**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

In the Matter of the Joint Application of Great Plains Energy Incorporated, Kansas City Power & Light Company and Westar Energy, Inc. for Approval of the Acquisition of Westar Energy, Inc. by Great Plains Energy Incorporated.	))))))	Docket No. 16-KCPE-593-ACQ

<u>NOTICE OF FILING OF CORRECTED TESTIMONY</u>

The Staff of the State Corporation Commission of the State of Kansas ("Staff" and "Commission," respectively) files the attached Corrected Testimony of Jeff McClanahan. For the convenience of the parties and to effect a more efficient hearing process, this filing is provided in lieu of live corrections being provided at hearing. A list identifying the location and an explanation of each correction is attached.

Respectfully Submitted,

Amber Smith, #23911
Michael Neeley, #25027
Andrew French, #24680
Kansas Corporation Commission
1500 S.W. Arrowhead Road
Topeka, Kansas 66604
Phone: 785-271-3110
Fax: 785-271-3167

ATTORNEYS FOR STAFF

Corrections to McClanahan Direct:

Correction of grammatical and spelling errors.

Insertion of a missing word(s) is noted in italics and deletion of a word is noted as a strikethrough:

Table of Contents – Section II. A. corrected to state "The proposed merger is *not* in the public interest".

Page 4 – "Hempling discusses the *fact that the* $2.3 billion control premium represents overcompensation to Westar's shareholders and that it conflicts with the public interest".

Page 4 – "He also discusses the fact that the claimed savings do not satisfy the public interest standard, allocation of the merger savings through rate cases means allocating without regulatory principle, and *how* the across-the-fence rivalry between Joint Applicants pressures monopolies to perform".

Page 4 – "Finally, Mr. Hempling discusses basing acquisition policy on a public interest first *basis* as the appropriate policy".

Page 16 – "As discussed previously, merger conditions will not remedy the fundamental flaws *identified* ~~with~~ *within* this proposed Transaction."

Pages 23 and 24 – "If GPE can finance $3.7 billion of Westar's equity at *3.95%* but earn on that equity 9.35%, its financial planners will have produced a large profit."

Page 31 – "~~These~~ *This* final offer accepted by Westar of $60/share results in a situation where Westar's shareholders went from a trading price of $34.22/share on June 30, 2015 to $60/share one year later.

Page 33 – "This value is *a* 230% premium over Westar's book value as of June 30, 2016."

Page 34 – "More specifically, Staff is in an untenable position where it ~~can't~~ *cannot* recommend approval of the Transaction with merger conditions knowing that such conditions will result in severe financial difficulties for GPE, its subsidiary utilities, and those utilities' customers."

Page 37 – "While it is highly unlikely the Joint Applicants *would* choose to do so, the Commission could offer the opportunity."

Page 37 – "However, as Staff points out in its testimony, ~~its~~ *we have* deep concerns related to the Joint Applicants' weakened financial condition, the short-term financial model, and undemonstrated savings associated with this Transaction. "

Page 39 – "Therefore, if a utility buys another utility for a significant premium in excess of the book value of equity, either one of two *expectations* must be the case."

Page 41 – Mr. Grady evaluates four factors that are key to GPE's economic decision to acquire Westar ~~as~~ *at* such a significant premium."

Page 50 – Added the following Question and Answer:

Q. Does this conclude your testimony?

A. Yes.

IN THE MATTER OF THE JOINT APPLICATION OF GREAT PLAINS ENERGY INCORPORATED, KANSAS CITY POWER & LIGHT COMPANY, AND WESTAR ENERGY, INC. FOR APPROVAL OF THE ACQUISITION OF WESTAR ENERGY, INC. BY GREAT PLAINS ENERGY INCORPORATED.	)))) DOCKET NO. 16-KCPE-593-ACQ))

DIRECT TESTIMONY

PREPARED BY

JEFFREY D. MCCLANAHAN

UTILITIES DIVISION

KANSAS CORPORATION COMMISSION STAFF

December 16, 2016

TABLE OF CONTENTS

Q. Please state your name and business address.

A. Jeffrey D. McClanahan, 1500 SW Arrowhead Road, Topeka, Kansas.

Q. Who is your employer and what is your title?

A. I am employed by the Kansas Corporation Commission (Commission or KCC) as Director, Utilities Division.

Q. What is your educational background and professional experience?

A. I hold a Bachelor of Arts degree in Accounting from West Texas State University. I was employed for approximately eight years by a Savings and Loan institution in professional positions in auditing and accounting. I joined the KCC in December 1997 as a Utility Auditor II. I was promoted to Senior Auditor in May 1998 and was subsequently promoted to Chief of Accounting and Financial Analysis in February 2002. I have held my current position since April of 2012.

Q. Have you previously testified before the Commission?

A. Yes, I have filed testimony in numerous dockets before the Commission. A list of my filed testimony is available upon request.

Q. What is the purpose of your testimony?

A. Due to the length of Staff witnesses' testimony and the number of issues involved in this case, I am primarily providing a summary of Staff's major issues in this case to aid the Commission in its review of Staff's positions, conclusions, and recommendations. I will also provide an overview of the Transaction, an introduction of Staff's witnesses, and a summary of Staff's overall recommendation. A review of my outline above will indicate that I am not organizing my testimony by the Commission adopted Merger Standards. Rather, I have organized my summary testimony by broader categories addressing Staff's major issues. Under each category, I will provide a summary of each witness' positions and conclusions along with a reference to the relevant section of the witness' testimony.

I.
Overview of Transaction and Introduction of Witnesses

A. Overview of Transaction

Q. Please provide an overview of the proposed merger transaction.

A. Great Plains Energy's (GPE) proposal to acquire Westar Energy (Westar) results in the two largest investor-owned electric utilities in Kansas will be separately-owned subsidiaries of a singular holding company – GPE. The general financial terms are as follows:

> ***Total Transaction value:*** The Transaction value is about $12.2 billion. GPE will pay $8.6 billion for all of Westar's equity, while assuming all $3.6 billion of Westar's debt.
>
> ***Payment to Westar shareholders:*** Westar shareholders will receive approximately $60 per share. Each share of Westar stock will be converted into a right to receive $51.00 in cash, plus an amount of GPE stock worth approximately $9.00 (subject to a 7.5 percent collar based upon the Great Plains Energy common stock price at the time of the closing). The compensation to Westar shareholders is therefore about 85% cash and 15% stock. This compensation amounts to an acquisition premium estimated at $4.9 billion (233%) over book value and $2.3 billion (36%) over Westar's "undisturbed stock price."
>
> ***Financing:*** GPE will finance its purchase of Westar with approximately 50% equity and 50% debt.

> ***Post-acquisition entity:*** After closing, Westar will be a wholly-owned subsidiary of GPE. Westar shareholders will own about 15% of GPE. [Hempling at Section I. B., cites omitted].

B. Introduction of Staff's Witnesses

Q. Who will be offering testimony on behalf of Staff?

A. I will introduce Staff's witnesses and then introduce the consultants testifying on behalf of Staff. Following my narrative introducing the witnesses, I will provide a listing of each merger standard along with the witnesses and issues addressed by the witness. The witnesses are as follows:

Staff Witnesses:

Justin Grady: Mr. Grady discusses the fact that the purchase price GPE has agreed to pay cannot be determined to be reasonable in light of the savings that can be demonstrated and it is not within a reasonable range. Mr. Grady performs financial analysis and evaluates the purchase price and related acquisition premium and finds that the primary reason GPE can pay such a high acquisition fee is due to its withholding of cost savings related to lowering overall capital costs. Finally, in support of Staff witness Hempling's control premium analysis, Mr. Grady supports a calculation of the value of the control premium that should be passed on to customers.

Adam Gatewood: Mr. Gatewood discusses the fact that the post-merger entity will be financially weaker than the existing stand-alone entities. He also asserts that the merger is not in the public interest because customers will be asked to pay rates that are in excess of the cost of providing services. Finally, the Transaction weakens the Commission's ability to effectively regulate the post-merger entity.

Casey Gile: Mr. Gile recommends quality of service standards.

Robert Glass, Ph.D.: Dr. Glass discusses merger standard (c) and finds that the Transaction will have a negative effect on the Kansas economy. Dr. Glass also addresses: 1) whether there will be any economic waste; 2) whether the Transaction will maximize Kansas energy resources; and 3) whether there is an impact on existing competition.

Staff's Consultants:

Scott Hempling, President of Scott Hempling, Attorney at Law LLC: Mr. Hempling discusses the fact that the $2.3 billion control premium represents overcompensation to Westar's shareholders and that it conflicts with the public interest. He also discusses the fact that the claimed savings do not satisfy the public interest standard, allocation of the merger savings through rate cases means allocating without regulatory principle, and how the across-the-fence rivalry between Joint Applicants pressures monopolies to perform. Finally, Mr. Hempling discusses basing acquisition policy on a public interest first basis as the appropriate policy.

Ann Diggs, CPA: Ms. Diggs discusses transaction savings, shared services savings, quantification of ratepayer benefits, preservation of KCC jurisdiction, and affiliate transactions and cost allocations.

Walter P. Dabrinski, President, Vantage Energy Consulting, LLC: Mr. Drabinski discusses generations system analysis, analysis of transmission and distribution integration, customer service integration, supply chain savings, and potential merger conditions.

C. Witnesses by Merger Standard

Q. Which witness or witnesses address each Merger Standard?

A. Staff's testimony, as a whole, addresses each and every Merger Standard. The witness or witnesses addressing each Merger Standard are as follows:

(a) The effect of the Transaction on consumers, including:

(i) the effect of the proposed transaction on the financial condition of the newly created entity as compared to the financial condition of the stand-alone entities if the transaction did not occur;

Discussed by: Adam Gatewood

(ii) reasonableness of the purchase price, including whether the purchase price was reasonable in light of the savings that can be demonstrated from the merger and whether the purchase price is within a reasonable range;

Discussed by: Scott Hempling, Justin Grady, and Ann Diggs

iii) whether ratepayer benefits resulting from the transaction can be quantified;

Discussed by: Scott Hempling, Ann Diggs, Walter Drabinski, Casey Gile, and Adam Gatewood

(iv) whether there are operational synergies that justify payment of a premium in excess of book value; and

Discussed by: Scott Hempling, Ann Diggs, Justin Grady, and Walt Drabinski

(v) the effect of the proposed transaction on the existing competition.

Discussed by: Scott Hempling, Dr. Robert Glass, and Walt Drabinski

(b) The effect of the transaction on the environment.

