Exhibit No.:
Issues: Accounting
Witness: Warner L. Baxter
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Union Electric Co.
Case No.: EM-96-149

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EM-96-149

SURREBUTTAL TESTIMONY

OF

WARNER L. BAXTER

St. Louis, Missouri
June 3, 1996

MISSOURI PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the matter of the Application of Union Electric Company for an order authorizing: (1) certain merger transactions involving Union Electric Company; (2) the transfer of certain Assets, Real Estate, Leased Property, Easements and Contractual Agreements to Central Illinois Public Service Company; and (3) in connection therewith, certain other related transactions.	))))))))))	Case No. EM-96-149

AFFIDAVIT OF WARNER L. BAXTER

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

Warner L. Baxter, being first duly sworn on his oath, states:

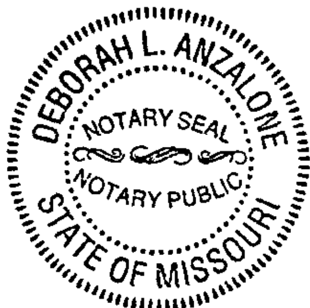
1. My name is Warner L. Baxter. I work in the City of St. Louis, Missouri, and I am the Assistant Controller at Union Electric Company.

2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony consisting of pages 1 through 16, inclusive, all of which testimony has been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Warner L. Baxter

Subscribed and sworn to before me this 31st day of May, 1996.



Notary Public

DEBORAH L. ANZALONE
NOTARY PUBLIC—STATE OF MISSOURI
ST. LOUIS COUNTY
MY COMMISSION EXPIRES APR. 18, 1998

1 SURREBUTTAL TESTIMONY
2 OF
3 WARNER L. BAXTER
4 MISSOURI PUBLIC SERVICE COMMISSION
5
6
7 **Q. Please state your name and business address.**

8 A. My name is Warner L. Baxter and my business address is 1901 Chouteau
9 Avenue, St. Louis, Missouri 63103.

10 **Q. Are you the same Warner L. Baxter who previously submitted direct**
11 **testimony in this docket?**

12 A. Yes, I am.

13 **Q. What is the purpose of your surrebuttal testimony?**

14 A. The purpose of my surrebuttal testimony is to respond to the rebuttal
15 testimony of certain Missouri Public Service Commission (MPSC) Staff and Office of Public
16 Counsel (OPC) witnesses who have addressed the following issues in Union Electric's merger
17 application:

18 • accounting for, and recovery of, merger transaction costs and costs to achieve;
19 • identifying merger related payroll costs separately;
20 • pooling of interests and purchase methods of accounting matters; and
21 • certain conditions imposed by the MPSC Staff.

22 MERGER TRANSACTION COSTS AND COSTS TO ACHIEVE

23 **Q. Turning first to Staff witness Imhoff, do you agree with Mr. Imhoff's**
24 **assertion that UE's accounting for merger transaction costs in 1995 is improper?**

25 A. No, I do not.

1 **Q. How did UE account for these costs?**

2 A. In accordance with generally accepted accounting principles (GAAP), UE
3 expensed these costs as incurred. UE recorded these expenses in Federal Energy Regulatory
4 Commission (FERC) Uniform System of Accounts (USOA) Account No. 426, Other
5 Deductions.

6 **Q. In his testimony, Mr. Imhoff states that UE should defer merger**
7 **transaction costs in FERC USOA Account 301, Organization Costs, or in FERC USOA**
8 **Account 186, Miscellaneous Deferred Debits. Do you agree with Mr. Imhoff's**
9 **recommended accounting treatment for these costs?**

10 A. No, I do not. With regard to FERC Account 301, Organization Costs, the
11 merger transaction costs and costs to achieve are not "organization costs." As defined in
12 FERC's USOA, Account 301 is to include all fees paid to federal and state governments for
13 the privilege of incorporation and expenditures incident to organizing the corporation and
14 putting it into readiness to do business. In addition, this account shall not include any costs
15 incurred in connection with the authorization, issuance or sale of capital stock. For example,
16 the fees that are included in Account 301 typically include costs of procuring the necessary
17 certificates from state authorities and the drafting and filing of the corporate charter and
18 bylaws. As a result, organization costs are typically incidental fees and are generally
19 insignificant. To the extent that these types of fees are incurred as a result of mergers and
20 consolidations, they could potentially be recorded in this account. However, the Company's
21 transaction costs and costs to achieve (as shown in Mr. Rainwater's Schedule 7 to his direct
22 testimony) are not the types of costs typically classified as organization costs. For example, it

1 would be inappropriate to classify as organization costs fees paid to consultants to assist the
2 Company in the integration of computer information systems, or fees paid to consultants to
3 assist the Company in identifying merger savings and managing the transition effort.

