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Acquisition
Witness: Charles R. Hyneman
Sponsoring Party: MoPSC Staff
Type of Exhibit: Rebuttal Testimony
Case No.: EM-2000-369

# MISSOURI PUBLIC SERVICE COMMISSION

## UTILITY SERVICES DIVISION

# REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

UTILICORP UNITED INC.

AND

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EM-2000-369

Exhibit No. 705
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Jefferson City, Missouri
June 2000

**Denotes Highly Confidential Information**

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**REBUTTAL TESTIMONY**

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**UTILICORP UNITED INC.**

**AND**

**THE EMPIRE DISTRICT ELECTRIC COMPANY**

**CASE NO. EM-2000-369**

Q. Please state your name and business address.

A. Charles R. Hyneman, 3675 Noland Road, Suite 110, Independence, Missouri 64055.

Q. By whom are you employed and in what capacity?

A. I am a regulatory auditor with the Missouri Public Service Commission (Commission).

Q. Please describe your educational background and work experience.

A. I graduated from Indiana State University in May 1985 with a Bachelor of Science degree in Accounting and Business Administration. I also earned a Masters of Business Administration degree from the University of Missouri – Columbia in December 1988. In May 1985, I was commissioned as an officer in the United States Air Force. I left the Air Force in December of 1992 and joined the Commission in April 1993. I am a Certified Public Accountant holding certification in the state of Missouri.

Q. Have you filed testimony before this Commission?

A. Yes. A listing of the cases in which I have previously filed testimony before this Commission is given in Schedule 1, attached to this rebuttal testimony.



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Q. With reference to Case No. EM-2000-369, have you examined the books and records of UtiliCorp United, Inc. (UtiliCorp) and The Empire District Electric Company (Empire) (collectively Joint Applicants)?

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

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

A. The purpose of this testimony is to provide to the Commission a description of the accounting rules for mergers and acquisitions. I will explain the reason why UtiliCorp will account for this merger using the purchase method instead of the "preferred" accounting method known as the pooling of interests, or pooling method. I will then describe the different types of merger costs (merger premium, transaction and transition costs) and the reason why the Staff is proposing different ratemaking treatment for these different types of costs.

In the acquisition adjustment section of my testimony, I will describe the three components that make up the acquisition adjustment (gain on sale of assets, control premium and merger benefits) that UtiliCorp, through its regulatory plan, proposes to recover from Empire's ratepayers. This amount, as shown on page 4 of UtiliCorp witness Jerry D. Myers direct testimony as an intangible asset, is estimated to be approximately $275 million. I will show that since UtiliCorp's shareholders are the primary beneficiaries of this merger, they, not Empire's ratepayers, should be held responsible for the costs (merger acquisition adjustment) of acquiring the merger benefits that they will enjoy.

Finally, I will describe the Staff's concern about the potential negative ratemaking impact if Empire's accumulated deferred income taxes are eliminated as a result of this merger.



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Q. How does your testimony filed in this Merger Application compare to the testimony you filed earlier concerning the same issues in the UtiliCorp/St. Joseph Light & Power Company (SJLP) merger application, Case No. EM-2000-292?

A. This testimony is very similar to that which I filed in Case No. EM-2000-292, and in some sections, is identical. However, due to certain differences between the UtiliCorp/SJLP and the UtiliCorp/Empire Merger Agreements, my testimony in the instant case differs from that filed earlier in the UtiliCorp/SJLP merger case in some areas. Also, my discussion of merger "control premiums" was not included in my earlier UtiliCorp/SJLP rebuttal testimony.

ACCOUNTING RULES FOR MERGERS AND ACQUISITIONS

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

A. The term acquisition adjustment is applied only to regulated utilities and is classified as a long-term asset on the balance sheet. An acquisition adjustment represents the difference between the amount paid to purchase a utility (including transaction costs), and the net book value (NBV) of the acquired utility's assets. The NBV of assets is the same as the stockholders' equity, and is the residual asset value after subtracting all liabilities. The Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts (USOA) defines an acquisition adjustment as the difference between the original cost of an asset when first placed in service (book cost or book value) and the actual cost to the utility of acquiring the asset.

The term goodwill is often used interchangeably with acquisition adjustment, but the two terms represent different values. Goodwill is the difference between the amount paid to



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acquire a group of assets and the current <u>fair market value</u> (FMV) of the individual assets. The asset goodwill is recognized in a merger or acquisition accounted for under purchase accounting rules, but it is not recognized in a merger accounted for as a pooling of interests. Under purchase accounting rules, acquired assets are recorded at the usually higher fair market values (stepped-up basis). Conversely, pooling accounting rules require assets to be recorded at existing historical cost or book value, thus there is no goodwill to be recorded. The numerical difference between an acquisition adjustment and goodwill is calculated as:

| | | |
|---|---|---|
| Acquisition Adjustment | = | (Purchase Price – Net Book Value of Assets) |
| Goodwill | = | (Purchase Price – Fair Market Value of Assets) |

The following example will clarify the difference between an acquisition adjustment and goodwill. Assume the following facts: XYZ Company purchases ABC Company for $1 million (including transaction costs). The FMV of ABC Company's assets is $800,000 and the NBV is $300,000.

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

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

A non-regulated company would record the acquired assets at FMV on its balance sheet and record goodwill of $200,000 ($1,000,000 purchase price less $800,000 FMV). This transaction would be reflected in a non-regulated company's balance sheet as:



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| | |
|---|---|
| Plant and Equipment (net of depreciation reserve) | $ 800,000 (FMV) |
| Goodwill | $ 200,000 |
| Total Assets | $1,000,000 |

It is common for both regulated and non-regulated companies to amortize the acquisition adjustment/goodwill over 40 years, the longest period currently 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 Empire's assets, less the NBV 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 UtiliCorp's estimated purchase price to acquire Empire in excess of the book value of Empire's net assets.

**APB 16 – THE POOLING AND PURCHASE METHODS OF ACCOUNTING**

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

A. All business entities, regulated and non-regulated, are required to comply with Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations*, as promulgated by the Financial Accounting Standards Board (FASB). A copy of APB 16 is attached as Schedule JDM-1 to UtiliCorp witness Myers' direct testimony.

Q. Please provide a general description of APB 16.

A. Depending on the nature and characteristics of the merger, APB 16 allows for two completely different methods of accounting for business combinations. The two



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methods are referred to as the purchase method and the pooling of interests method. The rules for purchase accounting reflect the substance of the merger as one company actually purchasing the assets of another company, while pooling rules reflect the transaction, not as a *purchase of assets, but a combining of shareholder interests in the assets of the newly-formed* company.

Purchase accounting rules for non-regulated companies require the acquiring company to record the purchase of the acquired company's assets and liabilities at the fair value on the date of combination. This is accomplished usually after the transaction closing date, through a purchase price allocation to individual identifiable assets based on an appraised or estimated fair values. Any remaining amount of the purchase price, after the allocation to the individual identifiable assets, is recorded as goodwill. For regulated companies, the acquiring company records the purchase of the acquired company's assets at NBV on the date of acquisition. Any excess of the purchase price over the NBV of the assets acquired is recorded as an acquisition adjustment.

In contrast, pooling of interests accounting requires that the book value of the assets *of the two combining companies simply be added together on the combined balance sheet.* There is no allocation of the purchase price to individual assets and thus there is no need to create the intangible asset goodwill. Both companies simply combine assets and continue operations, with no additional "cost" or "investment" created as a result of the combination. Consequently, a merger accounted for as a pooling does not result in the need to reflect an acquisition adjustment.

Q. Please elaborate on the reasons why no acquisition adjustment (or goodwill) is recognized in a pooling of interests merger.



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A. A pooling is considered to be a transaction between the shareholders themselves, and not a purchase or sales transaction between the corporate entities. The only relevant amount, and the only amount that is reflected on the financial records of the combined company in a pooling merger, is the current book value of the assets. No valuation adjustments (from book value to fair value) are made and no goodwill or acquisition adjustment is recorded.

A merger recorded using the purchase method is not considered as a joining of stockholder groups, but a purchase of one company by another company. Because the merger is considered a purchase, APB 16 requires the assets acquired to be revalued from book value to fair value. Utility companies are required to record plant assets at original cost and are prohibited by the FERC's USOA from recording valuation adjustments (writing up or down the value of individual plant assets). Because of this requirement, utility companies record the excess of fair value over book value of individual plant assets in the acquisition adjustment account on the balance sheet.

After the purchase accounting valuation adjustments from book value to fair value are made, any amount of the purchase price that has not been allocated to the individual assets is recorded as goodwill. As described above, because utility companies are not permitted to revalue their assets in a merger or acquisition, the total amount of the acquisition price (including transaction costs) over the book value (original cost less depreciation and amortization) of the acquired assets is recorded as an acquisition adjustment.

Q. Why do accounting rules allow for two completely different methods of accounting for mergers?



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A. Current accounting rules make a distinction in how to account for a merger based on the intended "purpose" of the merger. The primary indication of the purpose of a merger is the form of consideration exchanged, cash or stock. When stock is the consideration in a merger, the stockholders of the acquired company become stockholders of a bigger combined company. If certain other merger conditions are met, the transaction is considered more of a "combining of ownership interests" (pooling) than an actual purchase of assets (purchase).

Pooling rules were designed to reflect the substance of a transaction as a combination of two ownership groups into a single ownership group. The combining stockholder groups neither withdraw nor invest assets (as they would in a purchase and sale transaction), but merely exchange common stock in a ratio that determines their respective interests in the combined corporation. (This is why the main requirement to use pooling accounting is that stock, not cash, be used as the primary merger consideration.) A merger that combines virtually all of existing common stock interests avoids combining only selected assets, operations, or ownership interests, any of which is more reflective of a disposal and acquisition of interests (a purchase) than a mutual sharing of risks and rights in the combined operations (a pooling).

Q. What is the primary consideration in UtiliCorp's proposed mergers with SJLP (Case No. EM-2000-292) and Empire?

A. In the SJLP merger, with the exception of fractional shares, common stock is the only consideration paid. This is referred to as a stock-for-stock transaction, or a "stock swap". In the Empire merger, Empire's stockholders have the option, with certain restrictions, of being paid in either cash or stock. On page 49 of Empire's proxy



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statement/prospectus dated July 29, 1999 (Empire Proxy Statement), it is estimated that 62% of its cost to acquire empire will be paid in stock, and 38% in cash.

Q. Do both the SJLP and the Empire Boards of Directors view the merger with UtiliCorp as a combining of shareholder groups, consistent with the pooling of interests concept?

A. Yes. UtiliCorp's merger with SJLP was originally designed to be a pooling of interests, and it is clear that SJLP's shareholders see the merger as a joining of shareholder interests, as opposed to a sale of the company. At page 8 of his direct testimony in Case No. EM-2000-292, Mr. Terry F. Steinbecker, SJLP's President and Chief Executive Officer (CEO), and member of the Board of Directors, describes the impact of the merger with UtiliCorp on SJLP's shareholders:

> Our shareowners will become shareowners in a larger, much more diverse company. SJLP's shareowners' ownership in UtiliCorp has a better potential for growth, given UtiliCorp's financial strength and commitment to growth.

It is also clear that Empire's Board of Directors does not consider the merger with UtiliCorp as a sales transaction. On page 1 of the Empire Proxy Statement, Empire's Board of Directors advise the shareholders to vote to approve the merger because, in part, "the merger provides you with the opportunity to participate in a larger and more diversified company with greater financial stability."

Q. What specific conditions does APB 16 require be met in order for a merger to be accounted for as a pooling of interests?

A. APB 16 requires that the structure and terms of a proposed merger meet 12 specific conditions to qualify for pooling of interests accounting treatment. If the structure of the merger transaction does not meet any one of the 12 pooling conditions, the merger must be accounted for as a purchase.

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

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

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

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

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

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



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

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

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

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

A. No. Any new rulemaking by the FASB that could affect the use of pooling of interests accounting is unlikely to become effective until the end of this year. Even when

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(and if) a new FASB pronouncement is issued, it would not apply to merger agreements that were in progress prior to its issuance. UtiliCorp witness Myers recognized this in his direct testimony at page 4, where he states "the exposure draft will only affect transactions that are initiated after the final standard is issued, expected sometime in 2000."

**BENEFITS OF POOLING OF INTERESTS ACCOUNTING**

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

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

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

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

Q. Explain how the recognition of an acquisition adjustment creates an additional cost for a utility.

A. For utility companies that use purchase accounting, the amortization of an acquisition adjustment creates an additional expense that puts a downward pressure on earnings during the amortization period, usually 40 years. Recognition of an acquisition adjustment creates a need for additional revenues and/or cost reductions in an amount equal



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to the required return on the investment, in addition to the annual amortization of expense. If significant, the financial burden imposed by the acquisition adjustment may cause utility companies to seek explicit ratemaking treatment (as UtiliCorp is doing in this Merger Application) of an acquisition adjustment.