Discussed by: Walter Drabinski

(c) Whether the proposed transaction will be beneficial on an overall basis to state and local economies and to communities in the area served by the resulting public utility operations in the state. Whether the proposed transaction will likely create labor dislocations that may be particularly harmful to local communities, or the state generally, and whether measures can be taken to mitigate the harm.

Discussed by: Dr. Robert Glass, Walt Drabinski, and Casey Gile

(d) Whether the proposed transaction will preserve the jurisdiction of the KCC and the capacity of the KCC to effectively regulate and audit public utility operations in the state.

Discussed by: Scott Hempling, Ann Diggs, Walt Drabinski, and Adam Gatewood

(e) The effect of the transaction on affected public utility shareholders.

Discussed by: Justin Grady and Adam Gatewood

(f) Whether the transaction maximizes the use of Kansas energy resources.

Discussed by: Robert Glass and Walt Drabinski

(g) Whether the transaction will reduce the possibility of economic waste.

Discussed by: Dr. Robert Glass and Scott Hempling

(h) What impact, if any, the transaction has on the public safety.

Discussed by: *Casey Gile*

II.

Summary of Staff's Position: The Proposed Merger Should be Denied Because it Does Not Promote the Public Interest when Evaluated in Light of the Commission's Merger Standards and it Creates an Unacceptably High Financial Risk for Both Current and Future Customers and Shareholders

A. The proposed merger is not in the public interest.

Q. What is the Public Interest Standard and how is it applied in merger dockets?

A. Generally speaking, the public interest is served when ratepayer interests are carefully considered and protected. In the context of a rate case, the public interest can be served when ratepayers are protected from unnecessarily high prices, discriminatory prices, and/or unreliable service. In the context of a merger, the Commission's Order in Docket Nos. 172,745-U and 174,155-U[1] (KPL/KGE Merger) states the following:

> All parties generally agree that the merger should be approved only if it is "in the public interest." The parties have differed, however, on specifically what "in the public interest" means in the context of utility mergers. The Commission notes there are various cases addressing generally the meaning of "the public convenience and

[1] The Commission's Order in Docket Nos. 172,745-U and 174,155-U dated November 14, 1991, approved the merger of Kansas Power and Light Company with the Kansas Gas and Electric Company.

> necessity." Public convenience means the convenience of the public, not the convenience of particular individuals. 206 Kan. 670, 676 (1971). Public necessity does not necessarily mean there must be some showing of absolute need. As used, the word "necessity" means a public need without which the public is inconvenienced to the extent of being handicapped. Id.[2]
>
> Consistent with its broad authority to regulate public utilities for the benefit of the public interest, the Commission believes that in reviewing a merger or acquisition, it should consider a variety of factors. The Commission believes that to simply adopt a "no detriment" test as suggested by the Applicants or a "net benefits" standard as suggested by CURB is too simplistic. Utility mergers and acquisitions are complex transactions that affect both ratepayers and shareholders for many years to come and have significant implications for the utility service to be provided. Consistent with its mandate in approving the initiation of utility service as set out in K.S.A. 66-131, the Commission concludes that mergers and acquisitions be approved where the applicant can demonstrate that the merger or acquisition will promote the public interest. In determining whether a transaction promotes the public interest, the Commission looked to the variety of sources presented by the parties in their testimony and briefs. The Commission adopts the following list of factors it will weigh and consider in determining whether the proposed transaction promotes the public interest…[3] [Listing of Merger Standards omitted].
>
> The Commission believes these factors will allow the Commission to uniformly review mergers and acquisitions that may be presented to the Commission in the future while maintaining some flexibility to deal with the particular circumstances of each transaction. Additionally, these factors will provide utilities contemplating a merger or acquisition with a standard that will be utilized to review any contemplated transaction.[4]

In the September 28, 1999, Order on Merger Application in Docket No. 97-WSRE-676-MER, the Commission stated the following:

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[2] Id. at p. 34.
[3] Id. at pp. 34-35.
[4] Id. at p. 36.

> The November 15, 1991 Order approving the merger between KPL and KGE (Docket Nos. 172,745-U and 174,155-U) stated that mergers should be approved where the applicant can demonstrate that the merger "will promote the public interest." (p. 35.) The Order set forth a number of factors to be weighed and considered in determining whether this standard is met… [List of Merger Standards Omitted].[5]
>
> The Commission reaffirms that the information in these standards should be addressed by parties in merger cases. These factors are the beginning criteria to be used when evaluating a merger application, and are to be supplemented by any other considerations that are relevant given the circumstances existing at the time of the merger proposal. In essence, the question is whether the public interest is served by approving the merger as determined by the specific facts and circumstances of each case. The Joint Applicants bear the burden of proof in this case, and must demonstrate through the evidence in the record a sufficient basis upon which to approve the merger.[6]

The current Commission has reaffirmed the merger standards in its Order in this Docket dated August 9, 2016. Specifically, the Commission stated:

> In determining whether a proposed merger will promote the public interest, the Commission will evaluate the application under the following criteria. [7] [Merger Standards omitted].
>
> The Commission recognizes that the 97-676 Docket allows for some flexibility in the merger standards, including modifying those standards or even adding additional standards or considerations. At the same time, the Commission will require any deviation from the standards reaffirmed in paragraph 5 of this Order to be clearly identified in the application and justified in supporting testimony. Similarly, if Staff or an intervenor believes the standards need to be modified in a particular docket, they are obligated to explain the proposed modification and provide grounds supporting the proposed modification.[8]

[5] Docket No. 97-WSRE-676-MER, Order on Merger Application at ¶17.
[6] Id. at ¶18.
[7] Docket No. 16-KCPE-593-ACQ, Order on Merger Standards at ¶5.
[8] Id. at ¶7.

Based on the above statements, it is clear that the merger standards are entrenched as "…the beginning criteria to be used when evaluating a merger application, and are to be supplemented by any other considerations that are relevant given the circumstances existing at the time of the merger proposal."[9] Moreover, the Commission confirmed that the merger standards are the primary determination of whether the public interest is being promoted when it stated, "The Commission adopts the following list of factors [merger standards] it will weigh and consider in determining whether the proposed Transaction promotes the public interest."[10]

It is also clear that whether the public interest is promoted is based on "…whether the public interest is served by approving the merger as determined by the specific facts and circumstances of each case."[11]

Q. Does the Joint Application promote the public interest?

A. No. As reflected in Staff's overall recommendation, the Joint Application for approval of Great Plains Energy's (GPE) acquisition of Westar Energy (Westar) does not satisfy a majority of the merger standards. What's more, the proposed Transaction would leave ratepayers, the state, and even the post-transaction entity in a worse position moving forward. In fact, this Transaction primarily promotes the interests of Westar's shareholders – due to the overcompensation they will

[9] Docket No. 97-WSRE-676-MER, Order on Merger Application at ¶ 18.
[10] Docket Nos. 172,745-U and 174,155-U, Order at p. 35.

[11] Docket No. 97-WSRE-676-MER, Order on Merger Application at ¶ 18.

receive – to the detriment of the public interest.[12] Because the Commission uses the merger standards as guidance as to whether a transaction promotes the public interest, failure to meet the majority of the merger standards is a strong indication that the public interest will not be promoted by approving the Transaction.

B. Staff's overall recommendation.

Q. Please provide Staff's overall recommendation.

A. The merger transaction – as structured – should be denied.

Q. It is typical for Staff to recommend denial of a merger transaction as proposed, but provide specific merger conditions that allow Staff to recommend approval. Is that the case here?

A. No. Staff cannot recommend approval of the merger even with conditions. Merger conditions cannot remedy several fundamental flaws within the Transaction as proposed. These fundamental flaws are:

- The purchase price of $12.2 billion is too high because it results in GPE and its subsidiary – Westar – being in a significantly weaker financial position post-acquisition.
- Even though Joint Applicants assert they are not explicitly requesting recovery of the acquisition premium (AP), ratepayers will inevitably pay this AP implicitly through financial engineering.[13]

[12] Direct Testimony of Scott Hempling at Section II.
[13] Financial engineering will be defined later in this testimony, but it essentially requires the Commission to change its current approach to setting a utility's cost of capital by allowing GPE to earn equity-level returns on investment financed with lower-cost debt.

- Joint Applicants have failed to demonstrate that the Transaction benefits customers through demonstrable and quantifiable savings which can be reasonably attributed to the acquisition.
- Joint Applicants have failed to provide any certainty with regard to the continued financial health of the companies.

Q. Why is the purchase price a fundamental flaw in this Transaction?

A. GPE's and Westar's weaker financial positions post-acquisition are due primarily to the amount of debt used to finance the excessive acquisition price. This imposes unacceptably high risks on current and future customers and shareholders. The potential harms from these risks include increased capital costs due to credit rating downgrades, increased rates due to increased borrowing costs, and the diminished capacity of the Commission to effectively regulate a financially troubled utility. Moreover, these potential harms occur *with the financial engineering included* in the Joint Applicant's financial modeling. [Grady at Section II.]. [Gatewood at Sections II. and IV.].

Q. Why is the planned indirect recovery of the AP through financial engineering a fundamental flaw in this Transaction?

A. Despite the fact that the Joint Applicants' assert that they are not seeking recovery of the AP of $4.9 billion, ratepayers are in effect being asked to pay for the AP through financial engineering. This financial engineering requires the Commission to change its current approach to setting a utility's cost of capital by allowing GPE to earn equity-level returns on investment financed with lower-cost debt. Moreover, the Joint Applicants have stated that "…completion of the

Transaction is largely dependent on the Commission not applying the GPE consolidated capital structure ratios when setting Westar's and KCPL's revenue requirements."[14] Therefore, it appears the threshold feasibility of the proposed acquisition hinges on the Commission's decision related to the financial engineering used by GPE. [Hempling at Section II. D. a.]. [Gatewood at Section II. D., citing KCC-264].

Q. How is the failure to demonstrate quantifiable savings reasonably attributable to the merger a fundamental flaw to the proposed Transaction?

A. Joint Applicants have asserted that that they have reviewed prior merger dockets and understand that "the Commission views potential savings as a significant driver in the determination of whether a merger/acquisition is in the public interest."[15] Yet Joint Applicants have failed to demonstrate that the Transaction benefits customers through demonstrable and quantifiable savings which can be reasonably attributed to the acquisition. Joint Applicants have failed to demonstrate savings because the Joint Application relies on preliminary savings efficiency targets that will be validated through the integration planning process *currently* underway. Staff has not seen the results of the integration planning process because it is not expected to be completed until January 2017. [Diggs at Sections II., III., and V.].

