THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

Before Commissioners: Jim Robinson, Chairman
Keith R. Henley
Rachel C. Lipman

In the Matter of the Application of Kansas City Power & Light Company for approval of its acquisition of all classes of the capital stock of Kansas Gas and Electric, to merge with Kansas Gas and Electric, to incur debt obligations, and to transfer Kansas Gas and Electric's retail electric service authority and municipal franchises.	)	Consolidated Docket Nos. 172,745-U
In the Matter of the Joint Application of the Kansas Power and Light Company, KCA Corporation, and Kansas Gas and Electric Company for approval of the acquisition of all classes of the capital stock of Kansas Gas and Electric Company into KCA Corporation, to incur debt obligations, and to transfer Kansas Gas and Electric Company's retail electric service authority and municipal franchises.	)	174,155-U

ORDER

NOW, the above-captioned consolidated matters come before the State Corporation Commission of the State of Kansas (Commission) for consideration and determination on the joint application of the Kansas Power and Light Company (KPL) and the Kansas Gas and Electric Company (KGE), (together referred to as Applicants) for approval of their proposed merger. Having considered the evidence and testimony, the files and records, and being fully advised in the premises, the Commission's findings and conclusions are set forth below.

I. INTRODUCTION

The proposed merger between KPL and KGE is the most significant decision to come before the Commission since the Wolf Creek rate cases. In this order, the Commission finds it can not accept the merger as proposed by Applicants because the concerns raised by Commission staff (staff) and the intervenors can not be overlooked. However, the merger, as approved by the Commission subject to conditions, presents the Commission with a unique opportunity to place Kansas utilities in a position to take advantage of the power resources available in the state of Kansas for the coming decade and to utilize those resources to be a significant player in the regional power market.

The Commission believes that ratepayers will reap the benefits of synergies that result from the overlapping service territories of these two utilities. The Commission, with the conditions it imposes in this order, restructures the transaction to minimize those risks for the ratepayers and to the extent that risks exist, properly places them upon the shareholders, who authorized their managements to undertake this venture. Although the Commission's primary responsibility is to protect the ratepayers, the Commission believes that the merger also provides shareholders with the opportunity to realize benefits. The Commission thus issues the merged KPL/KGE company a challenge. The merged company will have to be aggressive in cutting costs and generating revenues through off-system sales. However, if they meet this challenge, as the Commission is convinced they are prepared to do, they have the opportunity to experience growth that the stand-alone entities would not have had the ability to achieve.

Although all parties in the proceeding have issues upon which they wish they could have prevailed, the Commission believes its approval of the merger, subject to conditions, balances the variety of interests and promotes the public interest. The concerns expressed at the hearing by staff and the interveners concerning the acquisition premium (hereinafter referred to as "AP") were persuasive. As a result, the Commission imposes conditions to limit recovery of the AP to an amount that reflects the realistic level of savings that the Commission believes can be achieved by the merged company. The Commission believes that the best thing to come out of this transaction for ratepayers is rate stability for all KPL and KGE customers. This is particularly true for KGE customers, who have endured electric rates that are among the highest in the state. Under conditions imposed by the Commission, retail customers will be able to receive rate refunds.

The utility trade journals suggest that during the 1990s, utilities that have capacity to sell will be the "haves" and those that are forced to build new plants or purchase power will be the "have nots." The Commission believes this combination will place the combined KPL/KGE in a position to be a strong regional and national player in the energy market. This should benefit the ratepayers and the Kansas economy overall. The proposed merger, as conditioned, promotes the public interest.

II. PROCEDURAL HISTORY

A. KCPL'S HOSTILE TENDER OFFER

On July 23, 1990, Kansas City Power & Light Company (KCPL) announced a tender offer to purchase all outstanding common shares of Kansas Gas and Electric (KGE) and made application to the Kansas Corporation Commission (Commission or KCC) for approval of such acquisition. KCPL would have been the surviving entity after the merger, with KGE's operations constituting a separate operating division of KCPL with its operations headquartered in Wichita. The terms of the proposed tender offer and merger were set forth in KCPL's application and KCPL sought the following Commission action:

(1) authorization and approval of the stock acquisition pursuant to K.S.A. 66-127;

(2) authorization to incur debt obligations pursuant to K.S.A. 66-125;

(3) authorization and approval of the contemplated merger pursuant to the general regulatory authority conferred on the Commission by K.S.A. 66-101;

(4) approval pursuant to K.S.A. 66-136 and 66-1,170 et seq., of the transfer of franchises granted to KGE by the municipalities in which it now provides electric service and

the authority previously granted by this Commission to KGE to provide retail electric service in KGE's service territory; and

(5) a declaration that the Kansas Holding Company Act, K.S.A. 66-1,401 et seq., does not apply to KCPL's acquisition of KGE stock.

On July 23, 1990, KCPL also filed a motion seeking an order waiving an evidentiary hearing in the matter and granting expedited approval of its application.

Since that time, the following parties filed motions to intervene, which were granted by the Commission: Citizens' Utility Ratepayers Board, July 25, 1990 (CURB); Sunflower Electric Power Corporation, August 8, 1990 (Sunflower); Kansas Power and Light Company, August 14, 1990 (KPL); KGE, August 16, 1990; Kansas Electric Cooperatives, Inc., August 17, 1990 (KEC); Centel Corporation, August 17, 1990 (Centel); Vulcan Materials Company, August 17, 1990 (Vulcan); Farmland Industries, August 21, 1990 (Farmland); UtiliCorp United, Inc., August 21, 1990 (UtiliCorp); Kansas Electric Power Cooperative, August 22, 1990 (KEPCo); Texaco Refining, August 24, 1990 (Texaco); City of Wichita, September 5, 1990; Beech Aircraft Corporation, Boeing Commercial Airplane Group--Wichita Division, Cargill, Inc., Lafarge Corporation, Total Petroleum, Inc., and the Coleman Co., August 24, 1990 (Industrial Consumers); Wichita/Sedgwick County Partnership for Growth, Inc., September 28, 1990; and the Wichita Board of Education U.S.D. #259, October 25, 1990. On August 7, 1990, the Commission issued an order and found that it had jurisdiction over the application to acquire KGE and a motion to waive evidentiary hearing filed separately by KCPL on July 23, 1990, pursuant to K.S.A. 66-104. Thus, the Commission found that it had jurisdiction over the mere offer to merge.

On August 16, 1990, KGE filed a motion to reject KCPL's application, or, in the alternative, deny KCPL's motion for expedited hearing and order. In support of its motion, KGE stated that KCPL's application should be rejected on four separate grounds. First, KGE stated that the tender offer was unlawful under the Public Utility Holding Company Act of 1935 (PUHCA); that KGE's Board of Directors had not consented to the filing of KCPL's application or the acquisition of KGE's facilities, and on public policy grounds the Commission is prohibited from facilitating a hostile takeover by approving KCPL's application; that the proposed stock tender offer was subject to a number of conditions which would have rendered KCPL's application subject to substantial revision; and that as a result of KCPL's offer, other companies may seek to acquire KGE during the pendency of the offer. KGE further stated that if the Commission were to proceed with the merits of KCPL's application, KCPL's motion for expedited hearing and order should be denied due to the complexity, magnitude, and novelty of the offer. KGE suggested the Commission delay taking action on KCPL's application until the Federal Energy Regulatory Commission (FERC) had acted on the application.

On August 23, 1990, KCPL responded to KGE's motion, and stated that KGE incorrectly interpreted the requirements of PUHCA when they claimed that PUHCA would have required KCPL to get Securities and Exchange Commission (SEC) approval prior to purchasing KGE stock. KCPL also rejected KGE's contention that public policy considerations prevented the Commission from approving the application because to do so would facilitate a hostile takeover. KCPL argued that if the Commission had no authority to approve the application, then KCPL need not obtain the Commission's approval before going forward with the proposed merger. KCPL stated that the Commission should not postpone acting on the application until all of the other purchase conditions are met because such a delay could influence the tender offer process in a negative way.

On August 20, 1990, KGE filed a motion to assess all intervenors' costs incurred as a result of KCPL's application, against KCPL. KCPL responded on August 24, 1990, and requested the Commission to deny KGE's motion, stating to grant such a motion would be unprecedented and inequitable. KCPL stated there was no legal basis for such a request in Kansas.

On August 24, 1990, the Commission held a scheduling conference and denied KGE's motion to assess intervenors' costs to the Applicants, and directed all parties to submit a proposed list of issues by August 29, 1990. The scheduling conference was found to be necessary to discuss a procedural schedule and those issues which may arise as a result of KCPL's application.

On September 7, 1990, the Commission issued its initial Order Setting Procedural Schedule, which, in addition to setting the procedural schedule, established a non-exclusive list of issues which the Commission desired to be addressed. In the order, the Commission recited its broad authority to supervise the acts of utilities doing business in the state in order to protect the public interest, pursuant to K.S.A. 66-101, 66-125, 66-131, 66-136, 66-1,170 et seq., and 66-1401. Because of this broad authority, the Commission noted it would consider all of the wide-ranging issues that a merger application could raise, and would not assume a position of preference for the goals of KCPL, KGE, or of any actual or prospective participant or observer of the merger process. The Commission also found that KCPL's unsolicited offer was an act sufficiently significant in terms of potential effects on the public interest to warrant an investigation in order for the Commission to carry out its responsibility to protect the public interest.

B. KPL/KGE MERGER AGREEMENT

On October 29, 1990, CURB filed a motion requesting that the procedural schedule be suspended and a pre-hearing conference held because on October 28, 1990, KPL and KGE announced the execution of a merger agreement, and that the response of KCPL was unknown. Other intervenors subsequently filed motions to suspend the procedural schedule in light of the KPL/KGE merger agreement, including Vulcan, October 31, 1990; KGE, October 31, 1991; KPL filed a response in support of KGE's motion, November 1, 1990; and Texaco and Beech filed a joint motion to suspend, November 2, 1990.

On November 1, 1990, the Commission issued an order denying suspension of the procedural schedule without prejudice. At that time, KPL had not filed an application with the Commission to approve a merger with KGE. Moreover, KCPL had neither filed with the Commission changes in its application nor notified the Commission of any change in its tender offer.

On November 20, 1990, KPL and KGE filed a joint application requesting approval of their proposal to merge, pursuant to the Commission's general regulatory authority under K.S.A. 66-101. The proposal provided for KGE's merger into KPL Sub, a wholly-owned subsidiary of KPL, with the surviving corporation being named Kansas Gas and Electric. KPL proposed to issue KPL common stock and to deliver up to $434 million of the proceeds of the financing to KGE common stockholders. The merger agreement provides for conversion of KGE common stock, no par value, to a total of approximately $32 in the form of cash and/or common stock of KPL, par value $5.00 per share, pursuant to a cash election procedure.

Also on November 20, 1990, KPL and KGE filed a joint motion to deny KCPL's application and to consolidate the two dockets and establish a new procedural schedule. In support of their request to deny KCPL's application, KPL/KGE stated that a contractual commitment existed between each company, and so each was legally obligated to take all steps necessary to consummate the merger, unlike KCPL's tender offer to acquire KGE. Additionally, they stated that the terms of its merger application were more attractive to customers and shareholders. In support of their request to consolidate the two dockets, KPL/KGE stated that the Commission's and each party's resources would be conserved by consolidation of the two dockets.

On November 21, 1990, the Commission issued an order consolidating the applications and revising the procedural schedule. The Commission determined that the joint application filed by KPL and KGE presented issues germane to those identified by the parties in the application filed by KCPL in Docket No. 172,145-U. Further, the Commission said the applications required consideration of the effect the proposed transactions would have on the public interest. The Commission also found that to consolidate the dockets would conserve the resources of the parties, ease the administrative burden and be more efficient.

Thereafter, KCPL filed a motion to intervene in the new Docket No. 174,155-U, which was granted. KCPL also filed a motion opposing the decision made by the Commission to consolidate Docket No. 172,745-U, KCPL's application, with the new Docket No. 174,155-U, KPL and KGE's joint merger agreement. On November 30, 1990, the Commission issued an order sustaining its decision to consolidate the two dockets and deemed all intervenors of record in Docket No. 174,155-U to be intervenors of record in the consolidated docket. The Commission also revised the procedural schedule to accommodate the consolidated docket.

On December 11, 1990, KPL and KGE filed for approval of their proposed merger before the Federal Energy Regulatory Commission (FERC). On January 4, 1991, the Commission filed its petition to intervene and became a party in the FERC proceeding.

On December 13, 1990, KCPL filed a withdrawal of its application wherein it notified the Commission of the withdrawal of its unsolicited tender offer to acquire KGE.

The following parties filed motions to intervene in the new consolidated docket, which were granted by the Commission: Midwest Gas Users Association, December 26, 1990 (MGUA); Quaker Oats Company, General Motors Corporation, Goodyear Tire & Rubber Company, Rockwell International, FMC Corporation, December 6, 1990 (Kansas Industrial Consumers); Atchison, Topeka & Santa Fe Railway, February 1, 1991 (Santa Fe); United Cities Gas Company, February 11, 1991 (United Cities); CURB on behalf of small commercial and residential ratepayers of KPL and KGE Shareholders, November 28, 1990; and Shareholder Intervenors, March 6, 1991.

On January 8, 1991, after motion by Industrial Consumers and Vulcan, and upon its own determination that a change in the procedural order would be in the best interests of all parties, the Commission revised the procedural schedule. On February 15, 1991, on its own motion, the Commission again revised the procedural schedule in order to allow all parties an equitable amount of time to adequately prepare for hearings.

On March 8, 1991, staff filed a motion requesting the Commission to allow staff to file supplemental direct testimony in the matter. On March 21, 1991, the Commission granted staff's motion to file supplemental testimony.

The Commission held a Prehearing Conference on March 22, 1991, wherein it considered various motions pending before the Commission. The Commission accepted a stipulation entered into by the parties whereby the hearings on the above-captioned matter would be held in two phases. The first phase, which was limited to the issue of the merger's effect on the wholesale market in Kansas and the merged company's transmission, was set for March 25, 1991. The second phase included all remaining issues and was set to begin April 11, 1991. On March 25, 1991, Phase I of the hearing commenced before the Commission. At that time, staff and Applicants presented the Commission with a Stipulation and Agreement regarding general principles for the provision of transmission service by the merged company, which was made part of the record on staff's motion. The issues staff and Applicants were concerned with were the effect of the merger on competition and transmission, including (1) the effect of the merger on competition in the bulk power market in Kansas and (2) the terms and conditions that should be adopted to govern the use of the Applicants' transmission facilities should the merger be approved. As a result of extensive discussions regarding these issues, a Stipulation and Agreement was reached between staff and Applicants, which established general principles for the provision of transmission service. In its order accepting the stipulation dated April 3, 1991, the Commission noted that successful implementation of the principles set forth in the stipulation would serve as a condition to final approval of the proposed merger, should the Commission determine that the merger as proposed otherwise satisfied Kansas law.

C. POST HEARING MOTIONS

On May 28, 1991, Industrial Consumers filed a motion requesting permission to file supplemental direct testimony on the issue of possible adverse consequences should the merger be denied. They stated that the issue of adverse consequences if the merger is disapproved was raised at hearing but not addressed in their pre-filed testimony.

On May 31, 1991, Industrial Consumers filed another motion requesting permission to file supplemental direct testimony on the issue of post-merger conditions. KPL/KGE answered these motions on June 5, 1991, stating that re-opening the record was unnecessary. They stated that the Commission should base its decision on the testimony that is already in the record, and nothing more.

On June 11, 1991, Applicants filed their answer to the motion of Industrial Consumers for leave to file supplemental testimony on post-merger conditions. On June 17, 1991, Industrial Consumers filed their reply in support of their motion to file supplemental testimony on the issue of post-merger conditions.

On June 17, 1991, staff filed a motion to re-open the record for purposes of filing supplemental direct testimony to address the issue of possible adverse consequences denial of the merger might have. On June 26, 1991, Applicants filed a reply to staff's motion to re-open the record for purposes of filing supplemental direct testimony, and asserted that the issues staff believes need to be addressed are in fact addressed at length in the record.

On July 1, 1991, Industrial Consumers filed a motion requesting oral argument on the issues raised in the post-hearing briefs. On July 10, 1991, KPL filed a response in opposition to Industrial Consumers' motion for oral argument stating they were unnecessary.

The Commission finds that the post-hearing motions should be denied as moot. The Commission also finds that oral argument on issues raised in the briefs is not necessary. The parties had ample opportunities to present their positions on the merits in testimony and post-hearing briefs. The record would not likely be enhanced by oral argument. Moreover, to the extent the Commission relies upon a position in the briefs of the parties that other parties believe is erroneous, the parties have a remedy in the form of petitions for rehearing.

III. APPEARANCES

The following parties entered an appearance in the above-captioned matters.

On behalf of the joint applicants, Kansas Power & Light Company and Kansas Gas and Electric Company:

John K. Rosenberg
Michael C. Pendergast
The Kansas Power & Light Company
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Topeka, Kansas 66612

J. Michael Peters
Ralph Foster
Richard D. Terrill
Alan R. Post
Kansas Gas & Electric Company
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Wichita, Kansas 67201-0208

On behalf of Kansas Industrial Consumers (Boeing, Cargill, LaFarge, Total Petroleum, Coleman, Quaker Oats, General Motors, Goodyear, Rockwell International, and FMC Corp.):

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Robert P. Van Cleave
McAnany, Van Cleave & Phillips
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Robert C. Johnson
Arthur Smith
Catherine Moore
Peper, Martin, Jensen, Maichel, and Hetlage
Attorneys at Law
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On behalf of Vulcan Materials Company:

Milo M. Unruh Jr.
Am, **Mullins,** Unruh, Kuhn **&** Wilson
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On behalf of the Citizens' Utility Ratepayers Board:

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On behalf of Sunflower Electric Power Corporation:

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On behalf of Kansas City Power **&** Light Company:

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On behalf of Kansas Electric Cooperatives, Inc.:

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On behalf of Kansas Electric Power Cooperative:

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On behalf of Centel Corporation and United Cities Gas:

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On behalf of the City of Wichita:

Joe Allen Lang
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Kansas City, MO 64108

On behalf of Commission staff and the public generally:

Brian J. Moline
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IV. THE PROPOSED MERGER AND POSITIONS OF THE PARTIES

A. APPLICANTS' CASE

Applicants' case in support of the merger consisted of the testimony and related exhibits of Messrs. Wilson K. Cadman, John E. Hayes, Jr., William Moore, Steven L. Kitchen, John D. McClellan, Thomas J. Flaherty, Kent Brown, William E. Brown, Earnest A. Lehman, James Haines, Paul H. Raab and Jerry D. Courington. That testimony may be summarized as follows:

KPL is a combination electric and natural gas public utility as defined in K.S.A. 66-101a, 66-104 and 66-1,200. KPL is involved in the generation, transmission, distribution and sale of electric power in the central and eastern portions of Kansas. KPL consists of seven divisions, the two major operations being Gas Service and KPL. (Tr. p. 514) The Gas Service Division is headquartered in Kansas City, Missouri, and provides retail natural gas service in Kansas, Missouri, and Oklahoma. The KPL Division provides electric service to retail customers in eastern and central Kansas and is headquartered in Topeka. It also supplies retail gas service to customers in northeastern and central Kansas in communities where electric service is also provided. (Tr. p. 514) KPL provides retail electric service to approximately 300,000 customers in 323 Kansas communities. KPL also provides electric sales and transmission services to numerous municipal customers and electric cooperatives located in Kansas and, through interchange agreements, to surrounding integrated systems. KPL owns and operates approximately 2,224 miles of high voltage transmission lines and is interconnected with the systems of six other utilities in Kansas, Missouri and Nebraska. KPL is a member of the MOKAN and Southwest Power Pools. KPL also transports and sells natural gas in Kansas, western Missouri and northeastern Oklahoma. In total, KPL provides natural gas service to approximately 1,100,000 retail customers, 550,000 of whom are located in Kansas.

KGE is a public utility involved in the generation, transmission, distribution and sale of electric power in south central and southeastern Kansas. KGE sells electricity at retail to approximately 253,000 customers in Kansas. KGE also provides wholesale electric and transmission services to numerous municipal customers and electric cooperatives located in Kansas, and through interchange agreements to surrounding integrated systems. KGE owns and operates approximately 1,075 miles of high voltage transmission lines and is interconnected with the systems of 12 other public utilities in Kansas, Missouri, Arkansas, Oklahoma and Nebraska for purposes of economy and reliability. KGE is a member of the MOKAN and Southwest Power Pools.

Pursuant to an "Agreement and Plan of Merger" between KPL and KGE dated October 28, 1990 (Agreement), KPL and KGE have agreed on the terms and conditions under which KGE will be merged with and into KPL Sub, which will be the surviving corporation in the merger and which will thereafter be named Kansas Gas and Electric Company. Upon closing the merger, KGE will be merged into KCA, Inc., a wholly-owned subsidiary of KPL formed for the purpose of completing this transaction. The name of KCA will be changed to KGE which will then operate as KGE does now, except that many of the gas distribution functions performed by KPL in jointly-served territories will be transferred to the new subsidiary. The headquarters of KGE will remain in Wichita. (Tr. p. 516) KGE will remain a wholly-owned subsidiary of KPL, with headquarters remaining in Wichita. The subsidiary would have its own board of directors.