4 In addition, recording the merger transaction costs and costs to achieve in Account
5 301 would imply that these costs may be capitalized since Account 301 is a utility plant
6 account. This accounting would directly conflict with Accounting Principles Board Opinion
7 No. 16, "Business Combinations" which requires that all expenses related to effecting a
8 business combination accounted for by the pooling of interests method be deducted in
9 determining net income as the expenses are incurred. Therefore, it is inappropriate to
10 capitalize any of the merger transaction costs and costs to achieve in Account 301.

11 With regard to Account 186, Miscellaneous Deferred Debits, FERC's USOA now
12 directs utilities to use Account 182.3, Other Regulatory Assets, for those expenses which are
13 deferred pending regulatory recovery. According to the USOA, Account 182.3 is to include
14 regulatory created assets resulting from the ratemaking actions of regulatory agencies. The
15 amounts included in this account consist of those expenses which would have been included in
16 net income under the general requirements of the USOA "but for it being probable that such
17 items will be included in a different period(s) for purposes of developing the rates that the
18 utility is authorized to charge for its utility services." (emphasis added) In FERC Order No.
19 552, FERC defined the term "probable" (as it is used in the definition for regulatory assets) as
20 "that which can reasonably be expected or believed on the basis of available evidence or logic
21 but is neither certain nor proved." Therefore, in accordance with the USOA, entities may only
22 defer expenses in Account 182.3 if it is "probable" that such costs will be recovered in future

1 rates. GAAP has similar requirements. Specifically, Statement of Financial Accounting
2 Standards No. 71 "Accounting for the Effects of Certain Types of Regulation" (FAS 71),
3 paragraph 9 states the following:

4 9. Rate actions of a regulator can provide reasonable assurance of the
5 existence of an asset. An enterprise shall capitalize all or part of an incurred
6 cost that would otherwise be charged to expense if both of the following
7 criteria are met:
8
9 a. It is probable that future revenue in an amount at least equal to the
10 capitalized cost will result from inclusion of that cost in allowable costs
11 for rate-making purposes.
12
13 b. Based on available evidence, the future revenue will be provided to
14 permit recovery of the previously incurred cost rather than to provide
15 for expected levels of similar future costs. If the revenue will be
16 provided through an automatic rate-adjustment clause, this criterion
17 requires that the regulator's intent clearly be to permit recovery of the
18 previously incurred cost. (emphasis added)
19
20 The term "probable," as used in FAS 71, is defined to mean that a transaction or event is
21 likely to occur.

22 Based upon the requirements of the USOA and GAAP, UE can not record merger
23 transaction costs and costs to achieve in Account 182.3 because management cannot make the
24 determination that it is "probable" that these costs will be recovered in future rates based on
25 available evidence. Therefore, pending regulatory treatment, these costs must continue to be
26 expensed as incurred for financial reporting purposes.

27 **Q. Would the receipt of an "Accounting Authority Order" permitting**
28 **deferral of these costs have provided sufficient evidence under the requirements of the**
29 **USOA or GAAP to defer these costs?**

1 A. Not in this particular situation. Based upon past history, it is likely that the
2 Accounting Authority Order would have only approved the deferral of these costs for
3 accounting purposes. The ratemaking treatment of these costs would have been deferred to a
4 later date. Since the USOA and GAAP requirements for deferring these costs are dependent
5 upon an assessment that these costs are "probable" of recovery for ratemaking purposes, such
6 an Accounting Authority Order would not have provided sufficient evidence to defer these
7 costs.