[14] Staff Data Request KCC-264.
[15] Direct Testimony of Darrin R. Ives at p. 5.

Q. Do the Joint Applicants believe that the requirement of merger standard (a)(ii) "reasonableness of the purchase price, including whether the purchase price was reasonable in light of the savings that can be demonstrated from the merger and whether the purchase price is within a reasonable range" is relevant to the Commission's determination of whether this Transaction is in the public interest?

A. No. Apparently the Joint Applicants believe that, because they are not explicitly requesting recovery of the acquisition premium, then even $1 of savings[16] is a benefit to customers. As KCP&L witness Darrin Ives states:

> Staff appears to have overlooked this important wording in Merger Standard (a)(ii), which causes Staff to similarly fail to appropriately recognize the fact that *Joint Applicants are not requesting recovery of any portion of the purchase price (i.e., the acquisition premium in excess of net book value or transaction costs) in revenue requirement and rates paid by customers for electric service and, as such, any savings realized from the Transaction that are reflected in revenue requirement and rates through the ratemaking process represent benefits for customers* in the form of rates that are lower than they would have been absent the Transaction. [Supplemental Direct Testimony of Darrin Ives, p. 4]. [Emphasis added].

Joint Applicants' position that it is not seeking recovery of the acquisition premium is obviously a fundamental disagreement with Staff since Staff asserts the Joint Applicants' use of financial engineering does in fact require customers to support the acquisition premium. Moreover, Staff witness Grady asserts in his testimony at Section III. F. that the implicit

[16] Supplemental Direct Testimony of Kevin Bryant at p. 6.

recovery of the AP through financial engineering will cost ratepayers much more than the traditional approach of sharing a portion the AP with shareholders based on demonstrated savings.

Q. How is Joint Applicants' failure to provide certainty with regard to the continued financial health of the companies a fundamental flaw to the proposed Transaction?

A. Joint Applicants have failed to provide any certainty with regard to the continued financial health of the companies, as contemplated in merger standard (a) (i), the effect of the proposed Transaction on the financial condition of the newly created entity as compared to the financial condition of the stand-alone entities if the Transaction did not occur. Application of this standard demands the Commission deny the Transaction because the Joint Applicants' financial model only goes through the year 2020, providing no certainty of the companies' future financial condition. [Gatewood at Section II. C.].

Q. Given Staff's position that merger conditions cannot remedy the fundamental flaws, is the Commission to assume Staff will not provide any merger conditions in its testimony?

A. Staff witnesses do provide illustrative guidance by discussing certain merger conditions in testimony. While it should be clearly noted that Staff is not recommending approval of the proposed Transaction – even with conditions – for issues that are not related to the fundamental flaws identified previously, we identify and discuss placing specific conditions on discrete issues which would otherwise be appropriate in a merger transaction. These conditions are intended as guidance for future transactions involving Kansas's electric utilities. As discussed previously, merger conditions will not remedy the fundamental flaws identified within this proposed Transaction. However, Staff's concerns expressed in its testimony should provide guidance for the Commission and Joint Applicants regarding Staff's positions, particularly with how the cost savings associated with the use of financial engineering should be allocated to customers.

C. Brief overview of major mergers in Kansas.

Q. Please provide a brief overview of major mergers in Kansas.

A. The table below provides an overview of the major mergers in Kansas beginning with the KGE/KPL merger filed in October of 1990.

Major Electric Utility Mergers and Acquisition in Kansas 1990-2016

Date	Docket No.	Acquiring Company	Target Company	Status
7/1990	172,745_U	Kansas Power & Light	Kansas City Power & Light	Terminated 12/1990
12/1990	91-UCUE-226-MER	UtiliCorp United	Centel	Completed 9/1991
10/1990	172,745-U & 174,155-U	Kansas Power & Light	Kansas Gas & Electric	Completed 3/1992
4/1996	97-WSRE-676-MER	Western Resources	Kansas City Power & Light	Terminated 1/2000
1/1996	Not Docketed	UtiliCorp United	Kansas City Power & Light	Terminated 9/1996
5/1999	00-UCUE-677-MER	UtiliCorp United	Empire District	Terminated 1/2001
11/2000	Not Docketed	Western Resources	PNM Resources	Terminated 1/2002
11/2005	06-MKEE-524-ACQ	Mid-Kansas Electric	Aquila Inc. West Plains Kansas Div.	Completed 2/2007
2/2007	07-KCPE-1064-ACQ	Great Plains Energy	Aquila Inc. (formerly UtiliCorp)	Completed 7/2008
3/2016	16-EPDE-410-ACQ	Liberty Utilities	Empire District	S&A to Approve; Order Pending
5/2016	16-ITCE-512-ACQ	Fortis	ITC Holdings	Completed 10/2016
6/2016	16-KCPE-593-ACQ	GPE	Westar Energy	In Process

As the table indicates, there have been twelve major mergers since the KPL/KGE merger. Of the twelve mergers, five were terminated by the merging parties. In addition, the transactions involving Kansas Gas & Electric and Aquila as the target companies were initiated because they were in poor financial health.

Q. The terms "merger' and "acquisition" seem to be used interchangeably in merger cases, is there a difference?

A. Yes. A merger is defined as combining two separate companies into a newly created company. An acquisition is defined as the purchase of one corporation by another. Most utility merger transactions that have been filed in Kansas have been acquisitions of one utility by another utility, and this case is no different. So, while Staff's witnesses sometimes refer to this Transaction as a merger, these are simply shorthand references to the acquisition of Westar by GPE.

III.

The Effect of the Purchase Price and Acquisition Premium on the Post-Merger Entity's Financial Condition

A. Development of the purchase price.

Q. What do the Joint Applicants assert as the primary reason for the Transaction?

A. Staff witness Scott Hempling notes at Section II. C. that Darrin Ives asserts "[c]reating efficiencies is the primary driver of the Transaction." Mr. Hempling notes that this statement cannot be reconciled with the facts because, once Westar identified GPE as the most cost-effective acquirer, Westar would simply have agreed to merge without demanding a premium.

Q. How was the purchase price GPE agreed to pay for Westar developed?

A. In order to maximize the purchase price, the $12.2 billion purchase price was achieved through a competitive bid process. Staff witness Scott Hempling explains at Section II. B. that this led to a significant acquisition premium (excess of purchase price over Westar's book value) and the control premium (excess of purchase price over Westar's pre-acquisition stock value) of $4.9 billion and $2.3 billion respectively. Moreover, the emphasis on price dominated all other considerations, relegating customer value and the public interest to incidental considerations.

Q. What is Staff's view of the reasonableness of the purchase price?

A. Staff's conclusion is that the purchase price is not within a reasonable range based on a comparison to other recent merger and acquisition (M&A) activity as well as in light of potential merger savings

B. Westar's and GPE's financial advisors' "fairness" opinions.

Q. Did GPE and Westar each obtain a fairness opinion from their respective financial advisors?

A. Yes. Westar retained Guggenheim Securities, LLC (Guggenheim), and GPE retained Goldman Sachs and Co. (Goldman).

Q. Does Guggenheim's financial analysis provide support that GPE's purchase price for Westar is excessive?

A. Yes. Mr. Grady addresses this issue in his testimony at Section II. C. 1. Mr. Grady's review and analysis indicates that:

- The Transaction multiples used by Guggenheim indicate the purchase price (inclusive of the acquisition premium) is among the highest or the highest paid for an electric public utility. In fact, Mr. Grady's analysis and critique of the multiples results in a conclusion that GPE's purchase price of Westar's equity is higher than every other relevant electric utility in the country.
- Guggenheim's Discounted Cash Flow (DCF) analysis and Peer Group Trading analysis both derive a low and high price with the high range being $54.46 and $57.38 respectively, both of which are clearly below the $60 purchase price GPE agreed to pay. Guggenheim's DCF analysis also uses a weighted average cost of capital (WACC) of between 4.5% and 5.5%, which is significantly lower than the 6.6% used to set Westar's current rates.
- Guggenheim's Precedent M&A Transaction Analysis valued its high range price of $57.76.
- Guggenheim did provide, "solely for informational purposes," a Transaction Premiums Paid Analysis that was the only analysis supporting a purchase price at or above $60 per share. However, Mr. Grady discounted this valuation as it relied on faulty assumptions.

Q. Did Goldman's financial analysis provide support that GPE's purchase price for Westar is excessive?

A. Yes. Staff witness Justin Grady addresses this issue in his testimony at Section II. C. 2. Mr. Grady's review and analysis indicates that:

- Mr. Grady reviewed Goldman's Purchase Premium Paid analysis and concludes that GPE's agreed-upon premium over Westar's unaffected stock price compared to other recent comparable transactions is the highest observation and is also substantially higher than the average premium paid when gas transactions are removed.
- Goldman conducted a Selected Transaction Analysis that used one-year forward price-to-earnings ratios to develop an earnings per share multiple. Mr. Grady's analysis again removes gas related transactions, which result in GPE's multiple being the highest (*i.e.*, the most expensive).
- Goldman performed a DCF that derives a low and high price with the low price being $43.16 and the high price being $57.47 per share, both of which are clearly below the $60 purchase price GPE agreed to pay. Goldman's highest DCF analysis also uses a weighted average cost of capital (WACC) of 3.5%, which is significantly lower than the 6.6% used to set Westar's current rates.
- The overall present value per share Goldman's DCF analysis developed is $43.16 per share to $57.47 per share when not including efficiencies and $54.95 to $71.48 per share when including forecasted efficiencies.

- Mr. Grady's analysis of Goldman's DCF found the analysis that included efficiencies was based on several faulty assumptions that Joint Applicants have designated as confidential and will not be discussed explicitly in my testimony. However, Mr. Grady does indicate that Goldman's DCF analysis of the valuation per share related to the inclusion of efficiencies should not be relied on because of the faulty assumptions. This is the only DCF analysis that Goldman created that provided a value at or above $60 per share.

C. GPE's financial model.

Q. Did GPE develop a financial model that includes financial projections to determine whether the additional debt and equity related to this Transaction can be supported by projected cash flows from all sources, including regulated cash flows?

