

Exhibit No.:

Issues:

Merger Accounting
Pooling of Interests
Merger Premium
Merger Benefits
Acquisition Adjustment
Deferred Taxes

Witness:

Charles R. Hyneman

Sponsoring Party:

MoPSC Staff

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Rebuttal Testimony

Case No.:

EM-2000-292

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

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REBUTTAL TESTIMONY

Missouri Public
Service Commission

OF

CHARLES R. HYNEMAN

UTILICORP UNITED INC.

AND

ST. JOSEPH LIGHT & POWER COMPANY

CASE NO. EM-2000-292

Jefferson City, Missouri
May 2000

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

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CHARLES R. HYNEMAN

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Rebuttal Testimony of
Charles R. Hyneman

1 Q. With reference to Case No. EM-2000-292, have you examined the books and
2 records of UtiliCorp United, Inc. (UtiliCorp) and St. Joseph Light & Power Company (SJLP)
3 (collectively Joint Applicants)?

4 A. Yes, with the assistance of other members of the Commission Staff (Staff).

5 Q. What is the purpose of your rebuttal testimony in this Case?

6 A. I will begin with a description of the accounting rules for mergers and
7 acquisitions, including a description of the benefits of the pooling of interests accounting
8 method. I will also explain the reason why UtiliCorp changed from its original decision to
9 account for this merger as a pooling of interests to accounting as a purchase. I will then
10 describe the different types of merger costs (merger premium, transaction and transition
11 costs) and the reason why the Staff is proposing different ratemaking treatment for these
12 costs. In the acquisition adjustment section of my testimony, I will describe the two
13 components of the acquisition adjustment (gain on sale and merger benefits or goodwill) that
14 UtiliCorp proposes to recover from SJLP's ratepayers and who will be the primary
15 beneficiary from incurring this acquisition adjustment. Finally, I will describe the Staff's
16 concern about the possibility of the loss of SJLP's accumulated deferred income taxes as a
17 result of this merger.

18 **MERGER ACCOUNTING**

19 Q. Before you begin with a description of the accounting rules for mergers,
20 please explain and differentiate between the terms goodwill and acquisition adjustment.

21 A. The term acquisition adjustment is applied only to regulated utilities. It
22 represents the difference between the amount paid to purchase a utility, and the net book
23 value (NBV) of the utility's assets. The NBV of a company is the same as the stockholders'

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1 equity and is the residual asset value remaining after subtracting all liabilities. The Federal
2 Energy Regulatory Commission's (FERC) Uniform System of Accounts (USOA) defines an
3 acquisition adjustment as "the difference between the original cost of an asset when first
4 placed in service (book cost or book value) and the actual cost to the utility of acquiring the
5 asset."

6 Goodwill is the difference between the amount paid to acquire a group of assets and
7 the current fair market value (FMV) of the individual assets. The asset goodwill is only
8 created in mergers or acquisitions accounted for under purchase accounting rules. Under
9 purchase accounting rules, acquired assets are recorded at the usually higher fair market
10 values (stepped-up basis), while pooling accounting rules require assets to be recorded at
11 existing historical cost or book value, thus there is no goodwill to be recorded. The
12 numerical difference between an acquisition adjustment and goodwill is:

13 Acquisition Adjustment	=	(Purchase Price - NBV)
14 Goodwill	=	(Purchase Price - FMV)

15
16 As an example, assume the following facts: XYZ Company purchases ABC Company
17 for \$1 million. The fair market value of ABC Company's assets is \$800,000 and the NBV of
18 these assets is \$300,000.

19 *A regulated company would record an acquisition adjustment of \$700,000
20 (\$1,000,000 purchase price less \$300,000 NBV) and carryover the purchased assets at
21 original cost. ABC Company's assets will be reflected in XYZ's balance sheet at the
22 following amounts:

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Plant and Equipment (net of depreciation reserve)	\$ 300,000 (NBV)
Acquisition Adjustment	<u>\$ 700,000</u>
Total Assets	\$1,000,000

*A nonregulated company would record the acquired assets at fair market value on its balance sheet and record the intangible asset Goodwill of \$200,000 (\$1,000,000 purchase price less \$800,000 FMV).

Plant and Equipment (net of depreciation reserve)	\$ 800,000 (FMV)
Goodwill	<u>\$ 200,000</u>
Total Assets	\$1,000,000

It is common for both regulated and nonregulated companies to amortize the acquisition adjustment/goodwill over 40 years, the longest period allowed by generally accepted accounting principles (GAAP).

Q. In its testimony, is the Staff using the term "merger premium" to represent the difference between the purchase price UtiliCorp agreed to pay for SJLP's assets, less the net book value of those assets?

A. Yes. The term "merger premium," as commonly used, can mean either the purchase price in excess of the book value or the purchase price in excess of the market value of the net assets acquired. Unless otherwise indicated, when used in the Staff's testimony in this proceeding, the term merger premium means the purchase price in excess of the book value of the net assets acquired. Both the merger premium and merger transaction costs make up the acquisition adjustment.

APB 16 – POOLING OF INTERESTS AND PURCHASE

Q. Please describe how companies are required to account for mergers and acquisitions in financial records.

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1 A. Companies are required to comply with Accounting Principles Board Opinion
2 No. 16 (APB 16), entitled *Business Combinations*, as promulgated by the Financial
3 Accounting Standards Board (FASB). Companies that account for a business combination
4 under APB 16's purchase method accounting rules (described below) must also comply with
5 the requirements of Accounting Principles Board Opinion No. 17 (APB 17) entitled
6 *Intangible Assets* as it relates to goodwill.

7 Q. Please provide a general description of APB 16.

8 A. Depending on the nature and characteristics of the merger, APB 16 allows for
9 two completely different methods of accounting for business combinations. The two
10 methods are referred to as the purchase method and the pooling of interests method.
11 Purchase accounting rules reflect the substance of the merger as one company actually
12 purchasing the assets of another company. The pooling of interests rules reflect that the
13 transaction is not a purchase of assets, but a combination of the shareholder interests in the
14 net assets of the combining companies.

15 Purchase accounting rules require the acquiring company to record the purchase of
16 the acquired company's assets and liabilities at the fair market value on the date of
17 combination. Any excess of the purchase price over the fair market value of the individual
18 net assets acquired is recorded as goodwill. In contrast, pooling of interests accounting
19 requires that the book value of the assets of the two combining companies be simply added
20 together on the combined balance sheet. No intangible asset (goodwill) is created by the
21 merger.

22 Q. Please explain why the purchase method of accounting results in the
23 recognition of goodwill and the pooling method does not.

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1 A. In a pooling of interests merger, the determination of an acquisition price is
2 not relevant. No valuation adjustments are made and no goodwill or acquisition adjustment
3 is recorded. The book values of the two companies are simply brought together to produce a
4 set of combined financial records. The merger transaction in a pooling of interests is
5 considered to be between the shareholders and not the companies themselves.

6 A merger recorded using the purchase method is not considered as a joining of
7 stockholder groups but an acquisition of one company by another company. Because the
8 merger is considered a purchase, APB 16 requires the assets acquired to be revalued from
9 current book value to current fair value prior to being recorded in the financial records of the
10 acquiring company.

11 After the valuation adjustments from book value to fair value are made, any amount
12 of the purchase price that has not been allocated in revaluing the assets is recorded as a
13 separate intangible asset called goodwill. For utility companies, the total amount of the
14 acquisition price (including transaction costs) over the book value (original cost less
15 depreciation and amortization) of the acquired assets is recorded as an acquisition
16 adjustment. Generally, utilities are not permitted to revalue their assets in any type of
17 ownership change, but must use the original cost of the investments as the value of the assets
18 on their books. The acquisition adjustment is used to reflect the difference between the
19 original cost of the assets and the purchase price paid to acquire those assets.

20 Q. Why are pooling accounting rules very different from purchase accounting
21 rules?

22 A. When stock is the consideration in a merger, the stockholders in the acquired
23 company become stockholders in a bigger combined company. If other conditions are met,

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1 the merger is considered more of a combining of ownership interests (pooling of interest)
2 than an actual purchase of assets (purchase).

3 Pooling of interest accounting rules are designed to reflect the substance of a
4 transaction as a combination of two ownership groups into a single ownership group. The
5 combining stockholder groups neither withdraw nor invest assets but merely exchange
6 common stock in a ratio that determines their respective interests in the combined
7 corporation. This is why the primary requirement to use pooling accounting is the exchange
8 of common stock. A merger that combines virtually all of existing common stock interests
9 avoids combining only selected assets, operations, or ownership interests, any of which is
10 more reflective of a disposal and acquisition of interests (a purchase) than a mutual sharing
11 of risks and rights in the combined operations (a pooling).

12 Q. Does APB 16 require certain conditions be met in order for a merger to be
13 accounted for as a pooling of interests?

14 A. Yes. APB 16 requires that the structure and terms of a proposed merger meet
15 12 specific conditions to qualify for pooling of interests accounting treatment. If the
16 structure of the merger transaction violates or does not meet any of the 12 pooling conditions,
17 the merger must be accounted using the purchase accounting rules.

18 Q. Why are there certain conditions that must be met to account for a merger or
19 acquisition as a pooling of interests?

20 A. A pooling of interests is intended to present as a single interest two previously
21 independent common stockholder interests. Mergers that do not reflect a "mutual sharing of
22 rights and risks" can preclude the use of pooling of interest accounting. Some examples that
23 violate the intent of a pooling of interest are transactions or events that:

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- 1 a. Alter the relative voting rights or equity interests of the stockholder
- 2 groups;
- 3 b. Result in preferential claims to dividends or assets to one group;
- 4 c. Leave significant minority interests in combining companies.
- 5

6 In addition, other transactions, events or merger conditions that reduce the common
7 stock interests of the separate stockholder groups are contrary to the idea of "combining"
8 existing stockholder interests and will prevent pooling of interests accounting. A listing of
9 the 12 pooling of interests conditions is provided in Schedule DJS-2 to UtiliCorp witness
10 Dan J. Streek's direct testimony in this case.

11 Q. Is the FASB currently involved in a project to review and possibly change the
12 current approved methods of accounting for business combinations?

13 A. Yes. In September 1999, the FASB announced its intention to eliminate the
14 pooling of interests method in an exposure draft of a new accounting standard for business
15 combinations.

16 This exposure draft has generated a significant controversy in the business
17 community, and many companies, especially in the technology industry, are requesting that
18 the FASB reconsider its decision and retain the pooling of interests accounting method. Both
19 the House Commerce Committee and the Senate Banking Committee of the U. S. Congress
20 recently held hearings on the FASB proposal to eliminate pooling accounting. The House
21 Commerce Committee has even sent letters to the FASB and the Securities and Exchange
22 Commission (SEC) seeking a one-year delay in the ban on the pooling of interests method so
23 that the SEC could conduct a study examining the impact of the pooling ban on the U.S.
24 economy.

25 Q. Is there a chance that the FASB will abandon its efforts to eliminate the
26 pooling of interests accounting method as a result of pressure from the U.S. Congress?

1 A. Yes. As described above, there is an indication that the Congress is opposed
2 to the FASB's proposal. The last time the Congress expressed significant concern with a
3 FASB proposal was in 1993 when the FASB proposed that the issuance of stock options be
4 reflected as an expense in the income statement. The Congress, responding to a tremendous
5 outcry from the business community, put significant pressure on the FASB to abandon this
6 proposal, which the FASB eventually did. Coincidentally, significant opposition to the
7 FASB's stock option proposal was from the technology industry, the same industry opposed
8 to the elimination of the pooling of interests method.

9 Q. Did the FASB's current project on business combinations have any effect on
10 UtiliCorp's decision to account for its acquisition of SJLP as a purchase instead of a pooling
11 of interests?

12 A. No. Any new rulemaking by the FASB that could affect the use of pooling of
13 interests accounting is unlikely to become effective until the end of this year. Even when
14 (and if) a new FASB pronouncement is issued, it would not apply to merger agreements that
15 were in progress prior to its issuance. UtiliCorp witness Streek recognized this in his direct
16 testimony at page 4 where he states "the exposure draft will only affect transactions that are
17 initiated after the final standard is issued, expected sometime in 2000."

18 **BENEFITS OF POOLING OF INTERESTS ACCOUNTING**

19 Q. Which of the two methods of accounting for business combinations is
20 generally considered the preferable method?

21 A. For many businesses, pooling of interests is preferable to purchase accounting.
22 This is why the FASB's proposal to eliminate pooling of interests accounting has run into
23 such stiff opposition from the business community.

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1 Q. Why is the pooling of interests method considered preferable to the purchase
2 method?

3 A. In a merger accounted for as a pooling of interests there is no recognition of
4 goodwill (acquisition adjustment for regulated utilities), which, when amortized to expense,
5 causes a reduction in earnings. The avoidance of this reduction in earnings is the primary
6 reason why pooling of interests is considered the preferred method of accounting for
7 mergers.

8 Q. Is the pooling of interest accounting method especially beneficial for both
9 regulated utility companies and utility customers?

10 A. Yes. Both utility companies and utility ratepayers benefit from the use of
11 pooling of interests accounting. Utility ratepayers suffer under purchase accounting because
12 recovery of an acquisition adjustment in rates will lead to higher rates than would be the case
13 under pooling of interests accounting. Rate recognition of an acquisition adjustment will also
14 reduce the portion of any actual merger savings that could be flowed through to reduce a
15 utility's cost of service.

16 For utility companies that use purchase accounting, the amortization of an acquisition
17 adjustment creates an additional expense that puts a downward pressure on earnings.
18 Recognition of an acquisition adjustment creates a need for additional revenues and/or cost
19 reductions in an amount equal to the required return on the investment in addition to the
20 annual amortization of expense. If significant, the financial burden imposed by the
21 acquisition adjustment may cause utility companies to seek explicit ratemaking treatment
22 (as UtiliCorp is doing in this merger application) of an acquisition adjustment.

1 Utility companies suffer because the financial burden of the acquisition adjustment
2 will lead to significant extra costs in creating a regulatory plan with a merger savings
3 tracking mechanism with fully litigated regulatory proceedings on the acquisition adjustment
4 issue.

5 Q. Has UtiliCorp previously recognized the benefits of the pooling of interests
6 method?

7 A. Yes. In a previous merger application before this Commission, UtiliCorp
8 recognized the ratemaking benefits of the pooling of interests accounting method, in that
9 it: 1) does not create an acquisition adjustment; and 2) avoids the need to create a merger
10 savings tracking mechanism. On June 7, 1996, UtiliCorp and Kansas City Power & Light
11 Company (KCPL) filed a Joint Application to merge operations with the Commission,
12 docketed as Case No. EM-96-248. The benefits of the pooling of interests accounting
13 method are described in paragraph 18 of this Application:

14 The mergers do not involve what is commonly known as an
15 "acquisition premium," a purchase of stock in excess of book value.
16 Consequently, the Joint Applicants will not seek the recovery of an
17 acquisition premium through rates. This will simplify the regulatory
18 consequences of the Mergers as the Commission will not be required
19 to put in place a procedure to "track" merger-generated savings in
20 order to consider the possible recovery of an acquisition premium from
21 Newco's customers.
22

23 Q. Are the benefits of the pooling of interest method recognized in the financial
24 and accounting industry?

25 A. Yes. The following recent articles in accounting and finance periodicals
26 describe why the pooling of interest method of accounting for mergers is preferable to the
27 purchase method.