8 **Q. Going back to a statement you previously made in your surrebuttal**
9 **testimony, you said "Therefore, pending regulatory treatment, these costs must be**
10 **expensed as incurred for financial reporting purposes." What will be the accounting for**
11 **the merger transaction costs and costs to achieve, assuming that UE is allowed to**
12 **recover these costs in rates?**

13 A. For those costs which have yet to be incurred, they would be deferred and
14 recorded in Account 182.3. These costs would then be amortized "above the line" over the
15 recovery period set forth by the MPSC. Those costs which had previously been incurred and
16 expensed for financial reporting purposes would also be charged to Account 182.3, with an
17 offsetting credit to Account 426 in the income statement. All merger transaction costs and
18 costs to achieve recorded in 182.3 would then be amortized in the manner I described
19 previously. The accounting for those costs which have yet to be incurred is consistent with
20 the provisions of Account 182.3 of the USOA and paragraph 9 of FAS 71. The accounting
21 for the costs previously incurred and expensed is consistent with the provisions of Emerging
22 Issues Task Force Issue No. 93-4, "Accounting for Regulatory Assets" (EITF 93-4). EITF

1 93-4 states that: "The Task Force also reached a consensus that a cost that does not meet the
2 asset recognition criteria in paragraph 9 of Statement 71 at the date the cost is incurred should
3 be recognized as a regulatory asset when it does meet those criteria at a later date."
4 Therefore, it is appropriate to recognize as a regulatory asset those costs previously incurred
5 and expensed once assurance of recovery of those costs in rates is provided at a later date.

6 **Q. Earlier in your surrebuttal testimony, you stated that the Company**
7 **recorded merger transaction costs and costs to achieve in Account 426, a nonoperating**
8 **expense account. Do you believe that these costs should be included in UE's cost of**
9 **service?**

10 A. Yes.

11 **Q. Why?**

12 A. The Company's position as to why it believes it is appropriate to recover these
13 costs in rates is addressed in the direct testimony of Mr. Rainwater, pp. 17-26.

14 **Q. Why then did UE record these costs in Account 426, as opposed to some**
15 **other operating expense account "above the line?"**

16 A. UE recorded these costs in Account 426 as a good faith effort to ensure that
17 these costs would not affect the operating expenses impacting the first sharing period under
18 the "Stipulation and Agreement" in Case No. ER-95-411, approved by the MPSC in July
19 1995. The first sharing period runs from July 1, 1995, to June 30, 1996. Since UE sought
20 specific recovery of the merger transaction costs and costs to achieve in its shared savings
21 plan proposal, UE did not wish to give the Staff or MPSC any impression that it was seeking
22 to recover these costs through the provisions of the "Stipulation and Agreement" prematurely.

1 Therefore, the Company believed that the "cleanest" way to segregate these costs from the
2 operating expenses to be considered in the first sharing period was to record them in Account
3 426. If Mr. Imhoff or other members of the MPSC Staff are troubled by the fact that UE
4 recorded these expenses in Account 426, UE will reverse this accounting entry and record
5 these expenses "above the line" in the appropriate operating expense accounts.

6 **Q. Did the Company inform the Staff why it chose to account for its merger**
7 **transaction costs and costs to achieve in this manner?**

8 A. Yes. I have had informal discussions with the Staff on this matter in which I
9 explained to them our rationale for recording these costs in Account 426. In addition, Mr.
10 Brandt discussed this matter with the Staff in his interview on March 28, 1996 (pp. 60-61, see
11 Schedule 1 to my surrebuttal testimony).

12 **Q. Do you agree with Mr. Imhoff's recommendation that the MPSC disallow**
13 **future recovery of 1995 transaction costs because "The Company chose not to capitalize**
14 **these costs or seek an accounting authority order for deferral of the costs to obtain the**
15 **opportunity for recovery in future periods, but instead expensed these costs as incurred**
16 **for financial statement purposes, thereby foregoing the opportunity to seek recovery of**
17 **these costs"?**

18 A. No. In fact, given all of the previous discussions with the Staff explaining the
19 rationale for our approach and our filed direct testimony, UE was surprised by Mr. Imhoff's
20 recommendation, especially since the "Staff believes, in general, prudently incurred actual
21 transaction costs by UE should be allowed recovery in rates . . . " (page 5, lines 7-8 of Mr.
22 Imhoff's rebuttal testimony). All of the merger transaction costs expensed in 1995 are

1 "actual" transaction costs and they are prudent. In addition, and as I have discussed
2 previously, UE did not have a "choice" in its accounting for these costs. Both the USOA and
3 GAAP require that these costs be expensed as incurred for financial reporting purposes,
4 pending regulatory treatment, even if an Accounting Authority Order was sought and
5 obtained. Clearly the Company did not "choose" to forego the opportunity to recover these
6 costs. In fact, UE's position is just the opposite. In the filed direct testimony of Mr.
7 Rainwater, we specifically seek recovery of these costs.