A. Yes. Staff witness Adam Gatewood discusses GPE's financial model at Section II. C. of his testimony. Mr. Gatewood expresses concern because GPE's financial model does not address de-leveraging the acquisition debt and only provides financial projections post-transaction for the years 2018, 2019, and 2020. This is unusual because most merger transactions filed with the Commission have long-term financial projections included in financial modeling.

Q. What particular financial concerns did Mr. Gatewood identify?

A. Mr. Gatewood identified a number of issues relative to the capital structure. Of particular concern to Mr. Gatewood are the following:

- GPE will have a consolidated capital structure with an equity ratio of 41% to 42%, compared to a pre-transaction equity ratio of 49% to 50%.
- GPE's short-term financial model as well as GPE discovery responses provides no plan for de-leveraging, so Staff must assume the leverage is a permanent change to GPE's consolidated capital structure.
- A permanent change to GPE's consolidated capital structure creates a markedly different capital structure at the GPE parent company level from the capital structures of the utility operating subsidiaries. This issue raises the question as to which capital structure – consolidated or utility operating company – should be used in setting rates for the utility operating subsidiaries.
- The difference in capital structures between consolidated parent company and utility operating company could result in a significant reduction in the revenue requirements of the utility operating companies, if the Kansas Corporation Commission (KCC) and/or the Missouri Public Service Commission (Missouri PSC) and the Federal Energy Regulatory Commission (FERC) choose to recognize the additional leverage at the parent company.
- The Joint Applicant's assume that all regulatory bodies that set rates for the utility operating companies will set their respective revenue requirements solely on the operating company capital structures. This assumption is included in all financial modeling developed by GPE and

was provided to credit rating agencies for their evaluation of the credit worthiness of the post-transaction entities.

- The Joint Applicant's assumption that all regulatory bodies will set rates based on the utility operating companies higher cost capital structure is troubling because it is contrary to how all regulatory bodies set rates. That is, rates are set based on the consolidated capital structure. Moreover, Staff has consistently investigated capital structures in rate cases to determine the most efficient and economical financing available (lowest cost capital structure) for the past two decades.

D. GPE's use of financial engineering.

Q. How would you describe GPE's use of low-cost debt to fund the higher-cost operating company capital structure?

A. I would describe this arrangement as defined as "double leverage" or "financial engineering." In describing why the gain from financing equity purchased with debt owes nothing to Westar shareholders at Section II. D. 1. A., Mr. Hempling defines it as such through the following question and answer:

> Q. Explain why the gain from financing equity purchase [*sic*] with debt owes nothing to Westar shareholders.
>
> **A.** To finance its purchase of $8.6 billion in Westar equity, GPE plans to borrow $4.4 billion, with the rest of the purchase financed by issuing new stock (to Westar shareholders and to the public). Debt is, of course, less costly than equity because its risk (to investors) is lower: the borrower has a contractual obligation to pay back the principal with interest; the stock issuer normally has no obligation to pay the stock buyer anything. GPE anticipates the interest rate on the acquisition debt to be 3.86%; Westar's most recent authorized return on equity approved by the Kansas Corporation Commission is 9.35%. If GPE can finance $3.7

> billion of Westar's equity at 3.95% but earn on that equity 9.35%, its financial planners will have produced a large profit. The anticipation of that profit is one reason why GPE is willing to pay the premium. (Financial analysts describe this action as "double-leveraging," because there is debt at both the holding company level and the utility level. They also call it "financial engineering," because the profit comes not from physical improvements but from financial arrangements.).

Q. Did the Joint Applicant's make an explicit request to change or modify the traditional lowest-cost capital structure approach used in Kansas?

A. No, they did not make such a request either in the Application or in direct testimony. However, Staff has had conversations with the Joint Applicants and has issued discovery on this issue. Based on our expressed concerns, GPE witness Darrin Ives addresses this issue in his Supplemental Direct Testimony dated November 2, 2016, at page 12. Specifically Mr. Ives states:

> Q: Has GPE committed that it will not seek to recover costs of the premium in excess of book value or transaction costs associated with the Transaction through inclusion in revenue requirement and retail rates paid by customers of KCP&L and Westar?
>
> A: Yes, and that commitment remains in place. *We have become aware, however, that some party or parties may desire to make use of the debt used by GPE to finance the Transaction during post-closing general rate cases of GPE's utility subsidiaries for purposes of determining a fair and reasonable return and setting customer rates. This would be inappropriate and unreasonable because, among other reasons, the debt used by GPE to finance the Transaction will be dedicated to paying for the acquisition premium in excess of book value as well as transaction costs and none of the proceeds of that debt will be available to support the regulated operations of GPE's utility subsidiaries*. But if a party to a KCP&L or Westar general rate case advances such a proposal, then KCP&L or Westar must have the ability to present all facts and counter-proposals necessary to fully explain and rebut it. Therefore, *if – and only if – any party to a KCP&L or Westar general rate case proposes to impute the cost or proportion of debt*

> *used by GPE to finance the Transaction for purposes of determining a fair and reasonable return, then Westar and KCP&L reserve the right to seek, in any such rate case, recovery of the acquisition premium in excess of book value and transaction costs associated with the Transaction through inclusion in revenue requirement and retail rates* in order to match the recovery of the use of funds with such a request to utilize the source of funds in setting retail rates. [Emphasis added].

Q. Did Staff request the Joint Applicants to use the Financial Model to run a scenario that uses the consolidated capital structure of GPE post-transaction? If so, what were the results?

A. Yes. Mr. Gatewood discusses the results of Staff's requested Financial Model run with the use of GPE's consolidated capital structure at Section II. D. in his testimony. Mr. Gatewood describes the results as having the following impacts:

- The Joint Applicant's acknowledge that the use of the consolidated capital structure does have a significant and negative impact on the pro-forma financials of GPE.
- The Joint Applicants confirm that the lower revenue requirements caused by recognizing the added leverage in the consolidated capital structure reduces the cash flow that GPE will have to cover its interest payments resulting from the debt necessary to finance this Transaction.
- Staff inquired as to whether the Joint Applicants discussed the results of Staff's model run with ratings agencies. The Joint Applicants responded that they have had no such discussion with rating agencies and could not speculate as to whether the use of a consolidated capital structure would maintain their existing credit ratings or maintain an investment grade

credit rating if the Commission were to use a consolidated capital structure. The Joint Applicants did acknowledge the use of a consolidated capital structure would create concerns by the rating agencies.

Q. Given the negative financial impacts to GPE's pro-forma financials that result from the use of a consolidated capital structure, have the Joint Applicants expressed concerns about their ability to complete the Transaction if a consolidated capital structure is used by the Commission?

A. Yes. As described by Mr. Gatewood at Section II. D. of his testimony, the Joint Applicants indicate that their ability to complete the Transaction is largely dependent on the Commission not applying the GPE consolidated capital structure ratios when setting Westar's and KCPL's revenue requirements.

Q. Is the Joint Applicants' position that their ability to complete the Transaction is largely dependent on the Commission not using GPE's consolidated capital structure surprising?

A. Very much so. As Mr. Gatewood discusses at Section II. D.:

- It is surprising that the Joint Applicants would commit to a transaction such as this one when the outcome is largely dependent on a specific ratemaking treatment (use of utility operating company capital structure) that is contrary to the common practice of the KCC, Missouri PSC, and FERC.
- Most surprising of all, the Joint Applicants did not raise this issue at all in their Joint Application or direct testimony and only briefly raise the issue in the Supplement Direct Testimony of Darrin Ives. It appears that the

Joint Applicants are willing to defer a decision on an issue that is critical to their ability to complete the Transaction. This willingness shifts a tremendous amount of risk to future rate cases and, as will be discussed later, impairs the Commission's ability to effectively regulate the post-transaction entity.

E. Overall effect of the purchase price and acquisition premium on the newly created entity compared to the stand-alone entities.

Q. What is the overall effect of the proposed Transaction on the financial condition of the newly created entity as compared to the financial condition of the stand-alone entities, if the Transaction did not occur?

A. Staff witness Mr. Gatewood states at Section II. A. that the overall effect of the proposed Transaction on the financial condition of GPE and Westar post-acquisition as compared to the financial condition of the stand-alone entities results in a newly created entity that is measurably financially weaker. Both GPE and Westar are currently financially sound with investment grade credit ratings; therefore, the Transaction, as proposed, fails merger standard (a)(i).

Q. What evidence supports Staff's conclusion?

A. Mr. Gatewood relies primarily on parties' (credit rating agencies' and equity analysts') published statements of to support his conclusion

1. Analysis of the Transaction by GPE's and Westar's credit rating agencies.

Q. What are the views of GPE's and Westar's credit ratings agencies?

A. GPE's and Westar's credit rating agencies were requested by GPE and Westar to evaluate the proposed Transaction and determine the credit worthiness of the post-transaction entity. The credit rating agencies' views are important because their analysis provides an indication of how much risk is associated with a particular entity and results in an assignment of what level of investment grade an entity should be. It is critical to note that the credit ratings agencies' evaluations are based on the Joint Applicants' Transaction as proposed. The Joint Applicants provided the credit rating agencies the financial model and pro forma financial information that was based on the financial engineering discussed above. Specifically, the pro-forma financial information included the utility's operating capital structure to derive revenues. As indicated below, even with this best case scenario, the rating agencies expressed deep concerns.

Moody's and Standard & Poors (S&P) provided indicative ratings on the Transaction as proposed, while Fitch performed a research update. And all three rating agencies expressed concerns regarding the post-transaction entity's financial strength for both Westar as a subsidiary and GPE as the parent company. As a result, all three agencies view GPE and Westar as financially weaker post-transaction, with certain concerns pointing either to a weakly positioned investment grade utility or to the potential for sub-investment grade ratings. Primary concerns expressed by the rating agencies are:

- Limited financial flexibility at GPE, weak consolidated financial metrics and demand for increased utility dividends.[17]
- Ring-fencing provisions and/or substantial customer benefits through bill credits or rate freezes would likely put negative ratings pressure on the utility (Westar subsidiary).[18]
- High consolidated leverage without a plan from GPE to de-lever.[19]
- GPE is sacrificing its strong financial profile and the Transaction's financing plans are viewed as a signal that GPE's management and board of directors have a higher tolerance for leverage than previously considered, which is a long-term credit negative.[20]
- GPE's significantly weakened financial position at close could result in a downgrade to speculative grade if anticipated financial improvements are jeopardized due to less regulatory supportiveness, financially restrictive merger requirements, declining or stagnant economic environment, or inability to capture synergies from acquisition.[21]

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[17] "Westar Energy, Inc.; Vertically Integrated Regulated Electric Utility;" Moody's Investor Services, Credit Opinion; June 2, 2016; p. 4, Direct Testimony of Adam Gatewood, Section I.A.
[18] "Westar Energy, Inc.; Vertically Integrated Regulated Electric Utility;" Moody's Investor Services, Credit Opinion; June 2, 2016; p. 4, Direct Testimony of Adam Gatewood, Section I.A.
[19] Fitch website: https://www.fitchratings.com/site/pr/1005447, Direct Testimony of Adam Gatewood, Section I. A.
[20] Moody's website: https://www.moodys.com/research/Moodys-Places-Great-Plains-Energy-on-Review-for-Downgrade-Westar--PR_349858; May 31, 2016 Press Release by Moody's Investor Service. Direct Testimony of Adam Gatewood, Section I. A.
[21] Great Plains Energy Incorporated; A Midwest Utility Holding Company; Moody's Investment Service; Credit Opinion; June 1, 2016, p. 2; Direct Testimony of Adam Gatewood, Section I.A.