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

A. Yes. Both utility ratepayers and utility companies benefit from the use of pooling as opposed to purchase accounting. Utility ratepayers are worse off under purchase accounting because recovery of an acquisition adjustment, either directly and indirectly, causes the flow through to utility rates of any actual merger savings to be delayed, sometimes significantly. In addition, rate recovery of an acquisition adjustment created by the use of purchase accounting results in higher utility rates than would otherwise be under pooling accounting.

For example, if UtiliCorp records the SJLP and Empire mergers as poolings, both ratepayer groups would not have to wait for UtiliCorp to recover any portion of the acquisition adjustment before all or a part of any actual achieved merger savings could be reflected in lower utility rates. Because there is no acquisition adjustment to recover in a pooling, merger savings could begin to flow to ratepayers as soon as the next rate proceeding. However, because UtiliCorp will not record either of the SJLP or Empire mergers as poolings, it will be forced to recognize the costs of the acquisition adjustment. Through its regulatory plan, UtiliCorp will try to recover as much of the acquisition adjustment as it can in the five-year rate freeze through retention of excess earnings. Therefore, simply because UtiliCorp's method of accounting for the merger, and its impact



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on the proposed regulatory plans, neither SJLP nor Empire ratepayers would see any benefit from this merger for at least five years. After a five-year rate freeze, UtiliCorp proposes to include in SJLP's and Empire's utility rates 50% of its total acquisition adjustment costs. If approved by this Commission, UtiliCorp's regulatory plans will result in electric utility rates that will be higher than if these mergers were recorded as poolings.

Utility companies suffer under purchase accounting because the financial burden of an acquisition adjustment can lead to significant additional costs incurred in devising a "regulatory plan" to recover the acquisition adjustment in rates. This type of regulatory plan will usually necessitate fully litigated regulatory proceedings on the acquisition adjustment issue, as well as on issues involving merger savings "tracking mechanisms." Mr. Steven W. Cattron, then Vice President of Marketing and Regulatory Affairs, Kansas City Power & Light Company (KCPL), has recognized the burden purchase accounting rules placed on utility companies. In his direct testimony at page 8 in support of UtiliCorp's and KCPL's merger application in Case No. EM-96-248, he described this benefit of the pooling method over the purchase method to his company:

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

Q. Has UtiliCorp previously recognized the benefits of the pooling of interests method in previous merger applications before this Commission?

A. Yes. As previously discussed, in 1996 UtiliCorp and KCPL filed a Joint Application to merge operations, docketed as Case No. EM-96-248. The benefits of the

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pooling of interests accounting method are described in paragraph 18 of UtiliCorp's and KCPL's Application:

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

Q. Are the benefits of the pooling of interest method recognized in financial and accounting literature?

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

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

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

In an article published in the *CPA Journal*, James R. Duncan and Robert L Carleton describe why many large mergers are structured as a pooling of interests. Mr. Duncan, PhD,



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CPA, is an assistant professor of accounting at Ball State University. Mr. Carleton, CPA, is Senior Vice President and Controller of Tricon Global Restaurants, Inc., and is a member of the FASB Task Force on Business Combinations. The article reads, in part:

> The first half of 1998 witnessed the largest merger wave in U.S. history, including several of the largest business combinations ever. Companies involved in these mergers span the financial services, automotive, telecommunications, health care, pharmaceutical and consumer products industries (see Exhibit 1). It is interesting that all of the large mergers were structured to achieve pooling-of-interests accounting (pooling). As companies combine to form large, often global organizations, pooling seems to be the merger accounting method of choice at a time when U.S. accounting standards setters are involved in reexamining existing standards for business combinations.
>
> At a time when U.S. companies are grappling for competitive positions in a globalizing economy, <u>pooling seems to be the preferred method of accounting for mega-mergers</u>. Companies once thought too large to combine are coming together to form enormously large organizations designed to serve global markets and doing so at prices that represent huge premiums over existing book values. As indicated in Exhibit 1, implied goodwill in these recent large mergers could approach $20 to $60 billion if each were accounted for as a purchase under APB No. 16. The effect would be to reduce future earnings of the combined companies by significant proportions.
>
> Many mergers are nontaxable transactions, such that goodwill amortization is without any tax benefit and essentially worsens future earnings.
> [Will Poolings Survive? By James R. Duncan and Robert L Carleton, *The CPA Journal*, January 1999, Emphasis added]

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

> In merger and acquisitions, one rule is simple: If you can possibly account for a business combination as a pooling of interests, you pool. Compared to the alternative purchase method, poolings provide the party without the hangover. <u>With pooling, there's no cash to change hands, only stock–cheap currency in today's market</u>



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> –no assets to write up, and best of all, no goodwill to drag on earnings over the next 40 years.
> [Say Goodbye to Pooling, *CFO Magazine*, February 1997, Emphasis added]

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

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

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

> The expected accounting treatment of the business combination is a pooling of interests, thereby avoiding reductions in earnings which would result for the creation and amortization of goodwill under the purchase method of accounting.
> [SEC Form S-4, Registration Statement, February 5, 1997]

In approving the Amended Merger Agreement with KCPL in 1996, UtiliCorp's Board of Directors specifically stated that the availability of the pooling of interests accounting



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method was one of the factors that led it to approve the merger agreement. The Board specifically noted that the pooling of interests method "avoids the reduction in earnings which would result from the creation and amortization of goodwill under purchase accounting" (KCPL SEC Form S-4A, June 25, 1996).

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

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

> POOLING. No party shall, nor shall any party permit any of its Subsidiaries to, take any action which would, or would be reasonably likely to, prevent the Company from accounting for the transactions to be effected pursuant to this Agreement as a pooling-of-interests in accordance with GAAP and applicable SEC regulations, and each party hereto shall use all reasonable efforts to achieve such result (including taking such commercially reasonable actions as may be necessary to cure any facts or circumstances that could prevent such transactions from qualifying for pooling-of-interests accounting treatment).
> [KCPL SEC Form 8-K, January 24, 1996. Emphasis added]

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

A. Yes. In April 1996, Western made an unsolicited tender offer to KCPL's shareholders structured as a pooling of interests. Western included the following condition in its proposal to acquire control of KCPL:



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

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

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

> POOLING. Neither party hereto shall, nor shall such party permit any of its Subsidiaries or any employees, officers or directors of such party or of any of its Subsidiaries to, take any action which would, or would be reasonably likely to, prevent the Surviving Corporation from accounting for the transactions to be effected pursuant to this Agreement as a pooling-of-interests in accordance with GAAP and applicable SEC regulations, and such party shall use all reasonable efforts to achieve such result (including taking such commercially reasonable actions as may be necessary to cure any facts or circumstances that could prevent such transactions from qualifying for pooling-of-interests accounting treatment)... [Western SEC Form 8-K February 10, 1997]

Q. On page 15 of his direct testimony, UtiliCorp witness John W. McKinney asserts that regardless of whether a merger is recorded as a purchase or a pooling of interests, a merger premium exists when the value of the consideration paid exceeds the book value of the consideration received. Is Mr. McKinney correct?

A. Mr. McKinney is correct, in theory that a merger premium may exist in a pooling of interests merger. However, UtiliCorp, as a utility company, does not record merger premiums on its balance sheet, it records acquisition adjustments. And the simple



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fact is that if UtiliCorp recorded this merger as a pooling of interests, it would not be seeking rate recovery of a booked acquisition adjustment, as it is doing so in this case.

Q. Please explain.

A. As described earlier, no acquisition adjustment is created and no goodwill is created using the pooling of interests accounting method. Because there is no acquisition adjustment to amortize, there is no additional expense for a utility company to recover in a pooling of interests merger. With the exception of a potential offsetting entry in the equity accounts, under pooling accounting there is absolutely no recognition of a merger premium in any of the financial books and records of any company, regulated or unregulated. In fact, as described below, UtiliCorp's Chairman of the Board and CEO, Mr. Richard C. Green, Jr., has recognized that there is a clear difference between the two merger accounting methods from an earnings and ratemaking perspective.

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

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

As discussed earlier, in June 1996, Mr. Richard Green and Mr. A. Drue Jennings, Chairman of the Board, President and CEO of KCPL, filed a First Amended Joint Application with the Commission to merge the operations of UtiliCorp and KCPL. In this Application, Messrs. Green and Jennings advised the Commission that because this merger was to be accounted for as a pooling of interests, it did not involve an acquisition premium:



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

Also, Mr. James F. Purser, Atmos Energy Corporation's (Atmos) Executive Vice President and Chief Financial Officer, presented direct testimony in support of the Joint Application of Atmos and United Cities Gas Company to merge in Case No. GM-97-70. In his direct testimony describing the pooling accounting method at page 6, Mr. Purser stated:

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

**ACCOUNTING FOR THE UTILICORP-EMPIRE MERGER**

Q. Was the pending UtiliCorp/SJLP merger, Case No. EM-2000-292, originally announced as a pooling of interests?

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

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



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

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

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

Q. For the SJLP merger, did UtiliCorp later change from the pooling of interests method to the purchase method of accounting?

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

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

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

A. UtiliCorp witness Dan J. Streek explains at page 3 of his direct testimony in Case No. EM-2000-292, that the March 5, 1999 SJLP Merger Agreement was announced as



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a pooling of interests before a complete analysis of the pooling conditions was made. UtiliCorp determined that the issuance of employee stock options in November 1998 was an "alteration of equity" under APB 16, paragraph 47. Because the issuance of stock options could alter the equity position of UtiliCorp, it potentially violated one of the pooling conditions and, according to UtiliCorp, prevents the UtiliCorp/SJLP merger from being recorded as a pooling of interests.

Q. How does UtiliCorp propose to account for the Empire merger?

A. UtiliCorp plans to account for the Empire merger as a purchase, as opposed to a pooling of interests.

Q. What reasons did UtiliCorp provide for its decision to account for the Empire merger as a purchase?

A. At page 2 of his direct testimony in this proceeding, UtiliCorp witness Myers describes how the accounting for a merger is a "function of the terms of the transaction", and the method (pooling or purchase) is not elective. Mr. Myers states that the UtiliCorp/Empire merger transaction does not meet one of the 12 conditions that must be met to account for the transaction as a pooling of interests, and therefore must be accounted for as a purchase.

Q. Do you agree that the method used to account for a merger (pooling or purchase) is a function of the terms of the merger and is not elective?

A. Technically, the terms of the merger agreement determine the type of accounting used to record the merger. Substantively, however, since the management and board of directors of the acquiring company dictate the terms and conditions of the merger agreement, they, in substance, decide to account for the merger as either a pooling or a purchase.



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As described above, some utility companies place so much value on the determination of the type of accounting for a pending merger, i.e., pooling of interests accounting, that they make this control over the type of accounting a condition of the merger. *In other words, if the utility could not use pooling accounting and had to record a purchase* accounting acquisition adjustment (and be burdened with the attendant negative earnings impact), it would not complete the merger.

Q. In regard to the Empire transaction, which of the 12 pooling conditions did Mr. Myers advise that UtiliCorp did not meet?

A. Mr. Myers attached Schedule JDM-2 to his direct testimony, which lists all 12 of the pooling conditions. On Schedule JDM-2, pages 3 and 4 of 8, he lists the pooling conditions with which UtiliCorp believes the instant transaction does not conform. The first nonconformance requirement involves the requirement that UtiliCorp only issue its common stock in consideration for Empire's common stock (stock-for-stock requirement). For the second nonconformance, UtiliCorp believes that its November 1998 stock option issuance violates the pooling condition that UtiliCorp could not alter the equity interest of its shareholders in contemplation of a merger.

Q. Explain why UtiliCorp believes the merger transaction does not comply with the "stock-for-stock" pooling requirement.

A. Instead of making the Empire merger a "stock-for-stock" transaction as it did with the SJLP merger, UtiliCorp decided to offer Empire's shareholders either cash or stock as the merger consideration. UtiliCorp anticipates that less than APB 16's required 90% of Empire's common stock will be acquired with UtiliCorp common stock. This is not in conformance with the APB 16 paragraph 47(b) pooling condition that requires UtiliCorp to



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issue only common stock in exchange for substantially all (90% or more) of Empire's common stock.

Q. Did UtiliCorp explain why it decided not to structure the Empire merger as a stock-for-stock transaction?

A. Yes. This issue was discussed in a transcribed interview on March 17, 2000 with Mr. Robert K. Green. In a question from the Staff about the difference in the consideration paid in the SJLP merger (stock) and the Empire merger (stock and cash) at page 72, he explained that the difference was based on UtiliCorp's "capital needs at the time." Mr. Green went on to say that Empire is a significantly larger transaction than SJLP, and UtiliCorp "probably didn't feel the need or have the desire to issue that much equity."