This board would be responsible ultimately to the board of directors of KPL. Under the merger agreement, this structure would be maintained for three years.

Merger discussions between KPL and KGE were initially held from about July 1989 through January 1990. (Tr. p. 357) KGE was a viable stand-alone company at the time of merger discussions with KPL in the fall of 1989. (Tr. p. 463) Those discussions did not lead to a merger agreement, but they did indicate that potential benefits could come about from a properly structured combination. Following the hostile tender offer of KCPL on July 23, 1990, KGE entered into merger discussions with KPL, which led, as a direct result, to a merger agreement between KGE and KPL on October 28, 1990. (Tr. p. 357, 358 and 480) KGE remained financially sound when the merger discussions took place with KPL in the fall of 1990. (Tr. p. 463)

The merger will accelerate and enlarge stand-alone opportunities for the company. For KGE customers, the merger will bring about a $15 million rate reduction. Synergies between the two companies were identified from earlier merger discussions. They include KGE and KPL's history as partners in the production and delivery of electricity, and that the two companies had worked together in storm recovery and pooling arrangements. (Tr. pp. 394-395)

Financial studies of the merger led the companies to conclude that the merger would result in no detriment to customers, and that customers and shareholders would benefit. (Tr. p. 517) KPL utilized a financial model devised by Deloitte & Touche to determine the financial results of merging KPL and KGE. (Tr. p. 1221) KPL electric and gas customers will not realize any immediate rate relief, but over time, rates should be lower than they otherwise would be as a result of efficiencies brought about by the merger. (Tr. p. 58) KPL intends to make additional generation and transmission capacity available that will benefit the entire region. (Tr. p. 520) The service area for KPL's gas operations will not change as a result of the merger. (Tr. p. 729) For efficiency of operation, some aspects of the distribution function will be transferred to KGE. (Tr. p. 730)

Costs will be kept lower than they would have been without the merger. Cost saving opportunities have been preliminarily identified in several broad areas attributable to: (1) cross-over gas/electric service; (2) the combining of key portions of the companies' electric operations; (3) administrative and general cost savings resulting from economies of scale and the elimination of duplicate activities; and (4) cost avoidance opportunities for the merged company in the future. Less quantifiable benefits are in the areas of economies of scale in financing, service quality, customer convenience and enhanced opportunity for economic development. (Tr. p. 974)

While current KPL rates will not change as a result of the merger, present KPL customers will benefit as future operating costs should be reduced. Likewise, current KGE customers will benefit from the anticipated savings in electric operating costs. If consummated, the merger will result in a $15 million rate reduction for KGE electric customers. Some of these electric customers are also KPL gas customers. (Tr. p. 596)

The application proposes that the companies be allowed to recover the cost of the merger through the savings it will achieve, not through raising prices to cover the cost of the acquisition. (Tr. p. 594) Applicants are confident in their estimates of cost savings and believe additional savings opportunities will be discovered as the companies merge. (Tr. p. 1946) There are sufficient savings to provide for recovery of the annual amortization and sufficient savings to provide a reduction to customer rates in the form of that savings share. (Tr. p. 2291)

The companies have put two processes in place to track savings resulting from the merger. One is the integration planning process where representatives from both KGE and KPL try to identify what counterparts in the other company can effect cost savings. On a parallel path, the cost savings tracking process has also been designed to facilitate demonstration of savings. (Tr. pp. 1243-1244) It is possible to track the cost savings that will result from the merger and the concerns of staff and CURB are related to the unusual nature of the undertaking rather than the impossibility of the undertaking. KPL is fully committed to installing an effective tracking system. (Tr. p. 2371) A number of merger integration teams between the two companies have been assembled to compile savings in such areas as labor/human relations, vehicles and vendors. Savings events can be distinguished between merger and non-merger related activities and future events can be accurately identified. (Tr. pp. 2373, 2375 and 2376) Once the system achieves results, these results will be placed into KPL's current accounting model to perform financial forecasting and budgeting. (Tr. p. 2378)

If the merger is completed, the companies would have excess generating capacity, 300 MW of which has been offered to KCPL for their purchase. (Tr. p. 615)

The financial advising firm, Morgan Stanley, was retained by KGE to assist in the evaluation of each tender offer. (Tr. pp. 850-851) KPL is offering $32 per share for each of KGE's outstanding common shares, subject to limitations on cash and stock. Based on KGE's 30,998,036 outstanding shares, the offer is worth $992 million. The purchase is financed by a combination of cash, raised initially by bank financing, and additional KPL common shares. They propose to use $434 million in cash (43.75 percent) and 24 to 28 million new KPL shares (56.25 percent) as consideration for the KGE stock. KGE shareholders will be able to elect the portion of cash or stock they would like to receive for their shares. (Tr. pp. 966-967) The total number of KPL and KGE shareholders who are Kansans are 4,692 which represents 17.28 percent of the total number of shareholders. The total number of shares owned by Kansas residents is more than 2.8 million. This represents 6.48 percent of the total number of shares outstanding. (Tr. p. 1292)

The only price offered to KGE was $32. The price could vary if the price of KPL stock changes, since the offer is a combination of cash and stock. (Tr. p. 575) During the *in camera* proceeding, specific details of how the offer price was reached and merger financing arrangements were given. (Tr. pp. 812A-838)

In connection with the acquisition, KPL will enter into a Credit Agreement ("Agreement") with Chemical Bank ("Chemical"). The Agreement consists of a Term Loan Facility ("Term Facility") not to exceed $500,000,000 and a Revolving Credit Facility ("Credit Facility") not to exceed $100,000,000 for a total facility ("Facility") of $600,000,000.

The Facility will bear interest at an annual rate equal to, at KPL's election: a) the London Interbank Offered Rate plus a margin of 1/4 percent to 1 1/4 percent depending on the credit rating of KPL's first mortgage bonds; or b) the Alternative Base Rate ("ABR"). The ABR is equal to the greatest of a) Chemical Bank's Prime Lending Rate; b) a rate based on the secondary market rate for three-month certificates of deposits, subject to certain adjustments, plus 1 percent; or c) the Federal Funds Rate as published by the Federal Reserve Bank of New York, plus 1 percent.

The Facility will mature on the fifth anniversary of the date of the borrowing of the Term Facility. The Term Facility will amortize in five installments equal to 20 percent of the original principal amount of the Term Facility. The first installment will be due 18 months after the borrowing under the Term Facility, with additional installments due annually thereafter and on the final maturity date.

KPL proposes to issue to KGE stockholders up to 28,000,000 shares of KPL common stock, $5.00 par value, ("Common Stock"). The funds from the Facility and Common Stock will be used by KPL to: 1) purchase all of KGE's common stock; 2) purchase all shares of all classes of KGE's preferred stock; and 3) provide working capital to the combined company.

It is anticipated that all of KGE's debt, including its mortgage bonds, letters of credit and other lines of credit will remain outstanding. However, KGE's preferred stock, currently \$18.7 million or 1.4 percent of KGE's capitalization is expected to be redeemed. (Tr. p. 967) KPL obtained the necessary bank financing from Chemical Bank in the amount of \$600 million. (Tr. p. 967) KPL has not committed to a single refinancing plan although the merger report assumes a preferred stock issuance in 1991 followed by annual issues of first mortgage bonds. KPL is keeping the option of short or medium-term debt, or public offerings of common equity in its financial plan. (Tr. p. 970) The appropriate debt-equity balance has to be measured in terms of the company's objectives. KPL wants an AA debt rating and they are predicting KPL will be an A rated company after the merger. (Tr. pp. 801-802)

The merger application includes a \$388 million AP over the current book value of KGE stock. Applicants assert that a merger cannot be undertaken unless shareholders are paid for the use of their capital and KPL has proposed a method to benefit both customers and shareholders. (Tr. pp. 974-975) There are three methods used to recover the cost of an AP to net book value: full rate base treatment, annual amortization, or complete disallowance. The company proposes a combination of all three. (Tr. pp. 2003-2004) A part of the AP would be included in rate base. That would have the effect of increasing the rate base above the original cost of utility plant. (Tr. pp. 2043-2044)

The AP for the offer will be \$388 million. (Tr. p. 1138) The conditions of arm's length bargaining and economic substance underlie the proposed acquisition by KPL of the properties that are now recorded on the books of KGE. (Tr. p. 1141) The amounts recorded as APs must be amortized or otherwise disposed of as the Commission may approve or direct. (Tr. p. 1142) KPL is not requesting full recovery of the costs of acquiring the KGE system. (Tr. p. 1146) The rate base will not include all \$1 billion in financing requirements, rather only the original cost portion will be included. (Tr. p. 1147)

The company does request ultimate recovery of the acquisition costs. The company will not seek to include the AP in rate base for recovery of a return on the unamortized portion of the investment in the AP. (Tr. p. 1148) The company is asking permission to defer amortization of the purchase price until the company comes in for its first rate case. (Tr. p. 633) This amount would require an amortization of $14 million a year. Including income tax effects, the $14 million figure would have to be raised to approximately $23 million a year. (Tr. p. 984) There will be approximately $30 million of savings per year, and after amortization of $23 million, the yield will be $7 million in savings the first year. (Tr. p. 985) KPL has proposed that the amortization be deferred until such time as the next KPL general electric rate case which is projected for 1993. After that rate case, amortization would be deducted from net savings in 1993, and for the first full year in 1994. (Tr. p. 986-987)

There are operational synergies associated with integrating the distribution-related functions of the two companies where KGE's electric service territory overlaps with KPL's natural gas service territory. (Tr. p. 1305) Most of the gas operations in the overlapping territory will be consolidated under KGE management. KPL employees responsible for those gas operations would continue in their positions, but now as part of the KGE operation. (Tr. p. 1299) Their functions encompass customer service, customer billing, meter reading, and other distribution-related activities. (Tr. p. 1305) The expected savings from integrating these functions was important to the merger decision, and experiences from the KPL and Gas Service Company merger in 1985 were a point of reference. Savings expected in this merger include those from the 1985 merger, such as integrated distribution-related and administrative functions, integrated customer office functions, retraining of service personnel to eliminate duplicate positions, and combined administrative functions. (Tr. pp. 1306-1307)

Additional efficiencies are expected to result from the increased coordination of the two companies' energy resources and dispatching operations, although much has already been achieved through participation in MOKAN and Southwest Power Pools. (Tr. p. 1308) None of KGE's fuel supply contracts or other contracts are to be terminated upon consummation of the merger. (Tr. p. 1287) Also anticipated are operational benefits to be realized through the consolidation of various corporate management and administrative functions such as finance, accounting, law, purchasing, shareholder relations, system planning, fuels management and administration. Personnel savings would result as well as external savings such as enhancement of the company's purchasing power to allow for the standardization of inventory. (Tr. pp. 1308-1309) The companies do not anticipate any layoffs of any employees, but the job that they are asked to do may not be the one they are doing today. (Tr. p. 1352)

Other reasons to merge include the strategic advantage of having joint operation of generating capacity and transmission capabilities which would enable the combined companies to expand off-system sales which afford access to a broader range of economical resource options for native customers. These should bear both long and short term benefits, through enhanced economic development throughout the region. (Tr. p. 1310)

The AP will not be charged to the retail or wholesale customers of KPL, but will be recovered through savings. (Tr. p. 1360) The savings that are achieved through the operation of the merged company will accrue to customers in all jurisdictions. The rates offered will be lower than they would be if KPL continued as a stand-alone company. The distribution cooperatives with whom KPL has contracts will enjoy rates that will be lower than they would be absent the merger. (Tr. pp. 1361-1362) The Applicants estimate it would file a rate case for its Kansas electric rates in the fall of 1992 with rates to go into effect in June 1993. (Tr. p. 2095)

If the merger does not work out as anticipated, ratepayers will not be asked to make the company whole. (Tr. p. 2217) The company has indicated that if a sufficient level of cost savings are not generated, no recompense for the amortization of the AP will be sought and thus, the company bears the risk of negative financial implications. (Tr. p. 2218)

The Applicants' overview of the transaction asserts that the merger is in the public interest with both immediate and future benefits. Applicants state that the merger does not mean rates will never be higher in the future; they contend the merger provides an opportunity for rate stability with future rates for the merged entity being lower than they would be absent the merger. The merger application balances the interests of all parties involved. (Tr. pp. 978-979) The combination of KPL and KGE benefits all stakeholders, while no stakeholder is disadvantaged as a result of the merger. Customers will benefit from the cost savings that result from the merger. (Tr. p. 1224) Cost savings from the merger will directly result in lower rates in the future than would otherwise be available without the merger. (Tr. p. 1224)

The benefits and cost savings resulting from a merger between KPL and KGE are largely unique because of the inherent advantages of overlapping service territory that KPL and KGE enjoy, which dramatically increases the opportunities for generating savings. (Tr. pp. 1220-1221) Since KPL's offer to merge with KGE is a friendly one, potential problems associated with a hostile takeover attempt may be avoided. Integration of the two operations into one will be more efficient as a result. (Tr. p. 1298)

The benefits of the merger to the shareholders, customers, and employees are strategic value, generation diversity, transmission access, and diversity within service territory. (Tr. p. 2187)

KPL is requesting Commission approval of: (1) the issuance of approximately 28 million additional shares of common stock; (2) the approval of credit facilities up to $600 million; (3) the pledge of KPL first mortgage bonds at least in the amount of $250 million; and (4) the pledge of the common stock in the KPL subsidiary to be renamed KGE upon closing. (Tr. p. 977)

B. COMMISSION STAFF'S POSITION

Staff opposed approval of the merger application as proposed. Staff supported its position with the testimony and related exhibits of the following witnesses: Ms. Shirley Sicilian, Ms. Debra J. Weiss, Messrs. Robert Elliott, Adam Gatewood, David Dittemore, and Robert H. Glass. Their testimony may be summarized as follows:

Staff contended that transactions effectuating mergers and acquisitions in Kansas should be economically efficient. However, the Commission should also consider equity in determining which transactions promote the public interest. (Tr. pp. 60-61) The Commission cannot rely entirely on the capital market process to produce optimal transaction. (Tr. pp. 68-69) Regulatory review would still be beneficial for three reasons: 1) the markets will not take into account the merger's effect on other sectors of the Kansas economy; 2) regulation of output market may not be entirely effective; and 3) even if regulators desired to and could be successful in holding returns to a fair market return on book, there may be other, non-economic incentives to merge which regulatory review can control. (Tr. p. 69)

Staff reviewed Applicants' claims of merger benefits. On a nominal basis, staff estimated the merger will generate $1.5 billion in net merger savings over the 27-year amortization period. The costs related to the $388 million AP are not reflected in this calculation. (Tr. p. 1466) Staff estimated for the period 1991-1996, the merger will generate $105 million in net savings, excluding the costs associated with the AP. The Commission should be aware of the uncertainty of the savings estimates due to the fact they are projections made from budgets. (Tr. p. 1467)

The costs of the merger significantly outweigh the benefits of the transaction. As such, the proposed merger is not in the public interest because these costs clearly exceed the benefits derived from merger savings. (Tr. p. 1639) This transaction, on its own merits, can not be justified on a net present value basis. (Tr. p. 1640) The most significant costs were those relating to the $388 million AP.

The Commission's policy with respect to the AP will determine how these benefits are allocated among ratepayers, KPL shareholders and KGE shareholders. The Commission should set a policy that effectively denies recovery of AP as a rule, and requires the flow through to ratepayers of approximately all merger-related cost savings. (Tr. p. 70) Alternatively, the Commission should allow recovery of an AP from ratepayers when the utility can demonstrate that the AP is the least cost means of achieving specific benefits. (Tr. p. 1659) Applicants did not meet their burden of demonstrating the AP was the least cost means of achieving the benefits because the merger will cost shareholders an estimated $200 million on a net present value (NPV) basis, which raised legitimate concerns about the future capital costs of the merged company. Applicants also failed to identify and seriously address significant costs to shareholders and the effect of those costs on ratepayers. (Tr. p. 1659)

The proposed merger tracking would require annual quantification, over the 27-year amortization period, of what costs would have been for the companies on a stand-alone basis if the merger had not occurred and a comparison of those amounts with actual costs of the merged company. (Tr. p. 1470) The proposed system is based upon too many unverifiable assumptions and estimates to make it a viable system. It would be virtually impossible over the span of 27 years to accurately measure the costs and savings generated by the merger. (Tr. 1473)

The Commission should deny the proposed merger for the following reasons: 1) on a net present value basis the transaction is not financially viable; the net costs of this transaction outweigh the benefits. 2) Despite the Applicants' claims that the merger is in the public interest because rates will be lower than they otherwise would be, there are substantial costs which will be borne by shareholders which quite likely will raise the cost of capital. This increase in capital costs would increase the Applicants' overall cost of service as a direct result of the merger. 3) The Applicants' have not met their burden of proof by supporting the $32 offer price as the least cost alternative to acquiring the assets of KGE. (Tr. pp. 1663-1664)

Market power is also a concern in this case, and the Commission should set conditions curbing the potential for its increase due to merger. (Tr. p. 84) The merger could reduce interfuel competition in the retail market, as well as "yardstick" competition, the competition for retail load and service territory. The ultimate result of any reduction in retail competition could be an increase in both electric and natural gas retail prices. (Tr. pp. 95-96)

Should the Commission approve the merger, it should also: 1) Deny recovery of the amortization of the AP from ratepayers; 2) establish regulatory guidelines which would attempt to ensure that ratepayers are not negatively impacted from increased capital structure costs as a result of the merger; 3) reject Applicants' proposal to retain one-half of the estimated merger savings which are in excess of the annual level of the amortization of the AP on a gross of tax basis; 4) reaffirm the principle that rates be based upon actual costs, adjusted for known and determinable changes; and 5) reaffirm the Commission's position in its March 1990 decision in Docket No. 142,098-U and order KGE to reduce its rates by $8.7 million. (Tr. p. 1664)

C. INTERVENORS' POSITIONS

The following witnesses' testimony and related exhibits were presented in support of the various intervenors' positions: Messrs. Neil H. Talbot and Carlton W. Bartels of the Tellus Institute for Citizens' Utility Ratepayers Board (CURB), James T. Selecky of Kansas Industrial Consumers (KIC), Paul N. Tobia of Vulcan Materials Company, Bob Knight of the City of Wichita, and Martin C. Libhart of Wichita Public Schools.