- There is little room for error within GPE's financial forecasts, including regulatory outcomes and economic factors (including interest rate levels) which creates a lower tolerance threshold for negative credit events and a higher likelihood for a downgrade.[22]
- The amount of debt related to the acquisition is viewed as highly aggressive and evidence of financial engineering.[23]

2. Analysis of the Transaction by GPE's and Westar's equity analysts.

Q. What are the equity analysts' views of the Transaction?

A. Equity analysts provide coverage of companies as a subscription service or as part of a broader investment advisory service for clients. The views of equity analysts are important because they are an indicator of the equity market's assessment of the risk a specific utility company poses as an equity investment.[24] The equity analysts' views expressing concerns about the Transaction as proposed generally are as follows:

- The amount of debt required to fund the Transaction places GPE at risk.
- The amount of leverage raises concerns over whether the utility operating company capital structure or the consolidated capital

[22] Moody's RAS Correspondence, p. 5; Direct Testimony of Adam Gatewood at Section I. A.
[23] Moody's RAS Correspondence, p. 6; Direct Testimony of Adam Gatewood at Section I. A.
[24] Direct Testimony of Adam Gatewood at Section II. B.

structure will be used by regulators because it is important that the operating company capital structure be used.

F. Effect of purchase price and acquisition premium on Westar's shareholders.

Q. What effect do the purchase price and acquisition premium have on Westar's shareholders?

A. Mr. Grady discusses the effect of the Transaction on Westar Shareholders at Section IV. A. of his testimony. Mr. Grady notes that GPE made its first board-sanctioned "preliminary proposal" to acquire Westar on October 7, 2015, for 20-25% over the then current market price. Assuming a 22.5% premium, GPE's offer of $46.75/share would have been 184% of Westar's book value of $25.32/share on June 30, 2015. GPE made its second board-sanctioned offer on February 18, 2016, at a price of $54.86, which was a 20% premium over the current market price. The value to Westar's shareholders would have been 212% of Westar's book value on December 31, 2015.

Westar did not accept either offer and instead decided to initiate an auction process. As a result of the competitive bid process, GPE agreed to pay $60/share, which equates to a 230% premium over Westar's book value as of June 30, 2016. This final offer accepted by Westar of $60/share results in a situation where Westar's shareholders went from a trading price of $34.22/share on June 30, 2015 to $60/share one year later. As described by Mr. Grady, this is an amazing level of gain in shareholder value in just one year. Moreover, the shareholder gain was not related to an increase in the net book value of equity supporting utility assets as the net book value only increased slightly ($0.76/share).

As Mr. Hempling notes in his testimony at Section II. D. 1. and 2., the control premium portion of the acquisition premium overcompensates Westar's shareholders. Mr. Hempling's rationale lies in the fact that when markets are efficient and when competition is effective, gain goes to those who create economic value. Thus, shareholders deserve gain when they take risks to improve their company and when their company's executives take action that increases quality or lowers costs. In Westar's case, the control premium of $2.3 billion is not related to risk-taking by Westar's shareholders or managerial actions by Westar executives.

G. Effect of the purchase price and acquisition premium on GPE's shareholders.

Q. What effect do the purchase price and acquisition premium have on GPE's shareholders?

A. Mr. Grady determines that this Transaction will likely be detrimental to GPE's shareholders in his evaluation at Section IV. B. Mr. Grady's general observation is that, while GPE's offer increased by $2 billion from October 2015 through May 31, 2016, the assets GPE purchased that generate earnings (book value of Westar's equity) only increased $107 million and the staggering size of the total acquisition premium of $5 billion over book value adds debt and equity to GPE's balance sheet, without a corresponding asset to produce regulated returns.

Mr. Grady also runs numerous scenarios through GPE's financial model. These scenarios include: 1) the impact of GPE's stock price decline; 2) the Commission deciding to use GPE's consolidated capital structure; 3) the Missouri PSC deciding to use GPE's consolidated capital structure; 4) the Commission agreeing with Staff's recommendation to require a sharing of 50% of the projected cost savings and that the savings be returned in the form of bill credits; 5) the Commission requires a rate moratorium of 3 years; and 6) a confidential scenario that I do not address in my testimony. Of important note, many of these scenarios are either likely to happen in a rate case or would be recommended as conditions to this Transaction. While much of the details of Mr. Grady's analysis are confidential, it is clear earnings per share and earned ROE are very significantly and negatively impacted by any of these assumptions.

H. Conclusions regarding the effect of the purchase price and acquisition premium on the post-transaction entity.

Q. What conclusions does Staff draw from the effect of the purchase price and acquisition premium on the post-transaction entity?

A. The following conclusions can be drawn:

- The competitive bid process initiated by Westar derived a $60/share value of Westar's shareholders. This value is a 230% premium over Westar's book value as of June 30, 2016. It is clear that Westar was highly successful in maximizing value for its shareholders to the detriment of GPE's expected financial condition.

- The purchase price and corresponding acquisition premium and control premium are so high that GPE is likely to be downgraded by credit rating agencies, even with the financial engineering included in GPE's financial model.
- Any decision by the Commission to recognize the financial engineering in rates by using GPE's consolidated capital structure to set Westar's and KCP&L's revenue requirements will most likely result in GPE being downgraded to below investment grade. The adverse financial results of such a decision have been modeled by Mr. Grady.
- The purchase price, size of the acquisition premium, and financial engineering included in GPE's financial model all result in a weakly positioned post-transaction entity, *as proposed*. Therefore, Staff cannot recommend approval of the Transaction with typical merger conditions because the merger conditions will further degrade GPE's financial condition and will most likely result in a credit rating downgrade to below investment grade. This creates a fatal flaw for the Transaction. More specifically, Staff is in an untenable position where it cannot recommend approval of the Transaction with merger conditions knowing that such conditions will result in severe financial difficulties for GPE, its subsidiary utilities, and those utilities' customers.

Q. The Commission's prior merger decisions have not required a target company to select the acquirer that is the best fit for customers. Given the auction process Westar used to establish its purchase price and related acquisition premium, should the Commission order such in this case?

A. Mr. Hempling asks this question at Section II. C. 2. Mr. Hempling's response to this question in pertinent part states:

> Would it have been better had the Commission, prior to this Transaction, made this point explicitly? Yes. But the rule has always existed implicitly, in the utility's unambiguous, undisputed obligation to minimize its customers' costs. And the rule exists within the Commission's merger standard (a)(ii). A purchase price cannot be "reasonable" if it reflects a decision to put shareholder and ratepayer interests in opposition, creating debt in the holding company not for purposes of investing in customer benefits but for purposes of providing target shareholders unearned gain.

Mr. Hempling continues by discussing how the Commision can fix the problem. Mr. Hempling advocates that one way to eliminate the conflict between shareholders and ratepayer interests is to require a utility to run a competition based on benefits to customers and, if there is a control premium (the excess of purchase price over market price), customers would receive a portion commensurate with their contribution to its value. Elaborating on the utility's obligation, as in a competitive market, to put customers first, Mr. Hempling states:

> This reasoning fits well within the Commission's merger standards (a)(ii), (a)(iv) and (g). In competition generally, in regulation

generally, and in just and reasonable ratemaking specifically, customer interests and shareholder interests are aligned—as long as those interests are legitimate. Customers need a utility whose financial condition is sufficiently strong to attract capital on reasonable terms. Shareholders need customers who are satisfied with their quality of service and the rates they pay. Just and reasonable rates satisfy both interests. There may be differences of opinion over methodologies and standards—differences that exist among customer groups as well as between customers and shareholders. But at bottom, the legitimate interests are aligned. The acquisition premium paid here creates a misalignment. It reflects Applicants' intent to set shareholders against ratepayers—to pay a purchase price determined not by the value of the transaction to consumers but by the gain-seeking goals of Westar shareholders. Such conflict cannot be consistent with the "reasonableness" criterion of Commission standard (a)(ii). And because the purchase price was determined by auction among buyers rather than analysis of customer savings, it violates the requirement of Commission standard (a)(iv), that there be operational synergies that justify payment of the premium. Finally, a transaction between monopolies, neither one disciplined by competition for the consumer, where the seller is seeking a price unrelated to the benefits it provides the consumers, is untethered from the goal of economic efficiency, necessarily violating Commission standard (g)'s requirement that the transaction "reduce the possibility of economic waste." Using dollars to pay Westar's gain rather than investing them prudently in needed infrastructure is the definition of "economic waste."

I. Recommendation regarding GPE's use of financial engineering.

Q. Given Staff's concerns noted above, what is Staff's recommendation regarding the financial engineering associated with the consolidated capital structure issue?

A. Staff's recommendation is that the Commission should issue a decision in its Order in this case that clearly states its position of whether it expects the consolidated capital structure to be used in future rate cases filed by

GPE's utility operating companies, as is now the case. If the Commission's decision is that GPE's consolidated capital structure should be used, then the Commission should order GPE and Westar to terminate the Transaction unless they can agree to modifications to the Transaction that cure the multitude of financial issues associated with GPE's retention of the savings associated with the use of financial engineering. This, of course, would require the Joint Applicants to file a new application with the Commission. While it is highly unlikely the Joint Applicants would choose to do so, the Commission could offer the opportunity. Should the Commission disagree with Staff and allow the use of a utility operating company capital structure, it is likely the merger could be completed from the Joint Applicants' perspective. However, as Staff points out in its testimony, we have deep concerns related to the Joint Applicants' weakened financial condition, the short-term financial model, and undemonstrated savings associated with this Transaction. Therefore, the Commission should prohibit the Joint Applicants from completing the Transaction until such time as they can provide savings estimates derived from the transition teams and can expand their financial model to at least ten years to provide a more accurate view of financial forecasts, including any plans to de-lever GPE.