8 Q. **In his rebuttal testimony, Mr. Imhoff states that it would constitute**
9 **retroactive ratemaking if the MPSC allowed UE to recover these costs. What are your**
10 **views on this matter?**

11 A. This matter will be addressed in a separately filed legal memorandum.

12 Q. **Do you agree with the Staff's recommendation that a modification be**
13 **made to Attachment C, "Reconciliation Procedure" to the "Stipulation and**
14 **Agreement."**

15 A. Yes. However, Mr. Imhoff recommends that the modification include that
16 these costs be amortized over 20 years as opposed to the 10-year period proposed by UE in
17 its Shared Savings Plan. UE still believes that 10 years is the appropriate amortization period
18 for these costs. The Company's position on the appropriate recovery period for these costs is
19 more fully addressed by Mr. Birdsong in his surrebuttal testimony.

20 Q. **Do you agree with the Staff's recommendation that only prudently**
21 **incurred, actual transaction costs and costs to achieve should be recovered in rates?**

22 A. Yes.

1 **Q. In a related matter, OPC witness Trippensee infers that UE's proposed**
2 **shared savings plan could result in merger transaction costs and costs to achieve being**
3 **recovered twice, or as Mr. Trippensee refers to it as a "double dip." Does UE's**
4 **proposed shared savings result in a "double dip?"**

5 A. No. UE will not include both estimated and actual merger transaction costs
6 and costs to achieve in its cost of service. Therefore, there will be no "double dip."

7 **Q. Has UE revised its estimate of merger transaction costs and costs to**
8 **achieve?**

9 A. UE has not revised its estimate of merger transaction costs; however, the
10 Company revised its estimate of the costs to achieve. Mr. Nelson addresses this matter in his
11 surrebuttal testimony.

12 MERGER-RELATED PAYROLL COSTS

13 **Q. Turning now to merger related payroll costs, one matter that Mr. Imhoff**
14 **cites as a condition of Commission approval of the merger is that UE should be ordered**
15 **to maintain merger related payroll costs separately and on a prospective basis**
16 **beginning January 1, 1996. Do you agree with Mr. Imhoff's recommendation?**

17 A. No, I do not. UE is not incurring any significant, incremental labor costs due
18 to merger-related activities. This is principally due to two reasons. While the merger-related
19 work is incremental to the Company's normal work activities, the fact remains that virtually all
20 of UE's normal, ongoing work activities are still being performed. Accordingly, all of the
21 same labor costs associated with those normal, ongoing work activities are still included in
22 UE's cost of service. Second, no significant incremental labor costs are being included in cost

1 of service because employees who are devoting significant time to merger-related efforts are
2 principally salaried employees who are not compensated for overtime. For example, the
3 Manager of General Accounting has been involved with the Accounting Transition Team's
4 efforts in determining merger-related savings in the Accounting area, as well as developing
5 accounting policies and procedures for Ameren Corporation and Ameren Services. Yet, that
6 same individual is still responsible for managing the ongoing activities of the General
7 Accounting Department, which include preparing financial statements, journal entries and
8 analyses, as well as making payroll and accounts payable disbursements. This individual is
9 working overtime to manage these activities, yet he is not compensated for his overtime. As a
10 result, this individual is continuing to manage the same activities and UE is incurring the same
11 labor dollars which have always been included in cost of service. Separately identifying this
12 individual's merger-related labor costs would be meaningless, as would be the case for the
13 vast majority of employees working on merger-related activities.
14 Another point which must be considered is that UE will have to incur additional costs
15 to comply with the Staff's condition. UE will have to divert management's transition efforts
16 and spend many hours establishing and maintaining a system to separate merger-related labor
17 costs prospectively, not to mention the time it will take to estimate the merger-related labor
18 costs incurred from January 1, 1996 to the current date. And these costs will be incurred to
19 track down an insignificant amount of expenses, especially when one considers that UE's total
20 operations expenses and operations and maintenance-related labor expenses for the year ended
21 December 31, 1995 were $1.7 billion and $261 million, respectively. As a result, the expected

1 benefits which the Staff hopes to attain by requiring UE to separate merger-related labor costs
2 do not sufficiently outweigh the costs associated with this effort.

3 Therefore, for all of the reasons cited above, the Staff's proposed condition to
4 maintain merger-related payroll costs separately should not be adopted by the MPSC.