1 Mr. Peter Atkins, a partner in the law firm Skadden, Arps, Slate, Meagher & Flom
2 L.L.P describes the benefits of the pooling of interests method over the purchase method:

3 Many stock-for stock combinations need to be accounted for as
4 poolings of interests under Accounting Principles Board Opinion 16,
5 or APB 16. The alternative, purchase accounting, often will result in
6 substantial goodwill, producing a significant annual earnings charge
7 for up to 40 years. This earnings impact often makes purchase
8 accounting a nonstarter for stock deals. The importance of pooling-of-
9 interests accounting is underscored by a condition to most transactions
10 that before mailing the proxy statement and/or closing each company
11 must receive a letter from its auditors confirming their view that
12 pooling treatment will be available. (Emphasis added)
13 [Stocking Up: Corporate Shopping, 1990s Style by Peter Allan Atkins,
14 *The National Law Review*, Monday, February 9, 1998, page B07.]
15

16 In an article published in the *CPA Journal*, James R. Duncan and Robert L Carleton
17 describe why many large mergers are structured as a pooling of interests. Mr. Duncan, PhD,
18 CPA, is an assistant professor of accounting at Ball State University. Mr. Carleton, CPA, is
19 Senior Vice President and Controller of Tricon Global Restaurants, Inc., and is a member of
20 the FASB Task Force on Business Combinations. The article reads, in part:

21 The first half of 1998 witnessed the largest merger wave in U.S.
22 history, including several of the largest business combinations
23 ever. Companies involved in these mergers span the financial
24 services, automotive, telecommunications, health care,
25 pharmaceutical and consumer products industries (see Exhibit 1).
26 It is interesting that all of the large mergers were structured to
27 achieve pooling-of-interests accounting (pooling). As companies
28 combine to form large, often global organizations, pooling seems
29 to be the merger accounting method of choice at a time when U.S.
30 accounting standards setters are involved in reexamining existing
31 standards for business combinations.
32

33 At a time when U.S. companies are grappling for competitive
34 positions in a globalizing economy, pooling seems to be the
35 preferred method of accounting for mega-mergers. Companies
36 once thought too large to combine are coming together to form
37 enormously large organizations designed to serve global markets
38 and doing so at prices that represent huge premiums over existing
39 book values. As indicated in Exhibit 1, implied goodwill in these

1 recent large mergers could approach \$20 to \$60 billion if each
2 were accounted for as a purchase under APB No. 16. The effect
3 would be to reduce future earnings of the combined companies by
4 significant proportions.

5
6 Many mergers are nontaxable transactions, such that goodwill
7 amortization is without any tax benefit and essentially worsens
8 future earnings. (Emphasis added)

9 [Will Poolings Survive? By James R. Duncan and Robert L
10 Carleton, *The CPA Journal*, January 1999]

11
12 Finally, in an article in *CFO Magazine*, staff writer Ian Springsteel summarizes the
13 benefits of the pooling of interests method over the purchase accounting method:

14 In merger and acquisitions, one rule is simple: If you can possibly
15 account for a business combination as a pooling of interests, you
16 pool. Compared to the alternative purchase method, poolings
17 provide the party without the hangover. With pooling, there's no
18 cash to change hands, only stock—cheap currency in today's market
19 —no assets to write up, and best of all, no goodwill to drag on
20 earnings over the next 40 years. (emphasis added)

21 [Say Goodbye to Pooling, *CFO Magazine*, February 1997]

22
23 Q. You provided examples of how certain practitioners in the financial and
24 accounting community consider the pooling of interests method to be preferable to the
25 purchase method. Have boards of directors of utility companies considered the benefits of the
26 pooling of interests method in making their decision to recommend approval of a merger to
27 the utility's shareholders?

28 A. Yes. In approving the merger agreement between Union Electric Company
29 and CIPSCO Inc. (CIPSCO), the Board of Directors of both companies considered the
30 pooling of interests method as a benefit because it "avoids the reduction in earnings which
31 would result from the creation and amortization of goodwill under the purchase method of
32 accounting" [Joint Proxy Statement/Prospectus, November 13, 1995, pages 30-31].

1 Also, the Board of Directors of Pacific Enterprises (a California utility holding
2 company) described the accounting treatment as one of the factors it considered in approving
3 its proposed merger with Enova Corporation (parent company of San Diego Gas & Electric
4 Company) as follows:

5 The expected accounting treatment of the business combination is a
6 pooling of interests, thereby avoiding reductions in earnings which
7 would result for the creation and amortization of goodwill under the
8 purchase method of accounting.

9 [SEC Form S-4, Registration Statement, February 5, 1997]

10
11 In approving the Amended Merger Agreement with KCPL in 1996, the UtiliCorp
12 Board of Directors specifically stated that the availability of the pooling of interests
13 accounting method was one of the factors that led it to approve the merger agreement. The
14 Board specifically noted that the pooling of interests method "avoids the reduction in
15 earnings which would result from the creation and amortization of goodwill under purchase
16 accounting" (KCPL SEC Form S-4A, June 25, 1996).

17 Q. How important was the retention of the pooling of interests accounting
18 method in the proposed 1996 UtiliCorp/KCPL merger?

19 A. Very important. The following condition of the merger agreement shows how
20 important the pooling of interests accounting method was to this proposed merger. Note that
21 the use of pooling of interest accounting was so important to the merger that UtiliCorp and
22 KCPL agreed to take "commercially reasonable actions" to cure (fix) any potential pooling
23 violations:

24 POOLING. No party shall, nor shall any party permit any of its
25 Subsidiaries to, take any action which would, or would be
26 reasonably likely to, prevent the Company from accounting for the
27 transactions to be effected pursuant to this Agreement as a pooling-
28 of-interests in accordance with GAAP and applicable SEC
29 regulations, and each party hereto shall use all reasonable efforts to

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1 achieve such result (including taking such commercially
2 reasonable actions as may be necessary to cure any facts or
3 circumstances that could prevent such transactions from qualifying
4 for pooling-of-interests accounting treatment).

5 [KCPL SEC Form 8-K January 24, 1996, Emphasis added)
6

7 Q. In 1996, Western Resources Inc. (Western) made hostile takeover attempt of
8 KCPL. Was this merger designed to be accounted for as a pooling of interests?

9 A. Yes. In April 1996, Western made an unsolicited tender offer to KCPL's
10 shareholders structured as a pooling of interests and tax free to shareholders of both
11 companies. Western included the following condition in its proposal to acquire control of
12 KCPL:

13 Pooling Condition. The consummation of the Offer and the Merger
14 is conditioned upon, among other things, the receipt by Western
15 Resources of a letter from its independent accountants stating that
16 the Merger will qualify as a pooling of interests transaction under
17 generally accepted accounting principles and applicable
18 Commission regulations. [Western Resources SEC Form S-4,
19 April 22, 1996]
20

21 Q. Did Western and KCPL eventually enter into a merger agreement?

22 A. Yes. In February 1997, Western and KCPL entered into a merger agreement
23 structured as a pooling of interests. Western described the importance of the pooling of
24 interests accounting method in the merger agreement:

25 POOLING. Neither party hereto shall, nor shall such party permit
26 any of its Subsidiaries or any employees, officers or directors of
27 such party or of any of its Subsidiaries to, take any action which
28 would, or would be reasonably likely to, prevent the Surviving
29 Corporation from accounting for the transactions to be effected
30 pursuant to this Agreement as a pooling-of-interests in accordance
31 with GAAP and applicable SEC regulations, and such party shall
32 use all reasonable efforts to achieve such result (including taking
33 such commercially reasonable actions as may be necessary to cure
34 any facts or circumstances that could prevent such transactions

1 from qualifying for pooling-of-interests accounting treatment)...
2 [Western SEC Form 8-K February 10, 1997]
3

4 Q. On page 14 of his direct testimony, UtiliCorp witness John W. McKinney
5 makes the assertion that regardless of whether or not the merger is recorded as a purchase or
6 a pooling of interests, a merger premium exists when the value of the consideration paid
7 exceeds the book value of the consideration received. Is Mr. McKinney correct?

8 A. Mr. McKinney may be theoretically correct that a merger premium could exist
9 in a pooling of interests merger, but this would not be the type of merger premium that would
10 be a concern in this merger proceeding.

11 Q. Please explain.

12 A. As described earlier, no acquisition adjustment is created and no goodwill is
13 created using the pooling of interests accounting method. Because there is no intangible
14 asset to amortize, there is no additional expense in a pooling of interests merger. With the
15 exception of a potential offsetting entry in the equity accounts, there is absolutely no
16 recognition of a merger premium in any of the financial books and records of any company,
17 regulated or unregulated. As described below, even UtiliCorp has recognized, that there is a
18 clear difference between the two merger accounting methods from an earnings and
19 ratemaking perspective.

20 Q. Are there examples where electric utilities in Missouri, in communications
21 with shareholders and filings before this Commission, have explicitly stated that no merger
22 acquisition premium exists in a pooling of interests merger?

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1 A. Yes. In two separate merger applications before this Commission, four senior
2 company executives have advised the Commission that no acquisition premium results in
3 mergers accounting for as a pooling of interests.

4 As previously discussed, in June 1996, Mr. Richard C. Green, Jr., Chairman of the
5 Board and Chief Executive Officer (CEO) of UtiliCorp and Mr. A. Drue Jennings, Chairman
6 of the Board, President and CEO of KCPL filed a First Amended Joint Application with the
7 Commission to merge the operations of UtiliCorp and KCPL. In this Application,
8 Messrs. Green and Jennings advised the Commission that because this merger was to be
9 accounted for as a pooling of interests, it did not involve an acquisition premium:

10 The mergers do not involve what is commonly known as an
11 "acquisition premium," a purchase of stock in excess of book
12 value. Consequently, the Joint Applicants will not seek the
13 recovery of an acquisition premium through rates. This will
14 simplify the regulatory consequences of the Mergers as the
15 Commission will not be required to put in place a procedure to
16 "track" merger-generated savings in order to consider the possible
17 recovery of an acquisition premium from Newco's customers.
18 [First Amended Joint Application of KCPL and UtiliCorp, Case
19 No. EM-96-248, page 10, No. 18]
20

21 Steven W. Cattron, then Vice President Marketing and Regulatory Affairs, KCPL, in
22 his direct testimony in support of the merger application in Case No. EM-96-248, also
23 recognized that no acquisition premium is created in a pooling of interests merger at page 8:

24 Because the merger does not involve what is commonly known as
25 an "acquisition premium," a purchase of stock in excess of book
26 value, there is no need in this case to establish an expensive, time-
27 consuming system to identify and track merger related savings.
28

29 Finally, Mr. James F. Purser, Atmos Energy Corporation's (Atmos) Executive Vice
30 President and Chief Financial Officer, presented direct testimony in support of the Joint

1 Application of Atmos and United Cities Gas Company to merge in Case No. GM-97-70. In
2 his direct testimony at page 6, Mr. Purser stated:

3 The merger will be accounted for as a pooling of interests. That
4 treatment results in a combining of the balance sheets of the pre-
5 merger United Cities and Atmos with the exception of the
6 shareholders' equity section...The proposed merger does not create
7 a Gas Plant Acquisition Adjustment.
8

9 Q. Did Union Electric Company (Union Electric) in its then proposed pooling of
10 interests merger with CIPSCO advise its shareholders that the pooling of interests method
11 avoids the earnings reductions caused by recognizing an acquisition adjustment?

12 A. Yes. In a letter to its shareholders dated November 13, 1995, Union Electric
13 described its then proposed pooling of interests merger with CIPSCO. In describing the
14 beneficial aspects of the accounting for the merger, Union Electric said that:

15 The expected accounting treatment of the Mergers as a pooling of
16 interests...avoids the reduction in earnings which would result from
17 the creation and amortization of goodwill under the purchase
18 method of accounting.
19

20 **UTILICORP/SJLP MERGER ANNOUNCED AS A POOLING OF INTERESTS**

21 Q. Was the UtiliCorp/SJLP merger originally announced as a pooling of
22 interests?

23 A. Yes. Section 3.21, Pooling of Interests, of the Agreement and Plan of Merger
24 Dated as of March 4, 1999 between UtiliCorp United Inc. and St. Joseph Light & Power
25 Company (Merger Agreement), reads:

26 Neither the Company nor any of its Subsidiaries has taken any
27 action or failed to take any action which action or failure would
28 jeopardize the treatment of the Merger as a pooling of interests for
29 financial accounting purposes. . . .
30

1 Q. Did UtiliCorp consider pooling of interests accounting important enough to
2 make it a firm condition of the SJLP merger?

3 A. No. The use of the pooling of interests accounting method was a condition of
4 the merger. However, this condition could be waived at UtiliCorp's discretion.
5 Paragraph 7.02(f), Accounting Treatment, of the Merger Agreement states that:

6 . . . if UCU, in its sole and exclusive discretion, determines at any time
7 not to account for the Merger as a pooling of interests thereby causing
8 this condition not to be satisfied, or if pooling of interests accounting
9 is unavailable due solely to any action taken by UCU on or prior to the
10 Effective Time (including prior to the date of this Agreement), this
11 provision shall not be relied upon by UCU as a reason for failing to
12 consummate the Merger.
13

14 Q. Did UtiliCorp later change from the pooling of interests method to the
15 purchase method of accounting?

16 A. Yes. Less than two months after the proposed merger was announced as a
17 pooling of interests, the accounting method was changed to a purchase. In the UtiliCorp and
18 SJLP Joint Proxy Statement/Prospectus (Joint Proxy) dated May 6, 1999, UtiliCorp disclosed
19 how it will account for the merger:

20 UtiliCorp will account for the merger as a purchase. Under this
21 method of accounting, the acquired assets and liabilities are
22 recorded at their fair values. If the amount paid exceeds the fair
23 value, as in the merger, the excess is recorded as goodwill, and is
24 amortized over a period of years.
25

26 Q. Why did UtiliCorp change the method in which it will account for this merger
27 from a pooling of interests to the purchase method of accounting?

28 A. Mr. Streek explains at page 3 of his direct testimony that the March 5, 1999
29 Merger Agreement was announced as a pooling of interests before a complete analysis of the

1 pooling conditions was made. UtiliCorp determined that the issuance of employee stock
2 options in November 1998 was an "alteration of equity" under APB 16, paragraph 47.
3 Because the issuance of stock options could alter the equity position of UtiliCorp, it
4 potentially violates one of the pooling conditions and, according to UtiliCorp, prevents this
5 merger from being recorded as a pooling of interests.

6 Q. Please define the term stock option and describe UtiliCorp's stock option
7 plans.

8 A. A stock option is the opportunity, or "option" to buy a share of stock in the
9 future at a set price that is determined on the day the option is awarded (exercise price).
10 UtiliCorp has two separate stock option plans. According to its SEC Form DEF 14A filing
11 dated March 16, 2000, UtiliCorp grants stock options every year under the 1986 Stock
12 Incentive Plan (Executive Stock Plan) to the Company's executives who are eligible to
13 participate in the Annual and Long-Term Incentive Plan. The Company also issues stock
14 options to executives and employees who do not participate in the Executive Stock Plan,
15 under the 1991 Employee Stock Option Plan (Employee Stock Plan).