1. CURB

This merger is unprecedented because it consists of two viable utilities with an AP of the magnitude of $388 million. (Tr. p. 1794) The social benefits of the merger were examined without regard to who the specific winners and losers would be as a result of the merger. It was determined that there are more savings than losses so that society as a whole saves funds. In this instance the social cost is very low. (Tr. pp. 1846-1847) The actual efficiency and savings from the synergies are the social savings regardless of who actually receives them. (Tr. p. 1847)

While there is scope for economies of scale resulting from more effective management of a larger corporation, it is difficult to see a strong "strategic fit" between KGE and KPL. The benefits from the overlapping gas and electric service territories are small. While some synergies will no doubt be achieved, CURB suggests that the motivation for this merger is primarily a response by KGE management to the threat of a hostile takeover by KCPL. While the broader studies suggest that there might be other benefits not specifically identified by KPL, CURB asserts that such benefits do not justify the price paid. The public interest requires that the most economical corporate organization be found since that can bring benefits to ratepayers as well as stockholders. It is clear that the $32/share offer price was the result of a bidding war with only two bids. KPL has made an offer that cannot be justified in terms of any reasonable expectations of merger synergies. (Ex. 58, pp. 4-5)

While the merger should result in savings, the amount of savings expected to occur is substantially less than the $388 million premium. CURB estimated a "confident level" of savings amounting to $243 million on NPV basis. The long-term savings forecast based upon Applicants' savings estimates yielded net savings of $398 million on NPV basis. While this estimate is above the AP, it is insufficient to support the tax effects and recovery "of" and "on" the AP. Accordingly, the Commission should reject the merger because the savings are insufficient to support the AP and provide ratepayers with any merger benefit. The merged company's financial well-being will be impaired. Additionally, the merger as structured presents significant risk to ratepayers that they are likely to suffer higher rates either by directly subsidizing the support of the AP or paying higher costs for capital in the future owing to the strain induced by the AP. (Tr. p. 1762)

The ultimate well being of the affected groups will be determined by the treatment of the merged company's costs for ratemaking purposes. (Tr. p. 1760) If the Commission allows the merger to take place, it should do so under several conditions regarding ratemaking treatment of the merger costs and benefits. (Tr. p. 1841) If the merger is approved, the company's financial dependence on revenues from savings will place the Commission in an invidious position. On the one hand the KCC could take a strict position with regard to the proof of merger benefits. If it does, CURB believes it is not likely that KPL will be able to show the major costs savings and synergies it needs to recover the AP. On the other hand, if the Commission adopts a permissive attitude with regard to the proof and allocation of merger savings, rates will rise higher than would be justified under normal ratemaking procedures. (Ex. 58, p. 13)

2. Kansas Industrial Consumers

The KCC should not approve the merger as proposed because it is uneconomical and the proposed ratemaking procedure to recover the merger costs and pass on merger benefits is not practical. (Tr. p. 1727) The total cost or revenue requirement associated with the acquisition exceeds the benefits or savings that will be derived from the merger. The industrial intervenors contend the Applicants' proposed ratemaking treatment for merger costs and benefits is impractical and unworkable. The proposed ratemaking treatment requires the Commission to set rates based on hypothetical costs for at least the next 27 years. The net costs incurred to accomplish the proposed merger could produce a financially weak utility. (Tr. p. 1706) Additionally, it is possible that the merger will result in a loss of the Commission's regulatory control over KGE retail rates. (Tr. p. 1721)

If the Commission does approve or endorse the merger, it should resolve the rate treatment it will provide the merged company for the acquisition related costs and specify procedures that will be followed in allocating benefits. (Tr. p. 1706)

3. Vulcan Chemicals Company

Vulcan had not formed a final opinion on whether the Commission should approve or deny the merger, but had substantial reservations about the viability of the merger. (Tr. pp. 1920-1921) Vulcan was concerned about the timing of the KPL/KGE application. It questions whether the business strategy of the "auction" style of the merger serves the best interest of the public noting the substantial AP. (Tr. p. 1923)

The availability of generating capacity for the merged company is a concern. The Commission should require KPL to address and identify any additional generating facilities required for the merged company in the event the merger is approved and the merged company sells KCPL power. (Tr. pp. 1928-1929)

The possibility of interruption in service to Vulcan under the terms of their contract with KGE is a concern, and there is a question whether the stand-alone company's supply would be more reliable. (Tr. p. 1932-1933) Uncertainty arises for KGE customers, on a long term basis, as to what effect the approval of the merger might have on electric rates. (Tr. p. 1933) The tracking system proposed by KPL is still being developed and is new, and therefore Vulcan is concerned that savings will not be reliably tracked. (Tr. p. 1934)

4. City of Wichita

The City Council had not yet taken a position relative to the friendly merger, but may decide that it might be appropriate in the future. (Tr. p. 1900) The interests of the City include those of its citizen/ratepayers as well as the municipality as both a customer and franchising body of KGE. (Tr. pp. 1900-1901) The City asserts it has a regulatory role over KGE through the franchise and general police powers, civic affairs and economic development of the community, and an interest as a potential utility competitor or user of electric transmission services. (Tr. p. 1901)

The City needs assurances that the sale of excess capacity which might benefit ratepayers in the short term does not result in a long-term detriment and rate increases. (Tr. p. 1903) A particular interest is what the proposed rate reduction will be for the City. (Tr. p. 1904) The City also expressed interest in how the merger would affect the current franchise agreement the City has with KGE. (Tr. p. 1905-1906)

5. Wichita Public Schools

Because of the amount of electric power that the school district uses each year, the Wichita Public Schools were concerned about any operational change or merger that might have an effect on their electric rates. (Tr. p. 1914) There are two areas of concern: the cost of electricity for the school district, and the level of service which both the district and community will receive upon merger. Lower rates in the short-term is beneficial, but rate equalization remains a concern. (Tr. pp. 1914-1915)

D. PUBLIC HEARINGS

The Commission scheduled four public hearings in different Kansas communities, which were held throughout January 1991, to give concerned citizens the opportunity to be heard on the matter. They were scheduled and held as follows:

> 7 p.m. Thursday, January 17, 1991, at the Kansas Corporation Commission Hearing Room, 1500 S.W. Arrowhead Road, Topeka, Kansas;
>
> 2 p.m. Tuesday, January 22, 1991, at the Civic Center, 420 N. Penn, Independence, Kansas;
>
> 7 p.m. Tuesday, January 22, 1991, at the City Council Chamber, 455 N. Main, Wichita, Kansas; and
>
> 7 p.m. Wednesday, January 23, 1991, at the Shawnee Mission West High School Auditorium, 8800 W. 85th Street, Overland Park, Kansas.

A total of thirty witnesses testified at the public hearings held by the Commission. The majority of the witnesses expressed their concerns that the costs of the merger would ultimately be borne by the ratepayers which would result in higher utility rates. Several witnesses specifically expressed their concern that consumer utility rates would rise due to the premium KPL was proposing to pay for acquiring KGE. Various witnesses also testified in favor of the merger because of the possibility that overlapping service territory would reduce costs, and because the transaction was a friendly one. Several witnesses also expressed concern over the long-term effect of the merger.

V. MERGER STANDARD IN KANSAS

A. THE COMMISSION'S JURISDICTION OVER THE PROPOSED MERGER

Applicants requested approval of their merger application pursuant to the Commission's broad grant of authority in K.S.A. 66-101. This provision grants the Commission full power, authority and jurisdiction to supervise and control electric public utilities operating in Kansas and expressly empowers the Commission to do all things necessary and convenient for the exercise of such power, authority and jurisdiction.

Applicants also request approval, to the extent the Commission deems the proposed merger a stock acquisition by competing utilities pursuant to K.S.A. 66-127. This statute prohibits any public utility, domestic or foreign, from purchasing or acquiring, taking or holding any part of any capital stock, bonds or other forms of indebtedness of any competing utility either as owner or pledgee, unless authorized by the Commission. The Commission's jurisdiction under this statute requires a finding by the Commission that KPL and KGE are "competing utilities" as that term is defined in the statute.

K.S.A. 66-101e authorizes the Commission, either upon complaint or its own motion, to investigate any practice or act whatsoever affecting or relating to any service performed or to be performed by the electric utility for the public to determine if it is in any respect unreasonable, unfair, unjust, unreasonably inefficient or insufficient, unjustly discriminatory or unduly preferential, or that any service performed or to be performed for the public is unreasonably inadequate, inefficient, unduly insufficient or cannot be obtained. This provision authorizes the Commission, after notice and hearing, to require electric utilities to make such improvements and do such acts as are or may be required by law to be done.

K.S.A. 66-101g provides that all grants of power, authority and jurisdiction made to the Commission shall be liberally construed and all incidental powers necessary to carry into effect the provisions of the Public Utilities Act are expressly granted to and conferred upon the Commission.

The Commission finds that it has jurisdiction over the proposed merger between KPL and KGE pursuant to K.S.A. 66-101, 66-127, and 66-101e. In finding that the Commission has jurisdiction over the proposed merger pursuant to K.S.A. 66-127, the Commission finds that KPL and KGE are "competing public utilities" as that term is used in the statute. Under the rules of statutory construction, it is well established that courts will look to the intention of the legislature. *State, ex rel., v. Throckmorton*, 169 Kan. 481, 486 (1950). Moreover, it is presumed that the legislature understood the meaning of the words it used and intended to use them, and that the legislature used the words in their ordinary and common meaning. *Rogers v. Shanahan*, 221 Kan. 221, 223-24 (1977). Pursuant to the general rules of statutory construction, "competing utilities" refers to competition between utilities.

Competition between utilities is not limited to competition for retail competition. Competition between utilities may include wholesale competition, inter-fuel competition between electric and natural gas utilities, and competition for new load. While the Retail Electric Suppliers Act, K.S.A. 66-1,170 *et seq.*, limits the competition that may occur at the retail level because it provides for the creation of exclusively certificated service territories for retail electric service, the term "competing utility" as used in K.S.A. 66-127 is broader than retail competition.

The Commission finds that KPL and KGE compete with one another on a variety of levels. First, they compete for new retail load. This type of competition is regional and national, and sometimes international. KPL testified that this type of competition will not be diminished by the merger. (Tr. p. 2490) While KPL is not in a completely free competitive market and regulation's primary purpose is to act as a substitute for competition, it is clear that competition in the utility industry is increasing. (Tr. pp. 1333-1334) Although KPL is a regulated utility, it competes with other utilities for the sale of power to large customers and for the sale of gas to intermediate and large customers. KPL also competes with other utilities for capital, labor and customers. (Tr. p. 798) KGE likewise believes that the wholesale and retail markets are becoming more competitive, and that natural gas is one of KGE's most common competitors. (Tr. pp. 895-896) In light of this testimony the Commission finds there is sufficient evidence to find that KPL and KGE are "competing utilities" as that term in used in K.S.A. 66-127. As such, Applicants are prohibited from consummating the proposed merger as structured unless approved by the Commission.

The Commission also finds that pursuant to K.S.A. 66-101, 66-101e and 66-101g it has authority to impose conditions on the proposed merger. The Commission's authority to impose conditions on the proposed merger is similar to its authority to impose conditions on the issuance of certificates. Any such conditions must be both lawful and reasonable. *Kansas Electric Power Coop., Inc. v. Kansas Corporation Comm'n*, 235 Kan. 661, 665 (1984). To be lawful, the condition must be within the statutory authority of the Commission and all statutory and procedural rules must be followed. *Central Kansas Power*, 206 Kan. at 675. To be reasonable, the condition must be based upon substantial competent evidence. *Jones v. Kansas Gas & Elec. Co.*, 222 Kan. 390, Syl. ¶ 2 (1977). Moreover, the Commission has authority to require a utility to take action necessary to forestall a future problem that will ultimately affect the utility's consumers in Kansas. *Kansas Electric Power Coop.*, 235 Kan. at 671-72.

B. THE APPROPRIATE STANDARD IN KANSAS

Kansas statutes do not contain a specific standard for mergers. Various parties have requested the Commission adopt a standard of mergers and acquisitions. The Commission finds it is appropriate to adopt a standard for mergers and acquisitions in this proceeding. The Commission must select a specific standard to govern whether a merger or acquisition is "in the public interest." Because the Commission is viewed as being in the best position to evaluate and weigh factors necessary to reach a proper decision on administrative policy questions to promote the public interest, *Central Kansas Power v. State Corporation Commission*, 206 Kan. 670, 679 (1971), the method by which the Commission selects a standard is one of policy judgment.

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 necessity." Public convenience means the convenience of the public, not the convenience of particular individuals. *Central Kansas Power v. State Corporation Commission*, 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.*

<u>Analysis</u>

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 should 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:

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;

   (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;

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

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

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

b. The effect of the transaction on the environment.

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.

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.

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

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

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

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

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. The Commission will evaluate the proposed KPL/KGE merger in light of the standard set out above.

VI. FINDINGS AND CONCLUSIONS ON THE MERITS

A. THE REGULATORY TREATMENT OF THE AP

1. Nature and Level of the AP

Under the terms of the proposed merger, the total value of the transaction is $1.032 billion. (Tr. p. 1138) Applicants have estimated that at $32/share, KPL will pay a $388 million AP to acquire KGE. (Tr. p. 467 and 1138) The consideration to be paid for KGE common stock is composed of both cash and stock components. The cash component of the consideration is capped at $434 million. The stock component of the consideration is dependent upon the market price of KPL common stock. (Tr. pp. 966-967) As initially estimated, the stock component of consideration will be $558 million.[1]

The total stock consideration to be paid is dependent upon the average market price of KPL common stock during a period before the close of the transaction. Applicants established a

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1 KPL will also pay approximately $20 million to retire KGE preferred stock and incur approximately $20 million in transaction costs.

price "collar" ranging from a low of $20.00 to a high of $23.75. (Ex. 1, p. IV-2) The number of KPL shares that will be issued in consideration for KGE will depend on the price of the KPL stock, so long as it is within the target price collar. (Tr. pp. 1041-1042) As long as the average market price of KPL common stock is within this range during the relevant period, the total value of cash and stock consideration for KGE common stock will be $32/share. However, if the average market price of KPL common stock goes above or below the limits in the price "collar," then those KGE common stockholders who are receiving some or all of their consideration in KPL common stock will receive total value more or less than $32/share.. If the total consideration that is given to KGE shareholders increases due to average market price, the result will be an increase in the AP. (Tr. p. 575) If the AP increases, the effect is an increase in the level of savings that will be needed in order to recover the AP. (Tr. p. 1044) During the hearing, estimates were that for every $1 the average market price of KPL common stock rises above the upper limit of $23.75, the increase in stock consideration would be approximately $25-26 million. (Tr. p. 576 and 1045) Under the transaction as structured, the specific amount of the AP cannot be determined until the actual date of the transaction when the two companies are merged together. (Tr. pp. 1197-1198) If the book value of KGE decreased or the costs of the transaction increased, the AP would increase. (Tr. p. 1162)

2. The Parties' Positions on the AP

Applicants argue the $32/share offer is reasonable. (Apps. br. at 28) A variety of prices were discussed with First Boston in arriving at the $32 offer price. (Tr. p. 1037) Applicants contend that a number of circumstances, including the hostile takeover bid, compelled a premium and that KCPL's offer had to be overcome in order for any offer by KPL to succeed. (Apps. br. at 29) KPL argues the unique factor in this merger situation which led it to believe that a cash premium would be appropriate or necessary was the fact that KCPL made a hostile tender offer of $7 over book value. (Tr. pp. 1973-1974) KPL did not believe they could win a competitive bidding situation with a $31 offer, based on their analysis of the competitor's capabilities. (Tr. p. 795) Applicants indicated at the time of the offer from KCPL, KGE was trading at approximately $19 per share which was a 52-week low. Immediately after the KCPL tender offer, the share price went above $24. The book value of KGE was approximately $20 per share. Applicants admit that no negotiations had taken place to arrive at the proposed $32 share price offered by KPL, and there was no bidding process. (Tr. p. 396, 398)

Applicants also argue the price offered for KGE was not casually determined. (Apps. br. at 4) Applicants contend that KPL offered $32/share because KPL concluded that the merger would create at least that much value and that $31/share would not succeed. (Apps. br. at 29) Applicants argue the 62 percent premium over book value could be justified because the combined company will result in a company more valuable than the two separate companies. The same service in the same volumes and quality can be produced for less money. For this reason, Applicants contend the assets used to produce those services are worth more. (Tr. pp. 522-523) Applicants contend the unique synergies of a KGE/KPL merger are only recognized in the merger premium. (Tr. p. 2011)

Applicants argue the merger benefits cannot be obtained without paying the premium. (Tr. p. 2008) Applicants claim an AP is a part of the investment. What is being acquired is not the premium, but the assets of the KGE. An investor looks at the extent to which they believe that all future cash flows of the company would result in an increase to the earnings level, and to dividends which would accrue to them. They would also look at future price appreciation. (Tr. p. 2186) Applicants claim the level of savings achievable from the merger depends on the amount KGE shareholders are paid for their shares, because if KGE shareholders are not paid a fair price, the merger will not occur, thus the savings will not occur. (Tr. p. 1993)

Applicants indicate that the whole premise of KPL's proposal was recovery of the AP through cost savings. Applicants contend no harm will result from payment of the premium to customers who are the beneficiaries of the merger. (Tr. p. 2033) Applicants contend the measure of reasonableness is a comparison of the AP with the merger savings and in this transaction, merger savings exceed the AP. (Apps. br. at 30)

Staff argued that the $32/share offer has absolutely no relationship to benefits Applicants claim will arise from the merger. (Staff br. at 11) Staff argues neither KGE nor KPL were concerned with the value of the benefits the merger would produce. Staff argued KGE was concerned with gaining the highest premium possible for its shareholders and KPL was willing to pay whatever premium was necessary to win the bid. (Staff br. at 11)

Staff points to several facts they believe reveal that KPL was not bidding for savings, but rather to win the bid. First, there were no negotiations regarding the offer price. The offer price of $32 was KPL's only offer to KGE and was not a negotiated price. (Tr. p. 1025, 1070 and 2022) The offer price contained elements of both a winning bid and a financial value approach. (Tr. p. 1027) Second, KPL's investment banker did not make an independent evaluation or appraisal of KGE's assets. The asset valuation for KGE's assets included in KPL arriving at their offer price was the book value of those assets. (Tr. p. 1028) Third, Applicants made it clear that KGE's performance would have no effect on the offer price. (Staff br. at p. 11-12) The offer price was not linked directly to the attainment of any specified return on common equity. (Tr. p. 1029) Staff also claims the fact that the total compensation to be paid to KGE common stockholders may fluctuate with the market price demonstrates that the premium KPL has agreed to pay has no relationship to the savings. (Staff br. at 15) Additionally, the costs associated with expenses other than financing would nonetheless be amortized as part of the premium. (Tr. pp. 1956-1957)

Staff argues it would be in the best interest of customers and utilities if the Commission would establish a policy on APs in utility acquisitions. Staff contends that with an established policy utilities would know what to expect with regard to any transaction involving an AP. (Tr. p. 1405) The general policy would be the starting point, and some case-by-case determination may be necessary. (Tr. p. 1406)

CURB argues that the price KPL offered for KGE is excessive and unjustifiable because it is the result of reactive conduct. (CURB br. at 22-23) CURB points to Applicants' testimony that, but for the takeover attempt by KCPL, KPL's merger proposal would not have been made. CURB also refers to statements that the merger was a "fallout" of KCPL's takeover attempt. (CURB br. at 24) CURB argues the reactive and defensive nature of the merger proposal resulted in a merger application that was put together hastily, between mid-August and late October 1990, without thorough considerations and poorly supported. (CURB br. at 27-28) Because of the reactive and defensive nature of the merger proposal, CURB contends the $32/share offer cannot be justified. (CURB br. at 37)

Vulcan argues there is little debate that the KPL/KGE merger application was triggered by and was a reaction to KCPL's hostile takeover attempt. (Vul. br. at 33) Vulcan contends the AP is nearly sixty percent (60%) over book value of KGE common stock at the time the application was filed. Vulcan states this substantial AP represents approximately one-third (1/3) of the combined equity of KPL and KGE; approximately nine percent (9%) of the total assets of the combined companies; approximately eleven percent (11%) of the capitalization of the combined companies; and approximately thirty percent (30%) of the equity of the combined companies. (Vul. br. at 33-34)

Vulcan argues it is clear that the $32/share offer for KGE common stock was never the subject of negotiation between KPL and KGE, was determined without any input from KGE, and was KPL's only offer. Vulcan argues that while KPL may have previously expressed a concern about avoiding a large AP, these concerns did not dissuade KPL from participating in a bidding war with the intent of submitting a preemptive winning bid that resulted in a substantially larger AP. (Vul. br. at 36) Vulcan also expressed concerns regarding the potential for the AP to increase as a result of the manner in which compensation for KGE common stock was structured. Vulcan notes that KPL is not proposing to put a cap on the AP at $388 million. (Vul. br. at 37)

Unlike other intervenors, United Cities argues the Commission should not adopt a generic policy regarding the treatment of the AP, but review each merger and acquisition on a case-by-case basis to determine the criteria under which the AP will be allowed. (U.C. br. at 1) United Cities contends the weight of the evidence before the Commission supports the position that a case-by-case determination best serves the public interest in matters relating to utility acquisitions and the Commission should not adopt and implement a generic rule or policy in this case to be applied to future utility acquisitions. (U.C. br. at 8)

Applicants argue costs that produce benefits, whether in the form of reduced rates, improved services, or otherwise, should be borne by those who realize those benefits. APs that do not benefit customers should not be paid for by them. (Apps. br. at 46) Applicants argue an AP should be allowed when the transaction produces benefits in which ratepayers will share and the transaction would not have occurred without the premium. (Apps. br. at 50) Applicants' position is that their ability to capture cost savings will bring benefits to consumers. (Tr. p. 2047) Applicants propose to use savings to offset amortization of the premium and share the remaining savings with customers. (Tr. p. 2049)

Applicants urge the Commission to determine that any merger savings above the level required to offset the amortized level be shared equally between the combined companies and their customers. (Apps. br. at 46) The estimated savings of $30 million a year will be used up by applying $23 million to the amortization of the premium, and the remaining $7 million in savings would be split between ratepayers and shareholders. (Tr. pp. 579-580) This split of residual savings between ratepayers and shareholders represents a partial return on the AP for shareholders. (Tr. p. 2359) Under Applicants' proposal, if savings are only $10 million in 1993, then only $10 million would be offset against the AP and the merged company would have to absorb the remaining portion of the amortization of the AP for that year. (Tr. p. 2102)

Applicants argue their proposed treatment of the AP reflects a balance of competing goals. (Apps. br. at 46) Applicants contend their proposal for recovering merger costs is appropriate because it puts the risk of achieving anticipated savings on management and shareholders of the combined company. (Apps. br. at 4) If cost savings were not sufficient to cover amortization, KPL would not receive the full amortization in the cost of service. (Tr. p. 1149) Applicants argue their proposal for shareholder "recovery of" and "return on" the premium is contingent upon the merger generating sufficient savings, which has the effect of protecting customers from any negative financial impact caused by the merger. (Apps. br. at 48)

Applicants argue that investors by definition accept the risks that conditions will continue as is or improve to gain required returns on their investments, common equity investors more than others. Applicants contend shareholders will be asked to approve this merger, and no one should be able to preempt that decision. In voting to merge, shareholders take into consideration the expectation of recovering the premium over book value from merger-related savings. If shareholders take the risks of the transaction, they should also have the opportunity to enjoy the fruits of success. (Tr. pp. 1942-1943)

Applicants indicate their only expectation is that the cost of the merger is recovered to the extent it produces benefits. (Tr. p. 1944) The AP serves to motivate management. Applicants have made the recovery of the AP contingent on realizing cost savings. Only when cost savings exceed the annual amortization of the AP will shareholders begin to directly share in the benefits from the merger. Rates will be directly influenced by an ability to achieve projected results. (Tr. p. 2474) Applicants contend a proposal that requests recovery of the AP through rates, only to the extent that merger-related savings are available as an offset, is sound public policy. Any significant AP is not a value which should be refunded to customers. (Tr. p. 1989)