Q. Explain why UtiliCorp believes that the Empire merger transaction does not comply with the pooling condition concerning altering the relative equity interests of the stockholder groups.

A. In November 1998, UtiliCorp issued stock options to all of its employees. UtiliCorp determined that this stock option issuance is not in conformance with APB 16 paragraph 47(c), which states:

> None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities. (Emphasis added)

Q. Assuming that UtiliCorp had a serious desire to account for the Empire merger as a pooling, does the Staff believe that UtiliCorp's reasons as to why it could not account for the Empire merger as a pooling are legitimate?



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A. No. As described above, the pooling of interests method is the preferred method of accounting for mergers, especially in the utility industry. The Staff believes that UtiliCorp could finance its merger with Empire with 100% stock and still maintain an appropriate capital structure.

Q. Please explain.

A. As described earlier, UtiliCorp expects that approximately 62% of the Empire merger will be financed with stock and 38%, or approximately $190 million, with debt. The Staff believes that if UtiliCorp was seriously concerned about recording the Empire merger as a pooling of interests, and avoiding the $275 million merger premium, it could finance this $190 million estimated cash portion of the Empire acquisition with stock instead of debt. Issuance of $190 million of stock instead of debt to save a $275 million cost burden over the next 40 years seems like the reasonable choice to make.

Q. Did you discuss this issue with the Staff's finance witness in the case, David P. Broadwater?

A. Yes. Mr. Broadwater advised that issuance of $190 million in stock instead of debt in the Empire transaction would not have a negative impact on UtiliCorp's capital structure.

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

A. A stock option is the opportunity, or "option" to buy a share of stock in the future at a set price that is determined on the day the option is awarded (exercise price). UtiliCorp has two separate stock option plans. According to its SEC Form DEF 14A filing dated March 16, 2000, UtiliCorp grants stock options every year under the 1986 Stock



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Incentive Plan (Executive Stock Plan) to the Company's executives who are eligible to participate in the Annual and Long-Term Incentive Plan. The Company also issues stock options to executives and employees who do not participate in the Executive Stock Plan, under the 1991 Employee Stock Option Plan (Employee Stock Plan).

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

A. "UtiliCorp has had a philosophy for many years of increasing employee ownership of stock in order to build a culture of shareholder value creation" (response to Staff Data Request No. 167 in Case No. EM-2000-292). Stock options granted under the Executive Stock Plan are intended to ensure that executives are focused on creating long-term shareholder value, as the executives only benefit if UtiliCorp's stock price increases. In its response to Staff Data Request No. 167, UtiliCorp stated that the sole purpose of the Employee Stock Plan was to increase "employees focus on shareholder value and stock appreciation." In a letter to the recipients of the November 1998 stock options, Mr. Richard Green, UtiliCorp's CEO, described a purpose of the Employee Stock Plan as being to "heighten our collective focus on UtiliCorp's stock price" (response to Staff Data Request No. 260, Case No. EM-2000-292).

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

A. It is the Staff's opinion that the benefits of pooling of interest merger were sacrificed in lieu of improving shareholder value, especially since UtiliCorp, as described below, did not take any action to cure or fix this potential violation of the pooling of interests conditions. As such, it is not appropriate for Empire's ratepayers to have to absorb the



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detrimental aspects of the loss of the pooling of interests accounting, when the reason for the loss was to increase UtiliCorp shareholder value and stock price.

Q. Please describe further the "alteration of equity interest" condition of a pooling of interests merger that UtiliCorp believes it has violated.

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

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

A. Yes. According to Accounting Interpretation No. 19 of APB 16, the alteration of equity interests presumption can be overcome provided there is sufficient, persuasive, and objectively verifiable evidence indicating that the alteration of equity interests was not done in contemplation of the proposed business combination. Since the enforcement of the pooling merger conditions is the responsibility of the SEC, such evidence would have to be presented before the Staff of the SEC.

Also, according to a book published by the public accounting firm of Arthur Andersen entitled, *Accounting for Business Combinations, Interpretations of APB Opinion No. 16, Business Combinations* (Interpretations of APB 16), page 112, this presumption can



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be overcome if evidence indicates that the change in equity interest was not made in contemplation of the merger. Whether or not the presumption can be overcome depends on the strength of the evidence available and the length of time between the change in equity interest and the initiation of the business combination.

Q. Did UtiliCorp issue the November 1998 employee stock options in contemplation of the mergers with Empire and SJLP?

A. No. In response to Staff Data Request No. 167, UtiliCorp witness Myers, Director, Corporate Reporting, and Mr. Robert Browning, Vice President, Human Resources stated that "the issuance of options in November 1998 was not done in contemplation of the SJLP merger," and "there was no relationship between this option issuance and the SJLP merger, which was announced two months later." As described below, the first discussions of a possible business combination between Empire and UtiliCorp did not take place until after the November 1998 stock option issuance was approved by UtiliCorp's Board of Directors. Therefore, it would not seem possible for the stock option issuance to have been done in contemplation of the Empire merger.

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

A. No. Included in Staff Data Request No. 167 in Case No. EM-2000-292, was the following Staff question and UtiliCorp response:

> Question 4: Did the Company ever have any discussions or correspond with the staff of the Securities and Exchange Commission (SEC), or any other regulatory body concerning the pooling of interests treatment of the proposed acquisition of SJLP? If yes, please provide copies of such correspondence and summaries of discussions. If no, please describe the reasons why



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> the Company did not seek an opinion from the SEC staff as to whether or not the issuance of stock options in 1998 would prevent the acquisition of SJLP from being accounted for under the pooling of interests method.
>
> Response: The Company did not consult with the SEC with regard to this issue. We relied on the opinion of our independent auditors and interpretations existing in published literature.

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

A. The Staff agrees with UtiliCorp that because of the closeness of the merger discussions with SJLP and Empire and the merger announcements with the stock option issuance, UtiliCorp has the burden to prove that the November 1998 stock option issuance was not done in contemplation of the SJLP and Empire mergers. However, the Staff believes that because of the significant financial consequences of losing the ability to use the pooling of interests accounting method (imposition of $391 million in combined SJLP and Empire acquisition adjustments) UtiliCorp should have vigorously presented its case to the SEC that the November 1998 stock option issuance was not done "in contemplation" of the SJLP and Empire mergers.

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

A. Yes. According to Arthur Andersen's Interpretations of APB 16, page 124, once the issuance of options is determined to be a change in equity interests in contemplation of business combination, the change can only be "cured" by canceling or rescinding the options so long as no option holder has exercised any of the options issued. If the result of



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rescinding the stock options returns the equity holders to the same equity position as existed before the change, then a "no harm/no foul" approach can be adopted and the pooling of interests rules are met.

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

A. Apparently so. According to the information provided in response to Staff Data Request No. 260 from Case No. EM-2000-292, the November 1998 stock options could not be exercised until November 1999. This is at least six months after UtiliCorp concluded that the stock option issuance violated the pooling of interests conditions. However, in the interest of employee morale, UtiliCorp decided not to rescind the November 1998 stock options. Staff Data Request No. 167 in Case No. EM-2000-292 and UtiliCorp's response included the following:

> Question 5: When the Company determined that the November 1998 stock option issuance would prevent it from using the pooling of interest accounting method for the SJLP acquisition, did the Company consider taking actions to "cure" the violation? If yes, please describe the Company discussions of this issue and why it was decided not to attempt to "cure" this pooling violation. If no, please describe the reasons why the Company did not consider taking actions to cure this potential pooling violation.
>
> Response: The only cure would have been rescinding or canceling the options. The Company did not feel this would have been in the best interest of employee morale and there were still uncertainties with regard to the eventual consummation of the transaction.

Q. Are you aware of a company that, in fact, did rescind a stock issuance in order for its pending merger to be accounted for as a pooling of interests?



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A. Yes. Synopsys, Inc. of Mountain View, California described in its 1998 Annual Report to the SEC, Form 10-K, how it rescinded its stock repurchase program in order to comply with pooling of interest accounting rules:

> NOTE 9. SUBSEQUENT EVENT
> On October 26, 1998, the Company signed a definitive agreement to merge with Everest Design Automation, Inc. (Everest). The Company will exchange approximately 1.4 million shares of its common stock for all the outstanding stock of Everest and will reserve approximately 100,000 shares of its common stock for issuance under Everest's stock option plan, which the Company will assume in the transaction. The business combination will be accounted for as a pooling-of-interests. <u>The Board of Directors approved the rescission of the Company's stock repurchase program in order to comply with pooling-of-interests accounting guidance provided in the Securities and Exchange Commission Staff Accounting Bulletin No. 96</u>. Retained earnings will be restated as of October 1,1998 to reflect the pooling-of-interests combination. (Emphasis Added)

Q. Are you also aware of a company that describes in its employee stock option plan that it will rescind a stock option issuance, if that issuance could prevent a proposed merger from being accounted for as a pooling of interests?

A. Yes. Red Hat, Inc. included such language in its 1999 Stock Option and Incentive Plan:

> POOLING-OF -INTERESTS-ACCOUNTING. If the Company proposes to engage in an <u>Acquisition intended to be accounted for as a pooling-of-interests</u>, and in the event that the provisions of this Plan or of any Award hereunder, or any actions of the Board taken in connection with such Acquisition, are determined by the Company's or the acquiring company's independent public accountants <u>to cause such Acquisition to fail to be accounted for as a pooling-of-interests, then such provisions or actions shall be amended or rescinded by the Board</u>, without the consent of any Participant, to be consistent with pooling-of-interests accounting treatment for such Acquisition.
> [Red Hat, Inc. SEC Form S-1 filed June 4, 1999, Exhibit 10.2, para. 7(e)(iv) Emphasis added]



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

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

Q. If UtiliCorp did decide to argue its case to the SEC Staff that the November 1998 stock options were not issued in contemplation of either the SJLP or Empire mergers, does the Staff believe that UtiliCorp would have very strong support for its position?

A. Yes. The following timelines show that the November 1998 issuance of stock options could not have been done in contemplation of the SJLP and Empire acquisitions. As shown below, UtiliCorp was not even contacted by Morgan Stanley Dean Witter (Morgan Stanley), SJLP's investment banker about the possible sale of SJLP until sometime during the week of November 9, 1998, a full week or more after the stock options were issued. For the Empire acquisition, the senior management of the two Companies did not even discuss the possibility of a business combination until after UtiliCorp's Board of Directors approved the November 1998 stock option issuance:

SJLP
July 1998 – UtiliCorp Chairman and CEO Richard Green decided to issue options under the 1998 Employee Stock Plan (Staff Data Request No. 260, Case No. EM-2000-292)



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> August 4, 1998 – UtiliCorp Board of Directors approved issuance of stock options (Staff Data Request No. 260, Case No. EM-2000-292)
>
> November 2, 1998 – Stock options issued (Staff Data Request No. 260, Case No. EM-2000-292)
>
> Week of November 9, 1998. - Morgan Stanley initially contacted the potential bidders (UtiliCorp/SJLP joint proxy statement/prospectus dated May 6, 1999, page 15)
>
> EMPIRE
> July 1998 – UtiliCorp Chairman and CEO Richard Green decided to issue options under the 1998 Employee Stock Plan (Staff Data Request No. 260)
>
> August 4, 1998 – UtiliCorp Board of Directors approved issuance of stock options (Staff Data Request No. 260)
>
> October 21, 1998 – Empire meeting at UtiliCorp where possibility of business combination was first discussed. (Empire proxy statement/prospectus dated July 29, 1999, page 17)
>
> November 2, 1998 – Stock options issued (Staff Data Request No. 260, Case No. EM-2000-292)

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

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

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



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> In assessing whether option or restricted share awards are "normal," the SEC staff considers the historical pattern of awards, including the class of employees receiving awards, the size of the award for a given level of an individual within the organization, the timing of awards and their terms, including exercise price, vesting, and exercise period.
>
> Furthermore, the granting of options between initiation and consummation of a business combination to be accounted for as a pooling of interests is permissible, so long as the grant meets the test of being a normal grant. . . .

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

A. Yes. The November 1998 stock options were granted under a preexisting plan, as the plan was adopted in 1991. There were only two option issuances under the Employee Stock Plan, one in May 1992 and one in November 1998. In May 1992, 4,342 employees received 1,114,350 options and in November 1998, 4,276 employees received 1,278,729 options. Both option issuances included both union and nonunion employees and excluded executive-level employees.

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

A. No. In response to Staff Data Request No. 167 in Case No. EM-2000-292, UtiliCorp explained that the November 1998 stock option issuance was not "normal" because there was no regularity to the issuance of options under this plan. Also, in response to Staff Data Request No. 99 from the same case, UtiliCorp advised that the "company's issuance of options to all employees which occurred in November 1998 does not meet the criteria for a "normal event" based upon the company's established history."