16 Q. Why does UtiliCorp issue stock options to its employees?

17 A. "UtiliCorp has had a philosophy for many years of increasing employee
18 ownership of stock in order to build a culture of shareholder value creation" (response to
19 Staff Data Request No. 167). Stock options granted under Executive Stock Plan are intended
20 to make sure the executives are focused on creating long-term shareholder value because the
21 executives only benefit if UtiliCorp's stock price increases. In its response to Staff Data
22 Request No. 167, UtiliCorp stated that the sole purpose of the Employee Stock Plan was to
23 increase "employees focus on shareholder value and stock appreciation." In a letter to the

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1 recipients of the November 1998 stock options, Mr. Richard Green, UtiliCorp's CEO
2 described a purpose of the Employee Stock Plan is to "heighten our collective focus on
3 UtiliCorp's stock price" (response to Staff Data Request No. 260).

4 Q. What is the Staff's opinion of UtiliCorp's decision not to account for the
5 merger as a pooling of interests because of the 1998 stock option issuance?

6 A. It is the Staff's opinion that the benefits of pooling of interest merger were
7 sacrificed in lieu of improving shareholder value, especially since UtiliCorp, as described
8 below, did not take any action to cure or fix this potential violation of the pooling of interests
9 conditions. As such, it is not appropriate for SJLP's ratepayers to have to absorb the
10 detrimental aspects of the loss of the pooling of interests accounting, when the reason for the
11 loss was to increase UtiliCorp shareholder value and stock price.

12 Q. Please describe the "alteration of equity interest" condition of a pooling of
13 interest that UtiliCorp believes it has violated.

14 A. Alterations of Equity Interests, Paragraph 47(c) of APB 16, prohibits a
15 combining company from altering the equity interests of its shareholders "in contemplation"
16 of effecting the proposed business combination to be accounted for as a pooling of interests.
17 APB – Accounting Interpretations Nos. 19 and 20 of APB 16 indicate a presumption that any
18 alteration of equity interests within two years of initiation of a business combination or
19 between initiation and consummation is "in contemplation" of effecting the business
20 combination, and so would preclude accounting for the proposed business combination as a
21 pooling of interests.

22 Q. Can the presumption that an issuance of stock options within two years of a
23 business combination was done "in contemplation" of the merger be overcome?

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1 A. Yes. According to a book published by the public accounting firm of Arthur
2 Andersen entitled, *Accounting for Business Combination, Interpretations of APB Opinion*
3 *No. 16, Business Combinations* (Interpretations of APB 16), page 112, this presumption can
4 be overcome if evidence indicates that the change was not in contemplation of the business
5 combination. Whether the presumption can be overcome depends on the strength of the
6 evidence available and the length of time between the change and the initiation of the
7 business combination.

8 Also, according to Accounting Interpretation No. 19 of APB 16, the alteration of
9 equity interests presumption can be overcome provided there is sufficient, persuasive, and
10 objectively verifiable evidence indicating that the alteration of equity interests was not done
11 in contemplation of the proposed business combination.

12 Q. Did UtiliCorp issue the November 1998 employee stock options in
13 contemplation of the merger with SJLP?

14 A. No. In response to Staff Data Request No. 167, Mr. Jerry Myers, Director,
15 Corporate Reporting, and Mr. Robert Browning, Vice President, Human Resources stated
16 that "the issuance of options in November 1998 was not done in contemplation of the SJLP
17 merger," and "there was no relationship between this option issuance and the SJLP merger,
18 which was announced two months later."

19 Q. Did UtiliCorp attempt to persuade the SEC that its November 1998 issuance
20 of stock options was not done in contemplation of the merger with SJLP, and thus at least try
21 to retain the use of the pooling of interests accounting for the merger?

22 A. No. Included in Staff Data Request No. 167 was the following Staff question
23 and UtiliCorp response:

1 Question 4: Did the Company ever have any discussions or
2 correspond with the staff of the Securities and Exchange
3 Commission (SEC), or any other regulatory body concerning the
4 pooling of interests treatment of the proposed acquisition of SJLP?
5 If yes, please provide copies of such correspondence and
6 summaries of discussions. If no, please describe the reasons why
7 the Company did not seek an opinion from the SEC staff as to
8 whether or not the issuance of stock options in 1998 would prevent
9 the acquisition of SJLP from being accounted for under the pooling
10 of interests method.

11 Response: The Company did not consult with the SEC with regard
12 to this issue. We relied on the opinion of our independent auditors
13 and interpretations existing in published literature.
14
15

16 Q. Is the Staff challenging UtiliCorp's determination that its 1998 issuance of
17 stock options under the Employee Stock Plan violated the alteration of equity pooling of
18 interests condition?

19 A. The Staff agrees with UtiliCorp that because of the closeness of the merger
20 discussions with SJLP and the merger announcement with the stock option issuance, it has
21 the burden to prove that the November 1998 stock option issuance was not done in
22 contemplation of the SJLP merger. However, the Staff believes that because of the serious
23 consequences of losing the ability to use the pooling of interests accounting method
24 (imposition of a \$97 million acquisition adjustment and a potential \$133 million after-tax
25 increase in SJLP's cost of service over 10 years) UtiliCorp should have vigorously presented
26 its case to the SEC that the November 1998 stock option issuance was not done "in
27 contemplation" of the SJLP merger.

28 Q. Is there another action UtiliCorp could have taken which could have enabled it
29 to keep the pooling of interests method of accounting for its merger with SJLP?

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1 A. Yes. According to Arthur Andersen's Interpretations of APB 16, page 124,
2 once the issuance of options is determined to be a change in equity interests in contemplation
3 of business combination, the change can only be "cured" by canceling or rescinding the
4 options so long as no option holder has exercised any of the options issued. If the result of
5 rescinding the stock options returns the equity holders to the same equity position as existed
6 before the change, then a "no harm/no foul" approach can be adopted and the pooling of
7 interests rules are met.

8 Q. Could UtiliCorp have rescinded the November 1998 stock option issuance and
9 retained the pooling of interests method?

10 A. Apparently so. According to the information provided in response to Staff
11 Data Request No. 260, the November 1998 stock options could not be exercised until
12 November 1999. This is at least six months after UtiliCorp concluded that the stock option
13 issuance violated the pooling of interests conditions. However, in the interest of employee
14 morale, UtiliCorp decided not to rescind the November 1998 stock options. Staff Data
15 Request No. 167 and UtiliCorp's response included the following:

16 Question 5: When the Company determined that the November
17 1998 stock option issuance would prevent it from using the pooling
18 of interest accounting method for the SJLP acquisition, did the
19 Company consider taking actions to "cure" the violation? If yes,
20 please describe the Company discussions of this issue and why it
21 was decided not to attempt to "cure" this pooling violation. If no,
22 please describe the reasons why the Company did not consider
23 taking actions to cure this potential pooling violation.

24 Response: The only cure would have been rescinding or canceling
25 the options. The Company did not feel this would have been in the
26 best interest of employee morale and there were still uncertainties
27 with regard to the eventual consummation of the transaction.
28
29

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1 Q. Is it likely that none of the November 1998 stock options have yet been
2 exercised?

3 A. Yes. The exercise price of the options when issued was \$36.03. Since the
4 options were issued, UtiliCorp has effected a 3-for-2 stock split, which reduced the exercise
5 price to \$24.02 (\$36.02/1.5). The stock options have a one-year vesting period, so they did
6 not become exercisable until November 1999. UtiliCorp's stock price has not reached the
7 \$24.02 per share exercise price since the options became exercisable in November 1999. If
8 none of the November 1998 stock options were exercised, there has not yet been an
9 "alteration of equity" interests of UtiliCorp and SJLP's shareholders.

10 Q. Does the Staff believe that UtiliCorp has strong support for its position that
11 the issuance of the 1998 stock options were not done in contemplation of the SJLP merger?

12 A. Yes. The following timeline shows that the November 1998 issuance of stock
13 options could not have been done in contemplation of the SJLP acquisition. As shown
14 below, UtiliCorp was not even contacted by Morgan Stanley Dean Witter (Morgan Stanley),
15 SJLP's investment banker about the possible sale of SJLP until sometime during the week of
16 November 9, 1998, a full week or more after the stock options were issued:

17 July 1998 – UtiliCorp Chairman and CEO Richard Green decided
18 to issue options under the 1998 Employee Stock Plan (Staff Data
19 Request No. 260)

20
21 August 4, 1998 – UtiliCorp Board of Directors approved issuance
22 of stock options (Staff Data Request No. 260)

23
24 November 2, 1998 – Stock options issued (Staff Data Request
25 No. 260)

26
27 Week of November 9, 1998. - Morgan Stanley initially contacted
28 the potential bidders (joint proxy statement/prospectus dated
29 May 6, 1999, page 15)

30

1 Q. Explain the SEC's view on when a stock option issuance is an "alteration of
2 equity interests," and thus a pooling of interests violation.

3 A. Arthur Andersen's Interpretation of APB 16, paragraph 47c-18, Transactions
4 Involving Equity Interests, describes the views of the SEC staff on this issue:

5 New stock option grants or awards to employees under a
6 preexisting plan (e.g., a plan adopted more than two years prior to
7 the initiation of the combination) if granted under the normal terms
8 of the plan and in normal amounts would not be an alteration of
9 equity interests that would preclude pooling-of-interests
10 accounting. However, awards of an abnormal nature or normal
11 awards that involve abnormal terms should preclude use of
12 pooling-of-interests accounting.

13
14 In assessing whether option or restricted share awards are
15 "normal," the SEC staff considers the historical pattern of awards,
16 including the class of employees receiving awards, the size of the
17 award for a given level of an individual within the organization,
18 the timing of awards and their terms, including exercise price,
19 vesting, and exercise period.

20
21 Furthermore, the granting of options between initiation and
22 consummation of a business combination to be accounted for as a
23 pooling of interests is permissible, so long as the grant meets the
24 test of being a normal grant. . . .
25

26 Q. Does the November 1998 stock option issuance appear to be consistent with
27 the requirements of the SEC described above, that is, preexisting plan, normal terms and
28 normal amounts?

29 A. Yes. The November 1998 stock options were granted under a preexisting
30 plan, as the plan was adopted in 1991. There were only two option issuances under the
31 Employee Stock Plan, one in May 1992 and one in November 1998. In May 1992,
32 4,342 employees received 1,114,350 options and in November 1998, 4,276 employees

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1 received 1,278,729 options. Both option issuance included both union and nonunion
2 employees and excluded executive-level employees.

3 Q. Does UtiliCorp consider the November 1998 stock option issuance to be
4 normal?

5 A. No. In response to Staff Data Request No. 167, UtiliCorp explained that the
6 November 1998 stock option issuance was not normal because there was no regularity to the
7 issuance of options under this plan. Also, in response to Staff Data Request No. 99, UtiliCorp
8 stated that the "company's issuance of options to all employees which occurred in
9 November 1998 does not meet the criteria for a normal event based upon the company's
10 established history."

11 Q. Does the fact that stock options under the Employee Stock Plan have only
12 been issued twice mean that the November 1998 issuance should be considered abnormal?

13 A. No. UtiliCorp issues stock options under its Executive Stock Plan every year.
14 Therefore, the regularity of issuance in a determination of normality would be a relevant
15 consideration for options issued under this plan. However, the Employee Stock Plan is very
16 different from the Executive Stock Plan.

17 A brochure entitled "The UtiliCorp Stock Option Plan, provided to employees states
18 that:

19 . . .there is no schedule for regularly granting stock options.
20 UtiliCorp may offer them at their discretion and there is no
21 guarantee of any future grants of option. UtiliCorp is one of very
22 few companies to offer stock options to all levels of employees.
23 Most companies offer stock options only as an executive benefit.
24

25 In any review of normality, it would be reasonable for the SEC to take into
26 consideration that, unlike most companies' stock option plans, UtiliCorp's Employee Stock

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1 Plan is unusual, and options under this plan are not intended to be issued on a regular basis.
2 In fact, because there is "no schedule for regularly granting stock options," under the
3 Employee Stock Plan, irregular issuances of stock options should be considered normal
4 because this conforms to the plan's intent and plan's history.

5 Q. Is it possible, then, that UtiliCorp's decision not to even try to argue its case
6 before the SEC was motivated by other legitimate business reasons?

7 A. Yes. The 12 pooling of interests conditions prevents companies using this
8 accounting method from engaging in certain types of transactions. For example, APB 16
9 paragraph 48c precludes a company using the pooling of interests accounting method from
10 disposing of a significant part of the assets of the combining companies within two years
11 after the combination, other than disposals in the ordinary course of business. Under this
12 condition, if the SJLP acquisition is completed in December 2000, UtiliCorp would not be
13 allowed to sell a significant part of its assets until December 2002. Since UtiliCorp is
14 considering selling some or all of SJLP's generation assets after the merger, the two year ban
15 on the sale of these assets by APB 16 (as well as other restrictions) could have had an effect
16 on UtiliCorp's decision not to take its case before the SEC to retain pooling of interests
17 accounting.

18 Q. Describe how UtiliCorp expressed an intention to sell SJLP's generation
19 assets after the acquisition?

20 A. UtiliCorp's Internet website (utilicorp.com) under Investor Information:
21 Presentations, includes the Company's 1999 Year-end Review Conference Call with
22 financial analysts, held on February 8, 2000 (February Conference Call). Mr. Robert Green,

1 UtiliCorp's President and Chief Operating Officer, discusses the potential sale of the
2 generation assets acquired from SJLP:

3 But take a look at the mid-continent footprint that we're building
4 on the network side of the business. With the St. Joe and the
5 Empire acquisition, we've brought together some very attractive
6 low-cost generation assets, and we have added some contiguous
7 distribution networks that afford us a significant opportunity for
8 synergies and efficiencies. 75% of those benefits are going to come
9 from the supply side.

10
11 And over time, we will look to restructure the supply-side assets
12 and potentially take them out of rate base and provide more of an
13 upside. It might be that the easiest path is to sell some of those
14 assets so we can establish a market value and avoid a stranded cost
15 to base [debate] with the regulator; and then redeploy that capital
16 strategically on the energy grid in other generation assets or other
17 growth investments.
18

19 **MERGER COSTS**

20 Q. Please explain and differentiate the three different types of merger costs
21 referred as the merger premium, transaction costs and transition costs.

22 A. The merger premium and transaction costs are "ownership" costs. Transition
23 costs are not ownership costs, but are incurred during the process of merging the operations
24 of the combining utilities into a single, more efficient utility. The term merger premium was
25 defined earlier, transaction and transition costs are described below.

26 Transaction costs are costs incurred by both the acquiring company and the acquired
27 company for the purpose of consummating the merger. Examples of these costs are fees paid
28 for legal, banking and consulting services necessary to close the transaction. The majority of
29 transaction costs will be incurred prior to merger closing. Transaction costs are referred to as
30 "direct costs of the merger" and are coupled with the merger premium to make up the amount
31 of the acquisition adjustment to be recorded on the utility company's balance sheet. Both the

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1 USOA and GAAP (APB 16) require that transaction costs be treated the same as the merger
2 premium.

3 Transition costs are also referred to as "cost to achieve." Transition costs are costs
4 incurred to merge or combine the operations of the two combining utilities into one,
5 potentially more efficient utility. Two of the more common transition costs are those related
6 to human resources and information technology:

7 Human resources costs - Reductions in staff through streamlining and
8 ending duplication. These include severance costs, buyout packages
9 and unpaid sick and holiday leave, as well as the physical relocation of
10 the work force.

11
12 Information technology - Moving from two to one integrated computer
13 system may require the purchase of new computer hardware and
14 software, the disposal of old machinery and outside consultant costs.
15 Old files need to be converted, data needs to be transferred and
16 employees need to be trained on new applications and work flow
17 processes.