5 **POOLING OF INTERESTS VS. PURCHASE METHODS OF ACCOUNTING**

6 **Q. Staff witnesses Hyneman and Featherstone cite several differences**
7 **between the pooling of interests and purchase methods of accounting. What do you**
8 **believe are the fundamental differences between the two methods of accounting?**

9 A. I believe that the fundamental difference between the two methods of
10 accounting is simply one of accounting presentation. I cite these accounting presentation
11 differences on pages 3 and 4 of my direct testimony. While the accounting presentation for
12 these two methods are significantly different, the circumstances surrounding why a particular
13 entity accounts for a particular business combination under the pooling of interests or
14 purchase methods are often very similar. This is due to the fact that there are several
15 conditions which must be met in order for an entity to account for a business combination
16 under the pooling of interests method as opposed to the purchase method of accounting.
17 Oftentimes, a slight modification of the facts and circumstances surrounding a particular
18 transaction can cause significantly different accounting results, while the economic substance
19 of the transaction has not changed. For example, APB 16, and Securities and Exchange
20 Commission Staff Accounting Bulletin No. 96 (SAB 96) prohibit treasury stock acquisitions
21 subsequent to consummation of a merger for a period of at least six months. If this
22 requirement is not met, than an entity must account for the business combination under the

1 purchase method of accounting. Taken literally, if Ameren Corporation (Ameren) would
2 reacquire common stock (a treasury stock acquisition) one day subsequent to the
3 consummation of the merger, then the accounting associated with the merger could be quite
4 different (that is, the purchase method of accounting would have to be utilized as opposed to
5 the pooling of interests method) however, the economic substance of the transaction would
6 really be no different. If Ameren did not reacquire the common stock subsequent to the
7 consummation of the merger, then the accounting for the transaction would be done under the
8 pooling of interests method (assuming that all of the other pooling of interests method criteria
9 are met) as opposed to the purchase method. Again, a slight modification of the facts and
10 circumstances surrounding a particular transaction can cause significantly different accounting
11 results, while the economic substance of the transaction has not changed.

12 For example, on page 8, lines 6 through 15 of Mr. Hyneman's rebuttal testimony, he
13 presents a set of facts and assumptions that depict the accounting entries for a pooling of
14 interests transaction. Utilizing those same set of facts but assuming the combined corporation
15 reacquired common stock one day subsequent to the combination (and therefore failed to
16 meet the APB 16 and SAB 96 pooling of interests requirements) would result in accounting
17 entries that would be the same as the accounting entries under the purchase method of
18 accounting as presented on pages 6 and 7 of Mr. Hyneman's rebuttal testimony except that
19 instead of cash being credited for $1,000,000, common stock and additional paid in capital
20 would be credited for $10,000 and $990,000 respectively (this is because stock was used to
21 acquire Company B as opposed to cash in Mr. Hyneman's example on page 8.)

1 As a result, oftentimes there are no substantive economic differences which distinguish
2 between the two accounting methods utilized for business combinations, despite the fact that
3 the accounting presentations are quite different. That is why the fundamental difference
4 between transactions accounted for under the purchase method of accounting and pooling of
5 interests method of accounting is often simply one of accounting presentation, and not of
6 substantive economic differences.

7 **Q. Are you aware of others who have commented on the substantive**
8 **differences between the purchase and pooling of interests methods of accounting?**

9 A. Yes. APB 16, paragraphs 35-41, addresses this issue. Some of the criticisms
10 cited in APB 16 related to the pooling of interests method are as follows:

11 • "Those who oppose the pooling of interests method of accounting doubt
12 that the method is supported by a concept." (paragraph 35)
13
14 • "However, so broad an application without effective criteria results in
15 applying the pooling of interests method to numerous business
16 combinations which are clearly in economic substance the acquisition of
17 one company by another." (paragraph 36)
18
19 • "All pronouncements have indicated that a large disparity in the size of the
20 combining interests is evidence that one corporation is acquiring another."
21 (paragraph 37)
22
23 • "The most serious defect attributed to pooling of interests accounting by
24 those who oppose it is that it does not accurately reflect the economic
25 substance of the business combination transaction. They believe that the
26 method ignores the bargaining which results in the combination by
27 accounting only for the amounts previously shown in accounts of the
28 combining companies . . . That coincidence rarely occurs because the
29 bargaining is based on current values and not past costs." (paragraph 39)
30
31 • "The result does not reflect the presumption that a corporation issues stock
32 only for value received and, in general, the greater the number of shares
33 issued, the larger the consideration to be recorded." (paragraph 40)
34

