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Acquisition Adjustment/
Affiliated Transactions

Witness // Type of Exhibit:

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Public Counsel

Case Nos.:

GM-2001-585

REBUTTAL TESTIMONY

OF

KIMBERLY K. BOLIN

Submitted on Behalf of the Office of the Public Counsel

**GATEWAY PIPELINE COMPANY,
MISSOURI GAS COMPANY AND
MISSOURI PIPELINE COMPANY**

Case No. GM-2001-585

Exhibit No. 12
Date 9-05-01 Case No. GM-2001-585
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July 30, 2001

NP

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

In the Matter of the Joint Application)
of Gateway Pipeline Company, Inc., Missouri)
Gas Company and Missouri Pipeline Company)
and the Acquisition by Gateway Pipeline)
Company of the Outstanding Shares of)
UtiliCorp Pipeline Systems, Inc.)

Case No. GM-2001-585

AFFIDAVIT OF KIMBERLY K. BOLIN

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Kimberly K. Bolin, of lawful age and being first duly sworn, deposes and states:


1. My name is Kimberly K. Bolin. I am a Public Utility Accountant for the Office of the Public Counsel.
2. Attached, hereto and made a part hereof for all purposes, is my rebuttal testimony consisting of pages 1 through 31 and Schedules KKB-1 through KKB-4.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.



Kimberly K. Bolin

Subscribed and sworn to me this 30th day of July, 2001.





Bonnie S. Howard, Notary Public

My Commission expires May 3, 2005.

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REBUTTAL TESTIMONY

OF

KIMBERLY K. BOLIN

GATEWAY PIPELINE COMPANY, INC.

CASE NO. GM-2001-585

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. Kimberly K. Bolin, P.O. Box 7800, Jefferson City, Missouri 65102.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by the Office of the Public Counsel of the State of Missouri (OPC or Public Counsel) as a Public Utility Accountant I.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I graduated from Central Missouri State University in Warrensburg, Missouri, with a Bachelor of Science in Business Administration, major in Accounting, in May, 1993.

Q. WHAT IS THE NATURE OF YOUR CURRENT DUTIES WITH THE OFFICE OF THE PUBLIC COUNSEL?

A. Under the direction of the Chief Public Utility Accountant, I am responsible for performing audits and examinations of the books and records of public utilities operating within the state of Missouri.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION?

A. Yes. Please refer to Schedule KKB-1, attached to this rebuttal testimony, for a listing of cases in which I have previously submitted testimony.

1 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

2 A. The purpose of my rebuttal testimony is to express the Public Counsel's position regarding the
3 approval of the proposed acquisition of Utilicorp Pipeline Systems (UPL) by Gateway Pipeline
4 Company (Gateway or Company). I will address the issues of acquisition adjustment (premium)
5 and the need for Gateway to follow the affiliate transactions rule set out in 4CSR 240-40.015.

6 **STANDARD OF PUBLIC INTEREST**

7 **Q. WHAT IS THE ISSUE BEFORE THE COMMISSION?**

8 A. The principal issue before the Commission is whether or not the proposed acquisition of UPL by
9 Gateway is detrimental to the public interest.

10 **Q. WHAT IS THE STANDARD OPC UTILIZED TO DEVELOP ITS**
11 **RECOMMENDATION CONCERNING THIS PROPOSED ACQUISITION?**

12 A. OPC utilized the "not detrimental to public interest" standard when analyzing this transaction. The
13 "not detrimental to public interest" standard was first articulated in State ex rel. City of St. Louis v.
14 Public Service Commission, 73 S.W.2d 303, 400 (Mo. Banc 1934). The Court in City of St. Louis
15 stated:

16 To prevent injury to the public, in the clashing of private interest with the
17 public good in the operation of public utilities, is one of the most
18 important functions of Public Service Commissions. It is not their
19 province to insist that the public shall be *benefited*, as a condition to
20 change of ownership, but their duty is to see that no such change shall be
21 made as would work to the public *detriment*. In the public interest, in such
22 cases, can reasonably mean no more than "not detrimental to the public."

23 The controlling statute is Section 393.190 RSMo. 1994.

1 **Q. HOW THE PUBLIC COUNSEL DEFINE " PUBLIC INTEREST?"**

2 A. OPC generally views the members of the public that are to be protected as those consumers taking
3 and receiving service, in this instance, wholesalers and local distribution companies (LDC's) served
4 by MPC and MGC operations. Therefore, Public Counsel would define the "public interest" as
5 referring to the level of impact or effect that the proposed transaction will have on the Missouri
6 ultimate retail customers of the two companies.

7 The fundamental concern in the regulation of public utilities is that the public being served will not
8 be adversely impacted or harmed by those responsible for providing the monopoly services. Thus,
9 the public interest generically addresses utilities customers because of the theory of regulation.
10 Regulation acts as a substitute for competition in a monopoly environment; therefore, utilities are
11 required to pass a public interest test because customer service options are limited by the fact that
12 they generally do not have a choice in the supplier of their utility services.

13 **Q. HAS THE COMMISSION EVER INDICATED HOW IT VIEWS THE TERM**
14 **" PUBLIC" WITH REGARD TO SECTION 393.190(2) RSMO 1994?**

15 A. Yes, it has. In KPL/KGE, Case No. Em-91-213, this Commission identified the "public" as
16 Missouri ratepayers. At page 13 of its Order, the Commission stated the following:

17 Based upon these findings and determinations, the Commission concludes
18 that Missouri ratepayers will be shielded from any potential ill effects
19 from the proposed merger and will suffer no detriment as a result.
20 Therefore, the Commission concludes that, in the absence of a finding of
21 detriment to the public interest, it may not withhold its approval of the
22 proposed merger and will authorize KPL to acquire and merger with KGE.