18 Staff Accounting witness James M. Russo will be addressing transaction and
19 transition costs in his rebuttal testimony as they relate to the UtiliCorp/SJLP merger.

20 Q. Explain why the Staff is proposing different accounting and ratemaking
21 treatment for the merger premium, transaction costs and transition costs.

22 A. The merger premium and transaction costs are types of ownership costs which
23 are rightly absorbed by the owners of the merging companies. For example, the merger
24 would not take place without the shareholders of both companies approving the transaction.
25 The decision on the amount of money to pay to acquire a company, and the amount of money
26 to accept in selling a company is made by the board of directors in their fiduciary duty to the
27 company shareholders. Once an agreement between the board of directors of both companies
28 is reached, a special meeting is usually required to be held in which both shareholder groups
29 vote to approve or reject the merger. (Because of the relatively small size of the SJLP

1 merger, a UtiliCorp shareholder vote was not required). The merger is approved, if, and only
2 if, both owner groups believe it is in their best interests. In this merger, the SJLP shareholder
3 group and the UtiliCorp Board of Directors (acting for the UtiliCorp shareholders) decided
4 that the \$23 per share price for each SJLP common share was in the best interests of the
5 respective shareholder group.

6 Ratepayer interests are not considered in the decision to buy (acquiring utility) or sell
7 (acquired utility). Ratepayer interests are not considered because the structure of a merger
8 agreement and the approval of the merger is an ownership decision. Ratepayers, as
9 nonowners, have 1) no ownership rights in utility assets, 2) no vote in the decision to be a
10 part of a merger, and 3) no influence in the structure of the terms and conditions of a merger.

11 As described above, transaction costs are those costs necessary to complete the
12 merger and include legal fees, regulatory approval cost and financial consulting fees. In
13 deciding whether or not to merge with another utility, SJLP's Board of Directors paid its
14 financial advisor, Morgan Stanley approximately \$2.6 million (response to Staff Data
15 Request No. 44) to provide an opinion if the \$23 per SJLP common share offer price from
16 UtiliCorp was fair, from a financial point of view, to SJLP's shareholders. This cost is clearly
17 not related to providing utility service more efficiently, but is only incurred to protect the
18 financial interests of the shareholders in the merger transaction. Because the merger premium
19 and transaction costs incurred in this merger were incurred solely to benefit both SJLP and
20 UtiliCorp shareholders, as owners, these costs should not be directly reflected in SJLP's
21 utility rates borne by SJLP's customers.

22 Unlike the merger premium and transaction costs, most transition costs are incurred
23 after the merger in an attempt to run the combined utility more efficiently. If attained, these

1 efficiencies should be reflected in a lower cost of providing utility service, thereby proving a
2 potential benefit to utility customers. These costs are similar to other "reorganization" or
3 "restructuring" costs incurred by utilities to operate more efficiently and effectively.
4 Because these costs are incurred by a utility attempting to make its operations more efficient,
5 transition costs, if prudent and reasonable, typically are included in a utility's cost of
6 providing service. Transition costs that do result in merger savings benefit the shareholders
7 though regulatory lag until these savings are reflected in rates in a rate proceeding or an
8 earnings complaint case.

9 For these reasons, the Staff does not believe it is reasonable to exclude, in rates, the
10 actual costs incurred to achieve the merger savings (transition costs), while simultaneously
11 flowing through all the merger savings in rates to the ratepayers. Consistent with this belief
12 is the Staff's position that reasonable and prudent transition costs actually incurred should be
13 reflected in rates to be recovered from ratepayers.

14 Q. UtiliCorp witness McKinney describes on pages 10 and 11 of his direct
15 testimony in this proceeding how the merger premium is similar to other types of costs a
16 utility incurs to be more efficient. Does the Staff concur with Mr. McKinney's analogy?

17 A. No. As discussed above, the merger premium and transaction costs are
18 ownership costs. These costs are incurred only by the explicit approval of the shareholders
19 (or board of directors acting in the best interests of the shareholders) and only after the
20 shareholders determine that the merger is in their best "financial" interests. The merger
21 premium and transaction costs are not associated with running the utility operations more
22 efficiently, and therefore, are not analogous to reorganizations or renegotiations of purchased

1 power contracts, which are designed to run utility operations more efficiently. The examples
2 in Mr. McKinney's testimony are similar to merger transition costs, not transaction costs.

3 **ACCOUNTING FOR THE SJLP PURCHASE**

4 Q. How much is UtiliCorp willing to pay to acquire SJLP?

5 A. UtiliCorp and SJLP negotiated a purchase price of \$23 per SJLP common
6 share outstanding. At December 31, 1998, SJLP had approximately 8.2 million common
7 shares outstanding, which results in a purchase price of \$188.6 million.

8 Q. Is this a complete calculation of the cost to acquire SJLP?

9 A. No. Both APB 16 and the FERC USOA require that transaction costs be
10 included along with the purchase price to determine the overall cost to acquire plant assets.
11 At page 6 of his direct testimony, UtiliCorp witness Vern J. Siemek states that transaction
12 costs for this merger were estimated to be approximately \$4.6 million, which includes the
13 legal fees of SJLP and UtiliCorp and banker fees for SJLP to complete the transaction.
14 Adding the \$4.6 million transaction costs to the purchase price of \$188.6 million results in an
15 estimated total SJLP acquisition cost of \$193.2 million.

16 Q. Please explain the calculation of the estimated acquisition adjustment.

17 A. The estimated acquisition adjustment is \$97 million. This amount differs
18 from the \$92.8 million amount of the acquisition adjustment (referred to as an intangible
19 asset) on page 4 of UtiliCorp witness Streek's direct testimony because it includes the \$4.6
20 million estimated transaction costs and reflects an increase of \$400,000 from using the net
21 book value of SJLP's assets at December 31, 1999 as opposed to the December 31, 1998
22 value reflected in Mr. Streek's testimony. This calculation is shown below:

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Total Estimated Cost to Purchase SJLP	\$193.2 million
Less Net Book Value of SJLP's Assets:	<u>(96.2) million</u>
Total Estimated Acquisition Adjustment	\$ 97 million

Q. Please describe how UtiliCorp will record the estimated \$97 million acquisition adjustment in its financial records?

A. The FERC USOA requires electric utilities to state their plant in service accounts at original cost. Specifically, the USOA requires that plant accounts:

...shall be stated on the basis of cost to the utility of plant constructed by it and the original cost, estimated if not known, of plant acquired as an operating unit or system. The difference between the original cost, as above, and the cost to the utility of electric plant after giving effect to any accumulated provision for depreciation or amortization shall be recorded in account 114, Electric Plant Acquisition Adjustments.

Because UtiliCorp is prevented from including any excess of purchase price over SJLP book value, the acquisition adjustment will be reflected as a single line item on SJLP's balance sheet (and UtiliCorp's consolidated balance sheet) below the plant in service account balances.

Q. What are the FERC USOA rules for the amortization of the acquisition adjustment?

A. The amortization of the acquisition adjustment depends on the actions of the utilities' regulator. An acquisition adjustment that is included in allowable expenses for ratemaking purposes is amortized to expense in Account 406, Amortization of Electric Plant Acquisition Adjustments. When amortization of the acquisition adjustment is not authorized to be included in operating expenses for ratemaking purposes, it is recorded "below-the-line" in Account 425, Miscellaneous Amortization.

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1 Q. What is the estimated annual amount of acquisition adjustment amortization
2 expense that will be recorded by SJLP?

3 A. The annual amount of acquisition adjustment amortization expense that SJLP
4 will charge to earnings is approximately \$2.4 million (\$92.4 million estimated merger
5 premium plus \$4.6 million estimated transaction costs divided by UtiliCorp's proposed 40
6 year amortization period).

7 Q. UtiliCorp witness Vern J. Siemek's Schedule VJS-1 shows three components
8 of the premium costs; Return on Premium, Amortization of Premium and Reflect Non-Tax
9 Deductibility of Premium. Please explain the component Reflect Non-Tax Deductibility of
10 Premium.

11 A. In a tax-free business combination, the Internal Revenue Service (IRS) does
12 not allow an income tax deduction for goodwill (acquisition adjustment) amortization
13 expense. Therefore, to calculate the total impact on net income (after taxes) of the
14 acquisition adjustment amortization expense, the before-tax amortization has to be grossed-
15 up for income taxes to reflect the non-deductibility of the acquisition adjustment. Therefore,
16 the annual amortization of \$2.4 million must be multiplied by 1.6231 (1/1-. 3839% SJLP
17 effective tax rate) to calculate the total impact of the amortization on SJLP's net income.
18 The annual cost to SJLP due to the nondeductibility of the acquisition adjustment is
19 \$1.5 million [(\$2.4 million x 1.6231 = \$3.9 million) (\$3.9 million - \$2.4 million) =
20 \$1.5 million].

21 Q. What is the total revenue requirement impact of the estimated \$97 million
22 acquisition adjustment over 40 years, the period of time this cost will be reflected on
23 UtiliCorp's books and records?

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1 A. Schedule 2 to this testimony shows that over 40 years, the recognition of the
2 acquisition adjustment will increase UtiliCorp's revenue requirement for SJLP's utility
3 properties by approximately \$368 million (tax grossed up amortization of \$157 million and
4 return on rate base impact of \$211million).

5 Q. What is the revenue requirement impact over the first ten years following
6 merger closing?

7 A. Schedule 3 to this testimony shows that over the first ten years after closing,
8 recognition of the acquisition adjustment will increase UtiliCorp's revenue requirement for
9 SJLP's utility properties by approximately \$133 million (tax grossed up amortization of \$39
10 million and return on rate base impact of \$94 million). This results in an average annual
11 increase in revenue requirement of approximately \$13.3 million over the first ten years.
12 Schedule 3 also shows that the cost of the acquisition adjustment exceeds estimated merger
13 savings over this period by \$73.2 million.

14 Q. Explain how UtiliCorp intends to recover the SJLP acquisition adjustment.

15 A. UtiliCorp is proposing a five-year rate freeze in which it intends to retain
16 100 percent of any realized merger savings to offset the cost of the acquisition adjustment.
17 In years 6 through 10 after merger closing, UtiliCorp is proposing explicit rate recovery of
18 50 percent of the rate base return on the acquisition adjustment and 50 percent return of the
19 acquisition amortization expense, including the negative income tax effect, which
20 significantly increases this expense. Staff Accounting witness Mark L. Oligschlaeger
21 describes UtiliCorp's proposed regulatory plan in more detail.

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1 Q. Please quantify the revenue requirement impact of UtiliCorp's proposal to
2 recover fifty percent of the acquisition adjustment in years 6 through 10 following merger
3 closing.

4 A. As reflected in Schedule 4 to this testimony, over years 6 through 10,
5 UtiliCorp proposes to increase the revenue requirement for SJLP by approximately \$31.5
6 million (tax grossed up amortization of \$9.8 million and return on rate base impact of
7 \$21.7million).

8 Q. Earlier you said that the IRS does not allow an income tax deduction for
9 acquisition adjustments (goodwill) in a nontaxable merger transaction. Has UtiliCorp
10 structured the SJLP acquisition to be tax-free to its shareholders?

11 A. Yes.

12 Q. What is the primary requirement for a tax-free reorganization?

13 A. Similar to the FASB's rules for pooling of interests accounting, the IRS has
14 rules that must be met for a merger to qualify as a tax-free reorganization under Internal
15 Revenue Code (IRC) Section 368. To qualify as a tax-free reorganization, the merger must
16 meet the "continuity of interest" requirement. This requirement is similar to the pooling
17 rules in that it mandates a substantial portion of the merger consideration be in stock as
18 opposed to cash. The purpose of this requirement is to prevent transactions that are really
19 asset sales from qualifying for non-recognition tax treatment under IRC Section 368.

ACQUISITION ADJUSTMENT

Q. Now that you've explained how the estimated merger premium was calculated, please describe the reasons why UtiliCorp's stockholders are willing to pay a \$93 million merger premium above net book value to acquire SJLP.

A. The \$93 million merger premium consists of two separate components. The first component represents payment of an approximate \$44 million gain (current market value less net book value) on the sale of SJLP's assets. The second component of the merger premium is the amount of money above market value that UtiliCorp determined it should pay for SJLP. This amount, \$49 million, represents payment for what UtiliCorp believes will be the benefits of the merger, including a control premium payment to SJLP's shareholders.

SJLP has been a financially successful electric utility with very low generation costs. Any utility intent on acquiring SJLP would know that, at a very minimum, it would have to pay the current market value of the company to convince the utility's shareholders to sell the company. SJLP's market value at the time of the March 5, 1999 merger announcement was \$141 million (\$17.05 average stock price over the preceding 20 days times the 8,267,548 common shares outstanding). Therefore, at a minimum, UtiliCorp would have to pay \$141 million to acquire SJLP.

UtiliCorp's Board of Directors, acting in their fiduciary responsibility to UtiliCorp's shareholders, had to decide how much above market value it would recommend that UtiliCorp's shareholders pay for SJLP. In making this recommendation, UtiliCorp's Board of Directors considered the financial benefits it can extract from SJLP's operations over and above what SJLP will generate as a stand-alone utility.

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1 Because UtiliCorp's Board of Directors decided to pay approximately \$190 million
2 for a company with a market value of \$141 million, the Board determined that the present
3 value of the SJLP merger benefits is at least \$49 million (\$190 million purchase price less
4 \$141million market value). This \$49 million is essentially what is referred to respecting
5 nonregulated companies as goodwill. It is not an asset like other tangible assets (plant,
6 materials and supplies, etc.), but an intangible asset.

7 Q. Why is goodwill considered an asset?

8 A. The FASB defines assets as "probable future economic benefits obtained or
9 controlled by a particular entity as a result of past transactions or events."
10 Walter P. Schuetze, a past Chief Accountant of the SEC explained how goodwill meets the
11 definition of an asset in a speech to the American Accounting Association on August 17,
12 1998:

13 (1) While the cost of goodwill itself lacks the capacity to generate
14 future net cash inflows, it has the capacity in combination with other
15 assets to contribute indirectly to those cash flows and therefore meets
16 the "future economic benefit" test; (2) control over the cost of
17 goodwill is provided by the acquirer's controlling financial interest in
18 the acquired entity's equity or equity securities; and (3) the cost of
19 goodwill obviously arises from a past transaction which is the third
20 condition in the definition.
21

22 Later in my testimony I will describe how this \$49 million payment for the
23 "goodwill" portion of the acquisition adjustment is expected to provide additional cash flows
24 to UtiliCorp, mostly to its nonregulated operations.

25 Q. The merger premium to be incurred by UtiliCorp is approximately \$93
26 million. You just explained how \$49 million of the \$93 million acquisition premium

1 represents the estimated present value of merger benefits. What does the remaining \$44
2 million of the acquisition premium represent?

3 A. The approximate \$44 million difference between SJLP's market value and its
4 book value represents an unrealized gain on the sale of SJLP properties that will be realized
5 by SJLP's shareholders at merger closing. Conceptually, this is the same as a gain on the sale
6 of individual utility assets except that it relates to the sale of the whole company.

7 **GAIN ON SALE OF SJLP ASSETS**

8 Q. In substance, then, is UtiliCorp seeking ratemaking recovery of the gain on
9 sale of SJLP's utility assets that UtiliCorp will pay to SJLP's shareholders?