3. Staff's Objections to Proposed Recovery of the Acquisition Premium

Optimally, staff argues the Commission should not allow any recovery of the AP. Staff contends recovery of the AP is inappropriate under traditional ratemaking principles which establish rates based upon book value, not current market value of utility assets, and the Commission has generally denied recovery of the AP. (Staff br. p. 46) Staff also contends if no AP is allowed, acquisition prices will decrease. Sellers may still demand a smaller AP to sell, but utilities have incentives to enter into efficient combinations without recovery of the AP. These incentives come in the form of capturing efficiency savings during periods of regulatory lag while strengthening their competitive position. (Tr. pp. 82-83) Staff urges the Commission to set a policy which effectively denies recovery of APs as a rule, and requires the flow-through to ratepayers of approximately all merger-related cost savings. Staff urges the Commission to make a decision that will discourage unlimited bidding wars that minimize, rather than maximize, ratepayer benefits to be realized from mergers and acquisitions. (Staff br. at 45)

Staff asserts that if the Commission decides that recovery of some portion of the AP is appropriate, there must be demonstrable and quantifiable ratepayer benefits at least equal to the AP and associated transaction costs. (Staff br. p. 46) Staff argued Applicants have not demonstrated that in this case. A utility should be required to prove that the claimed benefits can be estimated with reasonable certainty and would not have been achieved without the merger before recovery of an AP is permitted. (Tr. p. 1659) Further, the fact that the AP does not exceed benefits does not mean that the cost is the lowest cost means of producing those benefits. (Tr. p. 1660) Staff contends its condition would ensure that ratepayers gain at least as much as they give up. (Staff br. at 46-47)

4. Intervenors' Objections to Proposed Recovery of the Acquisition Premium

CURB argues the general rule is that APs are not recoverable from ratepayers. However, some state commissions have allowed recovery by including the premium in rate base where the acquisition was in the public interest and it produced benefits in which ratepayers shared, and where the premium was necessary to bring about the acquisition. CURB argues that recovery of the premium should not cost ratepayers so much that it negates the benefits of the merger. (CURB br. at 10) CURB argues that because the benefits are uncertain, long-term and difficult to measure, if measurable at all, Applicants' proposal for recovery of the premium presents significant problems. (CURB br. at 11)

CURB argues when the winners of a bid pay too much for acquisition of a company in the non-regulated sector, the buyers end up with a company whose cost of production is too great versus what the market will pay for their goods. This results in what has been referred to as the "winner's curse," where the company incurs losses often accompanied by the burden of heavy debt costs taken on to finance the acquisition. (Ex. 58, p. 15) However, in the regulated sector, the consumers are at a much greater risk because some of those costs may be passed through to them. Due to lack of alternatives, less elastic demand means the consumers wind up paying more than they should. (Tr. pp. 1843-1844) In the proposed merger, the synergies do not support the purchase price, and the result is similar to the winner's curse situation. (Tr. pp. 1844-1845)

CURB argues it is essential for the Commission to establish in this proceeding the level of the premium, if any, that will be recovered from ratepayers. (CURB br. at 13) CURB contends if the Commission turns the merger down, it should make it clear that the reason is the magnitude of the AP is disproportionate to the savings that could be achieved. (Tr. p. 1826) CURB warns that if the Commission approves a $388 million adjustment, the recovery of it under some circumstances opens the door for other companies to also come in with extreme proposals for acquisitions. (Tr. p. 1830) CURB asserts that if the Commission decides that ratepayers should pay some part of the AP, only a very limited portion should be allowed rate base treatment. (CURB br. at 3)

Industrial Consumers argue that despite three traditional options for regulatory treatment of the AP, Applicants propose none individually but a combination of the proposals. The three options are: (1) Full rate base treatment allowing "recovery of" the premium as well as a "return on" the premium; (2) allowing "recovery of" the premium but not recovery of the carrying charges, i.e., the "return on" the premium; and (3) not allowing recovery at all. (Ind. br. at 31) Industrials argue that under Applicants' proposal, in any year in which savings do not amount to at least $23.3 million, ratepayers receive no benefits from the merger.

Industrial Consumers argue that because of the amount of the AP, Applicants must recover the AP or the transaction becomes too expensive. The only means available for recovery of the AP is retention of merger savings. Industrials contend if the Commission is going to allow recovery of premium, it must do all that it can to ensure that as much of the savings as possible flow directly to ratepayers as quickly as possible. (Ind. br. at 48-49) Additionally, Industrials recommend that Applicants be entitled to recover only the AP and a reasonable return on it and should not be entitled to retain savings beyond this amount. (Ind. br. at 51) The only way KPL would be able to recover the "return on" the unamortized AP is if future cost savings exceed the revenue requirement associated with the amortization of the AP. If that occurs, a portion of the merger benefits or cost savings could be viewed as providing a "return on" the unamortized AP. (Tr. p. 1709)

Vulcan argues that if utilities wish to employ a "winning bid" strategy and participate in bidding wars, risk should lie with the shareholders and the burden of financing the bid should not be on the backs of ratepayers. Vulcan urges the Commission to send a signal to utilities desiring to merge that the Commission will not allow recovery of APs from ratepayers. (Vul. br. at 37-38)

Vulcan argues the Commission should condition the merger to deny recovery of the costs of amortization of the AP from ratepayers. Vulcan recommends that Applicants recover or pay for the AP from the market place by means of raising equity through the sale of additional preferred or common stock. (Vul. br. at 41) In the alternative, Vulcan recommends that if annual merger-related savings are at least twice or more of the level of the annual cost of amortization of the AP, then Applicants should be entitled to retain savings up to the annual amortization of the AP with remaining savings flowed through to ratepayers. (Vul. br. at 42)

Staff proposed its condition for treatment of the AP with the objective of ensuring that ratepayers receive an equitable portion of the savings and that all parties receive significant benefits. Under staff's proposed treatment, the Commission would establish a minimum relationship of benefits to costs that ensures the combination is being achieved in a cost efficient manner and provide at least an equitable level of benefits for ratepayers. Staff argues the merger as proposed by Applicants does not accomplish this allocation. (Staff br. p. 38)

Staff argued its proposed treatment of the AP created by the merger does not create a disincentive for utilities to undertake efficient mergers. (Tr. p. 83) Staff contends economically efficient transactions will be promoted by applying a consistent policy with respect to the AP and flow through of savings. (Tr. p. 84)

Applicants objected to staff's view that the AP paid in a merger transaction should not be recovered. When dealing with a publicly traded company, the selling company will require a control premium. (Tr. pp. 1953-1954) There are some companies who could afford to merge without recovering their premium. (Tr. p. 1954) There are cases where the acquiring company does not pay a cash premium, but a premium is reflected in the exchange of shares. (Tr. p. 1956) Applicants contend staff's framework denying recovery of any premium would create a double burden for customers by stopping the merger and depriving them of the merger benefits. In addition, as a stand-alone company under staff's framework, KGE would need to increase rates by $33 million. (Tr. p. 1987) Applicants contend adoption of staff's suggestions that the premium not be recovered through rates and that cost savings not be allowed to defray the cost of the transactions would not permit the company to complete the transaction, because it would undermine the financial viability of the merger. If staff's suggestions are adopted, there would be no benefits because there could be no merger. (Tr. p. 1944) Applicants did admit, however, if the same benefits can be achieved without paying an AP, then the premium becomes meaningless. (Tr. p. 1176)

Additionally, Applicants argue staff's framework would engender bad public policy to the detriment of customers and utility shareholders. (Tr. p. 1983) The framework bears no relationship to how the Commission has regulated KGE in the past. (Tr. p. 1983) From 1975 to 1990, KGE's market price was seldom above book value. In many years KGE's earned return fell far short of its allowed return. KGE shareholders lost $297,870,000 as a result of KGE's earned return consistently falling short of its allowed return in those years. Those losses were not transferred to customers, as staff's theory would have prescribed. The circumstances were not unique to KGE, but industry wide, and staff's framework has never been used to solve those problems. (Tr. p. 1985) Another example of how Kansas regulation has differed from staff's framework is the case of Wolf Creek, where KGE shareholders, not its customers, were assigned the risk that Wolf Creek's economic value was less than its book value. (Tr. p. 1986)

5. Analysis

As noted earlier, one of the factors the Commission will consider in evaluating mergers and acquisitions is the benefits available for ratepayers from the transaction. This Commission cannot view transactions that provide no benefits for ratepayers as one that promotes the public interest. To the extent potential benefits for ratepayers are threatened by other elements of the transaction, the Commission will determine whether conditions may be imposed to ensure not only that the transaction creates a utility in a financially stronger position, but also ensure that ratepayers are assured some share in the benefits of the transaction. The Commission believes the following conditions on Applicants' proposed recovery of the AP meet this policy goal.

Despite Applicants' claims that the basis for the AP was the enhanced value of KGE as part of the merged company and the potential for savings, the Commission finds that the basis of the AP was not the projected savings. The Commission is persuaded that KPL's $32/share offer was the result of KPL's white knight response to KCPL's hostile takeover attempt. The evidence is clear that KPL made the $32/share offer in an effort to win the bid for KGE. The evidence in the open hearing as well as the *in camera* proceeding made it apparent that KPL acted to ensure that it would be successful in obtaining KGE. Moreover, it was clear that regardless of the offer price per share, the potential savings from the combined operations identified by Applicants would not change. (Tr. p. 1993-1994) In light of the evidence, the Commission finds that the AP stemming from the $32/share offer price has a very tenuous relationship to the savings identified by Applicants.

Because of the tenuous nature of the relationship between the AP and the savings identified by Applicants, the Commission cannot allow full recovery of the $388 million premium. The Commission has determined that ratepayers should benefit from the merger. Ratepayer benefits should not be jeopardized for the sake of ensuring that utilities are able to fully recover the AP they agreed to pay in their efforts to win the bid for the acquired utility.

Under Applicants' proposal, the vast majority of the benefits resulting from the merger, the synergies generated by the overlapping service territories, would go to recover the AP and ratepayers would be left with the residual savings, if any. The Commission does not believe such a proposal promotes the public interest and rejects Applicants' proposal to recover the entire AP out of the savings generated by the merger.

The Commission can not ensure the recovery of the AP. The Commission can only ensure an opportunity to recover the AP. The Commission believes the appropriate regulatory treatment of the AP is to tie the potential recovery of the AP to benefits that will be realized by ratepayers as a result of the merger. In this case, the amount of the AP to be included in rates shall be tied to the savings reasonably projected to be generated by the merger. Applicants in future merger cases will have the burden of quantifying benefits that will accrue to ratepayers as a result of the merger. The Commission will not necessarily limit benefits to operating cost savings but will look at a variety of factors in determining ratepayer benefits. For example, Utility A is acquired by Utility B and Utility B is able to bring financial strength to make improvements to Utility A; Utility B may be allowed to include in its rates an AP commensurate with the improvements it was able to effect through its financial strength.

In this case where ratepayer benefits are tied to synergies that can be generated from cost cutting measures and synergies resulting from the overlapping service territories, to identify and quantify savings becomes a critical component of Applicants' burden of proof. The savings to be generated by the acquisition must be reasonably identified and capable of quantification, otherwise the Commission has no reasonable way to assess whether there are benefits for ratepayers.

B. THE LEVEL OF BENEFITS RESULTING FROM THE MERGER

Applicants' proposal to recover the AP out of savings and their contention that their ability to capture savings will result in benefits for consumers, requires the Commission to scrutinize the projected merger savings and benefits presented by Applicants. Achievement of savings appears to be the linchpin for not only recovery of the AP, but also for ratepayer benefits. The Commission must be convinced by the evidence that the merger savings levels Applicants presented is reliable enough to ensure the opportunity for recovery of the AP as well as provide ratepayer benefits.

The Commission's job is not easily completed. The savings estimates presented by Applicants and analyzed by staff and several parties span a wide range of estimates. Because the savings are a critical element of the merger as proposed, the Commission must focus on the merger-generated savings that are quantifiable and realizable when determining whether the Applicants' proposal for recovery of the AP is reasonable and whether the merger provides sufficient ratepayer benefits.

1. Applicants' Analysis of Benefits and Costs of the Merger

Applicants argue their savings estimates are conservative in nature and do not reflect the full level of savings and other benefits that will ultimately be achieved from the merger. (Apps. br. at 13) Applicants contend there are a variety of merger-related benefits that either had not been quantified or were incapable of being quantified. Applicants contend that while these benefits may not be capable of being quantified, they nonetheless represent real and substantial factors in favor of the proposed merger. (Apps. br. at 14-15) Applicants argue the greatest risk in this case is that the Commission will forego the benefits of the merger by taking an overly conservative view of their value. (Tr. p. 1946)

Applicants identified six specific areas of cost savings that will result from the merger. First, Applicants contend the merger will enable the companies to consolidate offices where their current service territories overlap. Applicants contend this opportunity is possible because approximately two-thirds (2/3) of KGE's electric customers also receive gas service from KPL. Applicants contend the consolidation of field offices to eliminate functional duplication will create personnel savings, vehicle savings and facility savings. (Apps. br. at 19) Second, Applicants contend headquarters operations will be consolidated after the merger because the need to perform many executive functions separately will no longer exist, reducing the cost of such functions. Applicants estimated that 25 percent of the total corporate positions in duplicate functions can be eliminated. (Apps. br. at 19) Third, Applicants contend the merger will reduce costs in areas of advertising, insurance, consulting fees and annual audit expense. Applicants indicate special projects involving outside experts will be coordinated or combined to eliminate duplicative efforts. (Apps. br. at 20) Fourth, Applicants contend the merger will enable them to establish one dispatch center to control all generation facilities. Applicants contend joint dispatch will result in fuel savings and improved maintenance scheduling. (Apps. br. at 20) Fifth, Applicants contend the merger will eliminate expenses for duplicate management tools by avoiding repetitive development and operating costs that would otherwise have to be incurred separately by both companies. (Apps. br. at 20-21) Sixth, Applicants contend the merger will result in savings in the procurement of supplies and reduction of inventories. (Apps. br. at 21) Savings are projected to consist of both actual reductions in costs and avoidance of costs. (Tr. p. 2420)

Applicants restricted their cost savings analysis to the first five or ten years because they contend the level of cost savings that can be achieved in the near term will continue into the future. (Tr. pp. 2193-2194) Additionally, Applicants indicated that attempting to project savings beyond the five or ten year time frame is highly speculative. (Tr. p. 1079) Applicants claim they will effect the majority of its permanently recurring savings within the first five years. (Tr. p. 2110) However, Applicants contend it is reasonable to assume that savings from the merger will continue beyond 27 years and even indefinitely. (Tr. p. 1187) By extrapolating the estimates out to 27 years, Applicants purported to recognize savings that will continue in perpetuity. (Tr. p. 2198) Applicants claim with their merger tracking proposal, cost savings will be identifiable in the future. (Tr. p. 1946)

Applicants did not agree that savings needed to be reviewed on a net present value (NPV) basis. Applicants argue that to view the cost savings estimates on a NPV basis, use of a terminal value is necessary because merger savings will extend beyond the period of the NPV analysis. In essence, Applicants contend that after the period of NPV analysis[2] savings do not drop to zero, but continue indefinitely. (Apps. br. at 16)

Applicants argue staff was incorrect in its selection of 15 percent as the appropriate discount rate in determining the NPV of cost savings. Applicants contend the item being evaluated is the benefits to be received by ratepayers in the form of reduced rates. Applicants argue the discount rate, in effect, represents an opportunity cost of capital for utility customers. Because it is impossible to determine the exact cost of capital for each customer, the utilities' after or "net of tax" cost of capital is often used. (Apps. br. at 17) Applicants contend that using this methodology, the NPV of cost savings over the next 27 years is $705 million. Applicants contend the NPV of customer benefits with terminal value and after-tax discount rate is $251 million. (Apps. br. at 18)

2. Staff and Intervenors' Analysis of Savings Projections

a. Staff's Calculation of Cost Savings

Staff questioned the credibility of Applicants' savings projections. Staff argues Applicants relied upon 1991 budget information as a starting point for quantifying merger savings. Since a budget is only an estimate of future revenues and expenses, and not based on

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2 The NPV analysis utilized by staff and intervenors in this case included a 27-year period, the useful remaining life on KGE assets and the amortization period for the AP.

actual historical data, the merger savings quantified are essentially estimates derived from estimates. (Tr. p. 1455)

Staff argues that the costs of the proposed merger outweigh the savings to be achieved. Staff estimated the NPV of cost savings available to ratepayers from the merger to be $49.7 million. Staff contends the NPV of total costs of the merger, which staff estimated at $200 million, exceeded the savings of the merger by approximately $137 million. (Staff br. at 8) Staff contended a NPV analysis is appropriate because the Commission must evaluate expected costs and benefits over an extended period of time on an equal value basis and the NPV computation calculates a value in today's dollars of future cash streams. Staff argues this analysis is particularly appropriate due to the nature of the proposed transaction where the costs of the transaction are certain but the expected future savings are uncertain. (Staff br. at 9)

Staff also argues that Applicants have not correctly identified costs they will incur in order to complete the merger. In several merger savings adjustments, staff contends Applicants have in essence netted merger savings and merger costs. (Tr. p. 1465) Applicants have estimated merger costs to be $11 million, not including transaction costs estimated by the Applicants to be $20 million. (Tr. p. 1466) In addition to the potential for an AP greater than $388 million, depending upon the stock market price of KPL common stock, staff claimed the executive compensation agreements built into the merger plan may further increase costs of the merger by up to $9.6 million if covered executives are not retained by the merged company. This would have the effect of further reducing ratepayer benefits. (Staff br. at 16)

The cumulative effect of all of staff's adjustments to the Applicants' 1992-1996 merger-related savings estimate is $35.4 million below the Applicants' estimate. (Tr. p. 1464) In summary, staff estimates the net merger savings to be $105 million for 1991-1996, less than Applicant's estimate of $140 million. (Tr. p. 1467)

Staff analyzed the merger from an overall perspective. The net present value cost of the merger is $136.6 million. (Tr. p. 1637) Staff utilized a net-of-tax discount rate for determining the NPV of shareholder costs and benefits and a gross-of-tax rate to determine ratepayer benefits and costs. Staff argued that to the extent that shareholders bear the costs of the acquisition debt by not obtaining a full return on the unamortized portion of the AP, they will receive a tax deduction for non-recovery of interest. Because the merged company will lose the tax benefits associated with operational expenses that are eliminated, the net effect is that the claimed benefits must be reduced by the amount of lost tax benefits. (Staff br. at 9-10)

b. CURB's Calculation of Cost Savings

CURB argued the merger costs, which are fairly certain, are excessive in relation to the benefits the merger creates. (CURB br. at 15) CURB argued the merger should result in savings, but in an amount substantially less than the $388 million AP being paid for KGE. A long-term savings forecast based on the Applicants' savings assumptions yields a net savings estimate of $398 million, an amount insufficient to support the tax effects and recovery "of" and "on" the AP. CURB urges the Commission to reject the merger due to insufficient savings and increased risk to ratepayers. (Tr. p. 1762)

CURB argued the company's valuation of the projected savings were not strongly based. (Tr. p. 1848) In its analysis, CURB took issue with Applicants' estimates of cost savings in the areas of personnel savings, vehicle savings, facility savings, dispatch and operations, inventory and purchasing, and savings from operating systems. (CURB br. at 41-54) CURB estimated that under their "confident level" estimate, the merger would create savings amounting to $243 million on a NPV basis. CURB performed a long-term cost benefit analysis based upon Applicants' savings assumptions. CURB's forecast revealed a NPV gross savings of $408 million that would require the Applicants to spend $9 million on NPV basis for new programs.