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

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

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

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

The Staff believes that in any review of normality, it would be reasonable for the SEC to take into consideration that, unlike most companies' stock option plans, UtiliCorp's Employee Stock Plan is unusual, and options under this plan are not intended to be issued on a regular basis. In fact, because there is "no schedule for regularly granting stock options," under the Employee Stock Plan, irregular issuances of stock options should, in fact, be considered normal because the issuances are totally consistent with the plan's intent and plan's history.

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

A. Yes. Pooling accounting rules prevent companies using this accounting method from engaging in certain types of transactions. For example, APB 16 paragraph 48c prohibits a company using the pooling method from disposing of a significant part of the



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assets of the combining companies within two years after the combination, other than disposals in the ordinary course of business. Under this condition, if the Empire acquisition is not completed until December 2000, UtiliCorp would not be allowed to sell a significant part of its assets until December 2002. Since UtiliCorp is considering selling some or all of Empire's generation assets after the merger, the two year ban on the sale of these assets by APB 16 (as well as other restrictions) could have influenced UtiliCorp's decision not to take its case before the SEC to retain pooling of interests accounting.

Q. Describe how UtiliCorp expressed an intention to sell SJLP's and Empire's generation assets after the acquisitions?

A. UtiliCorp's internet website (utilicorp.com) under Investor Information: Presentations, includes UtiliCorp's 1999 Year-end Review Conference Call with financial analysts, held on February 8, 2000 (February Conference Call). Joint Applicant's witness, Mr. Robert Green, UtiliCorp's President and Chief Operating Officer (COO), discusses the potential sale of the generation assets acquired from SJLP and Empire with the conference participants:

> But take a look at the mid-continent footprint that we're building on the network side of the business. With the St. Joe and the Empire acquisition, we've brought together some very attractive low-cost generation assets, and we have added some contiguous distribution networks that afford us a significant opportunity for synergies and efficiencies. 75% of those benefits are going to come from the supply side.
>
> And over time, we will look to restructure the supply-side assets and potentially take them out of rate base and provide more of an upside. It might be that the easiest path is to sell some of those assets so we can establish a market value and avoid a stranded cost to base [debate] with the regulator; and then redeploy that capital strategically on the energy grid in other generation assets or other growth investments.



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Q. Has UtiliCorp previously attempted to "spin-off" or remove its Missouri regulated generation assets from regulated operations?

A. Yes. In Case No. EM-97-395, UtiliCorp, before eventually withdrawing its case, applied to the Commission to transfer its Missouri generation assets to a non-regulated affiliate.

**MERGER COSTS**

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

A. A merger premium and transaction costs are "ownership" costs. Transition costs (also known as costs to achieve) are not ownership costs, but are incurred during the process of merging the operations of the combining utilities into a single, more efficient utility. The term merger premium was defined earlier. Transaction and transition costs are described below.

Transaction costs are costs incurred by both the acquiring company and the acquired company for the purpose of consummating the merger. Examples of these costs are fees paid for legal, banking and consulting services necessary to close the transaction. The majority of transaction costs will be incurred prior to merger closing. Transaction costs are referred to as "direct costs of the merger" and are coupled with the merger premium to make up the amount of the acquisition adjustment to be recorded on the utility company's balance sheet. Both the USOA and GAAP (APB 16) require that transaction costs be treated the same as the merger premium.



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Transition costs are costs incurred to merge or combine the operations of the two combining utilities into one, potentially more efficient utility. Two of the more common transition costs are those related to human resources and information technology:

> Human resources costs - Reductions in staff through streamlining and ending duplication. These include severance costs, buyout packages and unpaid sick and holiday leave, as well as the physical relocation of the work force.
>
> Information technology - Moving from two to one integrated computer system may require the purchase of new computer hardware and software, the disposal of old machinery and outside consultant costs. Old files need to be converted, data needs to be transferred and employees need to be trained on new applications and work flow processes.

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

A. The merger premium and transaction costs are types of ownership costs, which are rightly absorbed by the owners of the merging companies. For example, the merger would not take place without the shareholders of both companies approving the transaction. The decision on the amount of money to pay to acquire a company, and the amount of money to accept in selling a company, is made by the boards of directors in their fiduciary responsibility to the shareholders. Once an agreement between the board of directors of both companies is reached, a special meeting is usually required to be held in which both shareholder groups vote to approve or reject the merger. The merger is approved, if, and only if, both owner groups believe it is in their best interests. In this merger, the Empire and UtiliCorp shareholder groups decided that the $29.50 per share price for each Empire common share was in the best interests of the respective shareholders.

Ratepayer interests are not considered in the decision to buy (acquiring utility) or sell (acquired utility) – they have no vote. Ratepayer interests are not considered because the



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structure of a merger agreement and the approval of the merger are ownership decisions. Ratepayers, as non-owners, have 1) no ownership rights in utility assets, 2) no vote in the decision to be a part of a merger, and 3) no influence on the structure of the terms and conditions of a merger, including the amount of the merger costs that they are often asked to pay.

As described above, transaction costs are those costs necessary to complete the merger and include legal fees, regulatory approval cost and financial consulting fees. In deciding whether or not to merge with another utility, Empire's Board of Directors has paid or will pay its financial advisor, Salomon Smith Barney, a minimum of $2.5 million (Empire Proxy Statement, page 26) to provide an opinion whether the $29.50 per Empire common share offer price from UtiliCorp is fair, from a financial point of view, to Empire's shareholders. Also, Empire's Board of Directors retained legal advisors to counsel the Board on its fiduciary responsibilities throughout the merger process. These costs are clearly not related to providing utility service more efficiently, but are only incurred to protect the financial interests of the shareholders in the merger transaction. In fact, the higher the price that Empire receives from UtiliCorp (i.e., the higher the acquisition adjustment), the higher the fees Salomon Smith Barney will receive from Empire, as its transaction fee includes an additional amount of 3.0% of the total purchase price over $336 million.

Because the merger premium and transaction costs incurred in this merger were incurred solely to benefit both Empire and UtiliCorp shareholders, as owners, these costs should not be directly reflected in utility rates borne by Empire's customers.

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



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

For these reasons, the Staff does not believe it is reasonable to exclude, in rates, the actual costs incurred to achieve the merger savings (transition costs), while simultaneously flowing through all the merger savings in rates to the ratepayers. Consistent with this belief is the Staff's position that reasonable and prudent transition costs actually incurred should be reflected in rates to be recovered from ratepayers. Staff Accounting witness James M. Russo addresses the Staff's position on rate recovery of transaction and transition costs in his rebuttal testimony as they relate to the UtiliCorp/Empire merger.

Q. UtiliCorp witness McKinney describes on pages 11 and 12 of his direct testimony in this proceeding how the merger premium is similar to other types of costs a utility incurs to be more efficient. Does the Staff concur with Mr. McKinney's analogy?

A. No. As discussed above, the merger premium and transaction costs are ownership costs. These costs are incurred only by the explicit approval of the shareholders (or board of directors acting in the best interests of the shareholders) and only after the shareholders determine that the merger is in their best "financial" interests. The merger premium and transaction costs are not associated with running the utility operations more



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efficiently, and therefore, are not analogous to reorganizations or renegotiations of purchased power contracts, which are designed to run utility operations more efficiently. The examples in Mr. McKinney's testimony are similar to merger transition costs, not transaction costs.

**ACQUISITION ADJUSTMENT**

Q. How much is UtiliCorp willing to pay to acquire Empire?

A. UtiliCorp and Empire negotiated a purchase price of $29.50 per Empire common share outstanding. At December 31, 1998, Empire had approximately 17.1 million common shares outstanding, which results in a purchase price of $504.5 million. This calculation is provided on pages 3 and 4 of UtiliCorp witness Myers' direct testimony.

Q. *Is this a complete calculation of the cost to acquire Empire?*

A. No. Both APB 16 and the FERC USOA require that transaction costs be included along with the purchase price to determine the overall cost to acquire plant assets. At page 6 of his direct testimony, UtiliCorp witness Vern J. Siemek states that transaction costs for this merger were estimated to be approximately $19.3 million, which includes the legal fees of Empire and UtiliCorp and banker fees for Empire to complete the transaction. Adding the $19.3 million transaction costs to the purchase price of $504.5 million results in an estimated total estimated Empire acquisition cost of $523.8 million.

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

A. The estimated Empire acquisition adjustment is $294.3 million. This calculation (in millions of dollars) is shown below:

| | |
|---|---|
| Total Estimated Cost to Acquire Empire's Stock | $504.5 |
| Less Net Book Value of Empire's Assets 12/31/98 | (229.5) |
| Estimated Merger Premium | 275.0 |
| Estimated Transaction Costs | 19.3 |
| Total Estimated Acquisition Adjustment | $294.3 |



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Q. Please describe how UtiliCorp will record the estimated $294.3 million acquisition adjustment in its financial records?

A. As discussed earlier, 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 the net book value of Empire's assets in the regulated plant accounts, the acquisition adjustment will be reflected as a single line item on Empire'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.

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



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A. The annual amount of acquisition adjustment amortization expense that Empire will charge to earnings is approximately $7.4 million ($275 million estimated merger premium plus $19.3 million estimated transaction costs divided by UtiliCorp's proposed 40 year amortization period). The actual revenue requirement impact of this amortization is not the $7.4 million, but approximately $12 million.

Q. Please explain why the revenue requirement impact of the amortization of the acquisition adjustment is significantly more than the amortization itself.

A. In a tax-free business combination, the Internal Revenue Service (IRS) does not allow an income tax deduction for goodwill (acquisition adjustment) amortization expense. Therefore, to calculate the total revenue requirement impact of the acquisition adjustment amortization expense, the before-tax amortization has to be grossed-up for income taxes to reflect the nondeductibility of the acquisition adjustment. Therefore, the annual amortization of $7.4 million must be multiplied by 1.667 (1/1-40% effective tax rate) to calculate the total impact of the amortization on Empire's revenue requirement. The annual cost to Empire, due to the nondeductibility of the acquisition adjustment, is approximately $4.9 million. UtiliCorp witness Vern J. Siemek's Schedule VJS-1 shows three components of the premium costs; Return on Premium, Amortization of Premium and Reflect Non-Tax Deductibility of Premium. His calculation of the tax impact of the acquisition adjustment amortization is lower because he does not include transaction costs in his calculation of the acquisition adjustment.

Q. What is the total revenue requirement impact of the estimated $294.3 million acquisition adjustment over 40 years, the period of time this cost will be reflected on UtiliCorp's books and records?



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A. Schedule 2 to this testimony shows that over 40 years, the recognition of the acquisition adjustment will increase UtiliCorp's revenue requirement for Empire's utility properties by approximately $1.18 billion (tax grossed up amortization of $490 million and return on rate base impact of $686 million).

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

A. Schedule 3 to this testimony shows that over the first ten years after closing, recognition of the acquisition adjustment will increase UtiliCorp's revenue requirement for Empire's utility properties by approximately $419 million (tax grossed up amortization of $123 million and return on rate base impact of $296 million). This results in an average annual increase in revenue requirement of approximately $42 million over the first ten years. Schedule 3 also shows that the cost of the acquisition adjustment exceeds estimated merger savings over this period by $243 million.

Q. Explain how UtiliCorp intends to recover the Empire acquisition adjustment.

A. As described on pages 7-8 of UtiliCorp witness McKinney's direct testimony, UtiliCorp is proposing a five-year rate freeze (except for a rate case to go into effect in 2001 to include the new State Line combined cycle generating station in rate base) in which it intends to retain 100% of any realized merger savings to offset the cost of the acquisition adjustment. In years 6 through 10 after merger closing, UtiliCorp is proposing direct rate recovery of 50% of the rate base return on the acquisition adjustment and 50% return of the acquisition amortization expense, including the approximately $5 million annual negative income tax effect. Staff Accounting witness Mark L. Oligschlaeger describes UtiliCorp's proposed regulatory plan in more detail.



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Q. Please quantify the revenue requirement impact of UtiliCorp's proposal to recover 50% of the acquisition adjustment in years 6 through 10 following merger closing.

A. As reflected in Schedule VJS-1 to UtiliCorp witness Siemek's direct testimony (Line VII, Empire share of premium costs, Total, Years 6-10) UtiliCorp proposes direct rate recovery of approximately $92.6 million in acquisition adjustment costs in years 6 through 10 following the merger. On Schedule 3 to this testimony, the Staff calculates the acquisition adjustment, including transaction costs to be approximately $100 million during this period (50% of the total return and amortization in years 6 through 10).

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

A. Yes. Section 7.02(c) of Article VII of the UtiliCorp/Empire Merger Agreement allows UtiliCorp not to consummate the merger if it does not receive a written opinion from its legal counsel that the merger will be tax-free to UtiliCorp and its stockholders.