10 A. Yes. In its regulatory plan, UtiliCorp is seeking direct ratemaking recovery of
11 50 percent of the merger premium beginning the sixth year after merger closing. Included in
12 this amount is fifty percent of the approximate \$44 million gain on sale of SJLP's assets,
13 which represents the difference between the market value and book value of SJLP's net
14 assets.

15 Q. Do SJLP's customers benefit from the fact that SJLP has a market value that
16 is higher than its book value?

17 A. No. The increase from book value to fair value of SJLP's assets reflects gains
18 that have not been recognized in SJLP's books and records. For example, if SJLP were to
19 sell plant assets, (constituting an operating unit or system), a gain on the sale would be
20 realized equal to the amount received less the book value of the asset. Gains on the sale of
21 plant assets have traditionally not been reflected in setting rates by the Commission.
22 Therefore, SJLP's regulated customers should not be held responsible to UtiliCorp for the
23 realized gains on the sale of the assets paid to SJLP's shareholders.

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1 Q. Please explain why current stock market valuations of a utility's stock should
2 not be reflected in utility rates.

3 A. Unrealized asset gains (appreciation) while not reflected in book values are
4 reflected in stock market valuations. This appreciation in the market value of a utility's assets
5 is recognized by the utility's shareholders when they recognize capital gains on the sale of
6 stock, benefit from gains on the sale of utility assets, and benefit from a merger premium
7 paid to induce them to sell the entire company. The market value appreciation of utility
8 assets are not recognized in regulatory accounting procedures, which means that SJLP's
9 customers have not participated in this stock price appreciation through a sharing of any
10 gains from the sale of the appreciated assets.

11 By allowing UtiliCorp to recover the acquisition premium in this proceeding, the
12 Commission would be shifting from cost-based to market-based utility ratemaking in
13 Missouri. The Staff believes that such a movement would be ill advised and recommends
14 that the Commission retain cost-based regulation.

15 Q. Why does the Staff recommend that the Commission not depart from cost-
16 based regulation in Missouri?

17 A. Cost-based regulation provides assurances that the book costs of a utility's
18 assets will be recovered through the ratemaking process. Market values, while not
19 appropriate for utility ratemaking, are appropriately used by nonregulated companies who
20 account for a merger or acquisition using purchase accounting rules. It is appropriate for
21 nonregulated companies to revalue assets acquired in a merger to current market value
22 because they are not a party to a regulatory process that provides assurances that the

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1 historical (book) cost of a utility investment will have the opportunity be recovered in utility
2 rates.

3 A merger premium in a utility merger, is not a new investment in utility assets. As
4 described above, it represents 1) a revaluation of utility assets from book value to market
5 value, 2) a control premium to entice shareholders of the acquired utility to give up control of
6 the company, and 3) the benefits the acquiring utility expects to realize over and above
7 operating the utility on a stand alone basis (merger benefits).

8 Q. How does UtiliCorp justify its proposal to have SJLP's shareholders pay for a
9 significant portion of its costs to acquire SJLP?

10 A. The basis of UtiliCorp's proposal to recover the merger premium in rates is
11 that SJLP's customers will benefit from merger savings. However, as described in the
12 rebuttal testimony of Staff witness Mark L. Oligschlaeger, no merger savings benefits will
13 flow to SJLP's customers for at least five years after the merger closing. This five-year
14 period will be used by UtiliCorp to recover a portion of the acquisition adjustment, by means
15 of regulatory lag.

16 Also, a significant portion of UtiliCorp's estimated merger savings are associated
17 with SJLP's generation assets. According to Mr. Robert Green, 75 percent of the synergies
18 and efficiencies of the SJLP and Empire District Electric Company acquisitions by UtiliCorp
19 are going to come from the "supply side" or generation assets (February Conference Call).
20 As noted above, and as will be discussed later in my testimony, UtiliCorp has expressed a
21 desire to sell SJLP's generation assets, either to a third party, or to its affiliate, Aquila
22 Energy. If and when these generation assets are sold, any generation related merger savings
23 to SJLP's customers that do occur, will disappear at the time of the sale.

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1 Q. What is the general rule concerning the ratemaking treatment of acquisition
2 adjustments?

3 A. The general rule is that only the original cost of utility plant to the first owner
4 devoting the property to public service should be included in rate base. Any excess of the
5 purchase price over the net original cost is included in the acquisition adjustment account to
6 be treated for ratemaking purposes as determined by the jurisdictional regulatory
7 commission.

8 Q. How did this general rule for the ratemaking treatment of acquisition
9 adjustments develop?

10 A. The development of this general rule is explained in *Accounting for Public*
11 *Utilities*, Release 16, November 1999, Robert L. Hahne and Gregory E. Aliff, pages 4-9
12 through 4-10:

13 The necessity of this separate accounting treatment is largely a
14 consequence of certain abuses in the utility industry during the
15 acquisition and merger period of the 1920s and 1930s. Through the
16 process of acquiring utility assets or entire utility companies at prices
17 in excess of depreciated cost, purchasing utilities were able to write up
18 their basis in plant assets. If these purchase prices were in excess of
19 the "value" of the property, the utility was able to inflate its rate base
20 artificially. . .

21
22 The outgrowth of this situation was a general consensus among
23 regulators that utility customers should not pay on an amount in excess
24 of the cost when property was originally devoted to public service,
25 since any excess represented only a change in ownership without any
26 increase in the service function to utility ratepayers. By accounting for
27 the acquisition adjustments separately from plant in service, these
28 excess costs could be better controlled by regulatory authorities as to
29 their ultimate disposition.
30

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1 Q. Is the basis for the concern about ratemaking abuses of acquisition
2 adjustments just as valid today as it was in the 1920s and 1930s, when the general rule
3 prohibiting rate recovery of acquisition adjustments was developed?

4 A. Yes. In my opinion, allowing rate recovery of acquisition adjustments could
5 require Missouri ratepayers to pay for the same utility plant over and over again with no
6 increase in value.

7 Q. Please explain how this could occur.

8 A. A very recent example of utility acquisitions involving Missouri properties
9 will illustrate how the ratemaking abuses of acquisition adjustments in the 1920s and 1930s
10 could very well occur today.

11 In 1988, Arkansas Power and Light Company (APL) sold Missouri gas properties
12 known as Associated Natural Gas Company (ANG) to Southwestern Energy Company
13 (SWEN) of Fayetteville, Arkansas. APL's shareholders recognized a gain on the sale of
14 ANG, and SWEN recorded an acquisition adjustment. In its subsequent Missouri rate cases,
15 SWEN attempted to recover the acquisition adjustment in gas rates from its Missouri
16 customers, but was not successful. The Commission has recently approved the sale of
17 ANG's Missouri gas properties to Atmos Energy Corporation (Atmos). In the Unanimous
18 Stipulation and Agreement reached among the parties to Case No. GM-2000-312, which has
19 been approved by the Commission, Atmos agreed not to seek recovery of the acquisition
20 adjustment it will pay to SWEN for the ANG properties.

21 If, in the past, SWEN was allowed to recover the ANG acquisition adjustment in
22 rates, and if Atmos sought and was allowed recovery of the acquisition adjustment it
23 recorded in the purchase of ANG from SWEN, Missouri ratepayers would be paying over

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1 and over again increased amounts for the exact same gas plant, with no increase in value.
2 The asset gains (merger premium) recognized by utility shareholders who currently own
3 ANG will continue to roll into rate base each time the properties are bought and sold,
4 resulting in a gross distortion of utility rates. This example of what could have happened
5 very recently in Missouri with a Commission policy of allowing rate recovery of acquisition
6 adjustments is very similar to the types of abuses that led to the creation of the general rule
7 prohibiting rate recovery of acquisition adjustments in the first place.

8 Q. If the Commission allows direct ratemaking recovery of the acquisition
9 adjustment, as UtiliCorp proposes, would this treatment be consistent with how the
10 Commission has historically treated gains on sale of plant assets for ratemaking purposes?

11 A. No. This Commission has consistently ruled that gains (and losses) on the sale
12 of plant assets should be treated below the line and not flowed through to cost of service.
13 Above-the-line treatment of acquisition adjustments would be inconsistent with how the
14 Commission has historically treated gains and losses on asset sales.

15 Q. Please describe the Commission's reasoning for treating gains on sales of
16 plant assets below-the-line.

17 A. Although the Commission has modified its reasoning over the years, it has
18 consistently ruled that asset gains and losses should be treated below-the-line for ratemaking
19 purposes.

20 In Case No. ER-77-118, involving KCPL, the Commission held that ratepayers do not
21 become owners of the utility by paying their utility bills and therefore are not entitled to
22 benefit from any gains on sale of plant assets. In its Report and Order decided on October 20,
23 1977, the Commission ruled:

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1 It is the Commission's position that ratepayers do not acquire any
2 right, title and interest to the Company's property simply by
3 paying their electric bills. It should be pointed out that Company
4 investors finance Company while Company's ratepayers pay the
5 cost of financing and do not thereby acquire an ownership position.
6 Therefore, the Commission finds that the disposal of Company
7 property at a gain does not entitle its ratepayers to benefit from that
8 gain nor does the disposal of Company property at a loss require
9 that Company's ratepayers absorb that loss.
10

11 A few years later, in Case No. GM-81-368 involving ANG, the Commission again
12 ordered that the gain on sale of utility assets recognized by ANG should be treated below-
13 the-line for rate purposes. In that case, however, the Commission stated that its decision was
14 based on its interpretation of a General Instruction included in the USOA. The
15 Commission's Supplemental Report and Order stated that "it should be made clear that
16 'below the line' treatment of the gain on sales of the Kennett gas properties is not indicative
17 of a general policy to treat the gain on sale of utility property in this same manner as to other
18 utilities in future cases."

19 In Case Nos. WM-82-147, WM-82-192, WR-83-14 and SR-83-15, respecting
20 Missouri Cities Water Company, the Commission again ordered that gains on the sale of
21 utility assets should be treated below the line for ratemaking purposes. In the Report and
22 Order in those cases, however, the Commission did express an opinion that it would be open
23 to the concept of sharing of gains on sale of utility assets between ratepayers and
24 shareholders.

25 The Commission once again addressed the gains on asset sales issue in Case Nos.
26 EO-85-185 and EO-85-224, KCPL. In that case, the Commission agreed with KCPL's
27 position that ratepayers have no property interests in the utility assets; however, it said that

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1 "this fact alone does not dictate below the line accounting treatment for a gain on utility
2 assets."

3 Q. Since Case Nos. EO-85-185 and EO-85-224 in 1986, has the Staff proposed a
4 sharing of the gains on sale of plant assets between ratepayers and shareholders?

5 A. To the best of my knowledge, no. While there may be isolated exceptions, all
6 recognized gains on the sale of utility plant assets dating back to at least the past 23 years
7 (1977) have accrued solely to the benefit of the shareholders of Missouri's utilities. Also,
8 since the Commission's Report and Order in Case Nos. EO-85-185 and EO-85-224 in 1986, I
9 am not aware of any case where the Staff has proposed above-the-line treatment of gains on
10 utility asset sales.

11 Q. Because UtiliCorp is seeking to recover the merger premium in SJLP's utility
12 rates, wouldn't consistency require UtiliCorp to also propose above-the-line treatment of any
13 gains on the sale of its Missouri jurisdictional assets?

14 A. Yes, absolutely. The acquisition premium paid by the acquiring utility is the
15 gain on sale realized by the selling utility. They are the same dollars. The acquiring utility's
16 shareholders pay the gain to the acquired company's shareholders. The acquired utility
17 records the amount of the gain in the account "Gain On Sale of Plant Assets," while the
18 acquiring company records this same dollar amount in the "Acquisition Adjustment"
19 account.

20 For example, assume that UtiliCorp is allowed to recover in rates the \$97 million
21 acquisition adjustment paid to acquire SJLP. Assume further that in 2003, UtiliCorp sells
22 SJLP's generation assets at a significant gain over book value. In this situation, the
23 Commission, in applying consistent ratemaking treatment, would require that UtiliCorp

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1 record this gain in a deferred liability account and amortize the gain as a reduction to SJLP's
2 cost of service. If it is fair for UtiliCorp to charge the cost of the acquisition adjustment to
3 SJLP ratepayers, then it is fair for UtiliCorp to credit SJLP's ratepayers with any gain on the
4 sale of these assets. This is certainly the position that the Staff would recommend in such a
5 situation.

6 It is a long-held belief by the utility industry (including UtiliCorp) that ratepayers are
7 not owners and are not entitled to share in gains on asset sales. However, if SJLP's
8 ratepayers are required to pay for the acquisition adjustment in rates, for ratemaking purposes
9 they conceptually become owners, as they are forced to pay the ownership costs of acquiring
10 the property. As "owners," SJLP's ratepayers would be entitled to share in any future gains
11 on sales of utility assets along with other UtiliCorp shareholders.

12 Q. Does UtiliCorp have a consistent and fair position on the ratemaking
13 treatment of acquisition adjustments and gain on asset sales?

14 A. No. UtiliCorp's position (as described in the direct testimonies of UtiliCorp
15 witnesses Robert Green and John McKinney) is that utility ratepayers should be required to
16 pay for merger premiums paid to purchase utility assets. However, it takes a strikingly
17 contradictory position when it comes to the benefits of selling utility assets. UtiliCorp's
18 position on asset sales is that utility ratepayers do not own utility assets, and therefore are not
19 entitled to share in any gains on sale of utility assets. In other words, on asset purchases, it
20 does not matter if utility ratepayers are owners, they should still pay for the merger premium,
21 but on sales, it very much matters if ratepayers are owners. If they are not, they should not
22 benefit.

1 UtiliCorp's position on who should benefit from gains on asset sales was described by
2 UtiliCorp witness John W. McKinney in a transcribed interview with the Staff and the Office
3 of the Public Counsel on February 25, 2000 at UtiliCorp's offices. Mr. McKinney responded
4 to a question linking the treatment of recovering an acquisition adjustment to the sharing of
5 gains on the sale of an electric utility's generation assets:

6 Now, if you have a hypothetical sale with a gain, that's not a cost you
7 incurred to generate a savings for the customer. So, therefore, it's not
8 my testimony. I haven't addressed it. And I wouldn't put it in my
9 testimony at this time. I would need time to think about it, but I can't
10 think of a reason you would pass that back to the customers, because
11 it's not a cost generated to develop a level of costs for the customer to
12 pay for his energy. The customers do not own the assets; the
13 shareholders own the assets. They're their assets. We do not -- we're
14 not in a co-op.

15 [McKinney Transcript, pages 65-66.]

16 In a March 23, 2000 interview with the Staff, SJLP witness Terry Steinbecker, SJLP's
17 Chairman and CEO, echoed Mr. McKinney's views that ratepayers are not owners and
18 therefore are not entitled to any gains on sale of utility assets. In response to a question about
19 the possibility of sharing gains on the sale of generation assets, Mr. Steinbecker replied:

20 . . . It is my understanding that the Commission has held that no sharing
21 should occur and that customers are not entitled to benefit from any
22 gain from the disposition of utility property. I concur with this view.
23 [Steinbecker Transcript, pages 84-85.]
24

25 Q. If this merger is approved, is there a very real possibility that UtiliCorp will
26 eventually sell SJLP's generation assets at a substantial gain?