ACQUISITION ADJUSTMENT

Q. WHAT IS COMPANY'S REQUEST?

A. Gateway is requesting to acquire all the issued and outstanding shares of the capital stock of UPL from Utilicorp United, Inc. (Utilicorp) under a stock purchase agreement. UPL is the parent and owner of Missouri Gas Company (MGC) and Missouri Pipeline Company (MPL), which are regulated Missouri utilities. Under the transaction the parent of UPL will be changed from Utilicorp to Gateway with no change in the ownership of MGC or MPC. **

.**

Q. WHAT IS THE PURCHASE PRICE OF UPL?

A. **

.**

Q. IS GATEWAY SEEKING AN ACQUISITION ADJUSTMENT?

A. No. Gateway is not seeking an acquisition adjustment in this proceeding. However, Public Counsel is concerned that the Company will ask for an acquisition adjustment in a future rate proceeding because the Company has specifically failed to rule out such a request

1 Q. PLEASE EXPLAIN FURTHER.

2 A. ** _____:

3 _____
4 _____
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12 _____
13 _____
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15 _____
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18 _____ **

19 _____
20 ** _____

21 _____
22 _____ ** If the Company never utilizes Utilicorp Pipeline Systems, the Company
23 should not be allowed to recover acquisition adjustment through MPC or MGC.

24 Q. DOES THE COMPANY INTEND ON ACTIVATING THE ASSETS THAT IN THE
25 UTILICORP PIPELINE SYSTEM?

26 A. ** _____

27 _____ ** (See Highly Confidential Schedule KKB-2) In the future, if the Company
28 activates this pipeline the pipeline will be regulated by the Federal Energy Regulatory Commission

(FERC). The Missouri Public Service Commission will not have jurisdiction over the pipeline since it crosses the Missouri/Illinois state line.

Also if the Company activates the pipeline held by UPL and connects MGC and MPL to this system, the Missouri Public Service Commission (Commission) will no longer regulate MGC and MPL, but FERC will since the pipelines will become an interstate pipeline.

Q. PLEASE EXPLAIN WHAT IS MEANT BY THE ACCOUNTING TERM "ACQUISITION ADJUSTMENT?"

A. In traditional accounting, fixed assets, such as plant, are usually recorded at "original cost". Original cost, as applied to utility plant, means the cost of property to the utility devoting it to public service. An acquisition adjustment results when utility property is purchased or acquired for an amount either in excess of or below book value. Book value is the value placed on utility property and recorded on the Company's financial books and records at the time the utility property is first placed in public service.

If the utility property is purchased by another utility, the purchaser must record the acquisition in the appropriate "plant and property" accounts at the selling utility's original cost; similarly, the purchaser records the seller's accumulated depreciation, amortization, and contributions in aid of construction (CIAC) in the appropriate account(s). Any difference between the original cost and the actual price paid by the subsequent purchaser is recorded as the acquisition adjustment. An acquisition adjustment does not represent a contribution of capital (i.e., either cash or new investment) to the public service. It merely represents a purchase of the legal interests in the properties that were possessed by the seller.

1 **Q. WHAT IS ORIGINAL COST?**

2 A. The term "original cost" as defined by the Federal Energy Regulatory Commission (FERC)
3 Uniform System of Accounts (USOA) is:

4 "Original cost," as applied to gas plant, means the cost of such property to
5 the person first devoting it to public service. (18 CFR, Part 201)

6 The deduction of depreciation, amortization, and CLAC from the original cost results in a net
7 original cost recorded on the seller's financial books and records. Thus, any property acquired is
8 valued on the books and records of the purchaser at the same value that the seller placed on it. This
9 principle is referred to as the "original cost first devoted to public service concept."

10 **Q. SHOULD THIS COMMISSION CONTINUE ITS PAST PRACTICE OF**
11 **ENDORING THE " ORIGINAL COST" CONCEPT?**

12 A. Yes. This Commission has the duty to ascertain the reasonable value of all property of any
13 regulated public utility within its jurisdiction whenever such value becomes necessary in order to
14 ascertain fair and reasonable rates. The rate base of a public utility represents the reasonable value
15 of all property which is in service and devoted to the public use. Because the value of a utility's
16 property remains unchanged as its stock is bought and sold, the transfer of stock, the change of
17 ownership in a corporate entity whose stockholders are separate and distinct from the entity itself,
18 does not affect the value of its property in service and devoted to the public use. Thus, no
19 recalculation of the utility's property, or rate base, is appropriate.

20

1 Q. IS THE USE OF NET ORIGINAL COST FOR VALUING RATE BASE THE
2 PREDOMINANT FORM OF REGULATION IN THE STATE OF MISSOURI?

3 A. Yes, it is. The use of original cost to set rates is not only the predominant form of regulation, but
4 the only form that has been employed by the Missouri Public Service Commission. I know of no
5 other time that this Commission has deviated from the concept of using net original cost in setting
6 rates.

7 Q. IS THE USE OF ORIGINAL COST FOR VALUING RATE BASE CONSISTENT
8 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)?

9 A. Yes, it is. The accounting profession's cost principle specifies that cash-equivalent cost is the most
10 useful basis for initial accounting recognition of the elements recorded in the accounts and reported
11 on the financial statements. It is important to note that the cost principle applies to the initial
12 recording of transactions and events. Financial Accounting Standards Board (FASB) Concepts
13 Statement 5, paragraph 67, explains that the initial cost is commonly adjusted for depreciation,
14 amortization or other allocations. The accounting constant is the starting point, which is the
15 historical (i.e., original) cost of the property being purchased.

16 Q. WHAT IS THE HISTORICAL BACKGROUND FOR THE POSITION THAT NET
17 ORIGINAL COST SHOULD BE THE BASIS FOR SETTING RATES?