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

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



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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 $275 million merger premium above net book value to acquire Empire.

A. The $275 million merger premium consists of two separate components. The first component represents payment of an approximate $140 million gain (current market value less net book value) on the sale of Empire's assets. The second component of the merger premium is the amount of money above market value that UtiliCorp determined it should pay for Empire. This amount, $135 million, represents payment for what UtiliCorp believes will be the benefits of the merger, including a control premium payment to Empire's shareholders.

Empire has been a financially successful electric utility with very low generation costs. Any utility considering a merger with Empire would know that, at a very minimum, it would have to pay the current market value of the company to convince Empire's shareholders to sell or give up control of the company. Empire's market value at the time of the May 11, 1999 merger announcement was approximately $369 million ($21.6 average stock price over the preceding 20 days times 17.1 million common shares outstanding). Therefore, at a minimum, UtiliCorp would have to pay $369 million to acquire Empire.

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



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how much it would be willing to pay to Empire's shareholders to convince them to give up total control of Empire's business operations.

Because UtiliCorp's Board of Directors decided to pay approximately $504.5 million for a company with a market value of $369 million, the Board determined that the present value of the Empire's merger benefits (including control of the acquired assets) is at least $135 million ($504.5 million purchase price (excluding transaction costs) less $369 million market value). This $135 million is essentially what is referred to respecting non-regulated companies as goodwill. It is not an asset like other tangible assets (plant, materials and supplies, etc.), but an intangible asset.

Q. Why is goodwill considered an asset?

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

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

Later in my testimony I will describe how this $135 million payment for the "goodwill" portion of the acquisition adjustment is expected to provide additional cash flows to UtiliCorp, mostly to its non-regulated operations.

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**GAIN ON SALE OF ASSETS**

Q. The merger premium to be incurred by UtiliCorp is approximately $275 million. You just explained how $135 million of the $275 million acquisition premium represents the estimated present value of merger benefits. What does the remaining $140 million of the acquisition premium represent?

A. The approximate $140 million difference between Empire's market value and its book value represents an unrealized gain on the sale of Empire's properties that will be realized by Empire's shareholders at merger closing. Conceptually, this is the same as a gain on the sale of individual utility assets except that it relates to the sale of the whole company.

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

A. Yes. As described earlier, UtiliCorp will use the five-year rate freeze after merger closing to recoup as much of the acquisition adjustment as it can through the retention of excess earnings. In its regulatory plan, UtiliCorp is seeking direct ratemaking recovery of 50% of the merger premium beginning the sixth year after merger closing, regardless of how much of the acquisition adjustment it actually does recover during the five-year rate freeze. Included in the acquisition adjustment is the approximately $140 million gain on sale of Empire's assets, which represents the difference between the market value and book value of Empire's net assets when they are sold to UtiliCorp.

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

A. No. The increase from book value to market value of Empire's assets reflects gains that have not been recognized in Empire's books and records. For example, if Empire

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were to sell plant assets, (constituting an operating unit or system), a gain on the sale would be realized equal to the amount received less the book value of the asset. Gains on the sale of plant assets have traditionally not been reflected in setting rates by the Commission. Therefore, Empire's regulated customers should not be held responsible to UtiliCorp for the realized gains on the sale of the assets paid to Empire's shareholders.

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

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

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

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

A. Cost-based regulation provides assurances that the book costs of a utility's assets will be recovered through the ratemaking process. Market values, while not



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appropriate for utility ratemaking, are appropriately used by non-regulated companies who account for a merger or acquisition using purchase accounting rules. It is appropriate for non-regulated companies to revalue assets acquired in a merger to current market value because they are not a part of a regulatory process that provides assurances that the historical (book) cost of a utility investment will have the opportunity be recovered in utility rates.

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

Q. How does UtiliCorp justify its proposal to have Empire's customers pay for a significant portion of its costs to acquire Empire?

A. The basis of UtiliCorp's proposal to recover the merger premium in rates is that Empire's customers will benefit from merger savings. However, as described in the rebuttal testimony of Staff witness Oligschlaeger, no merger savings benefits will flow to Empire's customers for at least five years or more after the merger closing. This period will be used by UtiliCorp to recover a portion of the acquisition adjustment, by means of regulatory lag.

Also, a significant portion of UtiliCorp's estimated merger savings are associated with Empire's generation assets. According to Mr. Robert Green, 75% of the synergies and efficiencies of the SJLP and Empire acquisitions by UtiliCorp are going to come from the "supply side" or generation assets (February Conference Call). As noted above, and as will be discussed later in my testimony, UtiliCorp has expressed a desire to sell Empire's



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generation assets, either to a third party, or to its affiliate, Aquila Energy. If and when these generation assets are sold, any generation related merger savings to Empire's customers that do occur, will disappear at the time of the sale.

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

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

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

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

> The necessity of this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the acquisition and merger period of the 1920s and 1930s. Through the process of acquiring utility assets or entire utility companies at prices in excess of depreciated cost, purchasing utilities were able to write up their basis in plant assets. If these purchase prices were in excess of the "value" of the property, the utility was able to inflate its rate base artificially. . .
>
> The outgrowth of this situation was a general consensus among regulators that utility customers should not pay on an amount in excess of the cost when property was originally devoted to public service, since any excess represented only a change in ownership without any increase in the service function to utility ratepayers. By accounting for the acquisition adjustments separately from plant in service, these



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> excess costs could be better controlled by regulatory authorities as to their ultimate disposition.

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

A. I believe so, yes. Allowing rate recovery of acquisition adjustments could require Missouri ratepayers to pay for the same utility plant over and over again with no increase in value.

Q. Please explain how this could occur.

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

In 1988, Arkansas Power and Light Company (APL) sold its Missouri gas properties, known as Associated Natural Gas Company (ANG) to Southwestern Energy Company (SWEN) of Fayetteville, Arkansas. APL's shareholders recognized a gain on the sale of ANG, and SWEN recorded an acquisition adjustment, which included this gain. In its subsequent Missouri rate cases, SWEN attempted to recover the acquisition adjustment in gas rates from its Missouri customers, but was not successful. In 1999, SWEN sold these same properties to Atmos Energy Corporation (Atmos). The Commission recently approved this sale in Case No. GM-2000-312. In the Unanimous Stipulation and Agreement reached among the parties to this case, Atmos agreed not to seek recovery of the acquisition adjustment it will pay to SWEN for the ANG properties.



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If, in the past, SWEN was allowed to recover the ANG acquisition adjustment in rates, and if Atmos sought and was allowed recovery of the acquisition adjustment it recorded in the purchase of ANG from SWEN, Missouri ratepayers would be paying over and over again increased amounts for the exact same gas plant, with no increase in value. The asset gains (merger premium) recognized by utility shareholders who currently own the former ANG properties will continue to roll into rate base each time the properties are bought and sold, resulting in a gross distortion of utility rates and cost-based ratemaking.

The original owner, APL, recognized the gain as did SWEN's shareholders in its sale of the gas properties to Atmos. If Atmos decides to sell these gas properties in the future, it will also expect to retain any gain on the sale for its shareholders.

This example of what could have happened very recently in Missouri with a Commission policy of allowing rate recovery of acquisition adjustments is very similar to the types of abuses that led to the creation of the general rule prohibiting rate recovery of acquisition adjustments in the first place.

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

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

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



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

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

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

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

In Case Nos. WM-82-147, WM-82-192, WR-83-14 and SR-83-15, respecting Missouri Cities Water Company, the Commission again ordered that gains on the sale of utility assets should be treated below-the-line for ratemaking purposes. In the Report and



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Order in those cases, however, the Commission did express an opinion that it would be open to the concept of sharing of gains on sale of utility assets between ratepayers and shareholders.

The Commission once again addressed the gains on asset sales issue in Case Nos. EO-85-185 and EO-85-224, KCPL. In that case, the Commission agreed with KCPL's position that ratepayers have no property interests in the utility assets; however, it said that "*this fact alone does not dictate below the line accounting treatment for a gain on utility assets.*" The Commission's ruling in this case did not give any portion of the gains to KCPL's ratepayers.

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

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

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

A. Yes, absolutely. The acquisition premium paid by the acquiring utility is the gain on sale realized by the selling utility. They are the same dollars. The acquiring utility's shareholders pay the gain to the acquired company's shareholders. The acquired utility



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records the amount of the gain in the account "Gain On Sale of Plant Assets," while the acquiring company records this same dollar amount in the "Acquisition Adjustment" account.

For example, assume that UtiliCorp is allowed to recover in rates the estimated $294 million acquisition adjustment paid to acquire Empire. Assume further that in the future, UtiliCorp sells Empire's generation assets at a significant gain over book value. In this situation, the Commission, in applying consistent ratemaking treatment, would require that UtiliCorp record this gain in a deferred liability account and amortize the gain as a reduction to Empire's cost of service through some appropriate sharing mechanism. While it is not the Staff's position to reflect asset gains in rates, if it is fair for UtiliCorp to charge the cost of acquiring Empire's assets to Empire's ratepayers, then it is only fair for UtiliCorp to credit Empire's ratepayers with any gain on the sale of these assets. In other words, if customers are forced to pay for the acquisition policies of utilities, then it is only reasonable to expect customers to enjoy the benefits of any future gains on sale of these assets.

It is a long-held belief by the utility industry (including UtiliCorp) that ratepayers are not owners and are not entitled to share in gains on asset sales. However, if Empire's ratepayers are required to pay for the acquisition costs (ownership costs) in rates, for ratemaking purposes they conceptually become "owners", as like any other owners, they are responsible for the ownership costs of acquiring the property. It is precisely UtiliCorp's proposal to recover the acquisition adjustment in utility rates that is transforming Empire's ratepayers from customers to owners. As "owners," Empire's ratepayers should be entitled to share in any future gains on sales of utility assets (ownership benefits) along with other UtiliCorp shareholders.



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

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

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

> Now, if you have a hypothetical sale with a gain, that's not a cost you incurred to generate a savings for the customer. So, therefore, it's not my testimony. I haven't addressed it. And I wouldn't put it in my testimony at this time. I would need time to think about it, but I can't think of a reason you would pass that back to the customers, because it's not a cost generated to develop a level of costs for the customer to pay for his energy. The customers do not own the assets; the shareholders own the assets. They're their assets. We do not – we're not in a co-op.
> [Tr. at 65-66.]

Q. Did the Staff attempt to gain a better understanding of UtiliCorp's position respecting the treatment of gains from the sale of plant assets?



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A. Yes. In Data Request No. 232 (Case No. EM-2000-292), the Staff asked for UtiliCorp's position on the sharing of gains on plant asset sales between ratepayers and shareholders, considering the fairness in the allocation of acquisition costs and acquisition benefits. UtiliCorp witness John McKinney responded to this data request stating only "see the transcribed interview of John McKinney."

Q. Describe the position of SJLP and Empire on the treatment of gains on sale of plant assets.

A. In a March 23, 2000 transcribed interview with the Staff, Mr. Terry Steinbecker, SJLP's President and CEO, and a SJLP witness in Case No. EM-2000-292, echoed Mr. McKinney's views that ratepayers are not owners and therefore are not entitled to any gains on sale of utility assets. In response to a question about the possibility of sharing gains on the sale of generation assets, Mr. Steinbecker replied:

> ......It is my understanding that the Commission has held that no sharing should occur and that customers are not entitled to benefit from any gain from the disposition of utility property. I concur with this view.
> [Tr. at 84-85.]

Also, in a May 22, 2000 transcribed interview with the Staff, Empire witness Myron W. McKinney, Empire's Chairman and CEO, expressed his opinion that **____________

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

A. Yes. As described earlier, UtiliCorp is considering selling Empire's generation assets. Public Utilities Fortnightly published an analysis of electric generation asset sales in its September 1, 1999 issue. This analysis shows that the average purchase price of 40% generation asset sales transactions was 2.15 times book value. If Empire's generation assets were sold for 2.15 times book value, UtiliCorp would recognize a gain of approximately $213 million (Response to Staff Data Request No 36, generation book value of assets $185 million x 2.15 = $398 million sale price – $185 million book value = $213 million gain).

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

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



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**CONTROL PREMIUM AND MERGER BENEFITS**

Q. Earlier you explained that $140 million of the $275 million merger premium is the approximate difference between the book value (historical cost) of Empire and its market value. Can you explain why UtiliCorp was willing to pay $135 million above Empire's current market value (at the May 11, 1999 merger announcement) to acquire Empire?

A. Yes. The three components of a merger (or acquisition) premium, defined as the excess of purchase price over book value, are:

1. Unrealized Gain on Assets – the increase from book value to market value inherent in the purchase price.

2. Control Premium – the portion of the merger premium that can be attributed to valuable rights of ownership by virtue of controlling the combined company.