IV.

Limited Savings do not Justify the Purchase Price or a $5 Billion Acquisition Premium

A. Staff's NPV analysis of savings.

Q. Are there synergies that justify payment in excess of book value (Merger Standard (a)(iv))?

A. Mr. Grady concludes the answer is no at Section III. of his testimony. Mr. Grady's conclusion is based on two different discounted cash flows analysis he performed to determine the net present value (NPV) of GPE's expected savings, which demonstrate that the NPV of savings is nowhere near the premium GPE has agreed to pay in excess of Westar's book value. Mr. Grady performed a NPV analysis of GPE's expected retained synergies and derived an AP that can be supported of $264.3 million. Mr. Grady also performed a NPV analysis of GPE's expected total savings (rate recovery approach) that derived an AP that can be supported of $685.15 million.

Mr. Grady also notes that GPE has indicated in discovery responses and its direct testimony that neither the purchase price, nor the purchase price over book value (AP), is directly tied to costs savings anticipated by GPE. In fact, GPE admits through the Supplemental Direct Testimony of Kevin Bryant on page 7 that "the amount of the acquisition premium and the savings resulting from the merger result from different sources and are driven by different factors."

B. Reasons other than savings to pay the acquisition premium.

Q. If savings are not related to the acquisition premium, why would GPE pay a $5 billion AP and not request recovery of it?

A. Mr. Grady answers this question at Sections III. G. and H. of his testimony. Mr. Grady notes that, because utility companies in Kansas are fully-regulated monopolies, their ability to create earnings and value for shareholders is directly tied to the book value of equity they have invested in utility assets. Therefore, if a utility buys another utility for a significant premium in excess of the book value of equity, either one of two expectations must be the case. Either: 1) the buyer expects to create additional cash flows (earnings) by cutting costs, increasing revenues, etc. which the seller was unable to do; or 2) the buyer's expected cost of capital (required return on capital) is much less than is included in the rates of the acquired utility.

C. Rationale for sharing of the $2.3 billion control premium portion of the acquisition premium.

Q. Please summarize Staff witness Scott Hempling's rationale for advocating for customers sharing in the control premium paid to Westar's shareholders.

A. Mr. Hempling defines control premium as the excess of GPE's purchase price over Westar's pre-acquisition "undisturbed" stock value, where "undisturbed" means Westar's stock price on March 9, 2016, the day before news leaked of a potential purchase of Westar. [Hempling at Section II. A.].

Mr. Hempling articulates his rationale for sharing the control premium based on each parties' contributions in creating the premium at Section I. C. where he states:

> The $2.3 billion control premium (the excess of purchase price over undisturbed market value), paid by GPE exclusively to Westar shareholders, conflicts with the public interest. The control premium results from Westar running a competition won by the contestant offering the highest price, with customer benefit only incidental. The premium overcompensates Westar shareholders because (a) its value is grounded in factors unrelated to their risk-taking or their executives' decision-making; and (b) it exceeds the legally required compensation they already have received due to this Commission's lawful rate-setting.
>
> Adding to the public interest detriment is the large acquisition debt GPE would incur to buy Westar's equity at a premium. To pay off that debt, GPE would keep rates above costs plus reasonable profit. This plan contradicts Applicants' claim that their Transaction is the "best" for customers and that they will not recover the premium from customers. That same debt will constrain the Commission's future decisions, by making GPE less able to weather declines in revenue. Those declines could occur if the Commission or Legislature decides to attract new businesses to Kansas by offering them roles in expanding and modernizing Kansas's electricity infrastructure.
>
> The size of the premium—and the accompanying GPE debt—is reason enough to reject this Transaction. But if the Commission grants approval, it still should address the overcompensation. It can do so by allocating the control premium (the excess of purchase price over market value) between shareholders and customers according to their contribution to the premium's value. Only that way will the Transaction, and Commission policy, align acquisition decisions with the principles of economic efficiency and fiscal conservatism.

D. Quantification of the factors creating the $2.3 billion control premium.

Q. Can Staff quantify the factors driving the control premium?

A. Yes. Mr. Grady evaluates four factors that are key to GPE's economic decision to acquire Westar at such a significant premium. The factors are: 1) Westar's cost of equity is substantially lower than Westar's authorized return; 2) GPE's use of holding company debt to purchase Westar's equity; 3) operating cost savings and GPE's expectations that these savings can be retained from ratepayers (this factor was not allocated any dollars because Staff witness Diggs recommends that 50% of these cost savings be shared with ratepayers through bill credits); and 4) GPE's ability to accelerate the use of its regulated net operating losses. Mr. Grady's calculations result in $1.545 billion being allocated to ratepayers. Mr. Grady suggests this value can be shared via a bill credit or cash refund in the amount of $38.6 million over 40 years. Or the Commission could order Westar to issue a one-time rebate to customers of $478.6 million, which is the net present value of $38.6 million a year for 40 years discounted at Westar's last approved weighted average cost of capital of 7.65%. [Grady at III. I. and J.].

E. Quantification of the ratepayer impact from GPE's retention of the savings created by financial engineering.

Q. What impact does the financial engineering have on ratepayer benefits that can be quantified from the Transaction?

A. Mr. Gatewood defines the impact of the financial engineering as a negative benefit in his testimony at Section III. Mr. Gatewood's definition is based on the fact that Staff views savings from financial instruments the same as operational savings and customers should receive the benefit of such savings, be they labor efficiencies or a lower cost of capital. Mr. Gatewood also explains:

- Parent companies can manipulate subsidiary company capital structures to the benefit of the parent company's shareholders. This manipulation can occur because parent companies do not have to assign capital to utility subsidiaries based on an accurate reflection of the capitalization at the parent company level. Staff has found instances where parent company capital structures contained significantly more leverage than the capital structure assigned to the utility operating company. Thus the parent company had a lower overall cost of capital than its subsidiary.
- Mr. Gatewood estimates that the Joint Applicants plan to use utility operating company capital structures results in the annual retention for GPE shareholders of between $90 million and $136 million when using data from Westar's and KCP&L's currently filed abbreviated rate cases.
- The Joint Applicants were asked to use their financial model to estimate the annual retention in savings from use of the consolidate capital structure. The estimated annual retention for GPE's shareholders is confidential, but is in excess of $100 million. This number is different from Mr. Gatewood's analysis because the financial model contains assumptions regarding rate base growth and rate case timing.

Based on the above analysis, it is clear there are significant annual cost savings that are not being shared with customers.

Q. What is Mr. Gatewood's recommendation regarding the policy of using a consolidated capital structure to set rates?

A. Mr. Gatewood believes that the policy of using a consolidated capital structure and cost of debt is reasonable and within the Commission's discretion. Mr. Gatewood supports his assertion at Section III. A. by describing the absolute control a parent company has over the operations of a subsidiary and that this fact is also recognized by credit rating agencies. Mr. Gatewood also notes that he has consistently used the consolidated capital structure since at least 2000 and the Commission has consistently accepted its use.

V.

The Proposed Transaction Preserves the Commission's Jurisdiction but the Capacity of the Commission to Effectively Regulate the Post-Merger Entity Will be Impaired

Q. Why does Staff believe that the Transaction could diminish the Commission's ability to effectively regulate the post-merger entity?

A. Mr. Gatewood addresses this issue in his testimony at Section IV. Mr. Gatewood asserts that, if the Transaction is completed, the financial weakness of the post-transaction entity will be such that the Commission's regulatory and ratemaking options will be limited. Moreover, Moody's has concerns when it states "With little financial cushion, Great Plains will be more exposed to risks associated with successfully executing a transition and integration plan and long-term issues, such as waning regulatory support and softening of regional macro-economic fundamentals."[25] Given the fact that the post-transaction entity will have little financial cushion, a future Commission will be under pressure to adopt practices that it might not otherwise adopt in order to provide the regulatory support that Moody's is concerned might wane.

Q. Has the Commission experienced a financially troubled investor-owned electric utility before?

A. Yes. The two examples were Westar and Aquila. Both of these utilities required general investigation dockets to investigate and closely oversee their financial problems. In the case of Westar, Docket No. 01-WSRE-949-GIE was opened on May 8, 2001, and closed on August 26, 2005. Westar's credit rating remained below investment grade for approximately 7 years by one credit rating agency. In the case of Aquila, the investigation of Aquila's financial issues began on March 11, 2002, with the Commission opening Docket No. 02-UTCG-701-GIG. This Docket was closed on February 16, 2009. Aquila did not survive its financial issues and was acquired in a series of transactions.

[25] https://www.moodys.com/research/Moodys-Places-Great-Plains-Energy-on-Review-for-Downgrade-Westar--PR_349858; May 31, 2016 Press Release by Moody's Investor Service.

Q. Are there other issues that raise concerns regarding the Commission's ability to effectively regulate the post-merger entity?

A. Yes. Mr. Hempling has similar comments to Mr. Gatewood's. But Mr. Hempling also raises a relevant point regarding the use of surcharges, riders, and adjustment clauses at Section II. E. 1. Mr. Hempling specifically states:

> … But once GPE incurs its acquisition debt there will be pressure—from rating agencies, lenders, stockholders and GPE management—to set authorized returns based not on proper capital market theory and actual capital costs but on GPE's own needs—its acquisition-induced needs. The Commission can avoid this pressure by not allowing an acquisition that creates conflict between GPE's own interests and Kansas's broader interests.
>
> *This reasoning applies as well to the continuing conversation in the regulatory field about the use of surcharges, riders and adjustment clauses. Each of these devices is a departure from traditional cost-based ratemaking.* In traditional cost-based ratemaking, the revenue requirement and the resulting rates are based on predictions about costs and sales. Shareholders and customers bear the risk that actual costs and sales will vary from the predictions. The goal is always to allocate that risk in a way that strikes a cost-effective balance between minimizing the cost of capital (which rises with risk) and maximizing the utility's incentive to act prudently (which creates benefits for consumers). [Emphasis added].
>
> There are numerous ways to "skin this cat"—numerous ways to allocate risks between shareholders and customers. My purpose is not to advise the Commission on their merits. My purpose, rather, is to emphasize that once the Commission approves an acquisition for which the acquirer incurs large debt, it will face pressure to reallocate risks from shareholders to customers, regardless of the effects on economic efficiency.