18 A. Abuses occurred in the 1920's and 1930's that created the need to adopt the original cost method
19 for valuing rate base and setting rates. Utilities were acquiring other utility properties for amounts
20 in excess of net book value. The valuation and transfer of properties in excess of their book value
21 (i.e., positive acquisition adjustment) created inflated rate base which resulted in higher rates to

1 existing customers. The customers were paying higher rates based on services provided by the
2 exact same property that had been providing them utility service prior to the acquisition when, in
3 fact, nothing had changed except for the valuation of the properties transferred. Regulators and
4 legislators determined it was unreasonable to charge customers higher rates for the utilization of the
5 same utility property simply because the utility providing the service was acquired by another
6 company. Thus, the concept of using the original cost of the property when first devoted to public
7 service became to be widely accepted. This principle has served to protect ratepayers from utilities
8 who would buy properties at inflated prices and then seek revaluation of the properties at higher
9 levels in order to produce greater profits. Absent this protection, the potential for abuse through
10 acquisitions and mergers is the same today as it was prior to implementation of the original cost
11 concept.

12 **Q. HOW IS AN ACQUISITION ADJUSTMENT RECORDED IN THE FINANCIAL**
13 **BOOKS AND RECORDS?**

14 **A.** As I previously discussed in this testimony, an acquisition adjustment results when utility property
15 is purchased or acquired for an amount either in excess of or below book value. If the purchase
16 price exceeds book cost, a premium has been paid to the seller. If the purchase price is less than
17 book cost, a discount has been paid to the seller. The premium or discount would be classified and
18 booked on the purchasing company's financial records as an acquisition adjustment.

19 When utility property is purchased from another utility, the buyer is allowed to capitalize only the
20 cost of the property when it was originally dedicated to utility service. This means that the excess
21 paid over original cost for the property cannot be recorded in the USOA Account No. 101, Utility

Plant in Service. The difference (the premium amount) is recorded in the balance sheet plant USOA Account No. 114, Utility Plant Acquisition Adjustments, and any amortization of the balance is booked to the balance sheet plant reserve USOA Account No. 115, Accumulated Provision For Amortization or Acquisition Adjustments. The USOA account descriptions for the three accounts are as follows:

101. Gas plant in service

A. This account shall include the original cost of gas plant, included in accounts 301 to 399 prescribed herein owned and used by the utility in its gas operations and having an expectation of life in service of more than one year from date of installation. Including such property owned by the utility but held by nominees.

B. The cost of additions to and betterments of property leased from other which are includible in this account shall be recorded in subdivisions separate and distinct from those relating to owned property.

114. Gas plant acquisition adjustments

A. This account shall include the difference between (a) the cost to the accounting utility of gas plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (b) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated provisions for depreciation, depletion and amortization and contributions in aid of construction with respect to such property

B. With respect to acquisitions after the effective date of this system of accounts, this account shall be subdivided so as to show the amounts included herein for each property acquisition and to gas plant in service, gas plant held for future use and gas plant leased to others.

C. Debit amounts recorded in this account related to plant and land acquisition may be amortized to account 425, Miscellaneous Amortization, over a period not longer than the estimated remaining life of the properties to which such amounts relate. Amounts related to the acquisition of land only may be amortized to account 425 over a period of

1 not more than 15 years. Should a utility wish to account for debit amounts
2 in this account in any other manner, it shall petition the Commission for
3 authority to do so. Credit amounts recorded in this account shall be
4 accounted for as directed by the Commission.

5 115. Accumulated provisions for amortization of gas plant acquisition
6 adjustments

7 This account shall be credited or debited with amounts which are
8 includible in account 406, amortization of Gas Plant Acquisition
9 Adjustments or account 425, Miscellaneous Amortization, for the purpose
10 of providing for the extinguishment of amounts in account 114, Gas Plant
11 Acquisition Adjustments, in instances where the amortization of account
12 114 is not being made by direct write-off of the account.

13
14 The amortization of the acquisition adjustment is made to USOA account 406, Amortization of gas
15 plant acquisition adjustments, if the Commission grants authorization for above-the-line treatment
16 grants authorization. If Commission authorization is not given to include the amortization for
17 ratemaking purposes, the utility must account for the purchase price difference below-the-line in
18 USOA account 425, Miscellaneous amortization. The USOA account description for these two
19 accounts is as follows:

20 406. Amortization of gas plant acquisition adjustments

21 This account shall be debited or credited, as the case may be, with
22 amounts includible in operating expenses, pursuant to approval or order of
23 the Commission, for the purpose of providing for the extinguishment of
24 the amount in account 114, Gas Plant Acquisition Adjustments.

25
26 425. Miscellaneous amortization

27 This account shall include amortization charges not includible in other
28 accounts which are properly deductible in determining the income of the
29 utility before interest charges. Charges includible herein, if significant in

amount, must be in accordance with an orderly and systematic amortization program.

Items

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

2. Amortization of amounts in account 182, Extraordinary Property Losses, when not authorized to be included in utility operating expenses by the Commission.

3. Amortization of capital stock discount or expenses when in accordance with a systematic amortization program.

Q. WOULD RECOVERY IN RATES OF AN ACQUISITION PURCHASE PREMIUM BE A PUBLIC DETRIMENT?

A. Yes, it would be a detriment to ratepayers if rate recovery of any purchase price premium or purchase transaction costs are allowed recovery. To the extent any recovery of the purchase costs is included in rates it would have a detrimental effect on ratepayers because their gas costs will likely be higher than if the sale had not occurred.

Q. IF THE COMMISSION WERE TO DETERMINE THAT ACQUISITION PREMIUMS SHOULD BE INCLUDED IN THE RATEMAKING PROCESS, WOULD THERE BE A NEED FOR THE COMMISSION TO DETERMINE THE APPROPRIATE PRICE AT WHICH UTILITIES SHOULD ACQUIRE OTHER UTILITIES?