3. Payment for Strategic Merger Benefits and Synergies – strategic and financial benefits enjoyed by the acquiring company over and above what can be generated from both companies remaining independent.

Earlier I described the first component of a merger premium, unrealized gains on assets from book (historical cost) to market value appreciation. This amount, approximately $140 million, represents 51% of the total merger premium of $275 million. The other 49% consists of UtiliCorp's payment to Empire's shareholders for the ability to control the combined company, and payment for the incremental merger benefits UtiliCorp hopes to realize from the purchase of Empire's assets.

Q. What is a control premium?



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A. A control premium represents the portion of the total merger premium paid by the acquiring company to the acquired company's shareholders to ensure control of the combined-company's operations. It is simply the amount over the market price that was paid to obtain control of the target company. In strategic mergers, such as UtiliCorp's mergers with SJLP and Empire, the control premium often refers to the payment for both control and other strategic benefits. In this testimony, however, I use the term control premium to mean the payment for the elements of control, as listed below. The payment for strategic merger benefits is discussed separately.

Q. *What are some of the benefits of control acquired or secured in a merger through the payment of a control premium?*

A. A control owner (UtiliCorp's shareholders in this merger) will enjoy certain valuable rights that a minority owner (Empire's shareholders who become UtiliCorp shareholders) will not. In general, examples of elements of control include the right to:

* Appoint management
* Determine management compensation and perquisites
* Set policy and change the course of business
* Acquire or sell assets.
* Make acquisitions
* Select companies with whom to do business and award contracts.
* Declare and pay dividends to shareholders
* Change the articles of incorporation or bylaws.

[Shannon P. Pratt, CFA, FASA, *Introduction to the Valuation of Businesses & Professional Practices*, 2nd ed., Chap. 5, p. 41]

Q. *Did Empire attempt to maintain some control in the combined UtiliCorp/Empire organization after the merger?*

A. Yes. In a transcribed interview with the Staff on May 22, 2000, Mr. Myron McKinney, Empire's CEO, described **______________________________



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Q. Does UtiliCorp consider it important to "control" the companies it acquires through mergers and acquisitions?

A. Yes. In an article published in the April/June 2000 issue of *Leaders Magazine,* Mr. Robert Green describes the importance UtiliCorp places on acquiring value in its acquisitions and controlling the acquired assets:

> For President and Chief Operating Officer Bob Green, "value" seems to underlie every aspect of UtiliCorp's business strategy. Beginning with the day-to-day matter of business to business, he offers, "it all goes back to" delivering "good value and good service to the customer." With that philosophy in mind, the company is expanding into new markets "one step at a time," he explains, making sure to "add value with each step." For although he recognizes that "we need to continue to build scale," it "is not the be all and end all." No, "we need to look for opportunities to harvest value" - again - "hedge our risks, and continue to pursue our strategy, especially when we can do all that and still control the assets."(Emphasis Added)



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Later in this article, Mr. Robert Green explains how UtiliCorp is seeking to get bigger through acquisitions, but is doing so prudently and will look for acquisition that add value, especially when UtiliCorp is able to control the assets it acquires:

> Clearly, we need to continue to build scale, but scale is not the be all and end all. We need to take it one step at a time and add value with each step. Our industry is littered with examples of people reaching out for scale at the expense of value, and that strategy has spelled the end for many of those players. As in any industry, we need to seek scale but in a prudent way. We need to look for opportunities to harvest value, hedge our risks, and continue to pursue our strategy, especially when we can do all that and still control the assets.

Q. How does a company control another company in a merger?

A. The majority company's interest can dominate the board of directors and senior-level management. In the case of UtiliCorp's merger with SJLP and Empire, UtiliCorp will completely control the Board of Directors and all of the officer level positions of the combined utility, as no officer of either SJLP or Empire will be retained. UtiliCorp will make all decisions relating to these mergers, thus controlling all aspects of the combination. In order to convince Empire and SJLP Boards to give up all control of the respective companies, UtiliCorp had to pay a control premium.

Q. Did the Staff attempt to quantify the control premium inherent in the negotiated purchase price to acquire Empire?

A. No. This would be a difficult and impractical task. The control premium (what UtiliCorp was willing to pay to "control" the combined company) is a function of the dynamics of merger negotiations. For example, **________________________________ ________________________________________________________________** The



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additional compensation demanded by Empire because of this control-related decision by UtiliCorp is unknown. However, the Staff estimates the control premium in the Empire merger could be approximately 20%.

Q. What is the basis for the Staff's estimate of a 20% control premium in this merger?

A. On February 26, 1999, the Staff interviewed Mr. Thomas J. Flaherty, a witness for KCPL and Western in their previous joint application to merge, docketed as Case No. EM-97-515. Mr. Flaherty is a nationally known expert witness and has testified in several utility acquisitions cases before regulatory commissions. In this interview with the Staff, Mr. Flaherty defined a control premium and explained that the typical control premium is in the 20 plus percent range. In response to a question asking his knowledge of a control premium, Mr. Flaherty stated:

> It usually reflects a premium amount or level that is sufficient to ensure that the board and the management of the acquiring company have substantial control and ownership of the succeeding entity. So whereas a merger of equals premium might be relatively low, a control premium is typically in the 20 plus percent range.

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Q. The Empire merger premium (defined as purchase price over current market value) was stated to be 39% in UtiliCorp's press release announcing the merger. Does the



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Staff consider a 39% merger premium to be on the low, middle, or high end of merger premiums paid in recent mergers?

A. The 39% merger premium UtiliCorp negotiated with Empire is on the high end on premiums paid in recent mergers. This belief is based not only on the testimony of UtiliCorp witness Mr. Robert Green, but also on analyses performed by Empire's investment bankers, Salomon Smith Barney, and a comprehensive analysis of merger premiums reported in *Mergerstat Review*, currently published by Houlihan Lokey Howard & Zukin. *Mergerstat Review* is one of the primary sources of control premium statistics most commonly used by business appraisers.

On page 11 of UtiliCorp witness Green's direct testimony, he states that the average premium over current stock price for industry merger and acquisition transactions announced over the last 14 months, prior to UtiliCorp's offer in February 1999 was 27% percent. The difference between a 27% premium and a 39% premium UtiliCorp agreed to pay for Empire is approximately $43 million dollars in acquisition adjustment cost.

Q. Does Mr. Robert Green address this differential in his testimony?

A. No. Mr. Green calculates a 18.6% premium based on a Empire stock price of $24.875 around the February 1999 time period. However, Empire's stock price decreased significantly from February 1999 to the merger announcement in May 1999. According to the Empire Proxy Statement (page 18-19), the merger negotiations between Empire and UtiliCorp began on March 15, 1999 and continued through May 7, 1999. During the 20 days prior to the March 15, 1999 start of merger negotiations, Empire's average stock price was $22.89, and the average Empire stock price during the March 15, 1999 to May 7, 1999 negotiation period was $22.07, well below the $24.875 used in Mr. Green's testimony.



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Q. In addition to Mr. Green's testimony that the average merger premium for industry mergers from January 1998 through February 1999 was 27%, describe the other merger premium studies you relied upon in determining that the 39% Empire premium is on the high end of merger premiums paid in recent merger transactions.

A. **______________________________________________________________________________________________________________________________________________________** In comparison, UtiliCorp's 39% premium offer for Empire is significantly above these average electric industry merger premiums.

Also, using publicly available information, Salomon Smith Barney performed an analysis of selected electric utility industry transactions announced since 1997. A description of this analysis is found on page 25 of the Empire Proxy Statement. In this analysis, Salomon Smith Barney applied a range of control premiums from these transactions to the $19.00 to $22.50 per Empire share range derived n the public market valuation analysis to derive an implied valuation of $21.85 to $30.38. The control premiums used in this valuation of Empire ranged from a low of 15% to a high of 35%. UtiliCorp's 39% premium to Empire exceeds even the high range in this valuation analysis based on actual premiums incurred in recent electric industry mergers and acquisitions.

Finally, Mercer Capital Management, Inc. (Mercer) published a study of merger control premiums entitled *Source of Control Premium Data & What it Doesn't Tell Us*. This document was found on Mercer's website, bizval.com. Mercer Capital provides independent



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valuation services to businesses and financial institutions, including the issuance of fairness opinions in corporate mergers (similar to the work performed for Empire by its investment banking firm, Salomon Smith Barney).

In this control premium study, Mercer explains that *Mergerstat Review* publishes compiled data on publicly announced mergers and acquisitions, including control premiums. In this study, a control premium is defined as the difference between the public market price of a minority interest in the stock of a subsequently acquired company five days prior to a buyout announcement and the actual buyout price. Mercer looked at 560 merger transactions occurring in 1998-1999 involving at least a 50.1% equity interest. Of the 560 transactions, 78 acquisitions occurred at a discount to market price and 482 occurred at premiums. Of the 453 transactions, which included a premium between 0% and 100%, the median premium was 28.7%.

Q. Explain why merger benefits are related to the amount of the merger premium.

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 Empire for $504.5 million, UtiliCorp determined that the benefit of being a stronger competitor in a deregulated energy market, potential merger



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savings, and the potential financial benefits to UtiliCorp's non-regulated affiliates was worth the $135 million above Empire'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 increasingly deregulated environment?

A. This belief is based on the economics of the merger and UtiliCorp's statements to other entities. On page 12 of UtiliCorp witness Mr. Robert Green's direct testimony, he states that even if the Commission approves UtiliCorp's regulatory plan, the economic effect of this merger is neutral to slightly favorable to UtiliCorp's shareholders. It would not make sense for UtiliCorp to pay over $500 million for an investment that, at best, is slightly favorable to its shareholders. This testimony by Mr. Green indicates that the real purpose of the merger is strategic, not economic, in nature.

Q. Is Mr. Green's view of the economic effect of the merger as "neutral or slightly favorable" optimistic, considering UtiliCorp's own estimate of merger savings?

A. Yes. In response to Staff Data Request No. 1, UtiliCorp provided workpapers in support of witness Vern Siemek's direct testimony describing merger savings. The Company's workpapers show that the total cost of the merger over the first 10 years is $390.5 million, and the total estimated merger savings (net of costs to achieve) over this period is $359 million, prior to corporate overhead allocations. After overhead allocations, total net savings are only $176 million, or $214.5 million less than total merger costs.

Q. How is UtiliCorp describing the reasons for the Empire merger to other entities?



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A. UtiliCorp consistently portrays the primary reason for the Empire merger as strategic, that is, gaining size and scope to enhance its position in a competitive energy industry environment as well as taking advantage of opportunities to compete in new businesses, such as telecommunications.

In UtiliCorp's May 11, 1999 press release announcing the Empire acquisition, Mr. Robert Green termed the merger "a significant step in growing UtiliCorp's domestic operations." There was no mention of merger savings, or synergies as a reason for the merger in this press release.

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

In an article in Empire's November 1999 company newsletter, *Dispatch,* UtiliCorp Senior Vice President Jim Miller described why UtiliCorp is acquiring Empire (Response to Staff Data Request No. 142). Mr. Miller explained that combining smaller companies into a larger critical mass, thereby gaining a competitive edge, is essential as industry deregulation approaches.

Finally, in a "New York Analyst Meeting" on May 9, 2000, Mr. Richard Green, UtiliCorp's CEO described the strategic opportunity in the telecommunications business that UtiliCorp is acquiring through its merger with Empire. The following quote was obtained from UtiliCorp's internet website, utilicorp.com.

> The communication business, as you heard Peter talk about, we've been doing that successfully in Australia, where we have accumulated



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> 33,000 fiber miles. The key that we saw last year was to take that successful telecom strategy and apply it in other marketplaces where we are doing business. The opportunity in the US we have found first to be with our acquisitions of St. Joe and Empire. St. Joe has a small fiber company called ExOp, and Empire has 300 miles of fiber that we got with the Empire or will get with the Empire acquisition.

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

A. Yes. From its dealings with utility rate cases, the Commission is very well versed in a principle of accounting known as the "matching principle." The matching principle applies equally to merger cases, where rate recovery of acquisitions is sought, as it does to rate cases. This principle simply states that costs incurred in producing revenue should be matched as closely as possible with the revenue produced.

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

In this merger transaction, Empire's objective is clear – to maximize after tax proceeds from the sale of the company for its shareholders. For UtiliCorp, however, the objective is not so clear. UtiliCorp is buying:

(1) an electric utility company to increase its size and scope in an attempt to be a successful player in a deregulated energy industry;

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(2) highly-valued generation assets in which it can sell and reap substantial gains for its shareholders;

(3) a company with significant telecom assets (300 miles of fiber optic cable);

(4) a company which will provide additional maintenance and construction business for its controlling interest in Quanta Services;

(5) a company with electric utility operations that can be merged with existing utility operations to potentially create merger savings; and,

*(6) an existing customer base in which it can use Empire's brand name to market its* non-regulated ServiceOne energy services.