27 A. Yes. As described earlier, UtiliCorp is considering selling SJLP's generation
28 assets. Public Utilities Fortnightly published an analysis of electric generation asset sales in
29 its September 1, 1999 issue. This analysis, attached as a schedule to Staff Accounting
30 witness Steve M. Traxler direct testimony, shows that the average purchase price of 40 recent

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1 generation asset sales transactions was 2.15 times book value. If SJLP's generation assets
2 were sold for 2.15 times book value, UtiliCorp would recognize would recognize a gain or
3 approximately \$63 million.

4 **

7 **

8 **

19 **

21 Q. Should the Commission change its longstanding practice of not recognizing
22 gains on sale of plant assets for ratemaking purposes?

23 A. No. The Staff recommends that the Commission retain its longstanding policy
24 on both ordinary gains on asset sales and acquisition adjustments and continue to treat both
25 transactions below the line for ratemaking purposes. The Staff believes that these ratemaking
26 policies are fair and consistent to both ordinary utility shareholders and ratepayers.

MERGER BENEFITS TO UTILICORP

Q. Earlier you explained that \$44 million of the \$93 million merger premium is the approximate difference between the book (historical cost) value of SJLP and the market value of the company. Now please explain why UtiliCorp was willing to pay \$49 million above SJLP's current market value to acquire the company.

A. In acquiring SJLP and Empire, the Staff believes that UtiliCorp is positioning itself to be a stronger competitor in the future deregulated energy industry. In its 1998 Annual Report, Mr. Richard Green, UtiliCorp's Chairman and CEO, described the acquisition of SJLP as a "growth step." Mr. Green also described UtiliCorp's strategy to ensure long-term growth is to "go after customers with urgency, providing specialized products, services and pricing for each market." In deciding to purchase SJLP for \$190 million, UtiliCorp determined that the benefit of being a stronger competitor in a deregulated energy market, potential merger savings, and the potential financial benefits to UtiliCorp's nonregulated affiliates was worth the \$49 million above SJLP's current market value to acquire the company.

MERGER BENEFIT #1- STRONGER COMPETITOR

Q. Why does the Staff believe that UtiliCorp's primary motivation behind this merger was to enhance its competitive position in a deregulated environment?

A. It is widely believed in the utility industry that only large low-cost energy providers will survive in a deregulated energy industry. To increase size and scope is the main reason for the increase in the number of utility mergers over the last few years. UtiliCorp recognized this trend in its 1995 Sec Form 10-K405, Annual Report to the SEC:

1 The electric industry has increasingly become more competitive as
2 federal and state regulators and legislators continue taking steps
3 toward deregulation. The anticipation of reduced regulation triggered
4 some dramatic events in 1995. Five major utility mergers were
5 announced, including three that affect competitors close to or next to
6 the company's service territories.
7

8 In UtiliCorp's March 5, 1999 press release announcing the SJLP acquisition, Mr.
9 Richard Green described the merger agreement: "This agreement brings together two
10 companies with compatible views about the importance of customers, the value of employees
11 and the future direction of the industry. The merger strengthens our competitive position in
12 our home state and in the Midwest." Other than achieving a balance in its growth strategy
13 between regulated and unregulated investments and domestic and international operations,
14 the press release contained no other reason for the merger.

15 Also, Jerry Cosley, a UtiliCorp spokesman, described UtiliCorp's acquisition of SJLP
16 and Empire in a September 20, 1999 article in the KC Business Journal in this manner:
17 "These deals just made sense for everyone...With deregulation we've seen a lot of
18 consolidation in the industry to stay competitive. Since our territories were adjoining, it was
19 an easy fit."

20 Q. Should the reasons why UtiliCorp is acquiring SJLP be considered by the
21 Commission in its decision on who should pay for the costs (acquisition premium and
22 transaction costs) of the acquisition?

23 A. Yes. From its dealings with utility rate cases, the Commission is very well
24 versed in a principle of accounting known as the "matching principle." The matching
25 principle applies equally to merger cases where rate recovery of acquisitions is sought as it

1 does to rate cases. This principle simply states that costs incurred in producing revenue
2 should be matched as closely as possible with the revenue produced.

3 Applying this concept to utility mergers, merger costs should be matched as closely
4 as possible to merger benefits (future revenues or cost reductions). If the primary benefits of
5 this merger, are a strengthening of UtiliCorp's competitive position in a deregulated
6 environment and the creation of additional revenues to UtiliCorp's nonregulated investments,
7 then the costs to secure these benefits should be absorbed by the primary beneficiaries –
8 UtiliCorp's shareholders.

9 Q. Have other utilities committed not to seek recovery of merger premiums in
10 mergers where the shareholders are the primary beneficiaries?

11 A. Yes. The Illinois Commerce Commission (ICC) recently approved the
12 merger of Illinois Power Company (Illinois Power) and Dynergy Inc. (Dynergy). In its
13 Order approving the merger, the ICC quoted the testimony of Mr. John U. Clarke, Senior
14 Vice President and Chief Financial Officer of Dynergy describing the benefits of the merger:

15 The combined company will have the scale, scope, and skills to
16 compete effectively in the emerging national energy marketplace and
17 will benefit from advantages not available to either of the Merger
18 partners on a stand-alone basis.
19

20 The ICC's Order also quoted the testimony of Larry F. Altenbaumer, Illinois Power's
21 Senior Vice President and Chief Financial Officer stating that Illinois Power "has committed
22 to not seek to recover, in any future gas rate case, the costs incurred in accomplishing the
23 Merger."

1 Q. Was there another utility merger approved recently that was comparable to the
2 proposed UtiliCorp/SJLP merger where there was a commitment not seek recovery of the
3 merger premium?

4 A. Yes. In December 1999, the North Carolina Utilities Commission issued an
5 order approving the merger of SCANA Corporation (SCANA) and Public Service Company
6 of North Carolina, Inc. (PSNC). This merger is very similar to the proposed UtiliCorp/SJLP
7 merger.

8 Q. Please describe the similarities of the two mergers.

9 A. The similarities of the two mergers are shown below:

10 **Relative Size of Combining Companies**

11 SCANA, like UtiliCorp is a relatively large diversified utility holding company, and
12 PSNC, like SJLP is a relatively small utility.

13 **Size of Merger Premium**

14 SCANA agreed to pay an approximate 45 percent premium to PSNC's market value,
15 while UtiliCorp, in its press release announced that the merger premium paid to SJLP
16 will be 36 percent above current market value.

17 **Accounting of the Merger**

18 Purchase accounting was used for the SCANA/PSNC merger and will be used for the
19 UtiliCorp/SJLP merger.

20 **Purpose of the Merger**

21 In UtiliCorp's merger announcement, Richard Green, UtiliCorp's CEO, said that the
22 merger "strengthens our competitive position in our home state and in the Midwest."

23
24 In SCANA's merger announcement, William B. Timmerman, chairman, president
25 and CEO of SCANA, said "this acquisition is about growth, opportunity and

1 maximizing shareholder value in the face of the dramatic changes taking place in
2 today's utility industry."

3
4 Charles E. Zeigler, Jr., chairman, president and chief executive officer of PSNC, said,
5 "... Through this combination, we obtain the critical mass that facilitates significant
6 growth opportunities for the benefit of all our vital constituencies. Today, we have
7 taken our boldest step yet to position ourselves in the highly competitive energy
8 industry of the next century."

9 **Shared Corporate Culture**

10 SCANA - William Timmerman: "Both our companies share a common mission,
11 vision and values that are focused on competitive prices, high quality reliable
12 customer service and increasing shareholder value."

13
14 UtiliCorp - Richard Green: "This agreement brings together two companies with
15 compatible views about the importance of customers, the value of employees and the
16 future direction of the industry."

17 **Opportunity for Merger Savings**

18 According to SCANA's press release, the integration of PSNC into SCANA is
19 expected to provide opportunities for margin improvement and cost savings through
20 consolidation of duplicate functions and greater efficiencies in operations, business
21 processes and purchasing.

22
23 UtiliCorp believes that the acquisition of SJLP will lead to significant merger savings.

24 Q. Are there any similarities in SCANA's and UtiliCorp's merger regulatory plan
25 as it relates to merger costs and rate reductions?

26 A. No. In the UtiliCorp/SJLP merger, UtiliCorp, among other conditions, is
27 proposing ratemaking recovery of the merger premium and merger transaction costs and a
28 five-year rate freeze for SJLP with no rate reductions. In the SCANA/PSNC merger,

1 SCANA's CEO committed in his prefiled direct testimony that SCANA would "exclude all
2 costs of the merger and all direct and indirect corporate cost increases, including acquisition
3 premiums, attributable to the merger, from PSNC's utility accounts or costs for all purposes
4 that affect PSNC's retail rates and charges."

5 Q. What were the elements of the North Carolina Utilities Commission's
6 ordered merger rate plan?

7 A. In addition to accepting SCANA's commitment not to seek rate recovery of
8 any of the merger costs, direct and indirect, the North Carolina Utilities Commission ordered
9 a five-year rate freeze and a \$2 million rate reduction over two years.

10 Q. Did SCANA project that its acquisition of PSNC will have a positive impact
11 on SCANA's earnings even without recovery of any of the merger costs?

12 A. Yes. In its press release announcing the acquisition of PSNC, SCANA stated
13 that the transaction is anticipated to be accretive to SCANA's earnings per share in 2001.

14 Q. You described how the Staff believes that a prime motivation for acquiring
15 SJLP and Empire is for UtiliCorp to gain size and scope to position itself for financial
16 success in a deregulated energy industry. Is this how UtiliCorp is portraying the motivation
17 behind this merger in its direct testimony in this proceeding?

18 A. No. In order to put its best argument for acquisition adjustment recovery
19 before the Commission, UtiliCorp had to focus its testimony on the central theme of how
20 significant merger benefits will flow to SJLP's customers.

21 Q. Other than the benefit of an enhanced competitive position in a deregulated
22 energy market, what are the other benefits to UtiliCorp's nonregulated affiliates of the SJLP
23 acquisition?

1 A. Additional benefits include greater outsourcing of utility construction and
2 maintenance work to UtiliCorp's nonregulated affiliate, Quanta Resources, Inc. (Quanta),
3 acquisition of SJLP's rights of way and fiber optic cable network to support its recent
4 investment in telecommunications operations (telecom), and direct access to SJLP's 63,000
5 electric and 6,400 natural gas customers to sell the home energy appliance and service
6 agreement services (under the SJLP brand name) offered by UtiliCorp's ServiceOne affiliate.

7 **MERGER BENEFIT # 2: NONREGULATED BUSINESS OPPORTUNITIES**

8 Q. Is access to captive utility customers to generate additional revenue for
9 nonregulated affiliate companies an additional motivating factor behind the recent rise in
10 utility mergers?

11 A. Yes. Dr. Charles J. Cicchetti, a witness for Western Resources, Inc. and
12 Kansas City Power & Light Company in Case No. EM-97-515, describes the current impetus
13 behind mergers in the utility industry: "The momentum is for more, not less, mergers in the
14 energy sector. Regardless, successful utilities will concentrate on marketing, new product
15 offerings, and retaining and growing retail customers and sales." [Mergers and the
16 Convergence of the Electric and Natural Gas Industries, Natural Gas, March 1997, page 9].

17 Q. Does UtiliCorp believe that its acquisition of SJLP will lead to significant
18 financial benefits to its nonregulated affiliate companies?

19 A. Yes. In a March 15, 2000 Conference Call with Salomon Smith Barney
20 (March Conference Call) found in UtiliCorp's Internet website under Investor Information,
21 Presentations, Mr. Robert Green described how UtiliCorp intends to break apart some of
22 SJLP's embedded utility businesses and reposition them as nonregulated businesses:

23 We've also acquired two distribution assets here in the U.S., St. Joe
24 Power & Light and Empire District. We believe we can significantly

1 enhance the value of those assets by disaggregating, breaking apart
2 some embedded businesses, and repositioning them. We've done that
3 in Australia. Since 1995, our IRR in terms of that investment is over
4 30% and what we've done is break out the retail energy business and
5 we will joint venture that with Shell at a value significantly above
6 what we paid for it.
7

8 Q. Could you explain Mr. Robert Green's statement about "disaggregating and
9 repositioning" SJLP's embedded assets and businesses?

10 A. Yes. However, before I describe how UtiliCorp intends to disaggregate the
11 assets currently owned by SJLP into new unregulated business opportunities, it would be
12 helpful if I first described UtiliCorp's structural organization and its core investment strategy,
13 as described in its 1999 Annual Report. Structurally, UtiliCorp consists of three major
14 businesses; Energy Delivery Networks, Energy Merchant Business and Specialized Services.

15 A summary of these businesses follows:

16 **Energy Delivery Networks** – UtiliCorp describes itself as being a "world-class
17 manager of networks." This business segment consists of domestic and international
18 electric and natural gas distribution utilities.
19

20 In addition to its domestic gas and electric utility operations, this business segment
21 includes ServiceOne. ServiceOne repairs and services appliances and provides home
22 warranty and other services to about 170,000 contract customers both inside and
23 outside of UtiliCorp's utility service territories.
24

25 **Energy Merchant Business** – Includes Aquila Energy Corporation (Aquila) which
26 markets and trades wholesale natural gas, electricity and other commodities and deals
27 in a wide range of energy-related financial and risk management products and
28 services.
29

30 **Specialized Services** – Quanta Services, Inc. (Quanta) is one of the largest
31 specialized contractors serving utilities, telecommunications and cable TV operators.
32

33 UtiliCorp has recently announced a partnership called Everest Connections Corp to
34 offer telephone, high-speed Internet and cable TV services to consumers in several
35 markets, with the Kansas City area market to be first. Both UtiliCorp and SJLP are
36 investors in ExOp, a Kearney, Missouri company that plans to offer
37 telecommunications services in western Missouri.

1
2 A fundamental investment strategy UtiliCorp uses to constantly create new earnings
3 streams and build value, is the employment of what it calls a "value cycle." In its 1999
4 Annual Report, UtiliCorp describes how it employs this value cycle: "We invest, then
5 optimize and monetize." A graphical representation of UtiliCorp's value cycle is attached as
6 Schedule 5 to this testimony.

7 UtiliCorp claims that it creates value or "optimizes" its investments by enhancing
8 revenues, cutting costs, or applying UtiliCorp's utility operational model. UtiliCorp then
9 realizes the value by monetizing the investment, which can include selling all or part the
10 investment, seeking a partner, or developing some other strategic relationship (1999 Annual
11 Report page 5). In the February 8, 2000 Year-End Review Conference Call (February
12 Conference Call) Mr. Richard Green describes the monetize stage of the cycle as "grab that
13 value and push it to the bottom line."

14 Q. Describe a transaction where UtiliCorp has employed the use of the value
15 cycle.

16 A. In 1999, UtiliCorp decided to sell its investment in West Virginia Power, a
17 regulated electric utility subsidiary. To "optimize" the value of this investment, UtiliCorp
18 applied its centralized utility operational model, attempted to cut costs and enhance revenues.
19 UtiliCorp decided to "monetize" its West Virginia Power investment by selling the utility.
20 Not only did UtiliCorp's shareholders enjoy a significant gain on the sale of West Virginia
21 Power, but more importantly for UtiliCorp, it negotiated a 20-year gas supply agreement
22 between Aquila Energy and a West Virginia Power subsidiary. Mr. Richard Green described
23 this sale in the February Conference Call:

1 We were not interested in that sale just because we got a profit on the
2 assets. It was the strategic relationship we were able to develop with
3 Allegheny, and the long-term gas contract that we got for Aquila, that
4 made that a real good value proposition for us
5

6 Q. You just described how UtiliCorp leveraged its investment in West Virginia
7 Power to secure a long-term benefit for its nonregulated Energy Merchant Business
8 subsidiary, Aquila. How does UtiliCorp intend to leverage its investment in SJLP to benefit
9 its nonregulated affiliate companies?