A. Yes, if the Commission were to adopt a position of including acquisition premiums in rates this would place the burden of determining the appropriate purchase price of acquired utilities on the

Commission. Clearly, it is a difficult process to determine what the least cost or otherwise appropriate price should be for an acquired utility. In order to make that determination, the Commission would have to place itself, or its agents, in the negotiation process to ascertain if a utility property was being or had been acquired at the lowest possible price. If this were not done, then there is no way the Commission could in no way ensure that the public would not be harmed (i.e., that the transaction was not detrimental to the public interest). Also, the Commission would be telling investors how to invest (or how much to invest).

By maintaining its current position of not authorizing direct or indirect recognition of either positive or negative acquisition adjustments in rates, the Commission can avoid making a determination that the utility property in question was acquired at the lowest possible or otherwise appropriate price. The practical effect of authorizing recovery of acquisition premiums in the ratemaking process is to shift the burden of proof from the Company to the Commission in making determinations regarding the purchase price of acquired utility properties.

Q. DID THE COMPANY PERFORM ANY TYPE OF VALUATION ANALYSIS?

A. **. _____ . ** (See Highly Confidential Schedule KKB-3)

Q. SHOULD THE COMMISSION BE REQUIRED TO DETERMINE THE REASONABLENESS OF THE OUTLAY FOR THE ACQUISITION?

A. No, it should not. The Commission was not an active participant to the negotiations and it does not have complete access to the universe of events, materials and rationales surrounding the negotiation procedures or processes occurring prior to the sale being consummated. To make that

1 determination, under these circumstances, the Commission would be put in the position of
2 endorsing or sanctioning the terms of an event of which it has only a limited or superficial
3 knowledge. To make such a broad-based decision based only upon the information at-hand would
4 be ill advised and may result in a determination which is not reasonable.

5 **Q. ONE OF THE STANDARDS THAT SOMETIMES HAS BEEN USED TO**
6 **DETERMINE THE RATEMAKING TREATMENT OF ACQUISITION ADJUSTMENTS**
7 **IS WHETHER THE PURCHASE OF THE PROPERTY WAS AN ARM'S LENGTH**
8 **TRANSACTION. IF THE PURCHASE OF THE UTILITY PROPERTY WAS AN**
9 **ARM'S LENGTH TRANSACTION, WOULD IT GUARANTEE THE LOWEST**
10 **PURCHASE PRICE?**

11 **A.** No. Simply because an acquisition of utility property would be considered an arm's length
12 transaction (i.e., no affiliation or tie between the negotiating parties), this criterion alone would not
13 guarantee the lowest possible purchase price. This is particularly true if the purchasing utility
14 management believed that the ratepayers would be required to pay for any premium above net book
15 value. In that circumstance, there certainly would be no guarantee that the purchasing utility would
16 have negotiated the best possible terms. Allowing recovery of an acquisition premium in rates does
17 not provide sufficient incentive for the acquiring utility to negotiate the best possible price for the
18 acquired firm. If a utility were allowed recovery of acquisition premiums, it could negotiate less
19 than favorable terms in acquiring a property with the knowledge that the ratepayers would provide
20 recovery through rates. Allowing acquisition premiums in rates sends signals to buyers of utility
21 property that recovery is guaranteed regardless of whether the purchase price represents an inflated

1 amount above the value of the utility property. If the acquisition premium is allowed in rates, both
2 the purchaser and the seller of said property could benefit from inflating the rate base, while the
3 ratepayer foots the bill. Allowing a company to recover an acquisition premium in rates is
4 inconsistent with the Commission's function of setting rates which are just and reasonable for both
5 the Company and its customers.

6 In addition, the adoption of positive acquisition adjustments for ratemaking purposes removes from
7 purchasing utilities an incentive to negotiate a lower price or terminate negotiations when a seller
8 requests an unreasonable price for the property in question. A policy of giving ratemaking
9 treatment to acquisition premiums would place Missouri jurisdictional utilities at a competitive
10 advantage over unregulated entities, since Missouri jurisdictional utilities then would have in
11 essence a blank check for recovery of their acquisition expenditures from ratepayers. This situation
12 does not exist for unregulated entities. Thus, if utility executives knew that there was a very good
13 chance of recovery from ratepayers of an acquisition premium resulting from the purchase of utility
14 property for an amount in excess of net book value (i.e., original cost) this would pose the potential
15 for tainting the negotiation process between the buyer and seller. The purpose of regulation is to
16 serve as a surrogate for competition. That purpose would be defeated by giving acquisition
17 adjustments when a regulated utility was purchased for an amount over net book value.

18 **Q. HOW DO SELLERS OF UTILITY PROPERTY BENEFIT FROM SELLING ABOVE**
19 **NET BOOK VALUE?**

20 **A.** The sale of utility property above net book value benefits the selling party because the gain that is
21 created is generally treated below-the-line to the sole benefit of shareholders. The higher the price

1 that the utility property is sold at, the larger the gain for the seller. Clearly, if the buyer believes
2 there will be a recovery of the acquisition premium, there would be a greater potential for an
3 inflated rate base, which in turn would result in higher utility rates for customers as well as a larger
4 gain to the seller.

5 Based on past Commission practice, utilities expect, even demand that any gain on the sale of
6 company assets go to benefit the selling utility's shareholders, not ratepayers. To my knowledge,
7 no utility has ever come forward proposing any form of sharing the gains from the sale of
8 properties with ratepayers. It is inconsistent and extremely unfair to expect utility customers to pay
9 for the acquisition premium through rates, and then when the company disposes of the property
10 purchased, to allow only the shareholders to reap the benefits of any gains.

11 **Q. DO UTILITIES BENEFIT FROM THIS COMMISSION'S PRACTICE OF NOT**
12 **ALLOWING RECOVERY OF AN ACQUISITION PREMIUM IN RATES?**

13 A. Yes, they do. Based on the ratemaking treatment afforded utilities in the past, if there is an asset
14 acquired at less than net book value, utility shareholders reap any benefits associated with the
15 acquisition of that asset. This occurs because the buyer records the asset on its financial books at
16 net book value (i.e., that is the asset's original cost instead of the below book purchase price).