Mr. Hempling also discusses in Section V. of his testimony the impacts of eliminating "across-the-fence rivalry" and "benchmark" competition between GPE and Westar. Of particular note, Mr. Hempling states:

> Loss of benchmark competition was among the reasons the California Commission rejected the proposed merger between Southern California Edison and San Diego Gas & Electric. The Commission found that due to those two companies' longstanding rivalry, the public was "advantaged by the presence of proximate comparative data": data that spurred SDG&E to study the reasons for its higher rates. The Commission concluded that "the loss of SDG&E as a regulatory comparison is an adverse unmitigable impact of the proposed merger," diminishing the Commission's "ability to regulate the merged utility effectively." [Cite omitted].

VI.

Staff's Evaluation of Claimed Merger Savings

Q. **What are Staff witness Walt Drabinski's findings related to the savings claimed by the Joint Applicants?**

A. Mr. Drabinski performs an extensive generation unit retirement analysis on the generation units the Joint Applicants have included in their claimed savings at Section II. of his testimony. Overall, Mr. Drabinski finds that the Joint Applicants have not provided adequate analysis or support through testimony of the claimed savings. Mr. Drabinski concludes, in part:

- There is a great deal of uncertainty, hesitation, and disagreement as to exactly what will occur with the combined generation fleet post-merger.

- The fact that there is overcapacity in the Southwest Power Pool (SPP) and that SPP recently lowered its capacity reserve margin from 13% to 12% is a reason to evaluate generation unit retirement either pre or post-merger.
- Neither the Joint Applicants nor SPP has performed any comprehensive study to evaluate the impact of potential generation unit retirements.
- The generation unit retirements are not merger related because both Westar and GPE would face reserve margins that are well above the new requirements of SPP.
- The Joint Applicants did not include all of the costs to achieve the generation unit retirements. Excluded costs include stranded costs for the remaining net book value of each unit, the economic cost of dispatching the next highest cost unit, and lack of analysis on the impact to local communities.

Mr. Drabinski also evaluated supply chain savings at Section V. and determined that the savings can be achieved without a merger.

Q. What are Staff witness Ann Diggs' findings related to the savings claimed by the Joint Applicants?

A. Staff consultant Ann Diggs addresses the claimed Transaction savings, shared services savings, and quantifies ratepayer benefits. Ms. Diggs summarizes her findings at Section II. Her general findings are that the Joint Applicants have the burden to demonstrate savings for the Commission to evaluate the effect of the Transaction on consumers and determine if the Transaction will promote the public interest. Per Ms. Diggs, the Joint Applicants have failed to demonstrate a sufficient, credible estimate of savings.

VII.

Staff's Recommendation for Quality of Service Standards

Q. Does Staff recommend quality of service standards?

A. Yes. Staff witness Casey Gile's testimony addresses quality of service standards and the rationale for implementing standards while Walt Drabinski's testimony at Section VI. provides quality of service metrics.

Q. What is Staff's rationale for recommending quality of service standards?

A. Mr. Gile provides a rationale for recommending quality of service standards in his executive summary. Mr. Gile's primary concern is with the Joint Applicants' ability to maintain and improve the quality of service currently provided to Kansas customers while dramatically reducing the operating costs of the combined company.

VIII.

Analysis of the Integration of Joint Applicants' Transmission and Distribution Systems

Q. Did Staff evaluate the Joint Applicants' transmission and distribution systems?

A. Yes. Mr. Drabinski describes his analysis of the integration of the Joint Applicants' transmission and distribution systems in Section III. of his testimony. His analysis covers:

- Engineering Standards
- System design comparison
- Post-merger staffing and budget analysis
- Reliability programs and measurement
- Vegetation management
- Implementation of IT systems

IX.

Conclusion

Q. What is Staff's overall conclusion?

A. Staff's overall conclusion is that the proposed Transaction fails most of the merger standards and is, therefore, not in the public interest. Moreover, there are fundamental flaws in the proposed Transaction that prohibit Staff from recommending merger conditions that would support a finding that the Transaction is in the public interest. Thus the proposed Transaction should be denied.

Q. Does this conclude your testimony?

A. Yes.

CERTIFICATE OF SERVICE

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I, the undersigned, certify that a true and correct copy of the above and foregoing Direct Testimony of Jeff McClanahan with Corrections was served via electronic service this 27th day of January, 2017, to the following:

W. ROBERT ALDERSON, JR., ATTORNEY
ALDERSON ALDERSON WEILER CONKLIN BURGHART & CROW LLC
2101 SW 21ST STREET (66604)
TOPEKA, KS 66604
Fax: 785-232-1866
boba@aldersonlaw.com

MICHAEL E. AMASH, ATTORNEY
BLAKE & UHLIG PA
SUITE 475 NEW BROTHERHOOD BLDG
753 STATE AVE.
KANSAS CITY, KS 66101
Fax: 913-321-2396
mea@blake-uhlig.com

KURT J. BOEHM, ATTORNEY
BOEHM, KURTZ & LOWRY
36 E SEVENTH ST STE 1510
CINCINNATI, OH 45202
Fax: 513-421-2764
kboehm@bkllawfirm.com

JODY KYLER COHN, ATTORNEY
BOEHM, KURTZ & LOWRY
36 E SEVENTH ST STE 1510
CINCINNATI, OH 45202
Fax: 513-421-2764
jkylercohn@bkllawfirm.com

MARTIN J. BREGMAN
BREGMAN LAW OFFICE, L.L.C.
311 PARKER CIRCLE
LAWRENCE, KS 66049
mjb@mjbregmanlaw.com

ANDREW J ZELLERS, GEN COUNSEL/VP REGULATORY AFFAIRS
BRIGHTERGY, LLC
1712 MAIN ST 6TH FLR
KANSAS CITY, MO 64108
Fax: 816-511-0822
andy.zellers@brightergy.com

GLENDA CAFER, ATTORNEY
CAFER PEMBERTON LLC
3321 SW 6TH ST
TOPEKA, KS 66606
Fax: 785-233-3040
glenda@caferlaw.com

TERRI PEMBERTON, ATTORNEY
CAFER PEMBERTON LLC
3321 SW 6TH ST
TOPEKA, KS 66606
Fax: 785-233-3040
terri@caferlaw.com

THOMAS J. CONNORS, ATTORNEY AT LAW
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
Fax: 785-271-3116
tj.connors@curb.kansas.gov

DAVID W. NICKEL, CONSUMER COUNSEL
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
Fax: 785-271-3116
d.nickel@curb.kansas.gov

CERTIFICATE OF SERVICE

16-KCPE-593-ACQ

DELLA SMITH
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
Fax: 785-271-3116
d.smith@curb.kansas.gov

SHONDA SMITH
CITIZENS' UTILITY RATEPAYER BOARD
1500 SW ARROWHEAD RD
TOPEKA, KS 66604
Fax: 785-271-3116
sd.smith@curb.kansas.gov

DANIEL R. ZMIJEWSKI
DRZ LAW FIRM
9229 WARD PARKWAY STE 370
KANSAS CITY, MO 64114
Fax: 816-523-5667
dan@drzlawfirm.com

ASHLEY M. BOND, ATTORNEY
DUNCAN & ALLEN
1730 RHODE ISLAND AVENUE NW
SUITE 700
WASHINGTON, DC 20036-3155
Fax: 202-289-8450
amb@duncanallen.com

KEN HOLMBOE, ATTORNEY AT LAW
DUNCAN & ALLEN
1730 RHODE ISLAND AVENUE NW
SUITE 700
WASHINGTON, DC 20036-3155
Fax: 202-289-8450
kh@duncanallen.com

GREGG D. OTTINGER, ATTORNEY
DUNCAN & ALLEN
1730 RHODE ISLAND AVENUE NW
SUITE 700
WASHINGTON, DC 20036-3155
Fax: 202-289-8450
gdo@duncanallen.com

SHANNON FISK, ATTORNEY
EARTHJUSTICE
1617 JOHN F KENNEDY BLVD
SUITE 1675
PHILADELPHIA, PA 19103
sfisk@earthjustice.org

KEVIN HIGGINS
ENERGY STRATEGIES, LLC
PARKSIDE TOWERS
215 S STATE ST STE 200
SALT LAKE CITY, UT 84111
Fax: 801-521-9142
khiggins@energystrat.com

WILLIAM R. LAWRENCE
FAGAN EMERT & DAVIS LLC
730 NEW HAMPSHIRE SUITE 210
LAWRENCE, KS 66044
Fax: 785-331-0303
wlawrence@fed-firm.com

ALI NELSON, PARALEGAL
FAGAN EMERT & DAVIS LLC
730 NEW HAMPSHIRE SUITE 210
LAWRENCE, KS 66044
Fax: 785-331-0303
anelson@fed-firm.com

SARAH STEELE
GILMORE & BELL, P.C.
ONE MAIN PLACE
100 NORTH MAIN, STE. 800
WICHITA, KS 67202
ssteele@gilmorebell.com

DOUGLAS L. HEALY, ATTORNEY AT LAW
HEALY LAW OFFICES, LLC
3010 E BATTLEFIELD STE A
SPRINGFIELD, MO 65804
doug@healylawoffices.com

CERTIFICATE OF SERVICE

16-KCPE-593-ACQ

TERRY M. JARRETT, ATTORNEY AT LAW
HEALY LAW OFFICES, LLC
3010 E BATTLEFIELD STE A
SPRINGFIELD, MO 65804
terry@healylawoffices.com

DARRELL MCCUBBINS, BUSINESS MANAGER
IBEW LOCAL UNION NO. 1464
PO BOX 33443
KANSAS CITY, MO 64120
Fax: 816-483-4239
kwhiteman@ibew1464.org

DUANE NORDICK, BUSINESS MANAGER
IBEW LOCAL UNION NO. 1523
609 N BROADWAY
WICHITA, KS 67214
duane_nordick@sbcglobal.net

DAVID PINON, BUSINESS MANAGER
IBEW LOCAL UNION NO. 1613
6900 EXECUTIVE DR
SUITE 180
KANSAS CITY, MO 64120
local1613@earthlink.net

RAYMOND ROGERS, BUSINESS MANAGER
IBEW LOCAL UNION NO. 225
PO BOX 404
BURLINGTON, KS 66839-0404
rcrogers@cableone.net