The Empire merger premium has to be allocated to each of these potential merger benefits, in addition to the merger control benefits (elements of control) described above.

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

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

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

The ICC's Order also quoted the testimony of Larry F. Altenbaumer, Illinois Power's Senior Vice President and Chief Financial Officer stating that Illinois Power "has committed

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to not seek to recover, in any future gas rate case, the costs incurred in accomplishing the Merger."

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

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

Q. Please describe the similarities of the two mergers.

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

**Relative Size of Combining Companies**

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

**Size of Merger Premium**

SCANA agreed to pay an approximate 45 percent premium to PSNC's market value, while UtiliCorp, in its press release announced that the merger premium paid to Empire will be 39 percent above current market value.

**Accounting of the Merger**

Purchase accounting was used for the SCANA/PSNC merger and will be used for the UtiliCorp/Empire merger.

**Purpose of the Merger**

In UtiliCorp's press release, Robert K. Green, UtiliCorp President and COO, termed the merger "a significant step in growing UtiliCorp's domestic operations."



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In SCANA's merger announcement, William B. Timmerman, chairman, president and CEO of SCANA, said "this acquisition is about growth, opportunity and maximizing shareholder value in the face of the dramatic changes taking place in today's utility industry."

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

**Shared Corporate Culture**

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

UtiliCorp - Richard Green: "At UtiliCorp it is not much different than it is here at Empire. It is that sense of values, of customer service, or relationships with shareholders and just plain good business that we saw, together, when we started talking about combining the two companies." (Response to Staff Data Request No. 142 "Rick Green's Remarks to Shareholders", Empire Newsletter, October 1999)

**Opportunity for Merger Savings**

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

UtiliCorp believes that the acquisition of Empire will lead to significant merger savings.

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

A. No. In the UtiliCorp/Empire merger, UtiliCorp, among other conditions, is proposing ratemaking recovery of the merger premium and merger transaction costs and a five-year rate freeze for Empire with no rate reductions. In the SCANA/PSNC merger, SCANA's CEO committed in his prefiled direct testimony that SCANA would "exclude all costs of the merger and all direct and indirect corporate cost increases, including acquisition premiums, attributable to the merger, from PSNC's utility accounts or costs for all purposes that affect PSNC's retail rates and charges."

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

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

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

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

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



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

Q. Other than the benefit of an enhanced competitive position in a deregulated energy market, what are the other benefits to UtiliCorp's non-regulated affiliates of the Empire acquisition?

A. Additional benefits include greater outsourcing of utility construction and maintenance work to UtiliCorp's non-regulated affiliate, Quanta Resources, Inc. (Quanta), acquisition of Empire's rights of way and fiber optic cable network to support its recent investment in telecommunications operations (telecom), and direct access to Empire's 120,000 residential electric customers to sell the home energy appliance and service agreement services (under the Empire brand name) offered by UtiliCorp's ServiceOne affiliate.

**MERGER BENEFIT # 2: NON-REGULATED BUSINESS OPPORTUNITIES**

Q. Is access to captive utility customers to generate additional revenue for non-regulated affiliate companies an additional motivating factor behind the recent rise in utility mergers?

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



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Q. Does UtiliCorp believe that is acquisition of SJLP and Empire will lead to significant financial benefits to its non-regulated affiliate companies?

A. Yes. In a March 15, 2000 Conference Call with Salomon Smith Barney (March Conference Call) found in UtiliCorp's internet website under Investor Information, Presentations, Mr. Robert Green described how UtiliCorp intends to break apart some of Empire's embedded utility businesses and reposition them as non-regulated businesses:

> We've also acquired two distribution assets here in the U.S., St. Joe Power & Light and Empire District. We believe we can significantly enhance the value of those assets by disaggregating, breaking apart some embedded businesses, and repositioning them. We've done that in Australia. Since 1995, our IRR in terms of that investment is over 30% and what we've done is break out the retail energy business and we will joint venture that with Shell at a value significantly above what we paid for it.

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

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

> Energy Delivery Networks – UtiliCorp describes itself as being a "world-class manager of networks." This business segment consists of domestic and international electric and natural gas distribution utilities.
>
> In addition to its domestic gas and electric utility operations, this business segment includes ServiceOne. ServiceOne repairs and services appliances and provides home warranty and other services to about 170,000 contract customers both inside and outside of UtiliCorp's utility service territories.



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> Energy Merchant Business – Includes Aquila Energy Corporation (Aquila) which markets and trades wholesale natural gas, electricity and other commodities and deals in a wide range of energy-related financial and risk management products and services.
>
> Specialized Services – Quanta Services, Inc. (Quanta) is one of the largest specialized contractors serving utilities, telecommunications and cable TV operators.
>
> UtiliCorp has recently announced a partnership called Everest Connections Corp to offer telephone, high-speed Internet and cable TV services to consumers in several markets, with the Kansas City area market to be first. Both UtiliCorp and SJLP are investors in ExOp, a Kearney, Missouri company that plans to offer telecommunications services in western Missouri.

A fundamental investment strategy UtiliCorp uses to constantly create new earnings streams and build value is the employment of what it calls a "value cycle." In its 1999 Annual Report, UtiliCorp describes how it employs this value cycle: "We invest, then optimize and monetize."

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

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

A. In 1999, UtiliCorp decided to sell its investment in West Virginia Power, a regulated electric utility subsidiary. To "optimize" the value of this investment, UtiliCorp



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

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

Q. Does UtiliCorp intend to leverage its investment in Empire to benefit its non-regulated affiliate companies?

A. Yes. In the February Conference Call, Mr. Robert Green describes UtiliCorp's strategy of leveraging regulated utility assets to enhance its non-regulated investments as "take advantage of our network position to pursue growth opportunities." Consistent with this strategy, the Staff believes UtiliCorp intends to leverage Empire's regulated utility assets to secure financial benefits to its Specialized Services business (Quanta and telecommunications investments) and its Energy Delivery Networks (ServiceOne).

In the interview with *Leaders Magazine* referenced earlier, Mr. Robert Green is very clear about UtiliCorp's intention to leverage its regulated electric utility assets, particularly its distribution system, to develop its telecommunications business:

> You have a reputation for spotting trends that will affect the utility industry. What new trends do you see in the future?



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> In the near future I think we're going to see telecommunications layered over gas and power networks and assets, with energy companies becoming significant competitors to existing telecom players in certain niche markets. <u>For instance, where we already have the right-of-way to lay fiber for that last mile, UtiliCorp could be a formidable competitor. We can also leverage our distribution network to lay fiber across central business districts, to be used by other carriers.</u> Our operations in Australia already provide us with a model for how that's done. (Emphasis Added)

As Mr. Green describes, UtiliCorp could become a formidable competitor in the telecom business because, by the sole virtue of its ownership of the regulated electric distribution assets, it is able to secure a competitive advantage over other newly-formed competitive telecommunications companies.

**QUANTA SERVICES**

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

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

> <u>Strategic Agreement</u>
> UtiliCorp will use Quanta as a "preferred contractor" in outsourced transmission and distribution infrastructure construction and maintenance in all areas serviced by UtiliCorp.
>
> <u>Management Agreement.</u>

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> 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 [Quanta], 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 development, evaluation and marketing of the Company's products, services and capabilities; identification and evaluation of potential acquisition candidates and other merger and acquisition advisory services; and other services that the Company's Board of Directors may reasonably request.



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

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

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

> February Conference Call
> Now, if you look at contracting in North America, we believe utilities are going to largely outsource the construction and maintenance of their electric networks, and that is going to fuel tremendous growth in this market for a well positioned player like Quanta. In addition, the explosion of bandwidth is providing tremendous growth for Quanta. And they also do a significant amount of business in terms of installing cable network.
>
> We've talked about our Quanta strategy. We think they're terrific fundamentals in this market. We think it is the second-biggest market to be unbundled from the vertically integrated utility. The biggest is generation, clearly; and if you look at new generation and you look at generation coming out of rate base, that market is growing at over 30%.
>
> March Conference Call
> In addition, Quanta is positioned for what we believe will be a massive outsourcing of network construction and maintenance by utilities. We've seen this happen in markets that are further along in deregulation in Australia and New Zealand and we think in the next few months you'll see businesses outsource the construction and maintenance of their power and gas networks to companies like Quanta, not unlike a company outsourcing their IT needs to EDS or IBM.



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

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

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

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

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

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

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

A. Yes. In 1999 and 2000, Quanta provided construction and maintenance services for several of UtiliCorp's utility operating divisions. According to UtiliCorp's response to Staff Data Request No. 212 in Case No. EM-2000-292, for the 15 months ended March 31, 2000, UtiliCorp paid Quanta $14.4 million for work performed for its Missouri Public Service (MPS) division. It appears that UtiliCorp has already begun the process of



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outsourcing its utility construction and maintenance projects, even before deregulation takes effect.

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

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

Invest

$320 Million investment to secure controlling interest and two Board of Director seats and the right to control a third seat

Optimize

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

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

Monetize

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

**TELECOMMUNICATIONS**

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

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



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

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

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

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

> We will continue to pursue this telecom strategy that has emerged out of Australia. There is significant potential with the assets we're acquiring at Empire and St. Joe to create an Australian-like telecom play in the mid-continent.
>
> And as I said, we've got I think 300 miles of fiber at Empire, and a significant business at St. Jo that we think we can build, based on our Australian experience, into a real growth vehicle for UtiliCorp.
>
> We expect to offer voice services this year. And it really is our biggest venture into telecom. And it is a strategy we think we can replicate. We think we can replicate it in a place like Calgary, taking advantage of our power distribution position. We think we can replicate it in Missouri. Empire has 300 miles of fiber.
>
> We think we can implement this strategy in the Empire service territory. We think we can implement it in and around Kansas City. And we're developing the business plan and identifying the right partners to make this strategy most successful in these different markets. <u>But as we look at buying network assets, the telecom overlay will be a key part of the value proposition.</u> (Emphasis added.)



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Q. What is the significance of Mr. Green's statement "But as we look at buying network assets, the telecom overlay will be a key part of the value proposition?"

A. This statement is significant because it explains the benefit or value that *UtiliCorp is buying when it acquires or merges with other electric distribution utilities.* According to UtiliCorp, a "key part" of the value of a utility as an acquisition target is its telecommunications assets. These assets are the existing installed fiber optic cable, the utility's rights of way, the existing electric power infrastructure on which to install fiber optic lines for voice, video and data transmission. The Staff does not know exactly how much "value" UtiliCorp is attributing to Empire's telecommunication assets, or how much of the $135 million above current market value that UtiliCorp is paying for SJLP that should be attributed to these assets. However, *given UtiliCorp's significant interest in this area, the* amount could be substantial.

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

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

> Second, in terms of a near-term upside is our telecom business that's emerging first in Australia. We expect to float a telecom business at a valuation close to the initial investment value in United Energy, the power company we bought back in 1995. We think that should have a big impact on UtiliCorp's share price. As well, we are aggressively pursing that telecom strategy here domestically.
>
> The third near-term prospect for substantially enhancing shareholder value is a partner for our energy marketing and trading operation, Aquila. We think there are several very attractive candidates in the

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> market that have low cost generation that is being rolled out of rate base and provides a significant opportunity for Aquila to partner with them and create an entity that would be valued at a significantly higher multiple. A good example of that is the Dynergy-Illinova deal that occurred about a year ago. The value there has essentially more than doubled, and as we look at Aquila today, it trades at about a multiple of 8 to 8.5 times EBITDA. Combined with the right generation assets, we think we can double that multiple and that's what Dynergy has done. And we believe we can replicate that result.

**SERVICEONE**

Q. Will the acquisition of Empire's approximately 120,000 regulated utility residential customers potentially provide benefits to UtiliCorp's non-regulated energy services company, ServiceOne?

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

In marketing its non-regulated products through ServiceOne, UtiliCorp will be able to benefit from the existing Empire customer-utility relationship. Normally, a customer will be more likely to do business with a company that he/she has had a personal relationship with for many years, such as its local utility, over a company with which no such relationship exists. The value of this relationship is embedded in the brand name "Empire District Electric Company" and has a monetary value to whoever owns the right to use this brand name. When UtiliCorp purchases the assets of Empire, it is also purchasing the Empire



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brand name, an intangible asset that has the potential to provide benefits to UtiliCorp's non-regulated ServiceOne subsidiary.

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

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

Q. In your testimony you've provided several examples of how UtiliCorp places significant value on the non-regulated business opportunities from its acquisition of Empire and SJLP. Is this consistent with the information provided to the Staff in a transcribed interview with Mr. Robert Green on March 17, 2000?