This results in net savings of $398 million on NPV basis. (CURB br. at 39) CURB utilized, in its NPV analysis, a discount rate to reflect the standard after-tax cost of capital to a utility company, which CURB asserts is an approach often used in the evaluation of utility investments. CURB noted that arguments could be made for use of other discount rates in the NPV analysis. (CURB br. at 16)

c. Industrial Consumers' Calculation of Cost Savings

Industrial Consumers argue that under Applicants' proposal, they will not earn a return on the unamortized portion of the AP. Industrials argue these substantial unrecovered carrying costs will exceed the amount of the AP over the 27-year amortization period. (Ind. br. at 12) To evaluate the merger on a common basis, it is necessary to discount the costs and benefits to a present value. (Tr. p. 1717) Industrials estimated that, using Applicants' savings estimates and proposed capital structure, the unrecovered carrying costs associated with income tax requirements will be $72.7 million. From 1992-1999, Industrials estimated the AP plus associated carrying costs will exceed Applicants' estimate of savings by $324.5 million. Industrials argue that if Applicants' estimated savings do not materialize, the unrecovered costs will be even greater. (Ind. br. at 13)

d. Vulcan's Calculation of Cost Savings

Vulcan argues that the financial projections of the combined company are heavily reliant upon initially assumed conditions and based in part on unrealistic and optimistic assumptions and projections. In combination with merger-related savings and revenue requirements for amortization of the AP, Vulcan contends the resulting overall financial scenario is neither attractive nor supportive of the proposed merger. (Vul. br. at 23-24)

e. Applicants' Rebuttal to Objections to Savings Estimates

Applicants argue that CURB and staff have recognized that the combination would generate savings for customers and society in general, but contend the cost savings are understated by them. (Tr. p. 2465) Long-term cost savings and customer benefits identified by staff ($217 million and $49.7 million, respectively) and CURB ($243 million and $43.7 million, respectively) are wrong because both have greatly underestimated the cost savings which can be expected to occur as a direct result of the merger. (Tr. p. 2164) Applicants claim the merger-related cost savings estimates submitted by staff do not recognize the full range of benefits which can be expected as a result of the merger, and the testimony submitted by CURB greatly underestimates the savings levels. (Tr. pp. 2137-2138) Applicants contest the adjustments proposed by CURB and staff are, for the most part, not based upon the empirical analysis conducted by KPL and KGE, but rather are the result of difference in opinions. Applicants assert that CURB's testimony in particular is arbitrary and unexplained and the adjustments made by staff amount to no more than second-guessing of management. (Tr. p. 2139)

Applicants argue staff's calculation is flawed because a terminal value of the cost savings is not included, the discount rate used is inappropriate, and the analysis does not recognize additional benefits which can be anticipated over the 27-year period analyzed by the staff. (Tr. p. 2165) They also argue CURB's determination of long-term cost savings and customer benefits is flawed because CURB has improperly excluded a terminal value of cost savings and therefore has totally excluded savings which can be expected to occur long after the AP amortization period is over. (Tr. p. 2172-2173) Additionally, Applicants claim CURB's projections of the cost savings, like staff's, is flawed because it ignores the long-term benefits of areas in which savings have been quantified, but for which the specific items analyzed cease to exist during the amortization period. (Tr. p. 2173) CURB's discount rate used in determining the NPV of merger-related cost savings and customer benefits is wrong and CURB failed to identify the increased capital costs that they felt would be passed along to the consumer. (Tr. pp. 2174-2175)

3. Analysis

The estimates of the net present value of the total cost savings which might be achieved due to the merger varied by a significant range - from Applicants' $705 million to staff's $226 million. Staff's and CURB's estimates were significantly lower because of disagreements with Applicants' projections on numerous issues, including: how quickly some of the cost savings, such as employee reductions, could be achieved; whether some cost efficiencies, such as joint dispatch of generating facilities, could be achieved in the absence of a merger; and how avoided costs, such as development of a new computer system by KGE, should be calculated. Furthermore, the differences among the estimates were not just disagreements over the kinds and extent of cost savings measures which could be achieved. Significant differences were due to several other factors, including the discount rate used to calculate the net present value and the question of whether to use a terminal value to represent savings which might continue beyond the 27-year period represented in the analysis. As shown on the following table, if the estimates are calculated on a comparable basis with regard to discount rates and terminal value effects, the range of differences narrows considerably.

(Dollars in millions)

15% Discount Rate - No terminal value

*	Staff	226
	Applicants	276
	CURB	162
Midpoint of range		219
Average of range		221

9.25% Discount Rate - No terminal value

	Applicants	489
	Staff	409
	CURB	297
Midpoint of range		393
Average of range		398

11% Discount Rate - No terminal value

	Applicants	404
	Staff	336
	CURB	242
Midpoint of range		323
Average of range		327

9.25% Discount Rate - Terminal value

*	Applicants	705
	Staff	577
	CURB	405
Midpoint of range		555
Average of range		562

* Proposed in Testimony

In determining the expected level of cost savings which might be expected from a merger, the Commission believes it must take a cautious approach since the benefits of the merger to ratepayers will depend on the actual cost savings achieved. At the same time, it is neither necessary nor desirable for the Commission to determine the anticipated savings for each category of estimated savings or to specifically determine the appropriate discount rate to use. Instead, the Commission finds it more reasonable to use its judgment in arriving at the overall cost savings which may reasonably be assumed in determining an appropriate AP. In doing so, there are several significant considerations.

The projections of cost savings are inherently merely estimates of what might occur. There is no objective basis for precisely determining how effectively or quickly the various cost savings measures can be implemented. Although the Applicants may be in the best position of projecting what synergies might be achieved through merger of their operations, they obviously have every reason to present overly optimistic estimates of the benefits of the merger. Additionally, while the Commission believes that the estimates of CURB and staff may not adequately reflect Applicants' incentives to maximize cost savings in order to recover the AP and obtain company benefits of any savings sharing plan, there is another consideration which arises from the Commission's decision in this matter.

The net present value of the cost savings estimates is significantly affected by the projections of how quickly some of the measures may be implemented during the first five years of the merged company's operations. Thus, the Applicants' estimated net present value is greater because it assumes quicker implementation during the first few years. As set forth below, the actual cost savings which are achieved will not be subject to a sharing mechanism until August of 1995. Consequently, the Applicants' estimates of quicker implementation during the first three and a half years should not be given full weight since ratepayers will not receive full benefits of any such quicker implementation.

The use of a terminal value for calculating the net present value of anticipated cost savings may have a theoretical basis insofar as it is designed to reflect the continuation of cost savings for an indefinite period of time. However, it is difficult to conclude that all the benefits of a merger would, in fact, continue indefinitely. This requires an assumption that not only will there be no intervening events which affect the merged company's operations but also that the two stand-alone companies would have continued to operate in their current manner. Since changes in technology, regulations, utility industry structure, and organizational structure of both the merged and stand-alone companies could be expected, the Commission does not believe it appropriate to give much weight to the terminal value effects of measuring the cost savings.

For similar reasons, the Commission must view with some skepticism the avoided costs components of the Applicants' estimates. As discussed below with regard to the merger tracking system, the measurement of costs which might be avoided is very problematic in that it requires assumptions regarding what would happen under hypothetical situations.

Given all the above considerations, the Commission has decided to give roughly equal weight to the three estimates of Applicants, staff and CURB, without inclusion of a terminal value effect, to arrive at a reasonable approximation of the cost savings which might be expected to arise from the merger for purposes of an allowable AP. Thus, the midpoint of the various estimates at the different discount rates without terminal values from the above table results in a range of estimates from $219 million to $393 million. The midpoint of this range is $306 million. An averaging of the estimates within each discount rate results in estimates of $221 million, $327 million and $398 million. The simple average of those estimates is $315 million. Consequently, a reasonable range of estimates is $306 to $315 million. The Commission finds that a reasonable AP is $312 million, which is the average of the midpoints and also roughly corresponds to a price of $29.50 per share, which is half of the difference between the $27 per share offer tendered by KCPL and the $32 per share to be paid by KPL.

The Commission realizes that the actual AP to be paid by KPL is estimated to be $388 million and could change significantly, depending on the KPL stock price and the net book value of KGE at the time of consummation of the merger. However, the Commission believes that ratepayers should be responsible for no more than the reasonably determinable benefits which they can with some certainty expect from the transaction. Consequently, whether the actual AP paid by KPL is more or less than $388 million should not affect the amount recoverable through rates. Since the Commission has found that $312 million represents the cost savings which are reasonably anticipated from the merger, that is the AP which will be permitted, subject to the allocation procedures discussed below.

Although the Commission consequently finds that $312 million is the net present value of the reasonably expected benefits of the merger to ratepayers, that does not end the analysis. Several of the parties have argued that it is insufficient for the merger to merely result in no harm or have minimal net benefits. They suggest that the Commission should ensure that substantial benefits accrue to ratepayers as a result of the merger, if it is to be approved. The Commission agrees. Allowing recovery of an AP equal to the expected cost savings would result in no significant benefits to ratepayers. The Applicants have proposed recovery of the AP through a straight line 27-year amortization without carrying charges. The absence of carrying charges on the AP of $312 million which we have decided to allow would, of course, provide benefits to ratepayers since the net present value of that manner of AP recovery would be less than the $312 million net present value of cost savings. However, the Commission does not believe that that level of benefits to ratepayers is sufficient. Instead, the Commission believes that an amortization period of 40 years, without carrying charges, is more appropriate and increases the benefits to ratepayers to reasonable levels.

Although staff suggested that the Commission should establish a minimum standard for approval of proposed acquisitions and mergers which would require a sharing of realizable ratepayer benefits at least equal to the costs of the transaction, the Commission declines to adopt a hard and fast numerical rule. In the present case, the result of extending the amortization period for the $312 million AP to 40 years is that the annual level of amortization is approximately $12.67 million, including income tax impacts, rather than the $23.4 million which would have resulted from the $388 million AP proposed by Applicants. The Commission believes that under the sharing mechanism discussed below this merger will result in substantial ratepayer benefits. This is due not only to the fact that the net present value of the $312 million AP amortized over 40 years is much less than the value of cost savings but also because the lower annual amortization amounts will allow for greater cost savings to be shared with ratepayers.

It will be necessary in the next rate case to allocate merger savings and the AP between KPL's gas and electric operations and among the jurisdictions in which it operates.

4. Timing of the Amortization

Applicants propose that the premium be amortized and included in KPL rates over a period of years representing the average remaining life of KGE assets. (Tr. p. 523) Applicants urge the Commission to determine that the premium will be amortized over a 27-year period and that recovery of the amortized amounts will be allowed only to the extent of off-setting merger savings.

Applicants also request that the Commission delay initiating amortization of the AP until the next general rate filing, at which time both the cost recovery and the cost amortization would begin. (Tr. p. 1151) Applicants contend under their proposal, there will be no immediate rate impact on the customers of either system as a result of providing for recovery of the AP. Applicants contend the costs associated with the acquisition would not immediately be reflected in rates, and these costs will not impact rates until after the first general rate hearing. (Tr. p. 1150)

Staff opposed Applicants' proposal to delay amortizing the AP until after the first rate case. Staff argued that because the merged company will begin generating savings immediately, and Applicants have claimed savings are currently being generated, the amortization of the premium should begin, if at all, immediately to correspond with the timing of benefits. Because savings begin immediately, the sharing of those savings should begin immediately. (Tr. p. 1489) Otherwise, staff claims, savings accumulated between January 1992 and the time when the first post-merger rate case is filed in 1993 would go entirely to the company. (Tr. p. 1488) Using Applicants' estimate, staff contends nearly $10 million in cost reductions will result from the requested merger in 1992, and $26 million in 1993, all of which would be retained by Applicants. (Tr. p. 1647) Staff contends it is equitable for amortization of the AP and sharing of cost savings to be simultaneously implemented into rates immediately. (Tr. pp. 1652-1653)

CURB argues that if the Commission accepts Applicants' proposal for recovery of the AP, amortization of the AP should begin immediately to preserve savings generated immediately from the merger for ratepayers. CURB contends that delay in initiating the amortization of the AP provides Applicants with the opportunity to recover the entire premium. CURB contends immediate amortization is more equitable and with immediate amortization, costs and savings are matched. CURB notes that deferring the amortization of the AP is worth about $31 million to Applicants. (CURB br. at 11)

Industrial Consumers contend that if Applicants are allowed to defer the amortization of the AP until the first rate case, Applicants will retain all savings that accrue during this time period. Industrials argue that if Applicants do not adopt new rates until 1993, cost savings totalling $36 million in 1992 and 1993 will be retained by shareholders and not used to offset the costs of the AP. (Ind. br. at 39-40) Additionally, Industrials contend that because Applicants did not propose any mechanism for annual true-up, Applicants will retain all savings in excess of those demonstrated at the last rate case until a new rate case is filed. (Ind. br. at 40)

Vulcan contends that Applicants' proposal to defer amortization of the AP until new rates are placed in effect allows Applicants to retain all merger-related savings up until the time of the issuance of the Commission's order in the first rate case. Based upon Applicants' projections, Vulcan claims this will mean Applicants' will retain $10 million in net savings in 1992 and approximately $13 million in 1993. (Vul. br. at 26) Vulcan contends there is no reason to defer amortization of the AP, especially if Applicants are claiming that merger savings will be generated immediately after the merger. (Vul. br. at 27) Vulcan contends it is clear that deferral of the amortization of the AP was proposed for the purpose of substantially assisting the newly merged company in the first few years of operation when the pressure will apparently be the greatest. (Vul. br. at 28) Vulcan recommends the Commission prohibit deferral of amortization of the AP. (Vul. br. at 41)

The Commission believes that ratepayers should share in merger savings as soon as practicable; however, the Commission must be cognizant of the need for the Applicants to have a sufficient opportunity to begin capturing savings so that unexpected events will not frustrate achieving the savings or sharing the benefits. The Commission believes it is reasonable to allow Applicants to defer amortization of the AP until savings are sufficient to cover the annual amortization of the AP. Estimates by the Applicants, staff and CURB indicated that savings would increase each year commencing in 1992, and would reach a consistent level by 1995. Evidence presented by the Applicant indicated that savings should approximate $30 million annually by 1995. Accordingly, the Commission believes that amortization of the AP should commence in August 1995.

The Commission also believes that ratepayers should receive the benefit of savings accruing prior to August 1995. To that end the Commission finds that Applicants KPL and KGE shall be precluded from filing for rate relief until January 1, 1995, and new rates shall not take effect until August 1995. KPL shall not seek general rate relief for its gas operations until January 1995, and new rates shall not become effective until August 1995. The moratorium shall not apply to Docket No. 176,716-U or Docket No. 176,268-U, nor shall it apply to rates ordered and approved by the Commission resulting from safety improvements subsequent to the issuance of this order. Furthermore, to enable ratepayers to share the savings that will accrue prior to commencement of the amortization in August 1995, a rate moratorium shall be imposed. The Commission has previously determined that rate stability is a legitimate public policy goal and finds that synergies resulting from the merger will allow the Commission to implement that goal. In addition, refunds shall be issued to customers as set forth in the findings and conclusions, infra.

C. ANALYSIS OF APPLICANTS' REMAINING PROPOSALS

1. Evaluation of Applicants' Proposed Merger Tracking System

This issue presents another aspect of the Commission's savings analysis. To the extent Applicants are allowed to recover the AP out of merger savings and to the extent ratepayers receive benefits, the Commission is confronted with the issue of a mechanism to measure the savings as well as any unforseen costs which may occur over the course of the amortization period. Applicants' merger tracking proposals drew heated opposition from the parties for which Applicants accepted some responsibility because they were unable to develop a tracking system in time to include in their direct testimony. (Apps. br. at 53)

a. Applicants' Proposed Tracking Mechanism

Applicants presented a merger tracking mechanism which they claim is intended to gather data, capable of being audited, that supports the cost reductions caused by the merger. (Apps. br. at 53) KPL has begun to develop a system to track costs and benefits of the merger. The completed system will provide a comparison between actual costs incurred by the merged company in a given period and the costs which would have occurred had the companies continued to operate separately in that period. (Tr. p. 975) Applicants propose to use June 1990 as the starting point for purposes of tracking merger-related savings. (Tr. p. 2114)

Applicants argue the merger tracking proposal will show the difference between what occurs as a result of the merger and what would have happened on a stand-alone basis. (Tr. pp. 1065-1066) To show there are merger savings, KPL will have to demonstrate that the cost of providing service after the merger is lower than they otherwise would have been on a stand-alone basis. (Tr. pp. 2037-2038) KPL will have the burden of making that showing. (Tr. pp. 2037-2038) KPL contends the cost of service for the merged company, if compared with the stand-alone companies, would be less. Applicants claim they can be very definite about the level of cost savings over time with the cost tracking system. (Tr. pp. 2053-2054) Applicants also indicated there will be costs to implement the integration of the companies. (Tr. p. 2501) Applicants set out the following principles that underlie the tracking system:

i) A benchmark of June 30, 1990, which Applicants contend is the end of the accounting period that most closely reflects the status of the companies prior to any decisions being made in contemplation of the merger, against which cost savings would be measured.

ii) A process to identify the impacts of the merger by Integration Planning Teams.

iii) A process to distinguish between merger and non-merger related events. Applicants propose the criteria for making this determination include whether the cost savings is permitted by the merger and allows the companies to reduce costs through elimination of redundancies, achievement of greater economies of scale, the more efficient use of assets or use of more efficient assets, or the enhancement of revenues.

iv) A process to value these events. (Apps. br. at 53)

Applicants argue the savings to be tracked and the measurement of those savings will be accomplished in the same way that pro forma adjustments or normalization adjustments are developed. This particular system has not been used before, but the principles on which it is based have. (Tr. pp. 2403-2404) Applicants concede there is a higher level of accuracy called for when tracking cost savings in the context of ratemaking than for budgeting or financial forecasting. (Tr. p. 2405)

Applicants argue the system they propose will accumulate and track the savings that result from the merger. (Tr. p. 2382) A total of 54 teams consisting of 100-120 people all together will review day-to-day events and report them back to the merger savings tracking team, at which point they will then be input into the system. (Tr. pp. 2383-2385) Under Applicants' system, each team will be responsible for identifying potential and actual savings events resulting from the merger. (Tr. p. 2373) Each team will have reporting forms to classify individual events as merger-related or non-merger related events. (Tr. p. 2374) Applicants argue the person that is most knowledgeable about the event will be the person who makes the initial decision as to whether an event is merger-generated savings. (Tr. p. 2387) Clear-cut criteria has been established for determining whether a savings is merger related. (Tr. p. 2388) Applicants contend potential merger savings are already occurring. (Tr. p. 2391)

Applicants indicate that under their system each event will be documented. (Tr. p. 2392) The possibly thousands of merger tracking forms that the 54 merger implementation teams will fill out will create a trail that would be subject to audit by staff at least before any rate case, if not more often. (Tr. p. 2413) If the conclusion is that an event is not merger related, then all of the accumulated savings would be re-examined, which is very easy to do since the merger tracking system is event driven. (Tr. p. 2419) Applicants contend the merger tracking system could go on indefinitely. (Tr. p. 2422)

Applicants argue their proposed cost recovery mechanism of the AP would not necessarily require specific tracking of the savings for the life of the amortization of the adjustment. (Tr. p. 2005) Applicants contend it is practical to track those costs for five or six years, because most of the cost efficiencies will be effected in that time frame. (Tr. p. 1067) Applicants contend that because merger savings will most easily be identifiable in the early years, the tracking system need not be used for the full 27-year amortization period and at some point in the future some marker or index system could be adopted to supersede the tracking system. Applicants contend the exact form of the alternate procedure need not be determined now. (Apps. br. at 54-55) Applicants contend that after tracking savings for three to five years, the Commission will be in a better position to assess the appropriate mechanism to divide the fruits of the merger among affected groups. (Apps. br. at 55)

Applicants argue that although identification of merger benefits would involve some judgment, it is a judgment based on a set of criteria and has the ability of being reviewed through the normal chain of command, up through the schedule of authorizations, and also by external people including staff and CURB. Applicants contend that under their system, they bear the risk of substantiating merger savings, and the Commission ultimately will review the propriety of any claimed savings. (Apps. br. at 54) The person who documents an event as a merger or non-merger related event will have to determine the degree to which the savings are merger related. No estimates have been made with regard to the cost of implementing the merger tracking system. (Tr. p. 2426) Applicants contend it will not create too much of a burden on staff to audit the system. The auditors will only be concerned with those savings events that are merger related. (Tr. p. 2423)

b. Staff's Position on the Merger Tracking System

Staff argues Applicants have proposed a system that has never been used before anywhere. At best, staff contends, Applicants' proposal for a merger tracking system is problematic. Staff argues the proposed merger tracking system attempts to identify cost savings by comparing the merged company's cost of service with hypothetical stand-alone companies and would be based upon unverifiable opinions of company management. Because the purpose of the tracking system is to determine the difference between what actually occurs and what would have occurred on a stand-alone basis, to demonstrate merger savings, Applicants will be required to show the cost of service is lower than it would have been for the stand-alone companies absent the merger. As such, it will be imperative to know what costs would have been incurred by two non-existent companies. (Staff br. at 27)

Staff believes there are significant problems with Applicants' proposed merger savings tracking system, including their proposed treatment for the years in which merger costs exceed merger savings. (Tr. pp. 1468-1469) Savings would not only need to be tracked in the first years after the merger, but also throughout the 27-year amortization period. (Tr. p. 1469) Staff contends the merger tracking system, from the information Applicants have provided, is based on too many unverifiable assumptions and estimates to make it a viable system. (Tr. p. 1473) Staff argues Applicants' presentation of the merger savings retained by ratepayers and merger savings given to stockholders in the application is oversimplified. (Tr. p. 1478) If the merger is approved, Applicants have indicated that there will be a gas rate case filed in 1993, at which time Staff would be required to go back and audit every decision made by individuals in the company who had identified merger-related savings. (Tr. pp. 1487-1488) Staff contends that while the AP will certainly endure for the 27-year amortization period, it is less certain that the savings from this transaction will endure during that period. (Tr. p. 1508)

Staff argues that under Applicants' proposal, the identification process is necessarily extremely subjective. Staff contends there will be no strong objective basis for knowing what would have happened absent the merger. (Tr. pp. 1473-1474) Staff's biggest concern involves the judgments required in identifying those savings. (Tr. p. 1491) Additionally, in order to share precisely 50 percent of merger-related savings with ratepayers, an annual rate case, or "true-up" would be necessary, as savings have been projected to vary from year to year. (Tr. p. 1490)

Consequently, staff argues, Applicants' proposal requires a radical departure from the Commission's practice in setting rates. (Staff br. at 27) Staff contends the Commission has traditionally set rates based upon historical data adjusted for known and determinable changes.