17 **Q. DO UTILITIES BENEFIT FROM CONSISTENT TREATMENT OF ACQUISITION**
18 **ADJUSTMENTS?**

19 A. Yes, they do. Utilities that purchase property below book value resulting in negative acquisition
20 adjustments benefit because those same utilities receive a return on property valued at its net

1 original cost, not the purchase price. Since these utilities would be receiving a return on the net
2 original cost rate base; their return component would be computed on a rate base greater than that
3 which these utilities actually had invested. If the Commission then decides to allow utilities to
4 recover positive acquisition premiums, it creates a situation whereby utilities are put in the position
5 of arguing for net original cost ratemaking whenever a negative acquisition premium occurs, while
6 at the same time advocating that positive acquisition premiums be treated above net original cost.
7 Under either scenario, the utility would benefit to the detriment of the ratepayers.

8 **Q. ARE YOU AWARE OF ANY CASE IN MISSOURI WHEREBY A NEGATIVE**
9 **ACQUISITION ADJUSTMENT WAS AFFORDED ORIGINAL COST RATE**
10 **TREATMENT?**

11 A. Yes, I am. In the U.S. Water/Lexington, Missouri (U.S. Water) general rate case, Case No. WR-88-
12 255, the Commission rejected a negative acquisition adjustment that was proposed by this Office.
13 The negative acquisition adjustment was not used by the Commission to reduce U.S. Water's rate
14 base or to reflect a negative amortization to the cost of service. This Commission determined that
15 the reasonable value of property purchased from other utilities was not its purchase price but rather
16 the higher original cost to the first entity that devoted the property to public use.

17 The Commission did not recognize the negative acquisition adjustment associated with the
18 purchase nor, did it write down the value of the assets transferred; therefore, it would be
19 inconsistent to write up the assets, by whatever means, either through the recovery of an acquisition
20 premium or acceptance of any sharing of acquisition-related savings. Acceptance of a recovery of

1 an acquisition premium would be a reversal of the Commission precedent set in the U.S. Water rate
2 case.

3 **Q. DOES USING NET ORIGINAL COST VALUATION FOR RATEMAKING**
4 **PURPOSES GIVE CONSISTENT TREATMENT TO UTILITIES?**

5 A. Yes, it does. Using net original cost to determine rate base valuation for ratemaking purposes
6 provides utilities consistency in establishing their rates. It also provide utilities with the incentive
7 to acquire utility properties termed "troubled utilities" where it would be in the public interest for
8 these troubled utilities to be acquired by another utility. For example, if the Commission was
9 confronted with a troubled property and there was a buyer willing to purchase that troubled
10 property for less than original cost, the difference between the original cost and the lower purchase
11 price would be part of the incentive for the buyer to consummate the transaction. Without the
12 incentive associated with this opportunity, the property may never change hands and improvements
13 wouldn't even have been contemplated.

14 **Q. HOW HAVE GAINS ON SALE OF UTILITY PROPERTY BEEN TREATED FOR**
15 **RATEMAKING PURPOSES?**

16 A. To my knowledge, the Commission has never allowed ratepayers to share in any gains resulting
17 from the sale of a utility's property. The selling utility's shareholders have always realized the
18 entire benefit of any gains received.

19 The Commission's position on this issue is illustrated by its decision in Kansas City Power &
20 Light, Case No. ER-77-118. On page 42 of its Report and Order, the Commission stated:

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

9 Furthermore, in decisions reached by the Commission in rate cases involving Missouri Cities Water
10 Company, Case No. WR-83-14, and Kansas City Power & Light, Case No. EO-85-185, the
11 Commission found that gains of utility property sold by those utilities would be treated below-the-
12 line.

13 The Commission has consistently followed this practice of not allowing any gains resulting from
14 sales of utility property to flow to ratepayers. It would be inequitable for the shareholders of a
15 seller of utility property to receive the benefit of any gain, while at the same time, the buyer of
16 utility property is permitted to recover from its ratepayers any premium above net book value. It
17 would also be unfair to ratepayers if the seller's gain were taken below-the-line while the buyer's
18 premium is provided recovery above-the-line.

19 **Q. HAS THE COMMISSION BEEN CONSISTENT IN ITS TREATMENT OF**
20 **ACQUISITION PREMIUMS AND GAINS ON SALE OF UTILITY PROPERTY?**

21 **A.** Yes, it has. To my knowledge, this Commission has accorded acquisition premiums and gains on
22 sale of utility property consistent treatment in the ratemaking process. It has consistently ignored
23 the positive as well as the negative acquisition adjustments that have resulted from utility
24 acquisitions and mergers under its jurisdiction. It has also disregarded the concept of flowing any

gains derived from the sale of utility property to ratepayers. It has taken the position, as noted previously, that gains from the disposal of utility property belong to the utility's shareholders.

Q. PLEASE CITE A CASE IN WHICH THE COMMISSION HAS PREVIOUSLY DENIED AN ACQUISITION ADJUSTMENT?

A. The Commission ruled the following in the Missouri-American Water Company Case No. WR-95-205:

Missouri-American is proposing recovery of this acquisition adjustment in its revenue requirement. Missouri-American is requesting that it be authorized to amortize the acquisition adjustment over a 40-year period as well as include the unamortized acquisition adjustment in its rate base. This has the effect of increasing the company's revenue requirement by \$692,513. Missouri-American has stated four primary arguments in support of its request. First, the Company has demonstrated that the acquisition has already resulted in actual cost savings which more than offset the associated revenue requirement of including the acquisition adjustment in cost of service. Second, these (aforementioned) cost savings to ratepayers will continue to increase over time. Third, ratepayers of Missouri-American (including former ratepayers of MCWC) are receiving improved service as a result of the acquisition. Fourth, public policy is best served by encouraging mergers and acquisitions where cost savings or other benefits can be demonstrated to accrue to ratepayers.