10 A. Also in the February Conference Call, Mr. Robert Green describes UtiliCorp's
11 strategy of leveraging regulated utility assets to enhance its nonregulated investments as
12 "take advantage of our network position to pursue growth opportunities." Consistent with
13 this strategy, the Staff believes UtiliCorp intends to leverage SJLP's regulated utility assets to
14 secure financial benefits to its Specialized Services business (Quanta and
15 telecommunications investments) and its Energy Delivery Networks (ServiceOne).

16 **QUANTA SERVICES**

17 Q. Please describe UtiliCorp's investment in Quanta and how UtiliCorp intends
18 to provide financial benefits to this investment through the SJLP acquisition.

19 A. Since September 1999, UtiliCorp has invested a total of \$320 million to
20 acquire a 28 percent equity interest in Quanta (UtiliCorp 1999 Annual Report page 7).
21 Quanta installs, repairs and maintains electric transmission lines, cable TV, telephone and
22 data lines with the bulk of its sales from services to electric utility companies. In addition to
23 its equity investment in Quanta, UtiliCorp and Quanta entered into a six-year strategic
24 alliance agreement (Strategic Agreement) and a management services agreement
25 (Management Agreement). These affiliated agreements are summarized below:

Strategic Agreement

UtiliCorp will use Quanta as a "preferred contractor" in outsourced transmission and distribution infrastructure construction and maintenance in all areas serviced by UtiliCorp.

Management Agreement.

UtiliCorp will provide advice and services including financing activities; corporate strategic planning; research on the restructuring of the utility industries; the development, evaluation and marketing of the company's products, services and capabilities; identification of and evaluation of potential acquisition candidates and other merger and acquisition advisory services. In consideration of the advice and services rendered by UtiliCorp, Quanta will pay UtiliCorp \$9,300,000 annually.

UtiliCorp has a controlling ownership interest in Quanta and two UtiliCorp representatives (including Mr. Robert Green) are members of the Quanta Board of Directors. UtiliCorp is contractually obligated to treat Quanta as the preferred contractor for all of its utility construction and maintenance work. Quanta pays UtiliCorp \$9.3 million annually for among other things, assisting Quanta in acquiring outsourced electric utility construction and maintenance business.

The UtiliCorp-Quanta Agreements are explained in Quanta's Proxy Statement filed with the SEC on April 6, 2000:

Under the terms of the Strategic Alliance Agreement, UtiliCorp will use the Company, subject to the Company's ability to perform the required services, as a preferred contractor in outsourced power transmission and distribution infrastructure construction and maintenance and natural gas distribution construction and maintenance in all areas serviced by UtiliCorp, provided that the Company provides such services at a competitive cost. The Strategic Alliance Agreement has a term of six years.

The Company also entered into a Management Services Agreement with UtiliCorp. Under the Management Services Agreement, to the extent mutually agreed upon by the parties, UtiliCorp will provide advice and services including financing activities; corporate strategic planning; research on the restructuring of the utility industries; the

1 development, evaluation and marketing of the Company's products,
2 services and capabilities; identification and evaluation of potential
3 acquisition candidates and other merger and acquisition advisory
4 services; and other services that the Company's Board of Directors
5 may reasonably request.

6
7 In consideration of the advice and services rendered by UtiliCorp, the
8 Company will pay UtiliCorp on a quarterly basis in arrears a fee of
9 \$2,325,000. The Management Services Agreement has a term of six
10 years. The Company has the right to terminate the Management
11 Services Agreement at any time if, in the reasonable judgment of the
12 Company's Board of Directors, changes in the nature of the
13 relationship between the Company and UtiliCorp make effective
14 provision of the services to be provided unlikely.
15

16 Q. Why did UtiliCorp make such a large investment in Quanta?

17 A. In UtiliCorp's February and March Conference Calls, Mr. Robert Green
18 described how future utility outsourcing of maintenance and construction and the explosion
19 in demand for telecommunications services makes Quanta a very attractive investment:

20 **February Conference Call**

21 Now, if you look at contracting in North America, we believe utilities
22 are going to largely outsource the construction and maintenance of
23 their electric networks, and that is going to fuel tremendous growth in
24 this market for a well positioned player like Quanta. In addition, the
25 explosion of bandwidth is providing tremendous growth for Quanta.
26 And they also do a significant amount of business in terms of installing
27 cable network.

28
29 We've talked about our Quanta strategy. We think they're terrific
30 fundamentals in this market. We think it is the second-biggest market
31 to be unbundled from the vertically integrated utility. The biggest is
32 generation, clearly; and if you look at new generation and you look at
33 generation coming out of rate base, that market is growing at over
34 30%.

35
36 **March Conference Call**

37 In addition, Quanta is positioned for what we believe will be a massive
38 outsourcing of network construction and maintenance by utilities.
39 We've seen this happen in markets that are further along in
40 deregulation in Australia and New Zealand and we think in the next
41 few months you'll see businesses outsource the construction and

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1 maintenance of their power and gas networks to companies like
2 Quanta, not unlike a company outsourcing their IT needs to EDS or
3 IBM.
4

5 Because UtiliCorp has designated Quanta as a "preferred contractor" for utility
6 construction and maintenance projects, UtiliCorp's purchase of SJLP (and its future
7 construction and maintenance projects) will potentially increase Quanta's revenues and
8 income and therefore increase the value of UtiliCorp's investment in Quanta. Not only will
9 UtiliCorp's shareholders stand to gain financially by an increase in its investment in Quanta
10 (from outsourcing SJLP's construction and maintenance projects), it will also benefit from
11 the revenues (nonregulated) paid to UtiliCorp from Quanta for management services.

12 Q. Is it very likely that Quanta will be awarded most, if not all of the future
13 construction and maintenance work in the SJLP and Empire regulated service areas?

14 A. Yes. Given the following facts, it would be hard to conclude otherwise:

15 1. UtiliCorp has a controlling ownership interest in Quanta and two UtiliCorp
16 representatives (including Mr. Robert Green) are members of the Quanta Board of Directors;
17

18 2. UtiliCorp is contractually obligated to treat Quanta as the preferred contractor for
19 all of its utility construction and maintenance work;
20

21 3. Quanta pays UtiliCorp \$9.3 million annually for among other things, assisting
22 Quanta in achieving outsourcing business.
23

24 Q. Is UtiliCorp currently using Quanta for construction and maintenance
25 services?

26 A. Yes. In 1999 and 2000, Quanta provided construction and maintenance
27 services for several of UtiliCorp's utility operating divisions. According to UtiliCorp's
28 response to Staff Data Request No. 212, for the 15 months ended March 31, 2000, UtiliCorp
29 paid Quanta \$14.4 million for work performed for its Missouri Public Service (MPS)

1 division. It appears that UtiliCorp has already begun the process of outsourcing its utility
2 construction and maintenance projects, even before deregulation takes effect.

3 Q. Please relate how UtiliCorp is applying its value cycle philosophy with
4 Quanta and employing its strategy of taking advantage of its network position (regulated
5 utility assets) to pursue growth opportunities in nonregulated investments.

6 A. As illustrated below, UtiliCorp is "taking advantage" or leveraging its
7 regulated utility assets to generate new unregulated revenue sources in the optimize stage of
8 its Quanta value cycle.

9 Invest

10 \$320 Million investment to secure controlling interest and two Board
11 of Director seats

12 Optimize

13 Added \$55,800,000 in new revenue sources over six years from
14 Quanta Management Agreement

15 Preferred contractor status will lead to regulated utility construction
16 and maintenance business transferred to Quanta. Additional revenues
17 to Quanta will enhance UtiliCorp's equity earnings, and improve its
18 "bottom line" net income

19 Monetize

20 Potentially sell all or part of Quanta investment at a significant
21 financial gain

22 **TELECOMMUNICATIONS**

23 Q. Please describe how UtiliCorp first got into the telecom business.

24 A. As described in its 1999 Annual Report, UtiliCorp's Australian electric utility,
25 United Energy Limited (United Energy), has recently expanded into the broadband
26 telecommunications business. Ue Comm, a United Energy subsidiary, has a total fiber optic
27 network of 500 miles. In 2000, Ue Comm will also launch a high-speed Internet service

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1 called "Unite" using Ue Comm's fiber optic network. Ue Comm's marketing focus is on
2 commercial customers in Australia's central business districts and suburbs. In addition to
3 Internet service, Ue Comm leases space on the fiber-optic network to businesses, institutions
4 and others for use with multimedia, video conferencing and other telecommunication
5 services.

6 In the March Conference Call, Mr. Robert Green described the development of Ue
7 Comm as "we've built a telecom business leveraging our right-of-way in the power
8 business."

9 Q. Does UtiliCorp plan to enter the domestic telecommunications business using
10 the assets acquired from SJLP and Empire?

11 A. Yes. In the February Conference Call, Mr. Robert Green described how
12 UtiliCorp plans to replicate its Australian telecom strategy in Missouri:

13 We will continue to pursue this telecom strategy that has emerged out
14 of Australia. There is significant potential with the assets we're
15 acquiring at Empire and St. Joe to create an Australian-like telecom
16 play in the mid-continent.

17
18 And as I said, we've got I think 300 miles of fiber at Empire, and a
19 significant business at St. Jo that we think we can build, based on our
20 Australian experience, into a real growth vehicle for UtiliCorp.

21
22 We expect to offer voice services this year. And it really is our biggest
23 venture into telecom. And it is a strategy we think we can replicate.
24 We think we can replicate it in a place like Calgary, taking advantage
25 of our power distribution position. We think we can replicate it in
26 Missouri. Empire has 300 miles of fiber.

27
28 We think we can implement this strategy in the Empire service
29 territory. We think we can implement it in and around Kansas City.
30 And we're developing the business plan and identifying the right
31 partners to make this strategy most successful in these different
32 markets. But as we look at buying network assets, the telecom overlay
33 will be a key part of the value proposition. (Emphasis added.)
34

1 Q. In the above quote of Mr. Robert Green, you highlighted the following, "But
2 as we look at buying network assets, the telecom overlay will be a key part of the value
3 proposition." Please explain the significance of this statement as it related to merger
4 benefits.

5 A. This statement is significant because it explains the benefit or value that
6 UtiliCorp is buying when it acquires or merges with other electric distribution utilities.
7 According to UtiliCorp, a "key part" of the value of a utility as an acquisition target is its
8 telecommunications assets. These assets are the existing installed fiber optic cable, the
9 utility's rights of way, the existing electric power infrastructure on which to install fiber optic
10 lines for voice, video and data transmission. The Staff does not know exactly how much
11 "value" UtiliCorp is attributing to SJLP's telecommunication assets, or how much of the
12 \$44 million above current market value that UtiliCorp is paying for SJLP that should be
13 attributed to these assets. However, the amount could be substantial.

14 Q. Please explain.

15 A. In the February Conference Call, Mr. Robert Green said that UtiliCorp
16 invested approximately \$15 million in its Australian telecommunications operations and
17 these operations now have a value of \$300 million. He also said "in St. Joe I think we're
18 looking at putting \$4 million into the business to fund their expansion. We've laid a little
19 fiber in Colorado and it's just single digits in terms of millions, with very high returns."
20 UtiliCorp's Australian telecommunications operations has a valuation of 20 times investment
21 (\$300/\$15). Using UtiliCorp's investment estimate of \$4 million, assuming a return of only
22 half of what was experienced in Australia, SJLP's telecom operations will be worth

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1 approximately \$80 million, or, stated another way, approximately 87 percent of the total
2 SJLP acquisition premium.

3 Q. Consistent with its value cycle philosophy, does UtiliCorp intend to
4 "monetize" its Australian telecommunications business?

5 A. Yes. In May 1998, UtiliCorp sold 42 percent of its ownership in United
6 Energy to the Australian public and recorded a \$45.3 million gain. It appears that UtiliCorp
7 has similar plans for its Australian telecommunication business. In the March Conference
8 Call, Mr. Robert Green described the plans for the Australian telecommunications business:

9 Second, in terms of a near-term upside is our telecom business that's
10 emerging first in Australia. We expect to float a telecom business at a
11 valuation close to the initial investment value in United Energy, the
12 power company we bought back in 1995. We think that should have a
13 big impact on UtiliCorp's share price. As well, we are aggressively
14 pursuing that telecom strategy here domestically.

15
16 The third near-term prospect for substantially enhancing shareholder
17 value is a partner for our energy marketing and trading operation,
18 Aquila. We think there are several very attractive candidates in the
19 market that have low cost generation that is being rolled out of rate
20 base and provides a significant opportunity for Aquila to partner with
21 them and create an entity that would be valued at a significantly higher
22 multiple. A good example of that is the Dynergy-Illinova deal that
23 occurred about a year ago. The value there has essentially more than
24 doubled, and as we look at Aquila today, it trades at about a multiple
25 of 8 to 8.5 times EBITDA. Combined with the right generation assets,
26 we think we can double that multiple and that's what Dynergy has
27 done. And we believe we can replicate that result.
28

29 **SERVICEONE**

30 Q. Will the acquisition of SJLP's approximately 70,000 regulated utility
31 customers potentially provide benefits to UtiliCorp's nonregulated energy services company,
32 ServiceOne?

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1 A. Yes. EnergyOne is UtiliCorp's brand name for its utility products and
2 services. Operating under the EnergyOne brand name is ServiceOne, a UtiliCorp
3 nonregulated company that provides home warranties, service contracts, appliance repairs
4 and heating and cooling services. According to UtiliCorp's 1999 Annual Report, ServiceOne
5 serves about 170,000 contract customers in nine states, both inside and outside UtiliCorp's
6 regulated utility service territories.

7 Q. Will UtiliCorp continue to use the SJLP brand name and logo in running the
8 utility business in the SJLP service territory?

9 A. Yes.

10 Q. Is this important?

11 A. Yes, SJLP has been in business for over 100 years developing a relationship
12 with its customers. Its commitment to service and its customers are described in its Internet
13 homepage, www.sjlp.com:

14 * The company's strong reputation for service makes us a leader in
15 meeting customers' needs.

16 *Annually, Light & Power ranks among the nation's most reliable
17 utilities in quality of service.

18 *For value, our electric prices are among the lowest when
19 compared to other national and area utilities, and our natural gas
20 prices also are competitive.

21 *Our most distinguishing trait is the commitment we bring to our
22 tasks -- good service to customers through continued innovation
23 and responsiveness.

24 *Our most distinguishing trait is the commitment we bring to our
25 tasks -- good service to customers through continued innovation
26 and responsiveness.

27

28 In marketing its nonregulated products through ServiceOne, UtiliCorp will be able to
29 benefit from this customer-utility relationship. Presumably a customer generally will be
30 more likely to do business with a company that he/she has had a personal relationship with

1 for many years over a company with which no such relationship exists. When UtiliCorp
2 purchases the assets of SJLP, it is also purchasing the SJLP brand name, an intangible asset
3 that has the potential to provide benefits to UtiliCorp's nonregulated ServiceOne subsidiary.

