Exhibit No.:	______
Issues:	Empire Employees, Service and Shareholders
Witness:	Brad P. Beecher
Exhibit Type:	Surrebuttal
Sponsoring Party:	Empire District Electric
Case No.:	EM-2016-0213
Date:	August 5, 2016

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EM-2016-0213

SURREBUTTAL TESTIMONY

OF

BRAD P. BEECHER

ON BEHALF OF

THE EMPIRE DISTRICT ELECTRIC COMPANY

SURREBUTTAL TESTIMONY
BRAD P. BEECHER
THE EMPIRE DISTRICT ELECTRIC COMPANY
CASE NO. EM-2016-0213

TABLE OF CONTENTS

I. Witness Introduction 1

II. Purpose 1

III. Conditions 1

IV. Transaction 2

V. Structure 4

VI. Shareholders 7

VII. Transition Process 8

VIII. Operations Going Forward 9

IX. Officer Fiduciary Duties 11

X. Employment Issues 13

SURREBUTTAL TESTIMONY
BRAD P. BEECHER
THE EMPIRE DISTRICT ELECTRIC COMPANY
CASE NO. EM-2016-0213

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Brad P. Beecher and my business address is 602 S. Joplin Avenue, Joplin, Missouri, 64801.

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

A. The Empire District Electric Company ("Empire" or "Company") is my employer. I hold the position of President and Chief Executive Officer.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS CASE?

A. Yes, I have submitted direct testimony in this proceeding.

PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I will respond to issues related to current Empire employees, service, and shareholders that were raised in the rebuttal testimonies of Office of the Public Counsel ("OPC") witnesses Geoff Marke, Ryan Pfaff, and Ara Azad.

CONDITIONS

Q. ATTACHED TO THE SURREBUTTAL TESTIMONY OF DAVID PASIEKA AS SUR. SCHEDULE DP-1 IS A LIST OF CONDITIONS TO WHICH HE STATES THE JOINT APPLICANTS HAVE AGREED WITH STAFF AND OTHER

PARTIES, AS WELL AS OPC CONDITIONS, OR MODIFICATIONS THEREOF, TO WHICH THE JOINT APPLICANTS CAN AGREE. HAVE YOU HAD AN OPPORTUNITY TO REVIEW THAT LIST?

A. Yes, I have.

Q. DOES EMPIRE AGREE WITH MR. PASIEKA'S POSITION ON THOSE CONDITIONS?

A. Yes. Empire believes that those conditions are acceptable and further believes that the identified conditions represent a treatment of the issues that will provide benefits to Empire's customers.

TRANSACTION

Q. ON PAGE 43, LINES 9-16 OF OPC WITNESS PFAFF'S REBUTTAL TESTIMONY, HE CREDITS YOU AS STATING THAT THE PROPOSED MERGER IS "UNNECESSARY FOR EMPIRE TO CONTINUE TO PROVIDE SAFE AND RELIABLE SERVICE TO ITS CUSTOMERS." IS THIS AN ACCURATE REFLECTION OF YOUR STATEMENT?

A. Yes. I certainly believe that Empire is providing safe and reliable service today and that it can continue to do so for the foreseeable future. That being said, there are opportunities such as economies of scale, that can be gained with a larger organization that ultimately will be a benefit to consumers, and certain risks that can be mitigated or avoided over the long run as a result of the transaction. I'll discuss these within my testimony.

Q. OPC WITNESS PFAFF THEN DRAWS THE CONCLUSION THAT THE COMMISSION SHOULD, THEREFORE, "NOT FEEL COMPELLED TO APPROVE THIS MERGER." IS THIS A THOUGHT PROCESS THE COMMISSION SHOULD APPLY?

A. No. Counsel advises me that the courts and the Missouri Public Service Commission ("Commission") have never required that a merger be "necessary" in order to provide approval. The Joint Applicants' counsel will address in briefs and other appropriate documents in this proceeding that such a transaction should be approved if it is "not detrimental to the public interest."

Q. ARE THERE REASONS BEYOND WHETHER AN ACQUISITION OR MERGER IS "NECESSARY" FOR THE PROVISION OF SAFE AND ADEQUATE SERVICE THAT MUST BE CONSIDERED BY EMPIRE'S OFFICERS, BOARD OF DIRECTORS, AND SHAREHOLDERS?

A. Yes. First, a corporate Board of Directors' primary duty is to the shareholders of the organization. Empire's Board considered many factors in deciding whether to enter into the Agreement and Plan of Merger ("Agreement"). Those factors are outlined on pages 36, 37, 38, 39 & 40 of our May 3, 2016 Proxy Statement. A short excerpt from page 36 is included to provide the Commission a view into the depth of reasons considered.