1 I have attached copies of these paragraphs in Schedule 2 to my surrebuttal testimony.
2 Also, attached as Schedule 3 to my surrebuttal testimony is a May 9, 1996, Wall Street
3 Journal article on this matter. In this article, the author makes the following comments:

4 • "What's more important, economic substance or accounting
5 appearance? . . .Witness all those mergers in which banks use their shares
6 to acquire other banks. There are two ways of treating such mergers -
7 either as a 'pooling of interests' or as a 'purchase.' The substantive
8 difference is zippo."
9
10 • "Nonetheless, the real problem doesn't lie with Wall Street-wary banks, but
11 with an accounting system that permits different treatments for identical
12 events."
13
14 The comments made in APB 16 and in the Wall Street Journal article point out that
15 the circumstances surrounding transactions accounted for under the purchase and pooling of
16 interests methods of accounting are often not substantive, from an economic standpoint, and
17 that the fundamental difference between the two methods is one of accounting presentation.

18 **OTHER NECESSARY CONDITIONS FOR THE MERGER**

19 **Q. Are you aware that the Staff has recommended that certain conditions**
20 **must be met in order for the Staff to recommend approval of the merger to the MPSC?**
21 A. Yes, I am.
22 **Q. Are you prepared to comment on some of these conditions?**
23 A. Yes, I am.
24 **Q. Turning first to Staff witnesses Oligschlaeger and Moore, please address**
25 **whether UE should accept the following condition: "Acknowledgment and agreement**
26 **that the Commission may access and require without subpoena the production of all**
27 **accounts, books, contracts, records, documents, memoranda, papers of Ameren**

1 **Corporation and any affiliate or subsidiary of Ameren Corporation." (The above**
2 **language should be deemed to include invoices, reports, studies, analyses, calculations,**
3 **gas supply models, and electric and dispatch models.)**

4 A. UE will accept this condition.

5 **Q. Please address whether UE should accept these additional conditions set**
6 **forth by Mr. Oligschlaeger:**

7–11
- **Ameren and each of its subsidiaries and affiliates shall employ accounting and other procedures and controls related to cost allocations and transfer pricing to ensure and facilitate full review by the Commission, and to protect against cross subsidization of non-UE Ameren businesses by UE's retail customers.**

12

13–16
- **On a quarterly basis, Ameren and UE shall provide the Commission with a report detailing UE's proportionate share of Ameren's (i) total consolidated assets; (ii) total consolidated operating revenues; (iii) total operating and maintenance expense; and (iv) total consolidated number of employees.**

17

18 A. UE will accept these conditions.

19 **Q. Staff witness Moore recommends the following conditions:**

20–26
- **Acknowledgment and agreement that the Commission has access to all financial information on all subsidiaries, regulated or non-regulated, and any future utility or non-utility subsidiary or division of Ameren Corporation or an Ameren Corporation's subsidiary, necessary to calculate an estimate of the stockholders' required return on equity (ROE) for Ameren Corporation on a consolidated basis and then a differentiated ROE for each subsidiary or division, including Union Electric Company, on a stand-alone basis.**

27

28–29
- **UE will continue to provide monthly surveillance reports to the Staff in the same format that is currently being submitted to the Staff.**

30

31 **Will UE agree to these conditions?**

1 A. Yes. UE's acceptance of these and the other conditions discussed previously
2 will be further addressed (and, to the extent necessary, clarified) in the Legal Memorandum to
3 be filed on June 7, 1996.

4 **Q. Does this conclude your surrebuttal testimony?**

5 A. Yes, it does.

1 From our prospective, perhaps, deferral is a more
2 clean way of establishing these costs if there is some
3 expected future rate recovery. Can I ask, why did UE not
4 defer or choose to defer transaction costs?
5 A. Well, you say others have done it, and I don't
6 doubt that, but essentially, under ~~Phase~~ FAS 71, that governs
7 utility accounting, unless you can make a determination
8 that it's probable, you're going to recover those, and
9 unless you have evidence to support that, you can't defer
10 them, you know.
11 Some people do things, and they can stretch that,
12 but basically, the way we look at it is, we don't have the
13 evidence to support that we can defer those costs, and not
14 expense them, and we thought beyond doing just what is
15 right, the ~~SCC is~~ SEC is likely to be a real stickler on that
16 issue, and then we chose that they be an expense below the
17 line.
18 Getting back to your incentive plan, I didn't
19 want any question to come up, particularly, when we got
20 into this first year, that we had these unusual merger
21 transactions, whatever, costs, reflected above the line in
22 an attempt to do some premature or back door recovery. I'd
23 like -- And I'm sure you folks do too, at least this first
24 and every year there after, but particularly this first
25 year of the whole reconciliation process, or whatever you

Schedule 1
Page 1 of 2

1 want to call it, of the incentive plan to go as smoothly as

2 possible. I didn't want a bunch of investment legal fees

3 and legal fees related to this merger and above the line.