JOHN GARRETSON, BUSINESS MANAGER
IBEW LOCAL UNION NO. 304
3906 NW 16TH STREET
TOPEKA, KS 66615
Fax: 785-235-3345
johng@ibew304.org

BILL MCDANIEL, BUSINESS MANAGER
IBEW LOCAL UNION NO. 412
6200 CONNECTICUT
SUITE 105
KANSAS CITY, MO 64120
Fax: 816-231-5515
business.manager@me.com

JOHN KRAJEWSKI, PRESIDENT
J K ENERGY CONSULTING LLC
650 J STREET STE 108
LINCOLN, NE 68508
Fax: 402-438-4322
jk@jkenergyconsulting.com

RICHARD S. HARPER
JENNINGS, STROUSS & SALMON, P.L.C
1350 I Street, NW
Suite 810
WASHINGTON, DC 20005
Fax: 202-371-9025
rharper@jsslaw.com

ALAN I. ROBBINS, ATTORNEY
JENNINGS, STROUSS & SALMON, P.L.C
1350 I Street, NW
Suite 810
WASHINGTON, DC 20005
Fax: 202-408-5406
arobbins@jsslaw.com

DEBRA D. ROBY, ATTORNEY
JENNINGS, STROUSS & SALMON, P.L.C
1350 I Street, NW
Suite 810
WASHINGTON, DC 20005
Fax: 202-371-9025
droby@jsslaw.com

JOHN R. WINE, JR.
410 NE 43RD
TOPEKA, KS 66617
Fax: 785-246-0339
jwine2@cox.net

CERTIFICATE OF SERVICE

16-KCPE-593-ACQ

SUSAN ALIG, ASSISTANT COUNSEL
KANSAS CITY KANSAS BOARD OF PUBLIC UTILITIES
701 N 7TH STREET
KANSAS CITY, KS 66101
Fax: 913-573-5243
salig@wycokck.org

ANDREW FERRIS, DIRECTOR OF ELECTRIC SUPPLY PLANNING
KANSAS CITY KANSAS BOARD OF PUBLIC UTILITIES
312 N 65TH STREET
KANSAS CITY, KS 66102
aferris@bpu.com

ANGELA LAWSON, SENIOR COUNSEL
KANSAS CITY KANSAS BOARD OF PUBLIC UTILITIES
540 MINNESOTA AVENUE
KANSAS CITY, KS 66101-2930
alawson@bpu.com

ROBERT J. HACK, LEAD REGULATORY COUNSEL
KANSAS CITY POWER & LIGHT COMPANY
ONE KANSAS CITY PL, 1200 MAIN ST 19th FLOOR (64105)
PO BOX 418679
KANSAS CITY, MO 64141-9679
Fax: 816-556-2787
rob.hack@kcpl.com

DARRIN R. IVES, VICE PRESIDENT, REGULATORY AFFAIRS
KANSAS CITY POWER & LIGHT COMPANY
ONE KANSAS CITY PL, 1200 MAIN ST 19th FLOOR (64105)
PO BOX 418679
KANSAS CITY, MO 64141-9679
Fax: 816-556-2110
darrin.ives@kcpl.com

ROGER W. STEINER, CORPORATE COUNSEL
KANSAS CITY POWER & LIGHT COMPANY
ONE KANSAS CITY PL, 1200 MAIN ST 19th FLOOR (64105)
PO BOX 418679
KANSAS CITY, MO 64141-9679
Fax: 816-556-2787
roger.steiner@kcpl.com

MARY TURNER, DIRECTOR, REGULATORY AFFAIR
KANSAS CITY POWER & LIGHT COMPANY
ONE KANSAS CITY PL, 1200 MAIN ST 19th FLOOR (64105)
PO BOX 418679
KANSAS CITY, MO 64141-9679
Fax: 816-556-2110
mary.turner@kcpl.com

BRIAN G. FEDOTIN, DEPUTY GENERAL COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604-4027
Fax: 785-271-3314
b.fedotin@kcc.ks.gov

ANDREW FRENCH, SENIOR LITIGATION COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604-4027
Fax: 785-271-3314
a.french@kcc.ks.gov

DUSTIN KIRK, DEPUTY GENERAL COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604-4027
Fax: 785-271-3354
d.kirk@kcc.ks.gov

MICHAEL NEELEY, LITIGATION COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604-4027
Fax: 785-271-3167
m.neeley@kcc.ks.gov

AMBER SMITH, CHIEF LITIGATION COUNSEL
KANSAS CORPORATION COMMISSION
1500 SW ARROWHEAD RD
TOPEKA, KS 66604-4027
Fax: 785-271-3167
a.smith@kcc.ks.gov

CERTIFICATE OF SERVICE

16-KCPE-593-ACQ

MARK DOLJAC, DIR RATES AND REGULATION
KANSAS ELECTRIC POWER CO-OP, INC.
600 SW CORPORATE VIEW (66615)
PO BOX 4877
TOPEKA, KS 66604-0877
Fax: 785-271-4888
mdoljac@kepco.org

WILLIAM G. RIGGINS, GENERAL COUNSEL
KANSAS ELECTRIC POWER CO-OP, INC.
600 SW CORPORATE VIEW (66615)
PO BOX 4877
TOPEKA, KS 66604-0877
Fax: 785-271-4884
briggins@kepco.org

CATHRYN J DINGES, CORPORATE COUNSEL
KANSAS GAS & ELECTRIC CO.
D/B/A WESTAR ENERGY
818 S KANSAS AVE
PO BOX 889
TOPEKA, KS 66601-0889
Fax: 785-575-8136
cathy.dinges@westarenergy.com

JEFFREY L. MARTIN, VICE PRESIDENT, REGULATORY AFFAIRS
KANSAS GAS & ELECTRIC CO.
D/B/A WESTAR ENERGY
818 S KANSAS AVE
PO BOX 889
TOPEKA, KS 66601-0889
jeff.martin@westarenergy.com

LARRY HOLLOWAY, ASST GEN MGR OPERATIONS
KANSAS POWER POOL
100 N BROADWAY STE L110
WICHITA, KS 67202
Fax: 316-264-3434
lholloway@kansaspowerpool.org

CURTIS M. IRBY, GENERAL COUNSEL
KANSAS POWER POOL
LAW OFFICES OF CURTIS M. IRBY
200 EAST FIRST ST, STE. 415
WICHITA, KS 67202
Fax: 316-264-6860
cmirby@sbcglobal.net

JOHN MICHAEL ADRAGNA ESQ.
MCCARTER ENGLISH, LLP
1015 15TH STREET, NW
12TH FLOOR
WASHINGTON, DC 20005
Fax: 202-296-0166
jadragna@mccarter.com

KIMBERLY BRICKELL FRANK ESQ.
MCCARTER ENGLISH, LLP
1015 15TH STREET, NW
12TH FLOOR
WASHINGTON, DC 20005
Fax: 202-296-0166
kfrank@mccarter.com

WILLIAM DOWLING, VP ENGINEERING & ENERGY SUPPLY
MIDWEST ENERGY, INC.
1330 CANTERBURY ROAD
PO BOX 898
HAYS, KS 67601-0898
Fax: 785-625-1487
bdowling@mwenergy.com

EARNEST A. LEHMAN, PRESIDENT & GENERAL MANAGER
MIDWEST ENERGY, INC.
1330 Canterbury Rd
PO Box 898
Hays, KS 67601-0898
elehman@mwenergy.com

ANNE E. CALLENBACH, ATTORNEY
POLSINELLI PC
900 W 48TH PLACE STE 900
KANSAS CITY, MO 64112
Fax: 913-451-6205
acallenbach@polsinelli.com

FRANK A. CARO, JR., ATTORNEY
POLSINELLI PC
900 W 48TH PLACE STE 900
KANSAS CITY, MO 64112
Fax: 816-753-1536
fcaro@polsinelli.com

CERTIFICATE OF SERVICE

16-KCPE-593-ACQ

SUNIL BECTOR, ATTORNEY
SIERRA CLUB
2101 WEBSTER, SUITE 1300
OAKLAND, CA 94312-3011
Fax: 510-208-3140
sunil.bector@sierraclub.org

HOLLY BENDER
SIERRA CLUB
133 S BUTLER ST, STE. 106
MADISON, WI 53703
Fax: 608-257-3513
holly.bender@sierraclub.org

JAMES P. ZAKOURA, ATTORNEY
SMITHYMAN & ZAKOURA, CHTD.
7400 W 110TH ST STE 750
OVERLAND PARK, KS 66210-2362
Fax: 913-661-9863
jim@smizak-law.com

RENEE BRAUN, CORPORATE PARALEGAL, SUPERVISOR
SUNFLOWER ELECTRIC POWER CORPORATION
301 W. 13TH
PO BOX 1020 (67601-1020)
HAYS, KS 67601
Fax: 785-623-3395
rbraun@sunflower.net

JAMES BRUNGARDT, REGULATORY AFFAIRS ADMINISTRATOR
SUNFLOWER ELECTRIC POWER CORPORATION
301 W. 13TH
PO BOX 1020 (67601-1020)
HAYS, KS 67601
Fax: 785-623-3395
jbrungardt@sunflower.net

DAVIS ROONEY, VICE PRESIDENT AND CFO
SUNFLOWER ELECTRIC POWER CORPORATION
301 W. 13TH
PO BOX 1020 (67601-1020)
HAYS, KS 67601
Fax: 785-623-3395
hrooney@sunflower.net

AL TAMIMI, VICE PRESIDENT, TRANSMISSION PLANNING AND POLICY
SUNFLOWER ELECTRIC POWER CORPORATION
301 W. 13TH
PO BOX 1020 (67601-1020)
HAYS, KS 67601
Fax: 785-623-3395
atamimi@sunflower.net

MARK D. CALCARA, ATTORNEY
WATKINS CALCARA CHTD.
1321 MAIN ST STE 300
PO DRAWER 1110
GREAT BEND, KS 67530
Fax: 620-792-2775
mcalcara@wcrf.com

TAYLOR P. CALCARA, ATTORNEY
WATKINS CALCARA CHTD.
1321 MAIN ST STE 300
PO DRAWER 1110
GREAT BEND, KS 67530
Fax: 620-792-2775
tcalcara@wcrf.com

DAVID L. WOODSMALL
WOODSMALL LAW OFFICE
308 E HIGH ST STE 204
JEFFERSON CITY, MO 65101
Fax: 573-635-7523
david.woodsmall@woodsmalllaw.com

/s/ Vicki Jacobsen

Vicki Jacobsen