Staff argues that under Applicants' proposal, the Commission will be required to abandon its known and determinable standard for making adjustments to the cost of service by speculating about what non-existent companies would do in the future. Staff contends the Commission will be required to not only determine the level of savings, but also make a determination as to "why" the savings occurred. A system to objectively determine "why" savings occurred is simply impractical. Additionally, staff argues the subjective evaluations required to determine "why" savings occurred, which the Commission will be required to review, will be performed by individuals who are unavoidably biased, regardless of their intentions. (Staff br. at 28-29)

Moreover, staff argues auditing the tracking system would require substantial resources that would be costly and further reduce savings to ratepayers. (Staff br. at 29-30) Staff contends there will be great difficulty in auditing the Applicants' proposed merger tracking system. (Tr. p. 1492) Staff argues its review of the thousands of yearly forms reflecting subjective decisions of the Applicants will be terribly time-consuming and burdensome. Staff believes adoption of a merger tracking system will result in contentious proceedings wherein the parties will attempt to measure the savings resulting from the merger. (Staff br. at 29-30) In lieu of the proposed merger tracking system, staff proposed that Applicants be required to work with all interested parties concerning the development and implementation of an alternative merger tracking system to measure merger cost savings. (Staff br. at 59)

c. Intervenors' Positions on the Merger Tracking System

CURB argues Applicants' merger tracking proposal is impractical. CURB contends that savings cannot actually be measured, but must be estimated. Additionally, CURB contends the problems of estimating savings grow exponentially as time passes. Although the proposed mechanism appears to be based upon identifiable "events," Applicants would effectively be attempting to construct hypothetical stand-alone power systems for hypothetical stand-alone companies. CURB argues that Applicants' proposal implicitly assumes that KPL and KGE, absent the merger, would continue to exist as they exist today and the companies' cost of service would not be affected by changes in technology or other factors. (CURB br. at 56) Moreover, CURB contends the range of evidence, analysis and debate will be much softer than that traditionally relied upon in determining revenue requirements. (CURB br. at 57) CURB argues the tracking system requires the merged company to hypothesize costs for the stand-alone companies that no longer exist. (Tr. p. 1853) The proposed cost tracking system will add up the series of individual adjustments as to what occurred because of the merger. It is difficult to determine the savings of events in the negative, that is, if costs are not incurred because of the merger, but would otherwise have been. (Tr. p. 1857) The tracking system attempts to pick up all savings, but this becomes difficult without a strong objective basis. (Tr. pp. 1858-1859)

CURB argues the subjective nature of the mechanism will present a vehicle for Applicants to bolster their claimed savings and thereby their share of savings. CURB argues challenges to Applicants' claimed savings will be difficult, expensive and contentious. (CURB br. at 57) The person making the decision in the tracking system would have to be unbiased. (Tr. p. 1860) However, there is a built in bias for Applicants to achieve savings, which will be recovered dollar for dollar. (Tr. p. 1861)

Industrial Consumers argued the cost tracking mechanism originally proposed by Applicants cannot realistically be implemented over the next 27 years. (Ind. br. at 34) Industrials contend that while the process seems uncomplicated at first, it is wrought with unanswered questions that must be answered for every purported cost savings event. The process will be infinitely more complex with time. (Ind. br. at 35) Industrials contend the individual recording the cost savings events will be forced to hypothesize about what would have happened to each company had there been no merger. Additionally, Industrials contend that savings resulting from technological changes must not be recorded as being merger related.

However, because technological savings will be mixed in with merger-related savings, the system as proposed will not be able to distinguish between them. (Ind. br. at 36)

Industrial Consumers also argued the proposed tracking system would require the exercise of substantial discretion on the part of Applicants and consequently, significant oversight by the Commission and its staff. (Ind. br. at 37) Industrials argue that because merger-related savings inure to the benefit of the Applicants under their cost-sharing proposal, there will be a tremendous incentive for company officials to err on the side of the company. (Ind. br. at 38) Industrials further contend the alternative proposals presented in Applicants' rebuttal testimony lacked sufficient detail for the Commission to properly evaluate and should be rejected. (Ind. br. at 39)

Industrial Consumers proposed the condition that Applicants come forward with a detailed, well-developed tracking system and prove they have accounted for the difficulties highlighted by the parties in the proceeding. These include demonstrating the proposed system can account for technological change, remove entries previously designated as merger related but no longer such, accurately approximate the actions of the stand-alone companies absent the merger, and determine what proportion of additional costs are avoided because the company is one instead of two when expenditures are made. (Ind. br. at 52)

Industrial Consumers also proposed the condition that Applicants carry the burden throughout the tracking period to prove each and every savings that has been recorded as merger related, and the burden should never shift to the auditor to disprove a claimed savings. (Ind. br. at 52) Industrials also propose the Commission require an annual true-up of savings which should consist of an annual audit of merger-related savings conducted by an independent auditor. (Ind. br. at 50)

Vulcan argues that uncertainty abounds with respect to devising a system to measure merger-related savings and that even Applicants, despite their proposals in rebuttal testimony, have not concluded which mechanism should be utilized and made no recommendation to the Commission. Vulcan contends that the evidence makes it clear that the system as proposed by Applicants requires the Commission to determine, hypothetically, the prudent costs that would have been incurred by the two utilities over the next 27 years had the merger not taken place. (Vul. br. at 29) Vulcan contends that Applicants' merger tracking system, which is premised upon estimating prudent costs of hypothetical stand-alone companies for the next 27 years is speculative, unworkable and inappropriate. Vulcan proposed the condition that all merger-related savings be verified on an annual basis by an independent audit source, the cost of which should be borne by Applicants and not included as an expense item recoverable from ratepayers. (Vul. br. at 42)

d. Analysis

The Commission rejects the merger tracking system proposed by Applicants. The basis of the proposed system is the determination of the costs that would have been incurred on a stand-alone basis had KPL and KGE remained stand-alone entities. This would effectively require the Commission to make a finding regarding the cost of service and revenue requirement levels for utility companies that ceased to exist. The Commission would be in a position of taking into account any and all events, technological, economic, natural phenomena or otherwise, in determining revenue requirement levels for nonexistent companies. The Commission refuses to head down the path in which it will be required to engage in guesswork regarding nonexistent companies to determine savings from the merger. Nor can the Commission ignore the subjectivity inherent in Applicants' proposal for identifying savings events. The expense and time needed to track, quantify and audit the thousands of savings events that Applicants anticipate they will identify would represent a substantial cost which would diminish the benefits of the merger. Furthermore, the time and effort of staff audits and Commission proceedings regarding the tracking system is administratively unworkable and undesirable given the Commission's limited resources.

The Commission fully recognizes the need for a mechanism to determine savings levels for purposes of allowing recovery of the AP but believes that reasonable results can be reached without the burdensome and subjective intricacies of the proposed tracking system. The Commission believes this should be accomplished by use of a benchmark to compare operating costs of the merged company with the historic stand alone costs. The benchmark should be adjusted to reflect changes in costs which would be expected in the absence of the merger so that differences in the actual costs from the adjusted benchmark may be presumptively attributed to the merger. The Commission therefore finds that the period commencing on July 1, 1989 and concluding on June 30, 1990, should be utilized as a pre-merger base year level of operating costs for KPL and KGE. The normalized operation and maintenance costs of the two companies as stand-alone entities will be quantified. These base year levels will then be adjusted on an annual basis. Staff shall utilize the consumer price index for urban cities or another appropriate index which is mutually agreed to by staff and the Applicants. The merged company's operation and maintenance costs (excluding depreciation, taxes, fuel, purchased gas and purchased power or similar items), which will be subject to special procedures, will be multiplied by the chosen index and also adjusted for substantial changes in regulations or pertinent laws, e.g., new taxes, fees, or regulatory requirements for any extraordinary event that significantly affects the merged company and which the company can clearly demonstrate was outside its control, which is not reflected in the index. The Commission believes it is appropriate to establish a rebuttable presumption that any difference between the actual cost of service for the merged company and adjusted base year levels constitute merger savings. While this mechanism will not provide a perfect measurement of the savings generated by the merger, the Commission believes the index mechanism is reasonable. It will provide the Commission with a measuring mechanism while avoiding the guesswork inherent in Applicants' proposal and does so with lower administrative burden.

The Commission directs Applicants, staff and intervenors to meet and discuss the index mechanism that meets the requirements imposed by the Commission and to provide the Commission with a proposed mechanism and procedures by July 1, 1992. If the parties are unable to reach agreement by that date, the Commission will establish further proceedings to address the matter.

It should be noted that we have excluded fuel and purchased gas and purchased power costs from the indexing mechanism. This is for two separate reasons and requires elaboration. Purchased gas costs were not projected to be affected by the merger and will continue to be subject to a Purchased Gas Adjustment (PGA) clause in KPL's gas tariffs. Due to the changes occurring in the gas industry, driven in large part by new and proposed Federal Energy Regulatory Commission rules, there is some uncertainty concerning gas prices so that changes in the PGA would not be reasonable at this time.

However, the Commission has decided to take this opportunity to require the Applicants to eliminate their respective Energy Cost Adjustment (ECA) clauses contained in their tariffs for electric service. In the last several years, the Commission has approved of such ECA elimination for other electric utilities and believes it an appropriate time to do the same for KPL and KGE. These clauses, instituted in the mid-1970s, were designed to allowed for monthly adjustments in the fuel and purchased power components of the cost of electricity. Such monthly adjustments were appropriate because of the rapid escalations and fluctuations in the costs of fuel at the time. However, the existence of the ECAs also lessened the utilities' incentives to keep such costs as low as possible because there was very little lag in recovering cost changes through rates charged to customers, as there is with regard to other costs. Since fuel costs are now much more stable and the Commission desires to provide additional incentives to the utilities to manage their costs as efficiently as possible, it has been eliminating the ECAs on a case-by-case basis as the opportunity arose.

We are therefore directing the Applicants, staff and any other interested party to discuss how the Applicants' respective ECAs should be eliminated. The Commission directs staff to initiate a separately docketed proceeding to consider the elimination of Applicants' energy cost adjustment clauses, under the following guidelines. KPL shareholders will assume the risk of not achieving fuel savings from joint dispatch during the moratorium period. Likewise, any fuel savings actually achieved during that period will go to the shareholders. Ratepayers are guaranteed merger benefits during this period by virtue of the moratorium and the ordered refunds. In arriving at appropriate fuel costs to include in KPL and KGE's rates, in lieu of their energy cost adjustment clauses, average actual historical generating plant operating statistics since Wolf Creek commenced commercial operation in September 1985, and estimated fuel and fuel transportation costs during the moratorium period are to be used.

If the parties cannot reach resolution within a reasonable time, which we believe should be six months at most, they shall report that fact to the Commission.

The Commission's decision to eliminate the ECA, however, also affects how the indexing mechanism discussed above should operate in order to approximate the merger-related savings which are due to "joint dispatch." The cost savings projected with regard to joint dispatch of the Applicants' generating facilities arise from the more efficient use of those facilities. Consequently, the cost savings comes not only from the effects of using less fuel in the future but also from the use of less fuel which would otherwise be subject to price increases in the future. The ECA mechanism which we are eliminating, would, of course, have provided for such savings in total fuel and purchased energy costs to be passed on monthly to ratepayers as they actually occurred. In contrast, if an indexing mechanism like that discussed above which assumed certain levels of price change were applied generally to fuel and purchased power costs, the savings component associated with price increases could be overstated and in any event would correspond to actual price changes only by coincidence. Consequently, it appears that the application of the indexing mechanism to price changes in fuel and purchased power might be too drastic a change from the current existence of an ECA and that some other mechanism is necessary which would permit identification or approximation of joint dispatch savings - perhaps involving the application of actual per unit price changes to the quantities saved through joint dispatch. We therefore expect that this particular area of determining cost savings associated with the merger will need special attention from the parties.

2. Applicants' 50/50 Sharing Proposal for Savings

a. Applicants' Support for the Sharing Proposal

Applicants propose that customers and KPL share equally in all cost savings above the revenue requirement supporting amortization of the cost of merger. (Tr. p. 524) Applicants urge the Commission to determine that any cost savings above the level required to offset the annual amortization of the AP be shared equally between the combined companies and customers. (Apps. br. at 46) Applicants contend their cost recovery mechanism permits a "return of" and "return on" the AP to the extent justified by savings. (Apps. br. at 27) Applicants propose sharing savings on a 50/50 basis with ratepayers for succeeding years after the initial rate case. (Tr. pp. 2097-2098) One of the components recognized as a carrying cost associated with a utility investment is a return on investment. A return on investment is often calculated for purposes of determining what the return component might be; and in terms of looking at a carrying cost, a return amount system is usually a component of total carrying cost. (Tr. p. 2314) Applicants contend the proposed treatment of the AP and the sharing of savings above the amortization level fully protects customers from any negative financial impact caused by the merger. Applicants contend their proposal places the shareholders on the first line of risk that savings will not materialize because if savings do not materialize beyond the amortization levels, shareholders will not receive a return on their investment. (Apps. br. at 48)

Applicants argue that while intervenors speculate the proposal could result in pressure on the Commission to shift the burden of the AP to customers, the Commission retains all necessary authority to protect customers. (Apps. br. at 50) Applicants contend that if the division of merger savings results only in a return of 4.5 percent on the AP, then the Commission can ensure that this is all shareholders will receive. Applicants contend that utility regulation does not guarantee a profit to shareholders. (Apps. br. at 26-27) Additionally, Applicants argue that the fact that merger savings may not produce a full return on investment does not mean the Commission will automatically increase the combined company's authorized rate of return. In view of the financial forecasts for the merged company, Applicants argue key financial parameters will be consistent with an "A" credit rating. (Apps. br. at 27-28) Applicants are not requesting a full return on the capital required to finance the acquisition. (Tr. pp. 1146-1147) Applicants admit that the stockholders are foregoing a return on the premium associated with the transaction. (Tr. p. 2315) However, for the period from when a rate case is filed until the next rate case is filed, Applicants concede one effect of their proposal could be that the company retains all savings that are in excess of those which were proved in the rate case. (Tr. p. 2098)

b. Staff's Objection to the Sharing Proposal

Staff argues the proposed sharing mechanism creates an incentive for the merged company to overstate merger savings. Staff contends that while the sharing mechanism provides a high degree of motivation to achieve the cost savings, the incentive is a double-edged sword and there will be a temptation to overestimate savings in the regulatory arena. (Staff br. at 25-26) Additionally, the savings that would be shared with shareholders are effectively savings that would otherwise reduce the company's cost of service to ratepayers. (Tr. p. 1200) Staff argues that under Applicants' proposal, rates would not be based on historical cost of service, which is the traditional method for setting rates in Kansas, but on some level of costs that includes historical cost of service plus some level of "phantom" costs which represents recovery of the AP and Applicants' 50 percent share in the residual savings. Staff argues that Applicants have a clear incentive to claim as many "phantom" costs as possible so they can retain revenues from their share of the cost savings, which would be imputed to rates. Staff contends Applicants face temptation to both overestimate the cost savings that are actually achieved or mischaracterize actual cost savings that are not merger-related. (Staff br. at 26)

Staff also argues the Applicants' "sharing" proposal creates incentives for Applicants to focus on merger-related savings, which would be shared with shareholders, at the expense of other cost savings efforts that would go entirely to ratepayers. Staff contends major resources have already been devoted to the merger tracking system and Applicants would be further preoccupied, if not driven, by merger-related matters if the merger is approved. (Staff br. at 30) Staff argued that Applicants' responses in the hearing make it apparent that Applicants are not interested in pursuing non-merger related cost savings, which must flow directly to ratepayers. Staff also argues that between the use of substantial resources for the merger tracking system and the incentives to legitimately reduce personnel, there could be insufficient resources to explore other operating efficiencies that would otherwise benefit ratepayers. Staff contends such lost opportunities are another cost of the proposed merger. (Staff br. at 31)

However, staff also indicated that because the AP will not be included in rate base for ratemaking purposes, the costs of financing the AP will be shifted to shareholders. Staff contends KPL shareholders will be harmed to the extent that the equity component of financing does not earn a return and interest costs associated with the acquisition debt are not recovered from ratepayers. (Tr. p. 1628) Staff contended that shareholders of the merged company will incur substantial net costs as a result of the merger, especially in the early years following the consummation of the merger. The shareholder costs assume that the ratepayers will provide the recovery of the $388 million AP through annual payments of $14.3 million before income taxes. Shareholders will also receive one-half of the excess merger savings over the amortization of the AP. If the Applicants do not receive Commission approval of either of these requests, shareholder costs under Applicants' proposal will increase. (Tr. p. 1636-1637)

c. Intervenors' Positions on the Sharing Proposal

CURB contends that using Applicants' projections, no merger benefits would be reflected in rates until the second year and benefits for each of the first five years are inadequate to achieve full recovery of the amortization of the investment plus provide a full return on it. (CURB br. at 19) CURB argues that using Applicants' savings estimates and the 50/50 sharing proposal, KPL would earn only a 4.31 percent return on its investment over the 27-year life of the merger investment. (CURB br. at 17) Under the 50/50 sharing proposal, the company will not achieve a return on investment above 4.5 percent. (Tr. p. 1789) With Applicants' projections, CURB contends KPL will lose $220 million after tax, while ratepayers gain only $72 million. (CURB br. at 17) CURB contends that using its more realistic "confident level" of savings, KPL will suffer $277 million after-tax loss on investment while ratepayers receive only $28 million in benefits. (CURB br. at 17-18)

CURB argues that if the merged company were receiving a normal return apart from the premium, under-performance of investment would reduce the average return below the normal return levels being predicted by Applicants. CURB contends that based upon its more "confident level" savings projections, KPL's return on equity (ROE) is reduced to 9.4-10.7 percent range. Earnings per share would fall to $2.03-2.39 range in 1992-96. Assuming KPL would plow back retained earnings assumed in its projections, the amount available for dividends on common stock would fall to $1.42-1.56 range.[3] (CURB br. at 20-21) CURB argues this results in financial stress which may cause credit ratings to fall, which would increase carrying cost of the premium, which could result in a downward spiral. CURB contends savings will have to be $27 million per year greater in real 1992 dollars for the investment to earn a normal return under Applicants' proposal. (CURB br. at 21-22) CURB contends Applicants' inability to earn an adequate return would put pressure on the merged company and the Commission to make regulatory determinations that improve earnings. (CURB br. at 35)

Industrial Consumers argue that Applicants' proposed treatment of the AP and the sharing proposal unfairly burdens Kansas ratepayers. Industrials contend that under Applicants' proposal, ratepayers cannot recover any benefits from the merger until KPL recovers each and every penny of the amount to be amortized each year. Industrials argue that, under Applicants' proposal, when savings do not amount to at least $23.3 million, ratepayers receive no benefits from the merger. Industrials also argue that this proposed sharing is inconsistent with Applicants' proposal in Missouri, where ratepayers share in merger savings on a 50/50 basis from the first penny of savings. (Ind. br. at 32-33)

d. Proposed Conditions to Sharing of Savings

Staff argues that under Applicants' "sharing" proposal there is no guarantee that ratepayers will receive any benefits because more than $23.4 million in cost savings must first be realized before ratepayers have the opportunity to receive benefits. Staff contends the public interest is not served unless ratepayers are assured some benefits from the merger. (Staff br. at 54) Staff contends sharing of savings from the initial dollar rather than after the annual recovery of the amortized AP would ensure ratepayers receive some amount of ratepayer benefits regardless of the ultimate savings achieved. Staff proposes that ratepayers receive 10

3 KPL has made a commitment in its merger agreement with KGE to maintain a dividend level of $1.80 per share. (Tr. p. 1025)

percent of the initial $25.7 million in annual cost savings and an increased percentage each year thereafter so that the remaining percentage of estimated savings would still recover amortization of the AP. Staff argues under this proposal, Applicants would still be reasonably assured of recovery of the annual amortization level of the AP. (Staff br. at 55)

Staff proposes that another alternative is that all cost savings after annual recovery of the amortization of the AP should go to ratepayers until ratepayers receive benefits equal to the AP and transaction costs of the merger. (Staff br. at 56) At a minimum, staff recommends the sharing mechanism be 70/30 to recognize the additional ratepayer risks posed by the transaction. Staff contends the 50/50 sharing proposal is premised on Applicants' claim that risks of the merger are being borne equally by the company and ratepayers. Staff argues this fails to recognize that ratepayers are exposed to significant risks stemming from the fact there cannot be absolute guarantees to insulate ratepayers from additional capital costs; Applicants' incentives to attribute as much costs savings as possible to the merger; an incentive for Applicants to focus their efforts on merger-related savings at the expense of other non-merger related savings; and that ratepayers would share in savings only if savings exceed the amortization level of the AP. (Staff br. at 56-57)

Industrial Consumers propose that as a condition of the merger, ratepayers share in the merger-related savings from the outset. Industrials contend such a condition would serve to dilute some of the harmful effects on ratepayers and would be equitable. (Ind. br. at 48) Regardless of the size of the savings between Missouri and Kansas, if Missouri ratepayers are able to share in savings from the first penny, Kansas ratepayers should also be entitled to such savings. (Ind. br. at 49) Industrials also propose that ratepayers and shareholders should share savings on a 50/50 basis only to the extent that the AP and a return on the AP is recovered. Subsequent to this point in time, Industrials propose that ratepayers receive all savings from the merger. In effect, Industrials propose to cap the level of savings Applicants will be able to maintain at a level that recovers the AP and a return on the AP, and any additional savings would flow completely to ratepayers. (Ind. br. at 50-51)

Vulcan proposes that sharing merger savings should occur as follows: If annual merger savings are less than twice the annual amortization of the AP, the merger savings shall be split 50/50 between ratepayers and shareholders. Any difference between the annual cost of merger and one-half share allocated to Applicants shall be a loss borne by Applicants' shareholders. (Vul. br. at 42) Alternatively, if annual merger savings are at least twice or more of the amount of annual cost of the amortization of the AP, Applicants shall be entitled to retain merger savings only up to the annual amortization with the remaining savings flowing to ratepayers. (Vul. br. at 42)

e. Analysis

The Commission finds that it is appropriate for ratepayers and shareholders to share merger generated savings above the annual amortization level. Sharing savings above the annual amortization level will provide Applicants with an opportunity to recover the carrying costs of the allowed AP while minimizing the financial pressure on the merged company. The sharing of savings will commence when the amortization of the AP begins in August 1995 or whenever rates go into effect after the first general rate proceeding filed by the merged company or one of its divisions, whichever is later. The sharing of savings will be on a 50/50 basis between ratepayers and shareholders after taxes. In light of the Commission's determination to allow recovery of only $312 million AP, as opposed to the entire $388 million or larger AP, and the decision to extend the amortization period to 40 years, ratepayers will be assured a greater level of the savings once amortization begins in 1995. At this time, the Commission is not allowing the AP to be put in the rate base. The Applicants' only opportunity to earn a return of or on the allowed AP will be from merger-related savings. All savings above the allowed amortization will be shared 50/50 between customers and shareholders. The risk of achieving savings sufficient to earn a return of or on the allowed AP is entirely on the Applicants. These factors, therefore, require that all merger savings, other than 50 percent of the savings above the allowed amortization, will be excluded from cost of service in determining whether or not the merged company is earning its allowed return.