The commission finds in this case that the Company has failed to justify an allowance for the acquisition adjustment.....Therefore, the Commission finds that the original cost principle is sound for the purposes of this case. The Commission finds it is appropriate that the excess purchase costs over and above the net original cost of the Missouri Cities Water company properties be booked to USOA Account 114 (Utility Plant Acquisition Adjustment) and be amortized below the line over 40 years to USOA Account 425 (Miscellaneous Amortization).

1 Q. WOULD THE CONTINUED DISALLOWANCE OF THE RECOVERY OF ANY
2 ACQUISITION PREMIUM IN RATES CREATE A DISINCENTIVE FOR
3 UTILITES TO ACQUIRE OTHER UTILITES?

4 A. No. If the utility considering an acquisition believes that it is in its economic as well as its business
5 interest, it would still acquire the other company regardless of any recovery of an acquisition
6 premium from ratepayers. The prudent thing to do would be for the utility to pursue the acquisition
7 if it is considered to be in the best interest of the utility and the public absent an acquisition
8 premium recovery.

9 Q. HAVE ANY UTILITES PREVIOUSLY REQUESTED RECOVERY OF
10 ACQUISITION PREMIUMS BY DEMONSTRATING ALLEGED SAVINGS
11 RELATING TO THE ACQUISITION?

12 A. Yes. In the past, a number of utilities have attempted to convince regulators to permit recovery of
13 acquisition premiums by demonstrating purported savings relating to the acquisition. This is often
14 referred to as the "benefits test." However, actual savings that may result from an acquisition
15 and/or merger are very difficult to identify, and even harder to prove. All or a portion of the
16 savings purported to occur might have resulted from prudent management decisions other than the
17 acquisition as part of the ongoing operations of the utility. It is difficult, if not impossible, process
18 to determine if the savings are related to the acquisition or whether the savings would have
19 eventually occurred anyway. Purported savings are by their very nature vague, subjective, and
20 difficult to quantify.

1 Q. WHY IS IT DIFFFICULT TO PROVE AND VERIFY THE ACTUAL SAVINGS
2 THAT ARE RELATED TO THE ACQUISITION?

3 A. Utilities are very complex organizations with many overlapping activity and functional areas. They
4 also are dynamic organizations that operate in an ever-changing environment. Generally, utilities
5 are constantly organizing and reorganizing functions within its corporate structure to streamline
6 activities and obtain efficiencies where possible. Most utilities should and do attempt to achieve
7 efficiencies through implementation of productivity measures. It is unrealistic to believe that a
8 tracking system could be put in place to identify and quantify savings and then isolate these savings
9 as acquisition or non-acquisition related. It is very difficult to determine and measure the cause and
10 effect relationship that may exist between taking an action and identifying and measuring the
11 effects of that action.

12 Any cost saving tracking system developed would have to be sophisticated enough to not only
13 identify categories of savings and costs, but to create documentation so that an examination can be
14 conducted many years after the fact to recreate the decision-making process surrounding the costs
15 and savings. Obviously, a great number of controversies and differences can develop within the
16 context of the after-the-fact analysis. What one party may believe is the result of an acquisition;
17 another may view as nothing more than an operating efficiency of an ongoing concern. As stated
18 previously, there will be incentive for the utility to identify as many reductions to work force and
19 corresponding reductions in cost as acquisition-related. With this inherent incentive, it will become
20 more difficult going forward to truly identify and quantify acquisition as opposed to non-
21 acquisition related cost savings.

TRANSACTION COSTS

Q. WHAT ARE TRANSACTION COSTS?

A. Transaction costs are costs incurred by both the acquiring company and the acquired company for the purpose of consummating the purchase. The majority of transaction costs will be incurred prior to the purchase closing. Examples include costs and/or fees paid for legal, banking, and consulting services necessary to close the transaction and gain regulatory approval.

Q. SHOULD RATE RECOVERY OF TRANSACTION COSTS BE ALLOWED?

A. No. The purchase price and transaction costs are ownership costs that are rightly absorbed by the owners of the acquiring and acquired companies. For example, the purchase would not take place without the shareholders of both companies approving the transaction. The decision on the amount of money to pay to acquire a company and the amount of money to accept in selling a company is made by the board of directors in their duty to the company shareholders. Once an agreement between the board of directors of both companies is reached, a special meeting is usually required to be held in which both shareholder groups vote to approve or reject the purchase. A purchase is approved, if, and only if, both owner groups believe it is in their best interests.

Ratepayers interests are not considered in the decision to buy or sell a utility. Ratepayers, as non-owners, have no ownership rights in utility assets, no vote in the decision to be a part of a purchase, and little to no influence in the structure of the terms and conditions of the transaction.

1 Q. HAS THE COMPANY REQUESTED RECOVERY OF ANY TRANSACTION COSTS.

2 A. **
3
4
5 **

7 AFFILIATED TRANSACTIONS

8 Q. PLEASE EXPLAIN YOUR UNDERSTANDING OF AFFILIATED TRANSACTIONS
9 AND HOW SUCH TRANSACTIONS CAN HAVE A DETRIMENTAL EFFECT ON
10 THE RATEPAYERS.

11 A. An affiliated transaction is any transaction between two companies or operating divisions that also
12 have a corporate relationship. This relationship could include one firm being a subsidiary of the
13 other, both firm's stock being held by the same parent, or other various corporate relationships.
14 The potential detrimental financial consequences for ratepayers stem from the distinct possibility
15 that the utility will use its monopoly position to extract higher rates from the captive or monopoly
16 ratepayers or use its monopoly advantage to stifle potential competitors in the unregulated industry.
17 The utility may also incur higher costs, thus producing higher rates, by purchasing goods or
18 services from the affiliated non-regulated entity at a price higher than the non-regulated entity's
19 competitor.