A. No. According to Mr. Green's statements to the Staff during the interview, UtiliCorp does not place any importance to the "potential value" acquired in the SJLP and Empire mergers:

> Staff: Do you believe there is much potential value in the St. Joe non-regulated operations?
>
> Mr. Green: Again, what drove this transaction was building a mid-continent utility. I mean, none of the unregulated businesses were material and that was not a factor in our decision, in any way.
>
> Staff: Okay. All right. Perhaps to jump ahead, would that same answer be accurate for Empire, that transaction?
>
> Mr. Green: Yes.

Q. Please summarize your testimony to this point.

A. In this testimony I have shown that the pooling of interests is considered the preferred method of accounting for mergers, especially mergers in the utility industry. The primary reason for this is that no acquisition adjustment is created in a pooling merger. This fact was recognized by Mr. Richard Green, UtiliCorp's CEO, in a previous merger application before this Commission.

I have also shown that if UtiliCorp was at all concerned about the creation of an estimated \$391 million in combined SJLP and Empire acquisition adjustments (of which it proposes to have customers pay a significant portion), it could have accounted for both mergers as poolings. UtiliCorp chose not to do so. For this reason, as well as other reasons, UtiliCorp should not be allowed to charge its Missouri ratepayers for the recognition of acquisition costs that very well could have been prevented.

Allowing direct recovery of acquisition adjustments in rates would not be good regulatory policy, as it would distort the historical cost value of utility rate bases in Missouri. As I explained earlier and provided a recent example, the reason why acquisition premiums were first excluded from recovery in utility rates in the 1920s and 1930s (inflating rate base without additional investments) is just as valid today.

The Commission has consistently ruled that utility ratepayers should not share in gains on utility asset sales. One of the reasons cited for this position is that ratepayers are not owners of the assets and therefore are not entitled to benefit from the sale of the assets (an ownership decision). In my opinion, allowing direct rate recovery of an acquisition adjustment would require a reversal of this regulatory policy and require a sharing of all gains on sales of regulatory assets in the future.



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Other reasons why UtiliCorp should not be allowed to recover the acquisition adjustment in rates are directly related to the strategic benefits of the merger. I have shown that the overwhelming beneficiaries of this merger are UtiliCorp's shareholders, and as the beneficiaries, they should be responsible for 100% of the cost of UtiliCorp's acquisitions. Some of these strategic shareholder merger benefits include:

(1) increased size and scope in an attempt to be a successful player in a deregulated energy industry;

(2) ownership of highly-valued generation assets in which it can sell for substantial gains above book value;

(3) ownership of telecom assets (300 miles of fiber optic cable) which are expected to lead to significant returns to its non-regulated operations;

(4) additional maintenance and construction business for its controlling interest in Quanta Services;

(5) potential savings from combining utility operations of the two companies; and

(6) access to an existing customer base in which it can use Empire's brand name to market its non-regulated ServiceOne energy services.

Despite these clear shareholder benefits, UtiliCorp would have its captive rate customers pay for a substantial portion of the merger acquisition adjustment. This position is clearly unfair to these customers and should be rejected by the Commission.

**DEFERRED TAXES**

Q. In the introduction to your testimony you state that the Staff has a concern about a potential loss of Empire's accumulated deferred income taxes as a result of the



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merger. Please explain the term "accumulated deferred income taxes" and explain how these taxes are treated for ratemaking purposes.

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

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

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

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

A. That is what is expected, however, there is no guarantee. The final taxable status of this merger will not be known until after the acquisition.

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

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



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Q. Have any other Missouri utilities committed to continue to reflect the rate base offset respecting deferred taxes and tax credits eliminated as a result of a merger or acquisition?

A. Yes. Southern Union Company made this commitment in Case No. GM-94-40, its acquisition of the Missouri gas properties of Western Resources, Inc., in 1994. In addition to Southern Union Company, Atmos made this commitment to the Commission in Case No. GM-2000-312, its acquisition of ANG's Missouri gas properties from SWEN, described earlier.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.



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**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| In the Matter of the Joint Application of UtiliCorp United Inc. and The Empire District Electric Company For Authority To Merge The Empire District Electric Company With and Into UtiliCorp United Inc. and, In Connection Therewith, Certain Other Related Transactions, Filed. | ) ) ) ) ) ) ) | EM-2000-369 |

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI )
) ss.
COUNTY OF COLE )

Charles R. Hyneman, is, of lawful age, and on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 92 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 20th day of June, 2000.

ANNETTE KEHNER
Notary Public – Notary Seal
STATE OF MISSOURI
Cole County
My Commission Expires: July 17, 2003

## 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 |
| EM-2000-292 | UtiliCorp United Inc. Acquisition of St. Joseph Light & Power Company |

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| | | | | | | |
|---|---|---|---|---|---|---|
| Merger Premium | $274,950,000 | | | | | |
| Transaction Costs | $19,300,000 | | | | | |
| Acquisition Adjustment | $294,250,000 | | | | | |
| Amortization Period | 40 | | | | | |
| Amortization Expense | $7,356,250 | | | | | |
| | | | | | | |
| Year | Rate Base | Return | Return on RB | Per Book Amortization | Tax Gross Up Amortization | Total Return and Amortization |
| 0 | $294,250,000 | | | | | |
| 1 | $286,893,750 | 11.37% | $33,456,225 | $7,356,250 | $12,260,417 | $45,716,642 |
| 2 | $279,537,500 | 11.37% | $32,619,819 | $7,356,250 | $12,260,417 | $44,880,236 |
| 3 | $272,181,250 | 11.37% | $31,783,414 | $7,356,250 | $12,260,417 | $44,043,830 |
| 4 | $264,825,000 | 11.37% | $30,947,008 | $7,356,250 | $12,260,417 | $43,207,425 |
| 5 | $257,468,750 | 11.37% | $30,110,603 | $7,356,250 | $12,260,417 | $42,371,019 |
| 6 | $250,112,500 | 11.37% | $29,274,197 | $7,356,250 | $12,260,417 | $41,534,614 |
| 7 | $242,756,250 | 11.37% | $28,437,791 | $7,356,250 | $12,260,417 | $40,698,208 |
| 8 | $235,400,000 | 11.37% | $27,601,386 | $7,356,250 | $12,260,417 | $39,861,802 |
| 9 | $228,043,750 | 11.37% | $26,764,980 | $7,356,250 | $12,260,417 | $39,025,397 |
| 10 | $220,687,500 | 11.37% | $25,928,574 | $7,356,250 | $12,260,417 | $38,188,991 |
| 11 | $213,331,250 | 11.37% | $25,092,169 | $7,356,250 | $12,260,417 | $37,352,585 |
| 12 | $205,975,000 | 11.37% | $24,255,763 | $7,356,250 | $12,260,417 | $36,516,180 |
| 13 | $198,618,750 | 11.37% | $23,419,358 | $7,356,250 | $12,260,417 | $35,679,774 |
| 14 | $191,262,500 | 11.37% | $22,582,952 | $7,356,250 | $12,260,417 | $34,843,369 |
| 15 | $183,906,250 | 11.37% | $21,746,546 | $7,356,250 | $12,260,417 | $34,006,963 |
| 16 | $176,550,000 | 11.37% | $20,910,141 | $7,356,250 | $12,260,417 | $33,170,557 |
| 17 | $169,193,750 | 11.37% | $20,073,735 | $7,356,250 | $12,260,417 | $32,334,152 |
| 18 | $161,837,500 | 11.37% | $19,237,329 | $7,356,250 | $12,260,417 | $31,497,746 |
| 19 | $154,481,250 | 11.37% | $18,400,924 | $7,356,250 | $12,260,417 | $30,661,340 |
| 20 | $147,125,000 | 11.37% | $17,564,518 | $7,356,250 | $12,260,417 | $29,824,935 |
| 21 | $139,768,750 | 11.37% | $16,728,113 | $7,356,250 | $12,260,417 | $28,988,529 |
| 22 | $132,412,500 | 11.37% | $15,891,707 | $7,356,250 | $12,260,417 | $28,152,124 |
| 23 | $125,056,250 | 11.37% | $15,055,301 | $7,356,250 | $12,260,417 | $27,315,718 |
| 24 | $117,700,000 | 11.37% | $14,218,896 | $7,356,250 | $12,260,417 | $26,479,312 |
| 25 | $110,343,750 | 11.37% | $13,382,490 | $7,356,250 | $12,260,417 | $25,642,907 |
| 26 | $102,987,500 | 11.37% | $12,546,084 | $7,356,250 | $12,260,417 | $24,806,501 |
| 27 | $95,631,250 | 11.37% | $11,709,679 | $7,356,250 | $12,260,417 | $23,970,095 |
| 28 | $88,275,000 | 11.37% | $10,873,273 | $7,356,250 | $12,260,417 | $23,133,690 |
| 29 | $80,918,750 | 11.37% | $10,036,868 | $7,356,250 | $12,260,417 | $22,297,284 |
| 30 | $73,562,500 | 11.37% | $9,200,462 | $7,356,250 | $12,260,417 | $21,460,879 |
| 31 | $66,206,250 | 11.37% | $8,364,056 | $7,356,250 | $12,260,417 | $20,624,473 |
| 32 | $58,850,000 | 11.37% | $7,527,651 | $7,356,250 | $12,260,417 | $19,788,067 |
| 33 | $51,493,750 | 11.37% | $6,691,245 | $7,356,250 | $12,260,417 | $18,951,662 |
| 34 | $44,137,500 | 11.37% | $5,854,839 | $7,356,250 | $12,260,417 | $18,115,256 |
| 35 | $36,781,250 | 11.37% | $5,018,434 | $7,356,250 | $12,260,417 | $17,278,850 |
| 36 | $29,425,000 | 11.37% | $4,182,028 | $7,356,250 | $12,260,417 | $16,442,445 |
| 37 | $22,068,750 | 11.37% | $3,345,623 | $7,356,250 | $12,260,417 | $15,606,039 |
| 38 | $14,712,500 | 11.37% | $2,509,217 | $7,356,250 | $12,260,417 | $14,769,634 |
| 39 | $7,356,250 | 11.37% | $1,672,811 | $7,356,250 | $12,260,417 | $13,933,228 |
| 40 | $0 | 11.37% | $836,406 | $7,356,250 | $12,260,417 | $13,096,822 |
| | | | $685,852,613 | $294,250,000 | $490,416,667 | $1,176,269,279 |

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Schedule 3

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Merger Premium | $274,950,000 | | | | | | | |
| Transaction Costs | $19,300,000 | | | | | | | |
| Acquisition Adjustment | $294,250,000 | | | | | | | |
| Amortization Period | 40 | | | | | | | |
| Amortization Expense | $7,356,250 | | | | | | | |
| | | | | | | | | UCU Cost |
| | | | | Per Book | Tax Gross Up | Total Return | Net Savings | Over |
| Year | Rate Base | Return | Return on RB | Amortization | Amortization | and Amortization | Staff DR 1 VJS-1 | Savings |
| 0 | $294,250,000 | | | | | | | |
| 1 | $286,893,750 | 11.37% | $33,446,417 | $7,356,250 | $12,260,417 | $45,706,833 | $3,497,000 | $42,209,833 |
| 2 | $279,537,500 | 11.37% | $32,610,256 | $7,356,250 | $12,260,417 | $44,870,673 | $10,039,000 | $34,831,673 |
| 3 | $272,181,250 | 11.37% | $31,774,096 | $7,356,250 | $12,260,417 | $44,034,513 | $14,669,000 | $29,365,513 |
| 4 | $264,825,000 | 11.37% | $30,937,935 | $7,356,250 | $12,260,417 | $43,198,352 | $17,051,000 | $26,147,352 |
| 5 | $257,468,750 | 11.37% | $30,101,775 | $7,356,250 | $12,260,417 | $42,362,192 | $23,407,000 | $18,955,192 |
| 6 | $250,112,500 | 11.37% | $29,265,615 | $7,356,250 | $12,260,417 | $41,526,031 | $21,379,000 | $20,147,031 |
| 7 | $242,756,250 | 11.37% | $28,429,454 | $7,356,250 | $12,260,417 | $40,689,871 | $24,009,000 | $16,680,871 |
| 8 | $235,400,000 | 11.37% | $27,593,294 | $7,356,250 | $12,260,417 | $39,853,710 | $22,564,000 | $17,289,710 |
| 9 | $228,043,750 | 11.37% | $26,757,133 | $7,356,250 | $12,260,417 | $39,017,550 | $16,826,000 | $22,191,550 |
| 10 | $220,687,500 | 11.37% | $25,920,973 | $7,356,250 | $12,260,417 | $38,181,390 | $22,728,000 | $15,453,390 |
| | | | $296,836,948 | $73,562,500 | $122,604,167 | $419,441,115 | $176,169,000 | $243,272,115 |

**SCHEDULE 4**

**IS DEEMED TO BE**

**HIGHLY CONFIDENTIAL**

**IN ITS ENTIRETY**

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