4 Q. Will this intangible asset, SJLP brand name be recognized as an asset by
5 UtiliCorp after it acquires SJLP?

6 A. Yes, while it will not be separately listed, the value of the SJLP brand name,
7 as well as the value of the increased opportunities for its Specialized Services business,
8 Quanta and telecommunications investments, will be recognized in the acquisition
9 adjustment account on UtiliCorp's balance sheet.

10 **DEFERRED TAXES**

11 Q. In the introduction to your testimony you state that the Staff has a concern
12 about a potential loss of SJLP's accumulated deferred income taxes as a result of the merger.
13 Please explain the term "accumulated deferred income taxes" and explain how these taxes
14 are treated for ratemaking purposes.

15 A. Accumulated deferred income taxes (deferred taxes) are interest-free funds to
16 the company because they were not created by a shareholder investment, but by a
17 prepayment of income tax expense by the ratepayers. To recognize the cost-free nature of
18 these funds, deferred taxes are treated as an offset (reduction) to rate base.

19 Q. What impact does a merger have on a utility's deferred taxes?

20 A. The impact depends on the tax attributes of the merger, that is whether the
21 merger transaction is considered taxable or nontaxable. In a taxable transaction, deferred
22 taxes are eliminated from a company's accounts and are paid to the appropriate taxing

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1 authorities. In a nontaxable transaction, the deferred taxes of the acquired company remain
2 intact and are transferred to the acquiring company.

3 Q. Since the UtiliCorp/SJLP merger is expected to be a nontaxable transaction,
4 does that mean that SJLP's customers will retain the benefit of this rate base offset in future
5 rate proceedings?

6 A. That is what is expected, however, there is no guarantee. In response to Staff
7 Data Request No. 90, UtiliCorp stated:

8 . . . This is a tax free merger in which UCU will assume the tax basis of
9 the assets of SJLP. As a tax-free transaction under IRC S368(a)(1)(A),
10 the tax attributes of SJLP will survive and be inherited by UtiliCorp
11 United under IRC S381.
12

13 However, on page 28 of the Joint Proxy Statement, the Joint Applicants advise that
14 the opinion that this transaction will be treated as nontaxable is not binding on the IRS or any
15 court and does not preclude the IRS or a court from reaching a contrary conclusion.

16 Q. Does the Staff propose that as a condition of this merger UtiliCorp must agree
17 that if this merger is required to be recorded as a taxable transaction that Missouri ratepayers
18 will suffer no financial detriment as a result of the loss of SJLP's deferred taxes?

19 A. Yes. The Staff recommends that the Commission require this condition if it
20 decides to approve this merger.

21 Q. Does this conclude your rebuttal testimony?

22 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

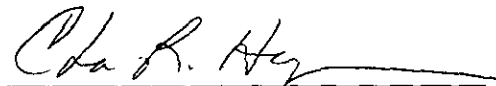
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of)
UtiliCorp United Inc. and St. Joseph Light &)
Power Company for Authority to Merge St.) Case No. EM-2000-292
Joseph Light & Power Company With and Into)
UtiliCorp United Inc. and, In Connection)
Therewith, Certain Other Related Transactions.)

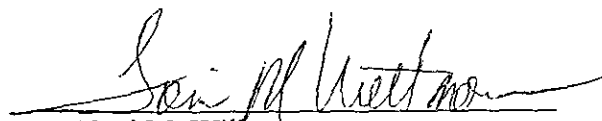
AFFIDAVIT OF CHARLES R. HYNEMAN

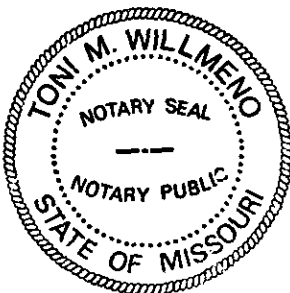
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Charles R. Hyneman, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 70 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


Charles R. Hyneman

Subscribed and sworn to before me this 2nd day of May 2000.


Toni M. Willmeno
Notary Public, State of Missouri
County of Callaway
My Commission Expires June 24, 2000



Charles R. Hyneman

Schedule of Testimony Filings

Case No.	Company
TR-93-181	United Telephone Company of Missouri
ER-94-163	St. Joseph Light & Power Company
HR-94-177	St. Joseph Light & Power Company
GR-95-160	United Cities Gas Company
EM-96-149	Union Electric Merger with CIPSCO, Inc.
GR-96-285	Missouri Gas Energy
GR-97-272	Associated Natural Gas Company
ER-97-394	UtiliCorp United, Inc.
GR-98-140	Missouri Gas Energy
EM-97-515	Western Resources, Inc. Acquisition of Kansas City Power & Light Co.
GM-2000-312	Atmos Energy Corporation Acquisition of Associated Natural Gas Company

Merger Premium	\$92,400,000					
Transaction Costs	\$4,600,000					
Acquisition Adjustment	\$97,000,000					
Amortization Period	40				Grossed up	
Amortization Expense	\$2,425,000				For Tax	Total
					1.6231	Return on RB
						and Amortization
Year	Rate Base	Return	Return on RB	Amortization	Amortization	Total
0	\$97,000,000					
1	\$94,575,000	11.18%	\$10,572,755	\$2,425,000	\$3,935,960	\$14,508,715
2	\$92,150,000	11.18%	\$10,301,658	\$2,425,000	\$3,935,960	\$14,237,618
3	\$89,725,000	11.18%	\$10,030,562	\$2,425,000	\$3,935,960	\$13,966,522
4	\$87,300,000	11.18%	\$9,759,466	\$2,425,000	\$3,935,960	\$13,695,426
5	\$84,875,000	11.18%	\$9,488,370	\$2,425,000	\$3,935,960	\$13,424,330
6	\$82,450,000	11.18%	\$9,217,273	\$2,425,000	\$3,935,960	\$13,153,233
7	\$80,025,000	11.18%	\$8,946,177	\$2,425,000	\$3,935,960	\$12,882,137
8	\$77,600,000	11.18%	\$8,675,081	\$2,425,000	\$3,935,960	\$12,611,041
9	\$75,175,000	11.18%	\$8,403,985	\$2,425,000	\$3,935,960	\$12,339,944
10	\$72,750,000	11.18%	\$8,132,888	\$2,425,000	\$3,935,960	\$12,068,848
11	\$70,325,000	11.18%	\$7,861,792	\$2,425,000	\$3,935,960	\$11,797,752
12	\$67,900,000	11.18%	\$7,590,696	\$2,425,000	\$3,935,960	\$11,526,656
13	\$65,475,000	11.18%	\$7,319,599	\$2,425,000	\$3,935,960	\$11,255,559
14	\$63,050,000	11.18%	\$7,048,503	\$2,425,000	\$3,935,960	\$10,984,463
15	\$60,625,000	11.18%	\$6,777,407	\$2,425,000	\$3,935,960	\$10,713,367
16	\$58,200,000	11.18%	\$6,506,311	\$2,425,000	\$3,935,960	\$10,442,271
17	\$55,775,000	11.18%	\$6,235,214	\$2,425,000	\$3,935,960	\$10,171,174
18	\$53,350,000	11.18%	\$5,964,118	\$2,425,000	\$3,935,960	\$9,900,078
19	\$50,925,000	11.18%	\$5,693,022	\$2,425,000	\$3,935,960	\$9,628,982
20	\$48,500,000	11.18%	\$5,421,926	\$2,425,000	\$3,935,960	\$9,357,885
21	\$46,075,000	11.18%	\$5,150,829	\$2,425,000	\$3,935,960	\$9,086,789
22	\$43,650,000	11.18%	\$4,879,733	\$2,425,000	\$3,935,960	\$8,815,693
23	\$41,225,000	11.18%	\$4,608,637	\$2,425,000	\$3,935,960	\$8,544,597
24	\$38,800,000	11.18%	\$4,337,540	\$2,425,000	\$3,935,960	\$8,273,500
25	\$36,375,000	11.18%	\$4,066,444	\$2,425,000	\$3,935,960	\$8,002,404
26	\$33,950,000	11.18%	\$3,795,348	\$2,425,000	\$3,935,960	\$7,731,308
27	\$31,525,000	11.18%	\$3,524,252	\$2,425,000	\$3,935,960	\$7,460,211
28	\$29,100,000	11.18%	\$3,253,155	\$2,425,000	\$3,935,960	\$7,189,115
29	\$26,675,000	11.18%	\$2,982,059	\$2,425,000	\$3,935,960	\$6,918,019
30	\$24,250,000	11.18%	\$2,710,963	\$2,425,000	\$3,935,960	\$6,646,923
31	\$21,825,000	11.18%	\$2,439,866	\$2,425,000	\$3,935,960	\$6,375,826
32	\$19,400,000	11.18%	\$2,168,770	\$2,425,000	\$3,935,960	\$6,104,730
33	\$16,975,000	11.18%	\$1,897,674	\$2,425,000	\$3,935,960	\$5,833,634
34	\$14,550,000	11.18%	\$1,626,578	\$2,425,000	\$3,935,960	\$5,562,538
35	\$12,125,000	11.18%	\$1,355,481	\$2,425,000	\$3,935,960	\$5,291,441
36	\$9,700,000	11.18%	\$1,084,385	\$2,425,000	\$3,935,960	\$5,020,345
37	\$7,275,000	11.18%	\$813,289	\$2,425,000	\$3,935,960	\$4,749,249
38	\$4,850,000	11.18%	\$542,193	\$2,425,000	\$3,935,960	\$4,478,152
39	\$2,425,000	11.18%	\$271,096	\$2,425,000	\$3,935,960	\$4,207,056
40	\$0	11.18%	\$0	\$2,425,000	\$3,935,960	\$3,935,960
			\$211,455,095	\$97,000,000	\$157,438,396	\$368,893,491
	A	B	C	D	E	F
			(AxB)	\$B\$5	D x 1.6231	C+E

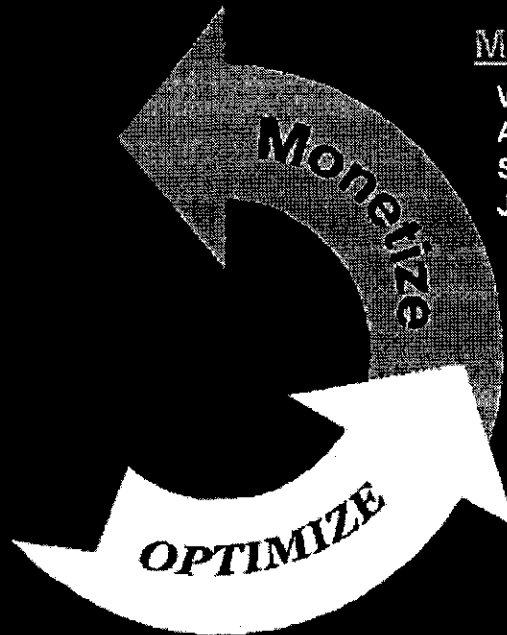
Merger Premium	\$92,400,000							
Transaction Costs	\$4,600,000							
Acquisition Adjustment	\$97,000,000							
Amortization Period	40				Grossed up			
Amortization Expense	\$2,425,000				For Tax	Total	Net Savings	UCU Cost
					1.6231	Return on RB	Staff DR 1 VJS-1	Over
						and Amortization		Savings
Year	Rate Base	Return	Return on RB	Amortization	Amortization	Total		
0	\$97,000,000							
1	\$94,575,000	11.18%	\$10,572,755	\$2,425,000	\$3,935,960	\$14,508,715	\$858,000	\$13,650,715
2	\$92,150,000	11.18%	\$10,301,658	\$2,425,000	\$3,935,960	\$14,237,618	\$3,489,000	\$10,748,618
3	\$89,725,000	11.18%	\$10,030,562	\$2,425,000	\$3,935,960	\$13,966,522	\$4,478,000	\$9,488,522
4	\$87,300,000	11.18%	\$9,759,466	\$2,425,000	\$3,935,960	\$13,695,426	\$5,764,000	\$7,931,426
5	\$84,875,000	11.18%	\$9,488,370	\$2,425,000	\$3,935,960	\$13,424,330	\$6,688,000	\$6,736,330
6	\$82,450,000	11.18%	\$9,217,273	\$2,425,000	\$3,935,960	\$13,153,233	\$8,101,000	\$5,052,233
7	\$80,025,000	11.18%	\$8,946,177	\$2,425,000	\$3,935,960	\$12,882,137	\$7,093,000	\$5,789,137
8	\$77,600,000	11.18%	\$8,675,081	\$2,425,000	\$3,935,960	\$12,611,041	\$8,198,000	\$4,413,041
9	\$75,175,000	11.18%	\$8,403,985	\$2,425,000	\$3,935,960	\$12,339,944	\$7,784,000	\$4,555,944
10	\$72,750,000	11.18%	\$8,132,888	\$2,425,000	\$3,935,960	\$12,068,848	\$7,230,000	\$4,838,848
			\$93,528,215	\$24,250,000	\$39,359,599	\$132,887,814	\$59,683,000	\$73,204,814
	A	B	C	D	E	F	G	H
			(AxB)	\$B\$5	D x 1.6231	C+E		G-F

Merger Premium	\$92,400,000							
Transaction Costs	\$4,600,000							
Acquisition Adjustment	\$97,000,000							
Amortization Period	40				Grossed up			
Amortization Expense	\$2,425,000				For Tax			
					1.6231	Total		Savings in excess
			Fifty Percent	Fifty Percent	Fifty Percent	Revenue	Net Savings	of Revenue
Year	Rate Base	Return	Return on RB	Amortization	Amortization	Requirement	Staff DR 1 VJS-1	Requirement
0	\$97,000,000							
1	\$94,575,000	11.18%				\$0	\$0	
2	\$92,150,000	11.18%				\$0	\$0	
3	\$89,725,000	11.18%				\$0	\$0	
4	\$87,300,000	11.18%				\$0	\$0	
5	\$84,875,000	11.18%				\$0	\$0	
6	\$82,450,000	11.18%	\$4,608,637	\$1,212,500	\$1,967,980	\$6,576,617	\$8,101,000	\$1,524,383
7	\$80,025,000	11.18%	\$4,473,089	\$1,212,500	\$1,967,980	\$6,441,069	\$7,093,000	\$651,931
8	\$77,600,000	11.18%	\$4,337,540	\$1,212,500	\$1,967,980	\$6,305,520	\$8,198,000	\$1,892,480
9	\$75,175,000	11.18%	\$4,201,992	\$1,212,500	\$1,967,980	\$6,169,972	\$7,784,000	\$1,614,028
10	\$72,750,000	11.18%	\$4,066,444	\$1,212,500	\$1,967,980	\$6,034,424	\$7,230,000	\$1,195,576
			\$21,687,702	\$6,062,500	\$9,839,900	\$31,527,602	\$38,406,000	\$6,878,398
	A	B	C	D	E	F	G	H
			(AxB)x.50	\$B\$5 * .50	D x 1.6376	C+E		G-F

Value Cycle Philosophy

Overall

St. Joseph
 Empire District
 Aries Power Plant
 Australia - electric
 Australia - telecor
 Katy Storage
 New Zealand -
 TransAlta,
 TrustPower, PNZ
 Australia - gas
 Quanta Services
 Gas commodity
 contract



Monetize

WEL Energy
 Australia - electric
 Sale of WV properties
 J.V. Aries Plant

Optimize

Reduce costs
 Add new revenue
 sources
 Transfer operating
 model
 Develop emerging
 opportunities

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