4 Q. In regard to the accounting question then, you

5 are saying that it is part of a good faith effort to comply

6 with Phase 71, you thought below the line treatment was --

7 A. I think the expense and treatment.

8 Q. Expense and treatment, okay.

9 A. Under generally accepted accounting principles, I

10 don't think deferral was an option.

11 MR. MOORE: Did you consider filing for an

12 accounting authority order around the same time or shortly

13 after the merger to try and defer those until some

14 regulatory treatment was decided and would your external

15 officers allow you to defer those on the books until, you

16 know, a year or so after it was decided?

17 A. Well, did we consider, yes, I thought about that,

18 Jay, but the accounting order would have been along the

19 line of -- You know, we approved the accounting, but we

20 don't approve the rate making treatment, and nothing for

21 that, and the see has really gotten on deferred debts with

22 utilities in these regulatory assets, and what kind of

23 proof do you have.

24 People used to rely on the accounting authority

25 orders, but if you get questions from the see, you're on

35. *Defects attributed to pooling of interests method.* Those who oppose the pooling of interests method of accounting doubt that the method is supported by a concept. In their view it has become essentially a method of accounting for an acquisition of a company without recognizing the current costs of the assets, including goodwill, underlying the transaction. The concept of a pooling of interests was described in general terms in the past—for example, as a continuity of equity interests or as a combination of two or more interests of comparable size. The descriptions tend to be contradictory. For example, accountants do not agree on whether or not relative size is part of the pooling of interests concept. Attempts to define the concept in terms of broad criteria for applying the method have also been unsuccessful.

36. Indeed, many opponents of the pooling of interests method of accounting believe that effective criteria cannot be found. The concept of a uniting or fusing of stockholder groups on which pooling of interests accounting is based implies a broad application of the method because every combination effected by issuing stock rather than by disbursing cash or incurring debt is potentially a pooling of interests unless the combination significantly changes the relative equity interests. However, so broad an application without effective criteria results in applying the pooling of interests method to numerous business combinations which are clearly in economic substance the acquisition of one company by another.

37. Some critics point out that the method was first applied to combining interests of comparable size and that pronouncements on business combinations have never sanctioned applying pooling of interests accounting to all or almost all business combinations effected by exchanging stock. All pronouncements have indicated that a large disparity in the size of the combining interests is evidence that one corporation is acquiring another.

38. Other criteria restricting application of pooling of interests accounting, such as those prohibiting future disposals of stock received and providing for continuity of management, were added to the size restriction. Those criteria have, however, tended to strengthen the view that one corporation acquires another because they are unilateral, that is, they are applied only to the stockholders and management of the "acquired" company.

39. The most serious defect attributed to pooling of interests accounting by those who oppose it is that it does not accurately reflect the economic substance of the business combination transaction. They believe that the method ignores the bargaining which results in the combination by accounting only for the amounts previously shown in accounts of the combining companies. The acquiring corporation does not record assets and values which usually influence the final terms of the combination agreement with consequent effects on subsequent balance sheets and income statements. The combined earnings streams, which are said to continue after a pooling of interests, can continue unchanged only if the cost of the assets producing those earnings is identical for the acquiring corporation and the acquired company. That coincidence rarely occurs because the bargaining is based on current values and not past costs.

40. Pooling of interests accounting is also challenged because the amount of assets acquired less liabilities assumed is recorded without regard to the number of shares of stock issued. The result does not reflect the presumption that a corporation issues stock only for value received and, in general, the greater the number of shares issued, the larger the consideration to be recorded.

41. Traditional principles of accounting for acquisitions of assets encompass all business combinations because every combination is effected by distributing assets, incurring liabilities, issuing stock, or some blend of the three. Those who oppose the pooling of interests method believe that a departure from the traditional principles is justified only if evidence shows that financial statements prepared according to other principles better reflect the economic significance of a combination. In their opinion, the characteristics of a business combination do not justify departing from traditional principles of accounting to accommodate the pooling of interests method.