1 Any cross-subsidization that occurs between the regulated and non-regulated companies could
2 create an unfair advantage to the non-regulated affiliate. The Commission must ensure that any
3 transfer pricing and cost allocations that occur will adequately recover utility costs and prevent
4 cross-subsidization, it must also prevent anti-competitive consequences by ensuring that
5 confidential market sensitive information is not transferred between the utility and the non-
6 regulated affiliate.

7 **Q. WHAT DO YOU MEAN WHEN YOU USE THE TERM "CROSS-**
8 **SUBSIDIZATION" ?**

9 A. The term describes the transfer of goods and services, financial or non-financial, from the regulated
10 company to the non-regulated company at a price or cost below the actual cost to the regulated
11 company. When such an event occurs the regulated company does not receive compensation for
12 the goods or services equal to the actual costs of the goods or services. Such an event penalizes
13 ratepayers because the costs for which the regulated utility did not receive compensation from the
14 non-regulated affiliate, are likely to be passed on to the regulated utility's captive ratepayers as an
15 element of the regulated company cost of service when, in fact, ratepayers have already
16 compensated the utility for the costs.

17 **Q. IF THE RATES CHARGED THE RATEPAYER ARE EQUAL TO THE COST THE**
18 **UTILITY INCURS, PLEASE EXPLAIN HOW THE RATEPAYERS COULD BE**
19 **CHARGED RATES HIGHER THAN APPROPRIATE RATES.**

20 A. Purchases of goods or services by an affiliate company result in a revenue or asset being recorded
21 on the utility company's financial records. The revenue or asset will offset the utility's cost of

1 producing the goods or services. However, if the price paid by the affiliate is below the production
2 cost of the good or service, the utility company must recover the difference elsewhere. The
3 customer most likely to make up the difference will be the regulated company's captive utility
4 customers.

5 Stated another way, there is the potential for a non-regulated affiliate to gain a competitive
6 advantage due to transfer pricing below fair market value. There is also the potential for excessive
7 use of utility services or property in a way that may diminish the quality of service or increase the
8 cost of service provided by the utility to the ratepayer.

9 **Q. PLEASE EXPLAIN HOW A UTILITY COULD USE ITS MONOPOLY POSITION**
10 **TO STIFLE COMPETITION IN THE COMPETITIVE SEGMENTS OF THE GAS**
11 **INDUSTRY.**

12 **A.** There are multiple ways, both direct and indirect, that a utility could adversely affect competition,
13 for example:

- 14 1. A utility would be able to give preferential treatment to an affiliate
15 company that supplies goods or services by not requiring a competitive
16 bidding process or allowing insider information on the bid process via
17 direct means of the use of common employees.
- 18 2. A utility could supply a marketing affiliate with data not normally
19 available to the affiliates competitors such as customer billing information
20 in either a direct means or through the use of common employees or other
21 access to the joint corporate records.
- 22 3. A utility and an affiliate could jointly advertise thereby allowing the
23 affiliate to utilize the goodwill that the monopoly utility has developed
24 over the decades it has served as a sole source provider of a ratepayer
25 funded basic service.

1 4. A utility could offer single billing for both its services and those of the
2 affiliate.

3 5. A utility could jointly market its services and those of the affiliate via its
4 customer service personnel.

5 6 A utility could allow an affiliate to utilize the brand name and logo of the
6 utility in conducting affiliates business.

7
8 **Q. WHO HAS THE BURDEN OF DEMONSTRATING THE REASONABLENESS OF THE**
9 **COST OF AFFILIATED TRANSACTIONS?**

10 A. The utility bears the responsibility to demonstrate the reasonableness of the revenues and costs
11 associated with affiliated transactions. Absent evidence of reasonableness such transactions cannot
12 be considered to be accomplished at arm's length. Such transactions should be subjected to close
13 scrutiny.

14 **Q. PLEASE CITE THE AFFILIATED TRANSACTION STANDARDS LISTED IN THE**
15 **AFFILIATED TRANSACTION RULE (4CSR240.015) THAT YOU WOULD**
16 **EXPECT THE COMPANY TO FOLLOW.**

17 A. The following list is not exhaustive but highlights the types of safeguards OPC would expect to see
18 to protect the captive utility customers from cross-subsidization of its non-regulated activities.

19 Affiliated Transactions Standards

20 A) A regulated gas corporation shall not provide a financial advantage to an
21 affiliated entity. For the purposes of this rule, a regulated gas corporation
22 shall be deemed to provide a financial advantage to an affiliated entity if

23 1) It compensates an affiliated entity for goods or services above the
24 lessor of

1 A. The fair market price; or

2 B. The fully distributed cost of the regulated gas corporation to
3 provide the goods or services for itself; or

4 2) It transfers information, assets, goods or services of any kind to an
5 affiliated entity below the greater of

6 A. The fair market price; or

7 B. The fully distributed cost to the regulate gas corporation.

8 B) Except as necessary to provide corporate support functions, the regulated
9 gas corporation shall conduct its business in such a way as not to provide
10 any preferential service, information or treatment to an affiliate entity over
11 another party at any time.

12 C) Specific customer information shall be made available to affiliated or
13 unaffiliated entities only upon consent of the customer or as otherwise
14 provided by law or commission rules or orders. General or aggregated
15 customer information shall be made available to affiliated or unaffiliated
16 entities upon similar terms and conditions. The regulated gas corporation
17 may set reasonable charges for costs incurred in producing customer
18 information. Customer information includes information provided to the
19 regulated utility or unaffiliated entities.

20 D) The regulated gas corporation shall not participate in any affiliated
21 transactions which are not in compliance with this rule, except as
22 otherwise provide in section (10) of this rule.

