk.  
8 The UtiliCorp shareholders are taking the risk in this merger by making the initial  
9 investment, developing the required synergies, guaranteeing a reduction in the  
10 cost of service for Empire customers in year 6, and funding costs only if the  
11 incremental values can be proven. The regulatory plan virtually and explicitly  
12 guarantees that Empire customers will not be detrimentally impacted by this  
13 transaction.

14 The Staff and OPC want the Commission to ignore what is known today about the  
15 operations of both Empire and MPS, ignore that reasonable synergies can be  
16 estimated and created, and engage in speculative scenarios of what might happen  
17 if the two companies continued to operate independently for the next five years.  
18 This merger is not detrimental to either the Empire or MPS customers and the  
19 proposed regulatory plan should be approved to enable UtiliCorp to create the  
20 guaranteed benefits.

21 Q. Does that conclude your surrebuttal testimony?

22 A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

In the Matter of the Joint Application of    )  
UtiliCorp United Inc. and The Empire       )  
District Electric Company for Authority to   )  
Merge The Empire District Electric        )  
Company with and into UtiliCorp United     )  
Inc., and, in Connection Therewith, Certain )  
Other Related Transactions.                )

Case No. EM-2000-369

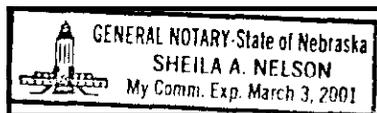
County of Douglas    )  
                              )  
State of Nebraska    )

**AFFIDAVIT OF JON R. EMPSON**

Jon R. Empson, **being first duly sworn**, deposes and says that he is the witness who sponsors the accompanying testimony entitled surrebuttal testimony; that said testimony was prepared by him and or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

  
\_\_\_\_\_  
Jon R. Empson

Subscribed and sworn before me this 16th day of August, 2000.



  
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Notary Public