3. Revised Depreciation Rate for JEC

Applicants request that the Commission approve modification of the depreciation rates associated with the JEC. The changes are requested based on a recent evaluation of its operational life and measures to extend it. Applicants contend that as a result of a recent evaluation of the JEC, they are proposing that the service life be extended from 35 to 40 years. (Apps. br. at 56) Applicants contend that by giving JEC a 40-year operational life, customers will be benefitted by more accurately reflecting expected depreciation levels and providing additional cost savings at the time of the merged company's next general rate case. (Tr. p. 977) Applicants urge the Commission to approve their request to increase the service life of JEC to permit the merger to proceed. (Apps. br. at 57)

Staff argues the proposed change in depreciation rate at JEC is totally unrelated to the merger and should not be viewed as a ratepayer benefit stemming from the merger. (Staff br. at 39) Staff contends that if the JEC depreciation rate is modified, then KPL's rates must be changed in order to avoid over-recovery. (Tr. p. 1643-1644) This is necessary because any reduction in cost of service should result in reduced rates for customers. Staff recommends that an independent investigation be conducted by staff to determine whether the proposed JEC depreciation rate change should be implemented. (Tr. p. 1664)

Applicants contest staff's position that the increase in service life and decrease in depreciation rate be accompanied by immediate recognition in rates. Applicants contend staff's position wholly ignores the September 1, 1991, expiration of deferred tax amortization for KPL that will effectively increase KPL's cost of service by $9.3 million annually. Applicants also argue staff's position fails to recognize that the depreciation rate change is an integral component of the overall merger plan. (Apps. br. at 56-57) Applicants argue there is no rule that requires a simultaneous change in service rates when depreciation rates change. They agree there is no basis to assume revenues will be excessive after the change occurs. This change will have no immediate effect on Applicants' rates, but will tend to reduce them in next rate case. Applicants contend the accounting proposals are essential elements of the merger plan, and as such the Commission should not change them. (Tr. p 2017)

Industrial Consumers argue the savings generated from changing the depreciation rate at JEC are not merger related and could occur without the merger. As such, Industrials argue these savings should not be considered as merger related and should be flowed through to ratepayers currently. (Ind. br. at 53)

Vulcan argues that Applicants' proposal to modify the depreciation rate change which allows the merged company to achieve $6-6.5 million a year is not supportable unless a corresponding change in rates is made in conjunction with any change in the current JEC depreciation rate. Like the proposal to defer the amortization of the AP, Vulcan contends the purpose of the proposal to change the depreciation rate for JEC is for assisting the merged company in the first few years of operations when the pressure will apparently be the greatest. (Vul. br. at 28)

The Commission approves the change in the depreciation rate for JEC to extend the depreciable life to 40 years. While the depreciable life of JEC may be unrelated to the merger, the change helps the merged company to maintain its financial stability during the time that savings are getting started. The change promotes the public interest by ensuring the merged company has ample opportunity to begin combining operations without putting undue financial pressure on the merged company.

4. Proposed $15 Million Rate Decrease for KGE Customers

Applicants proposed some changes in accounting conventions for two reasons: (1) they will help reconcile the differing accounting methods used by the two companies; and (2) they will assist in maintaining the financial profile of the merged company in the period immediately following closing by providing temporary benefits. (Tr. p. 976) Applicants proposed to reduce rates by $15 million in KGE's service territory subsequent to the merger. Applicants indicated this rate reduction represented a flow-through of cost savings in advance of reflecting cost savings in rates after the first rate case. (Tr. p. 1369) Applicants are prepared to offer rate reductions in advance of realizing equivalent merger-related savings which would dilute earnings and could be seen as negative. The changes KPL is proposing would offset this effect and accommodate the merger. (Tr. p. 976) Applicants contend it is easier for the merged company to make the $15 million reduction in rates ahead of savings by changes in accounting conventions and depreciation rates. (Tr. p. 1074)

Because Applicants anticipate substantial merger-related cost savings and want to immediately share the anticipated savings with customers, the $15 million rate reduction is offered as an immediate benefit to KGE customers. However, Applicants claim KPL customers' electric rates will not be reduced, as they are already paying lower rates than KGE customers. (Tr. p. 1369) The $15 million rate reduction is to be implemented when the merger is closed. (Tr. p. 1383)

Staff argues that because Applicants have proposed the rate reduction in conjunction with other accounting proposals, the rate reduction cannot be viewed alone. Staff contends the change in the depreciation rate for Jeffrey Energy Center (JEC), which amounts to $6.5 million annually, effectively reduces the proposed rate reduction of $15 million to $8.5 million. Additionally, staff contends Applicants have estimated savings during the first two post-merger years amounting to $36 million. Staff argues the $8.5 million reduction would amount to an "advance" on cost savings that average $18 million for each of two years. (Staff br. at 51) Staff argues Applicants' proposal is not financially neutral to ratepayers and effectively increases Applicants' revenues by $19 million. (Staff br. at 51-52)

Staff argues that in order to ensure that the proposed rate reduction actually reflects anticipated cost savings, the Commission should require the $15 million rate reduction without approval of the depreciation rate change for JEC. Staff contends that an annual rate reduction of $18 million would be necessary to approximate the level of cost savings Applicants are projecting during the first two years after the merger. (Staff br. at 52) Staff argues that although ratepayers are promised a rate reduction, there is no link between the level of anticipated savings and the rate reduction. (Tr. p. 1489) Staff argues Applicants proposed accounting and ratemaking changes that are independent of the merger and reduce operating expenses in excess of the rate reduction offered. (Tr. pp. 1641-1642) Instead of offering a rate decrease that reflects merger-related cost reductions, staff argues Applicants have proposed a rate reduction compromised of non-merger related events.

CURB argues that when Applicants filed their direct case, they indicated that the $15 million rate reduction would be from rates that KGE was charging when the merger was announced. (CURB br. at 54) CURB contends this effectively meant the rate reduction was comprised mostly of reductions and refunds already ordered by the KCC but not yet implemented by KGE, and accounting adjustments that had nothing to do with the merger. In Applicants' rebuttal case, CURB contends they changed their position and indicated the reduction would be in addition to any pending refunds and reductions. CURB argues that according to Applicants' estimates, accounting changes alone will save the combined companies $29 million annually. As a result, CURB views the proposed $15 million rate reduction as not as good a deal for ratepayers as it appears at first glance. (CURB br. at 55)

In rebuttal testimony, Applicants stated that if the U.S. Supreme Court denied certiorari, and as a result KGE was required to make the $8.7 million refund order in Docket No. 142,098-U, that the $8.7 would be in addition to the $15 million refund to KGE customers offered by the Applicants to KGE ratepayers in their case in chief.[4] (Tr. p. 1944)

The Commission agrees with the staff and believes that the proposed rate reductions must be viewed as part of the entire merger package. The Commission agrees with CURB's position that the $15 million refund is insufficient in light of the accounting changes proposed by the Applicants. The Commission finds that the interests of both the ratepayers and the shareholders can be balanced. Ratepayers can benefit from rate stability accomplished by imposing a rate moratorium with mandated rate refunds. Shareholders can benefit by deferring the amortization of the AP until the savings resulting from the combination of the two entities are sufficient to cover the $12.5 million annual amortization of the premium.

It is the Commission's desire that ratepayers share in cost savings that will be generated by the combined operations of the Applicants during the moratorium, prior to the amortization of the AP. To that end the Commission finds that Applicants shall make refunds to KPL and KGE electric customers as follows: $8.5 million at the time of closing; $8.5 million in December 1993; and $15 million in September 1994. The Commission believes that KPL electric customers as well as KGE electric customers should share in the rate refunds since the savings that occur during the moratorium period will emanate from various cost efficiencies affecting

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4 KGE's petition for writ of certiorari was denied by the U.S. Supreme Court on June 17, 1991. See, *Kansas Gas and Electric Company v. State Corporation Commission of the State of Kansas*, Case No. 90-984. KGE and CURB subsequently entered into a settlement agreement involving the refund whereby approximately $5.6 million in refunds were agreed to by KGE and CURB agreed not to pursue further refunds in that case or Docket No. 164,211-U. The Commission approved the settlement by order dated September 11, 1991.

both sets of customers, including the joint dispatch of KPL and KGE electric facilities, and from the revised depreciation schedule of the Jeffrey Energy Center in the KPL service territory.

As discussed below, there is currently no firm basis for allocation of the cost savings which are expected to be generated by the merger. Rather, the precise allocations will be determined in the context of a rate case. Consequently, the allocation of the refunds ordered above will need to be made without the benefit of cost of service studies or other guidance. In similar circumstances when there is no firm basis for allocating refunds, the Commission has found it appropriate to use both usage and customers as allocation factors. Thus, it has ordered half of the refund amounts to be returned based on customer usage and half on a per customer basis. In this case, a similar methodology would be appropriate except that slightly greater weight should be given to the usage factor to reflect the fact that the cost savings projected by the parties appear to be predominantly in areas which are usage related.

The Commission therefore finds that the refunds should made to KGE and KPL electric customers on the following basis. Each installment shall first be allocated between the companies based on their respective operating revenues. Fifty-five percent of the respective resulting amounts shall then be allocated among that company's customer classes based on usage during the most practicable recent twelve month period, and forty-five percent allocated on a per-customer basis, except that no refunds shall be paid to customers of either company taking service under special rate contracts approved by the Commission. This is because those contracts already provide rates lower than standard rates as a result of the ability of the affected companies to self or cogenerate power. At this time it does not appear to the Commission, therefore, that these special rate customers should be further benefitted through the refunds granted by this order. The Applicants shall work with Commission staff in the implementation of these refunds and provide a final report and accounting with regard to each installment.

D. *EFFECTS OF THE MERGER ON OTHER ELEMENTS OF THE PUBLIC INTEREST*

1. Effects of Merger on Competition in Retail Energy Market

Applicants argue that customers who receive both gas and electric service from KPL and those that receive gas service from KPL and electric service from KGE have a choice between gas and electric service, which will remain after the merger. Applicants argue the merger will enable both gas and electric customers to choose between two services with a lower price than they would otherwise obtain. (Apps. br. at 43) Applicants argue they do not now operate in a freely competitive market, but the prices they charge are regulated by the Commission who bases rates on demonstrated cost of service. (Apps. br. at 42) Applicants argue that if there is legitimate competition between services in KGE's territory, it will continue after the merger because of the presence in the Wichita area of several gas suppliers which have service areas overlapping KPL's service territory. (Apps. br. at 43) Applicants contend the merger will not change the fact that KPL is already a dual service utility. (Tr. p. 2487) KGE also believes that the wholesale and retail markets are becoming more competitive, with natural gas being one of KGE's most common competitors. (Tr. p. 895) Applicants contend competition has a chance to be enhanced by the merger because savings will be achieved in both gas and electric services resulting ultimately in lower rates than would otherwise be achieved. (Tr. pp. 1336-1337)

Staff argued the proposed merger could enhance the monopolization of Kansas retail electric markets by reducing "gas on electric" competition in retail energy markets. The merger could also reduce "yardstick" competition, competition for retail loads, and competition for franchise territory. (Tr. pp. 95-96) Staff contends the merger has the effect of consolidating control of utility service in the overlapping service territory and will inevitably reduce competition in this market. Staff argues that competition works in tandem with regulation to constrain pricing and to the extent competition is eliminated, an ally of regulation is eliminated. (Staff br. at 31-32)

Staff also argues that because electricity is more capital intensive than gas, a combination utility has an incentive to create a more favorable rate/quality/promotions mix for electricity relative to gas. Staff contends this will increase the consumption of electricity and thereby the incentive to the utility to increase its rate base and profit by building more electric plants. Staff argues the result is that over the long-term, ratepayers will be steered toward the more capital intensive electric service, regardless of whether it is the more cost efficient service. (Staff br. at 32-33)

Applicants argued that staff's concern that the combination of KPL's gas operation and KGE's electric operation could have an adverse effect on competition is unfounded. Because the prices set for utility services are based on the cost of service as regulated by the Commission, the efficiencies achieved from the merger will be translated into enhanced, less expensive service for customers. Retail competition will not be reduced by the merger. (Tr. p. 2484) The company expects both electric and gas customers to benefit from this transaction. (Tr. p. 2488)

Applicants also argue that the existence of inherent incentives in regulation that lead utilities to favor capital intensive electric generation is a matter of great dispute among economists. (Apps. br. at 42) Applicants contend the economic field has historically been split on the issue of whether there is any empirical support for the Averch-Johnson effect. (Tr. p. 2129) Applicants also argue the Commission's existing regulatory powers concerning the sitting and construction of new facilities give the Commission authority to assure that the theoretical bias does not result in an over-expenditure on capital projects. (Apps. br. at 42) Applicants argue prudence reviews, investment disallowances, and requirements that regulatory approval be obtained before large utility projects may be initiated have made the

A-J effect increasingly irrelevant in today's utility environment. (Tr. p. 2131) Applicants contend none of the economic arguments raised by staff regarding the A-J effect are of sufficient merit to provide any argument against the merger. (Tr. p. 2133)

The Commission has concluded that one of the most attractive aspects of the proposed merger is the potential for synergies that exists. Capturing these synergies will benefit both ratepayers and shareholders over the long term. Absent the merger, such synergies would not be realized. While staff expressed concern that the merger would potentially lead to inefficiencies due to diminished inter-fuel competition, the Commission believes the potential for such inefficiencies is outweighed by the synergies achievable under the merger.

The Commission was not persuaded that combining KPL and KGE would result in inefficiencies that would not exist if KPL and KGE remained stand-alone companies. Staff produced no evidence of the impact from the potential inefficiencies resulting from the consolidation of control of utility service in the market. In contrast, all parties presented substantial evidence of the synergies that could be generated due to the overlapping service territories of these two utilities. Even assuming there was some evidence of inefficiencies resulting from the merger, the Commission believes the substantial long-term benefits from the synergies that have been quantified by the parties would outweigh all but the most egregious adverse effects of combining the operations.

Additionally, the Commission is not convinced that over the long term, KPL will steer customers towards electric consumption and away from natural gas consumption because electric service is more capital intensive and provides greater returns to shareholders. The evidence before the Commission indicated that result may have occurred in studies conducted of small utilities, but that was not the case in all combination utilities. Competition may very well work in tandem with regulation to ensure there is no anti-competitive pricing, but it does not follow that without competition, regulation will be unable to prohibit anti-competitive pricing.

This Commission is charged with the regulation of public utilities that are granted the exclusive franchise to provide service in a particular territory. While the proposed merger would result in KPL providing both gas and electric service to the Wichita area as well as some other areas in Kansas, this is not the first time the same entity has provided both gas and electric service to an area. Topeka, Manhattan, Salina and other communities are currently receiving both gas and electric service from KPL. The Commission believes the key to whether a single provider of utility service can exercise abusive monopoly power is determined by the pricing of those services, and it is the job of this Commission to regulate the pricing of those services. If there is an abuse of monopoly power in the provision of utility service, it is because this Commission and its staff are not doing its job.

2. Effect of Merger on Kansas Economy and Local Communities

Applicants argue the merger will create a larger company with increased opportunities. Applicants indicate they have promised job protection and made a commitment of no merger-related layoffs. Applicants contend customers, communities, shareholders and employees will all benefit from the merged company. (Tr. p. 358) Applicants contend the cost savings generated by the merger will make the rates for the merged company lower than would otherwise be the case and will enhance economic development because locating in the service territory will be financially more attractive. (Tr. p. 1310) Applicants believe KPL will be a stronger company and will continue KGE's programs of special rate provisions for elderly and disadvantaged low income customers. (Tr. p. 653)

Staff indicated they reviewed two possible economic effects associated with the merger: Possible effects of cutbacks on employment and reductions in the dispersal of wage and salary income; and the possible effects of rate changes on KPL and KGE service area economies. (Tr.

pp. 1694-1695) Staff argues the merger results in adverse effects on the Kansas economy. Staff contends that of the net $140 million Applicants claim in cost savings during the first five years of the merger, $76.1 million would occur through reductions in personnel costs. Staff argues these employee reductions will harm the Kansas economy because they will not be offset by a corresponding reduction in rates. Staff projects the net loss to the Kansas economy from employment reductions and secondary impacts of lost jobs to be between $15 million and $17.5 million in salary and wage income. Staff argues this economic loss only compounds the financial concerns and demonstrates the merger does not promote the public interest. (Staff br. at.35)

Applicants argue that from the model used by staff, elimination of any jobs, no matter how redundant, unnecessary or wasteful, would harm the Kansas economy. (Apps. br. at 43) Applicants contend the creation of jobs in Kansas should not be achieved through an inefficient utility infrastructure. Applicants argue the public interest demands that utility services be provided as efficiently as possible and the proposed merger is more efficient than either two separate companies or a combination of KGE and any other utility. (Apps. br. at 44) Applicants contend staff's study indicates that the reduction in jobs occasioned by combining the companies has a greater negative impact on the Kansas economy than the corresponding positive impact of the proposed initial rate reduction. (Tr. p. 1945) Applicants contend the implication that improved efficiency in the rendition of utility service is not good for Kansas is disturbing. Applicants urge the Commission not to consider such an unrealistic posture. (Tr. p. 1945)

The City of Wichita (Wichita) expressed concerns regarding the effect of the proposed merger on KGE's existing franchise agreements. Wichita contends the current franchise agreement was granted to KGE in 1982 for a 20-year period. (Wichita br. at 3) Wichita contends the franchise fees are a significant factor in funding the City's operations and it needs stability in these revenues. (Wichita br. at 4) Wichita argues the merged company must be in a position to meet the obligations of the existing franchise agreements, especially in light of the terms of the merger that require KGE to keep its headquarters in Wichita for only three years. Wichita contends the Commission must take this into consideration when determining conditions to be placed on the merger. (Wichita br. at 5) Wichita also contends that KGE has been a good corporate citizen and an asset in the community of Wichita. They express concerns regarding the impact of the merger on communications and civic participation. (Tr. p. 1908) Wichita contends that while there is no legal requirement for community involvement on the part of utilities, such involvement is in the best interest of the State of Kansas. Wichita contends any conditions imposed on the merger should not hamper such activity. (Wichita br. at 6)

Applicants indicated that with the cost savings and personnel reductions they did not anticipate taking resources away from Wichita. Applicants indicated they would continue the same level of community support and involvement in Wichita. (Tr. p. 648)

The Commission finds that the merger as conditioned will have a positive impact on the economy and local communities. Staff's concerns regarding the negative impact of possible employee reductions without a corresponding rate reduction has been addressed by the Commission's imposition of rate refunds for not only KGE customers, but KPL gas and electric customers as well. These refunds will counteract any potential adverse impact from labor force reductions. Additionally, the Commission believes the policy of this State is that utilities should always strive to increase efficiency in providing safe, reliable utility service. Where synergies are available in the overlapping service territories, the Commission believes Applicants should act to capture those savings.

The Commission believes the merger as conditioned will provide for a financially stable utility that will be able to meet all existing agreements, including franchise agreements, that currently exist. The Commission has taken specific action to impose conditions that it believes will serve to relieve some of the financial pressure that existed under Applicants' proposal. Nor does the Commission believe it has imposed any conditions that would prevent the merged company from continuing its participation in civic activities in the towns and cities located within its service territory.