23 E) If a customer requests information from the regulated gas corporation
24 about goods or services provided by an affiliated entity, the regulated gas
25 corporation may provide information about its affiliate but must inform
26 the customer that regulated services are not tied to the use of an affiliate
27 provider and that other service providers may be available. The regulated
28 gas corporation may provide reference to other service providers or to
29 commercial listings, but is not required to do so. The regulated gas
30 corporation shall include in its annual Cost Allocation Manual (CAM), the
31 criteria, guidelines and procedures it will follow to be in compliance with
32 the rule.

33 F. Marketing materials, information or advertisements by an affiliate entity
34 that share an exact or similar name, logo or trademark of the regulated
35 utility shall clearly display or announce that the affiliate entity is not
36 regulated by the Missouri Public Service Commission.

Record Keeping Requirements

A) A regulated gas corporation shall maintain books, accounts and records separate from those of its affiliates.

B) Each regulated gas corporation shall maintain the following information in a mutually agreed-to electronic form (i.e., agreement between the staff, Office of Public Counsel and the regulated gas corporation) regarding affiliate transactions on a calendar year basis and shall provide such information to the commission staff and the Office of Public Counsel on, or before, March 15 of the succeeding year:

1. A full and complete list of all affiliated entities as defined by this rule;

2. A full and complete list of all goods and services provided to or received from affiliated entities;

3. A full and complete list of all contracts entered with affiliated entities;

4. A full and complete list of all affiliate transactions undertaken with affiliated entities without a written contract together with a brief explanation of why there was no contract;

5. The amount of all affiliate transactions, by affiliated entity and account charged; and

6. The basis used (e.g., fair market price, FDC, etc.) to record each type of affiliate transaction.

C) In addition each regulated gas corporation shall maintain the following information regarding affiliate transactions on a calendar year basis:

1. Records identifying the basis used (e.g., fair market price, FDC, etc.) to record all affiliate transactions; and

2. Books of accounts and supporting records in sufficient detail to permit verification of compliance with this rule.

Records of Affiliated Entities

A) Each regulated gas corporation shall ensure that its parent and any other affiliated entities maintain books and records that include, at a minimum, the following information regarding affiliate transactions:

1 1. Documentation of the costs associated with affiliate transactions that
2 are incurred by the parent or affiliated entity and charged to the regulated
3 gas corporation;

4 2. Documentation of the methods used to allocate and/or share costs
5 between affiliated entities, including other jurisdictions and/or corporate
6 divisions;

7 3. Description of costs that are not subject to allocation to affiliate
8 transactions and documentation supporting the nonassignment of these
9 costs to affiliate transactions;

10 4. Descriptions of the types of services that corporate divisions and/or
11 other centralized functions provided to any affiliated entity or division
12 accessing the regulated gas corporation's contracted services or facilities;

13 5. Names and job descriptions of the employees from the regulated gas
14 corporation that transferred to a nonregulated affiliated entity;

15 6. Evaluations of the effect on the reliability of services provided by the
16 regulated gas corporation resulting from the access to regulated contracts
17 and/or facilities by affiliated entities;

18 7. Policies regarding the availability of customer information and the
19 access to services available to nonregulated affiliated entities desiring use
20 of the regulated gas corporation's contracts and facilities; and

21 8. Descriptions of, and supporting documentation related to, any use of
22 derivatives that may be related to the regulated gas corporation's
23 operation, even though obtained by the parent or affiliated entity.

24 Access to Records of Affiliated Entities

25 A) To the extent permitted by applicable law, and pursuant to established
26 commission discovery procedures, a regulated gas corporation shall make
27 available the books and records of its parent and any other affiliated
28 entities when required in the application of this rule.

29 B) The commission shall have the authority to

30 1. Review, inspect and audit books, accounts and other records kept by a
31 regulated gas corporation or affiliated entity for the sole purpose of
32 ensuring compliance with this rule and make findings available to the
33 commission; and

1 2. Investigate the operations of a regulated gas corporation or affiliated
2 entity and their relationship to each other for the sole purpose of ensuring
3 compliance with this rule.

4 C) That this rule does not modify existing legal standards regarding which
5 party has the burden of proof in commission proceedings.

6 **RECOMMENDATION**

7 **Q. WHAT IS PUBLIC COUNSEL'S RECOMMENDATION REGARDING THIS**
8 **ACQUISITION?**

9 A. Public Counsel recommends that the Commission not approve of this acquisition. If Gateway
10 provides sufficient additional information (See the Rebuttal testimony of Mark Burdette) this
11 recommendation could change.

12 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

13 A. Yes.

CASE PARTICIPATION
OF
KIMBERLY K. BOLIN

<u>Company Name</u>	<u>Case Number</u>
St. Louis County Water Company	WR-95-145
Missouri-American Water Company	WR-95-205
Steelville Telephone Company	TR-96-123
St. Louis Water Company	WR-96-263
Imperial Utility Corporation	SR-96-427
Missouri-American Water Company	WA-97-45
Associated Natural Gas Company	GR-97-272
St. Louis County Water Company	WR-97-382
Union Electric Company	GR-97-393
Gascony Water Company, Inc.	WA-97-510
Missouri Gas Energy	GR-98-140
Laclede Gas Company	GR-98-374
St. Joseph Light & Power	ER-99-247 GR-99-246 HR-99-245
Laclede Gas Company	GR-99-315
Missouri-American Water Company	WR-2000-281
St. Louis County Water Company	WR-2000-844
Osage Water Company	SR-2000-556 WR-2000-557
Empire District Electric Company	ER-2001-299

SCHEDULE KKB-2
HAS BEEN DEEMED
HIGHLY CONFIDENTIAL
IN ITS ENTIRETY.

SCHEDULE KKB-3
HAS BEEN DEEMED
HIGHLY CONFIDENTIAL
IN ITS ENTIRETY.

SCHEDULE KKB-4
HAS BEEN DEEMED
HIGHLY CONFIDENTIAL
IN ITS ENTIRETY.