Schedule 2

INTRINSIC VALUE/By Roger Lowenstein

A Modest Proposal to Stop 'Pooling'

What's more important, economic substance or accounting appearance?

Banks are voting for appearance, hands down.

Witness all those mergers in which banks use their shares to acquire other banks. There are two ways of treating such mergers—either as a "pooling of interests" or as a "purchase."

The substantive difference is zippo. On a cash basis, the combined new company is identical either way. Save for this: Companies that label a deal a "purchase" are free to buy back stock. But companies (in all industries, not just banking) that adopt the pooling method generally can't do so for at least six months and in some cases for as long as two years.

That should make the purchase method a clear favorite. All the more so, because the Securities and Exchange Commission recently put the issue under a spotlight, making more explicit the warning that companies that repurchase stock soon after mergers would jeopardize their "pooling" status.

But the SEC's bulletin is having what Pat McConnell, intrepid accounting analyst for Bear Stearns, correctly terms the "wrong effect," particularly on bankers. Rather than damping the bankers' enthusiasm for pooling, it is damping their enthusiasm for buying back stock. Remember, the appeal of using the pooling method is purely cosmetic; stock buybacks are a real, value-enhancing event.

Banks are ducking talking about the issue. But of those that recently completed pooling-style mergers, such as Chase Manhattan, First Chicago NBD, First Union, Fleet Financial Group, PNC Bank and Summit Bancorp, it's a good bet that many will postpone buybacks or repurchase fewer shares than they would have, rather than be forced to adopt purchase accounting. "Absolutely," the controller of one big bank concedes. "The SEC has chilled buybacks."

Why do banks treat purchase accounting like the plague? When the acquisition price is more than the fair market value of the acquired's assets, accountants like to—need to—assume that the premium represents *something*. The something they came up with is an intangible asset known as "goodwill." Under current rules, goodwill—like a tangible asset—must be gradually written off against earnings, reducing reported net income for many years.

Not so in a pooling. Here, the acquirer's books are rewritten to look as though the merged corporations had always been one. The two companies' assets and earnings are simply added; no goodwill is created, thus no amortization. For that reason, banks and others have been fond of pooling ever since the conglomeration rage of the 1960s.

Of course, goodwill amortization has *no effect* on cash or "economic" earnings. But banks are fearful of goodwill nonetheless. In the short term, at least, Wall Street pays attention to reported numbers, substantive or not. So if you run your company for Wall Street, rather than for economic substance, a pooling is the way to go.

The big exception to the trend is Wells Fargo, which acquired First Interstate as a purchase and has been buying back stock ever since. Wells has been telling investors they ought to value it according to its "cash" earnings, and to disregard the lower number that results after amortizing goodwill. Their attitude is, if managers pay attention to value, investors will figure it out. Other banks have taken note.

"We're watching," William Boardman, senior executive vice president of Banc One, said. "We love to be the second one to do something revolutionary. Before we jump on the Wells bandwagon we've got to see what the marketplace is going to say."

But banks and all companies that let Wall Street call the tune may do so in vain. After all, the Street's prejudices are fickle.

Nonetheless, the real problem doesn't lie with Wall Street-wary banks, but with an accounting system that permits different treatments for identical events. And of the two methods, the "purchase" treatment better describes the event. As Jack Ciesielski, publisher of Analyst's Accounting Observer, points out, "With a pooling, you don't know what the acquirer paid for the other company."

Herewith, a modest proposal. Abandon pooling (which is rare or nonexistent in most other countries). Then, modify purchase accounting to conform to an idea being proposed in Britain. Goodwill would be counted as an asset, but needn't be amortized as long as the acquired company continues to be worth a premium.

Such a fix is getting a preliminary look at the Financial Accounting Standards Board. It or something similar would be welcome at the SEC, which now devotes much unproductive time to angels-on-a-pin debates about which mergers qualify for pooling treatment.

The best-of-all-worlds result: Accounting would better portray the underlying companies; the forced but meaningless amortization of goodwill would stop; and the system here would more closely resemble accounting abroad, advancing the worthy goal of one set of rules for all. What's more, within the U.S., identical mergers couldn't be described in vastly dissimilar ways. That they can be today is absurd.

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