3. Effect of Merger's Corporate Structure on KCC Jurisdiction

Applicants propose that following the merger, electric operations of KGE will be conducted through a wholly-owned subsidiary of KPL. (Apps. br. at 39) Applicants indicate that KPL and KGE now exist as separate corporations and power sales between the two are wholesale transactions and made in accordance with FERC tariffs. Applicants argue that KGE's status as a KPL subsidiary would not change the nature of these inter-corporate transactions to either enhance or reduce the Commission's jurisdiction. Applicants contend the Commission would have the same jurisdiction it now possesses to determine the prudence of either KGE's or KPL's conduct in purchasing energy or capacity from the other. (Apps. br. at 40) Applicants contend that while KPL initially anticipated that KGE would become a KPL division, to satisfy requirements of obligation bonds issued in conjunction with the sale and leaseback of KGE's interest in LaCygne 2 and to meet KPL's existing indenture requirements, KGE must initially be established as a wholly-owned subsidiary corporation. Applicants argue that if KGE were initially to become a division of KPL, either the sale and leaseback facility or all KPL's mortgage bonds could have to be refinanced immediately, at the option of the bondholders. (Apps. br. at 40-41) Applicants contend the subsidiary structure was not proposed to reduce the Commission's jurisdiction over power supply transactions between Applicants or avoid Commission review of their joint dispatch operations. Applicants contend they fully anticipate comprehensive and continuing examination of merger costs and savings by the Commission. (Apps. br. at 41)

Applicants contend from a day-to-day operating viewpoint, there is no difference in the way the merged company of KPL/KGE will be operated, i.e., whether it resembles a subsidiary or a division. The same synergies can be achieved regardless of whether KGE is a subsidiary or a division. (Tr. pp. 1340-1341) Neither KPL nor KGE desire to avoid KCC review of the prudence of joint dispatch operating decisions. (Tr. p. 1343)

Staff argues the corporate structure chosen by Applicants for the merged company can lead to an erosion of the Commission's authority over retail rates charged by the merged company. Staff argues that U. S. Supreme Court precedent establishes that under certain facts, FERC's approval of a wholesale seller's price is exclusive and binding on state commissions when the wholesale buyer requests retail rate recovery. (Staff br. at 33) Staff contends that because Applicants have proposed to operate the merged company as a single system, Applicants may argue that under the legal precedent the Commission is precluded from reviewing inter-corporate transactions for purposes of setting retail rates. (Staff br. at 34)

Staff argues the Commission should impose a condition on the merger that preserves its authority over retail rates. Staff recommends the most effective method of preserving its authority would be to require KGE to be operated as an operating division of KPL rather than a separate subsidiary, which would remove power transactions between the two from FERC jurisdiction. As an alternative, staff recommends the Commission condition approval of the merger on its ability to veto, in advance, the terms and conditions of any wholesale power transactions between Applicants. Under this condition, KPL and KGE would be required to agree to first submit to the Commission all agreements, contracts or other documents concerning transactions between the two, which are to be filed with FERC for approval. Further, Applicants would agree not to file any such matters with FERC until they have received the Commission's consent. (Staff br. at 58-59)

Vulcan argues that given the "murky waters" relative to the potential for the Commission to lose jurisdiction with respect to power transactions between KPL and KGE subsequent to the merger, the Commission should strictly scrutinize whether the proposed corporate structure will impair the effective regulation by the Commission in the future.

Vulcan proposes the Commission condition the merger by securing the consent of Applicants to the Commission's jurisdiction to review the prudence of any decision relating to power transactions between KPL and KGE. (Vul. br. at 40-41, 43)

The Commission finds that a condition is appropriate to preserve its long-term ratemaking authority over the merged company. The Commission is keenly aware of the potential for federal preemption of state regulation and has recognized such concerns in previous proceedings.[5] Additionally, the Commission cannot ignore the action taken by KGE in previous proceedings where they sought appeal of the decision of the Kansas Court Appeals on grounds that the Commission could not engage in ratemaking adjustments involving transactions approved by FERC for purposes of setting retail rates.[6] Vulcan's description of the legal precedent as "murky waters" is appropriate. Moreover, it would be unconscionable for the Commission to approve a transaction where the Commission's approval had the effect of impairing its authority to establish rates for retail customers. The Commission believes such action would constitute a breach of its legislative mandate to ensure that utility customers pay only just and reasonable rates.

To preserve the Commission's full authority over retail ratemaking, the Commission finds it is appropriate to approve the proposed merger on the condition that the corporate status of KGE as a wholly-owned subsidiary of KPL lasts no longer than January 1, 1995, except upon a showing by the Applicants and a finding by the Commission that good cause exists to continue

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5 See the Commission's order in the *Matter of the General Investigation Upon the Commission's Own Motion to Establish General Policies With Regard to Purchased Natural Gas*, Docket No. 106,850-U, order issued October 13, 1989. The Commission reviewed the state of the law regarding federal preemption of state regulation and determined it was preempted from disallowing pass-through of certain FERC approved take-or-pay gas costs.

6 See *Kansas Gas and Electric Company v. State Corporation Commission of the State of Kansas*, Case No. 90-984, petition for writ of certiorari denied June 17, 1991.

the subsidiary status of KGE. At or before that time, KGE shall become a division of KPL. The condition will not impair the potential for synergies as the evidence before the Commission was that synergies were achievable regardless of the corporate structure of the merger. Additionally, the condition also satisfies Applicants' concerns regarding mortgage bonds and indenture requirements associated with the sale and leaseback of KGE's interest in LaCygne 2. Moreover, the condition addresses the future problem of the Commission's impaired retail ratemaking authority stemming from federal preemption of state regulation.

4. Effect of the Merger on KPL Gas Customers

Applicants indicated that with this merger, KPL electric and gas customers will not realize any immediate rate relief, but over time their rates should be lower than they otherwise would be as a result of efficiencies created by the merger. (Tr. p. 518) Applicants also indicated that the merger would have no effect on KPL's gas line replacement program now under way. (Tr. p. 520)

MGUA expressed concerns that the merged company would be left in such a financially precarious position, that claims for increases in natural gas rates will result. MGUA also expresses concerns that KPL will be financially unable to complete its safety-related distribution main replacement program for its gas service. (MGUA br. at 2) MGUA argues the Commission can resolve these concerns by either denying the merger or conditioning approval of the merger upon terms that adequately protect natural gas customers of KPL. MGUA contends that the Commission can ensure that KPL's natural gas operations are not adversely affected by merger-related activities by establishing a base financial status and a presumption that all post-merger cost increases and financial changes that result in increased expenses or increased overall costs of capital are results of the merger. MGUA argues the presumption could be rebutted if KPL could show by clear and convincing evidence that cost increases or detrimental changes to KPL's cost of money result from non-merger related factors. MGUA also suggests that the establishment of any base case must predate the two most recent rate case filings, so that the presumption would apply to revenue requirement requests made in those two cases. (MGUA br. at 3-4)

MGUA also argues natural gas customers of KPL have had a substantial role in the pre-merger financial status of KPL, which has permitted KPL's management and shareholders to seek this perceived corporate opportunity. MGUA contends KPL's natural gas customers should have an allocated share of any benefits that result from the merger based upon the proportionate share of the natural gas revenues to KPL's total revenues. MGUA argues such a condition would assure an equitable sharing of merger benefits for KPL's natural gas customers. (MGUA br. at 6)

The Commission agrees that the proposed merger should not disadvantage KPL's current electric and gas customers. Moreover, the Commission finds that these customers should also share in the immediate benefits of rate refunds. As such, the Commission has imposed the condition that all electric retail ratepayers of KPL receive rate refunds as set out above. Additionally, the Commission has frozen retail gas rates until 1995. Both of these conditions serve to address MGUA's concerns.

The Commission is likewise concerned that the merger not adversely affect the progress of the pipeline safety programs that KPL has undertaken pursuant to the Commission's directives. For that reason, the rate moratorium imposed by the Commission does not include natural gas rates currently under consideration in Docket Nos. 176,716-U and 176,268-U. The level of rates required by KPL to proceed with its pipeline safety program will be taken up in those proceedings. The Commission's condition alleviates this concern expressed by MGUA.

5. Effect of Merger on Reliability and Safety

The evidence before the Commission was that the merger would not adversely affect the reliability and safety of the electric systems. Staff indicated the post-merger combined availability of the KPL and KGE generation units, plus a larger pool of generation to call upon, should result in either no change or an improvement in the reliability of the merged company's generating system. (Tr. p. 156) Staff also indicated that the merger will have no significant effect on the reliability of the transmission system. (Tr. p. 156)

The evidence also indicated that the merger would provide significant environmental benefits over the long term, but neither staff nor Applicants quantified these benefits. (Tr. p. 1554) Staff indicated society in general will benefit environmentally as a result of the merger in at least three ways: 1) fuel savings result in less air pollution; 2) fewer solid waste disposal problems; and 3) coal conservation. (Tr. p. 161)

The Commission finds the merger will have no adverse impact on the reliability or safety of the electric systems and will promote the public interest by providing long-term environmental benefits.

E. OTHER CONDITIONS ON THE MERGER

1. Treatment of Capital Costs in Future Rate Cases

The Commission cannot overlook the potential for failure when it exists and when Applicants fail to even analyze the potential for increased costs. The risk that savings do not materialize is a significant risk and one that the Commission finds should be borne by shareholders. Likewise, any increased capital costs resulting from the merger should likewise be borne by shareholders.

The Commission has imposed conditions to limit recovery of the AP to a specified range of savings and extended the amortization period. These conditions have the effect of lowering the annual amortization levels and thereby the threshold level of savings from the merger. These conditions serve to reduce the risk that sufficient savings do not materialize. However, the risk still exists and the Commission believes the further condition of limiting recovery of capital costs is necessary to protect ratepayers from bearing these costs.

2. Treatment of Transaction Costs in Future Rate Cases

Applicants will incur significant levels of transaction costs to bring about the merger. The estimated $20 million in transaction fees is made up of a variety of items, which Applicants claim are a necessary part of the costs for KPL to complete acquisition of KGE. Of that figure, Applicants propose that $10 million be included in the AP and $10 million be recorded as an asset deferred and amortized over a five-year period. (Tr. pp. 1047-1048, 2023) Applicants contend the cost of the short-term debt is a cost of service item. All $20 million constitutes transaction costs incurred by KPL, according to Applicants, but only $10 million is associated with the credit facility and is accounted for differently. (Tr. pp. 2024-2025) Of the $20 million, the credit facility costs of $10 million are capitalized and therefore do not increase the AP.

In addition to the transaction costs incurred by KPL are the costs incurred by KGE in its defense against the hostile KCPL tender offer as well as in connection with KPL's friendly offer. Through February 1991, the expenses incurred by KGE related to the KCPL tender offer were $6 million and the expenses associated with the KPL merger agreement were $1.4 million, for a total of $7.4 million. (Tr. p. 470) It is the position of Applicants that the merger-related expenses should be treated as a business expense. KGE feels that the expenses associated with the tender offer made by KCPL should be above the line and recovered from ratepayers, but they are uncertain how expenses for items such as Public Relations should be treated. (Tr. p. 472)

The potential for additional administrative costs also exists. As part of the agreement, KPL will provide for the indemnification of KGE officers and directors for any liability, and will vest the benefits of KGE's directors under their deferred compensation program. This makes it possible for the directors to increase their actual benefits with no additional cost to the company. (Tr. p. 417) The agreement also contains a severance plan for KGE employees and executives that are terminated within 36 months after a change in control of the company. (Tr.

pp. 417-418) As a result of these labor termination expenses, Applicants could incur possibly $12 million in additional costs associated with the merger. Applicants contend these costs should also be recovered above the line from ratepayers. (Tr. p. 469, 473)

Staff recommended the Commission not implicitly approve all related transaction costs associated with effectuating the merger, including those incurred by KGE in its defense against the KCPL offer. Staff argues that during hearing, various concerns were raised that some of the transaction costs may be costs that are traditionally below-the-line costs or otherwise not reasonable or prudent. Staff contends that because they and other parties have not had an opportunity to examine all such costs in detail and some of these costs are not yet finalized, the Commission should expressly reserve its authority to consider the reasonableness and prudence of these costs in the first rate proceeding subsequent to the merger. (Staff br. at 59-60)

Industrial Consumers argue ratepayers, unlike shareholders, had no input into the decision to merge and should not be burdened with any portion of the $20 million in transaction costs. Industrials recommend that no transaction costs be included in the AP nor as an expense item of cost of service. (Ind. br. at 54) Wichita also argues the transaction costs incurred in consummating the merger should not be borne by ratepayers. (Wichita br. at 3)

The Commission finds that the transaction costs incurred to consummate the merger may be costs that result in benefits to both ratepayers and shareholders under the merger as conditioned. As such, these costs should be borne by both ratepayers and shareholders. Furthermore, the Commission has historically determined that utilities are able to recover only prudently incurred and reasonable costs. As such, only prudently incurred and reasonable costs will be eligible to be recovered from ratepayers. This proceeding did not involve detailed analysis by the parties of the prudence and reasonableness of the transaction costs and because the merger has not been completed, the specific levels of transaction costs are unknown. As such, the Commission finds it appropriate to preserve its determination on this issue until the first post-merger rate proceeding where the parties traditionally consider the prudence and reasonableness of costs incurred by utilities and the method of recovering such prudently incurred costs from ratepayers.

3. Cost Allocation Methodology

Applicants recognize that there is a substantial difference in rates between KPL and KGE electric customers. Applicants do not propose to commingle these rates and they argue the merger does not require commingling of rates. Applicants contend that to properly allocate costs and savings fairly, a detailed cost of service study is required. Applicants contend that no cost allocation study, either to be proposed or in existence today, will perfectly allocate costs to those for whom the costs were incurred. However, Applicants believe the cost savings allocations are not unworkable. (Tr. p. 2018) Applicants adopt CURB's recommendation for workshops to discuss and determine appropriate cost allocation methodologies. (Apps. br. at 45) Applicants argue the fact that costs are estimated and not definite does not preclude a sound cost allocation within the context of a cost of service determination. (Tr. p. 2019)

CURB contends that if the Commission approves the merger, the Commission should immediately initiate an investigation to search for an appropriate cost allocation methodology. (CURB br. at 3) CURB argues that one area of risk for ratepayers stems from cost allocation. CURB contends that under Applicants' proposal, total savings equal less than two percent (2%) of total revenue requirements by 1996. Consequently, some mechanism needs to be put in place to fairly allocate the remaining 98 percent of revenues. CURB contends that allocation of these costs can have a much greater impact on inter-ratepayer equity and fairness than the ultimate disposal of savings. (CURB br. at 36)

CURB contends there is a significant differential between current KGE and KPL cost structures and the average cost of electricity is considerably higher on the KGE system and is expected to stay that way for the foreseeable future. CURB argues a complex cost allocation system will be necessary if all ratepayers are to be shielded from merger-created rate increases. (CURB br. at 36-37)

Industrial Consumers argue rates in Kansas should continue to be cost based and combining the two companies for ratemaking purposes would have the effect of imposing upon KPL ratepayers the higher costs of KGE service. Industrials recommend the Commission require KPL and KGE retain their separate identities for ratemaking purposes for at least a ten-year period. (Ind. br. at 54-55)

Vulcan recommends the Commission condition approval of the merger by requiring KPL and KGE to file and have approved cost of service studies, which will include a cost allocation methodology and savings allocation methodology based upon the divisional structure advocated by Applicants. (Vul. br. at 43)

The Commission believes that quantifiable costs and benefits from the merger should be allocated to the extent possible at this point in time. To that end, the Commission has conditioned approval of the merger on KPL and KGE making refunds to its retail ratepayers as set out above. The Commission agrees with Applicants that a more detailed allocation of costs should be made when the information necessary to make such allocation becomes available. Such allocations are made during rate cases because that is the point in time in which cost of service determinations are completed. The Commission believes that such an allocation should be made when a cost of service study is completed in the first post-merger rate case. Such a study is essential in order to fairly and equitably allocate not only the cost savings which may result from this merger but also the costs of the merger, including the AP, among the various customer groups and jurisdictions.

VII. CONCLUSION

The KPL/KGE merger as proposed is unacceptable because it does not promote the public interest and, as such, is hereby rejected. Even so, a merger between KPL and KGE presents the Commission with a rare opportunity to achieve material and significant cost savings. As proposed, however, the savings would go primarily to the stockholders of the Applicants and very little would flow to consumers. Consequently, the proposed merger will be approved with a rigid set of conditions that will work to ensure that customers of KPL and KGE receive their equitable share of savings generated by the merger. The conditions are as follows:

1. The merger will be approved on the condition that KGE and KPL electric rates will be frozen until August 1995, subject to changes for extraordinary events such as those described in condition No. 5 below.

2. The merger will be approved on the condition that KPL gas rates will be frozen until August 1995, subject to changes for extraordinary events such as those described in condition No. 5 below. However, the moratorium shall not apply to Docket Nos. 176,716-U and 176,268-U, nor to rates ordered and approved by the Commission resulting from safety improvements subsequent to the issuance of this order.

3. The merger will be approved on the condition that KGE and KPL retail electric customers receive cash refunds as follows: $8.5 million as soon as the merger is effective; $8.5 million in December 1993; $15 million in September 1994. Total refunds will amount to $32 million. Refunds shall be allocated between the companies based upon their operating revenues. Fifty-five percent of the respective resulting amounts shall then be allocated among that company's customer classes based on usage during the most practicable recent twelve month

period, and forty-five percent allocated on a per-customer basis, except that no refunds shall be paid to customers of either company taking service under special rate contracts approved by the Commission.

4. The merger will be approved on the condition that KPL will be limited to recovery of an AP to the extent of reasonably anticipated merger-generated savings adopted by the Commission, $312 million. The merger-generated savings adopted by the Commission was approximately $318 million which translates to an offer price recoverable out of merger-generated savings of $29.50/share. Recovery of the annual amortization shall come only from merger-generated savings and ratepayers shall bear no risk for the premium and will not make up any shortfall in savings.

5. The merger tracking system proposed by Applicants is rejected. The merger will be approved on the condition that Applicants implement a simplified measuring mechanism for merger savings. The mechanism shall consist of the following: A pre-merger base year commencing on July 1, 1989, and concluding on June 30, 1990, for operation and maintenance costs (excluding depreciation, taxes, fuel, purchased gas and purchased power or similar items) of KPL and KGE shall be established and annually adjusted by the consumer price index for urban cities or another appropriate index which is mutually agreed to by staff and the Applicants and adjusted for changes in government edicts, laws, regulatory requirements and other extraordinary events that significantly affect Applicants and which they can demonstrate is beyond their reasonable control and not reflected in the index. The difference remaining between the adjusted pre-merger base year levels and the actual cost of service for the merged company will have the rebuttable presumption of being merger-generated savings.

6. The Commission will approve the merger on the condition that merger-related savings in excess of the annual amortization of the AP shall be shared between ratepayers and shareholders on a 50/50 basis after taxes are paid beginning August 1995. All merger savings other than 50 percent of the savings above the allowed amortization will be excluded from cost of service in determining whether or not the merged company is earning their allowed return.

7. The merger is approved on the condition that the AP shall be amortized over a 40-year period commencing August 1995. Annual amortization of the AP will occur only out of merger savings.

8. The Commission approves Applicants' request to adjust the depreciation rate for the Jeffrey Energy Center to be calculated on a 40-year basis. The new depreciation rate shall become effective after 30 days from the date of this order.

9. The Commission directs staff to initiate a separately-docketed proceeding to consider the elimination of Applicants' energy cost adjustment clause. The Commission directs staff to initiate a separately docketed proceeding to consider the elimination of Applicants' energy cost adjustment clauses, under the following guidelines. KPL shareholders will assume the risk of not achieving fuel savings from joint dispatch during the moratorium period. Likewise, any fuel savings actually achieved during that period will go to the shareholders. Ratepayers are guaranteed merger benefits during this period by virtue of the moratorium and the ordered refunds. In arriving at appropriate fuel costs to include in KPL and KGE's rates, in lieu of their energy cost adjustment clauses, average actual historical generating plant operating statistics since Wolf Creek commenced commercial operation in September 1985, and estimated fuel and fuel transportation costs during the moratorium period are to be used.

It should be noted that many of the conditions set forth above are efforts to achieve a fair and reasonable balance between the Applicants' requirements for a successful merger and the interests of ratepayers in receiving reasonable benefits from the merger. Of most importance, however, is the Commission's continuing duty to ensure that utility rates are just and reasonable. If the various conditions we have set forth above, either singly or in combination with one another, appear to result in unreasonable or unjust rates, the Commission will not hesitate to modify or revoke that condition or otherwise act to ensure that rates are reasonable and that neither Applicants nor ratepayers receive unwarranted benefits or detriments.

IT IS, THEREFORE, BY THE COMMISSION ORDERED THAT:

The merger shall be approved subject to the conditions set forth above and as further set out in the body of the order. In addition:

1. KPL shall be allowed to incur certain debt obligations necessary to complete the proposed transactions and to provide working capital for the combined companies following the merger. Said authorization shall permit KPL to secure financing of up to $600 million dollars ($600,000,000) to be provided by Chemical Bank from a secured bank loan facility.

2. KPL shall be authorized to issue common stock and to deliver up to $434 million ($434,000,000) of the proceeds to holders of KGE common stock.

3. KPL shall be allowed to acquire the capital stock of KGE and merge KGE, except upon a showing by the Applicants and a finding by the Commission that good cause exists to continue the subsidiary status of KGE. KPL shall report to the Commission within six months of the date of issue of this order on its progress in eliminating the subsidiary status of KGE.

4. Pursuant to K.S.A. 66-136 and 66-1,170, et seq., the franchises granted to KGE by the municipalities in which it now provides electric service shall be transferred to the KGE subsidiary of KPL and the KGE subsidiary shall retain the authority previously granted by the Commission to KGE to provide retail electric service in KGE's existing service territory. Said

franchises shall remain with KGE's operating division in January 1995, when KGE ceases to be a subsidiary of KPL and becomes an operating division of KPL.

ORDER MAILED
NOV 15 1991
Executive Director

NOV. 15 1991

Judith McConnell
Executive Director