Reasons for the Merger

In evaluating the merger agreement and the transactions contemplated thereby, including the merger, the Board consulted with Empire's management, outside legal counsel and financial advisors and, in recommending that Empire's shareholders vote "FOR" the approval of the merger agreement, considered numerous positive factors relating to the merger agreement and the transactions contemplated thereby, including the merger. Such positive factors include the following material factors (which are not necessarily in the order of relative importance):

- the Board's understanding of Empire's businesses, operations, financial condition, earnings, regulatory positions and strategy;
- the Board's understanding of Empire's business plan and historical and projected financial performance and the risks of remaining as a standalone public company, including the risks and uncertainties in executing on the business plan and achieving such financial projections, limited identifiable growth opportunities, general macroeconomic challenges and market risks;
- based on Empire's forecasts and historical trading ranges of our common stock on the NYSE and the potential trading range of our common stock absent takeover speculation, including following a public news report on December 11, 2015 that Empire was exploring a potential sale, the possibility that absent such speculation the trading price of our common stock may not trade in the foreseeable future at a level in excess of the per-share merger consideration of $34.00 in cash, without interest, on a present value basis;

STRUCTURE

Q. OPC WITNESS MARKE CRITICIZES THE PROPOSED TRANSACTION, IN PART, BECAUSE EMPIRE, A "KNOWN, STABLE LOCAL UTILITY WITH OVER ONE-HUNDRED YEARS OF OPERATING EXPERIENCE" WOULD TRANSITION TO MORE "ORGANIZATIONAL AND AFFILIATE COMPLEXITY." (PAGE 3, LINES 12-16) IS THE NEW ORGANIZATIONAL STRUCTURE SOMETHING THAT IS UNFAMILIAR TO THIS COMMISSION?

A. No. OPC ignores the consolidation that has been ongoing in the electric utility industry. In the June 2016 Public Utilities Fortnightly article entitled "Expanding Deals, Shrinking Companies," which is attached hereto as **Sur. Schedule BPB-1**, data is presented concerning this consolidation. Figure 1 of the article shows that the number of investor-owned electric utilities in the U.S. has declined from 96 in 1995 to only 40 as of June 2016. A similar trend is on-going with investor-owned gas local distribution companies, which declined from 51 to 21 over the same period. This data supports my personal observations of consolidation that has occurred within our four-state region over the course of time. For example:

1. Kansas Gas and Electric merged with Kansas Power and Light and became Westar Energy. It is now potentially combining with Great Plains Energy;
2. Arkansas Power and Light is part of Entergy;
3. Public Service of Oklahoma is part of American Electric Power Co. ("AEP");
4. Southwestern Electric Power Company ("SWEPCO") is now part of AEP;
5. St. Joseph Light & Power Company, Missouri Public Service, and Kansas City Power & Light Company are all part of Great Plains Energy; and,
6. Union Electric Company and Central Illinois Public Service are now part of Ameren.

In each of the cases listed above, uninterrupted electric service at, presumably, just and reasonable rates has continued post transaction.

I believe Empire is now the last of its breed as the only remaining publicly traded utility operating company in Missouri. Every other investor-owned electric and natural gas utility providing service in Missouri is a wholly-owned subsidiary of some form of holding company structure. This includes Liberty Utilities (Midstates Natural Gas) Corp., which has been providing natural gas service in Missouri since 2012, and Liberty Utilities (Missouri Water) LLC, which has been providing water service in the Missouri since 2005, both as subsidiaries of the same organization that Empire would join as a result of the proposed transaction.

Q. WHAT ARE SOME OF THE REASONS THAT YOU BELIEVE HAVE LED TO SUCH CONSOLIDATION?

A. There are many. One consideration is providing service to customers at just and reasonable prices. Though OPC states that we only have "aspirations" to find efficiencies from the proposed transaction, the costs of operating a stand-alone publicly traded company are substantial. Figure 4 in **Sur. Schedule BPB 1** lists the market capitalization of electric and gas utilities in the United States. You can see that as of 2015, only 5 companies remained that had a market cap of less than $1 Billion (Empire's comparable size when the transaction with Algonquin Power & Utilities Corp., ("Algonquin") was announced). To my knowledge, the only primarily electric utility with a smaller pre-announcement market cap than Empire is Unitil Corporation.

Q. HOW HAS THIS LACK OF SCALE AFFECTED EMPIRE?

A. One example is Iatan 2. As the Commission is aware, Iatan 2 is a coal-fired power plant that came on-line in 2010 at a total cost in excess of $2 billion. Empire was not able to build a $2 billion dollar project on its own, and therefore partnered with Kansas City Power & Light Company to achieve economies of cost and scale for our customers. In return, we were required to give up some operational control and decision-making authority. Similar decisions were made for Iatan 1 and Plum Point. Therefore, despite the OPC's apparent desire for a "local" hometown utility, in many instances the reality is that the capital demands and capital scale of the industry have outgrown that same local utility, and its customers today are subject to the decisions of other corporations in other locations.

In Algonquin, we have found a partner that not only helps with the scale issues mentioned above, but also has a commitment to maintaining the "local" feel through its business model and has made significant commitments to the state of Missouri both in the Joint Application, the Agreement, and subsequently in stipulations executed with Intervenors including the City of Joplin, the Missouri Division of Energy, and ReNew Missouri. We were pleased to be able to find a merger partner that not only embodies these principles, but that already operated within our state and thus was a known entity by the Commission and others.

SHAREHOLDERS

Q. THERE APPEARS TO BE NO MENTION OF THE INTEREST OF THE SHAREHOLDERS IN THE OPC REBUTTAL TESTIMONY. IS THAT AN INTEREST THE COMMISSION SHOULD CONSIDER?

A. Yes. The ability to sell one's property is a fundamental aspect of ownership. This right should be considered a part of the public interest and respected, unless there is a detriment to the public associated with that sale.

Q. HAVE THE SHAREHOLDERS TAKEN A POSITION AS TO THE PROPOSED TRANSACTION?

A. Yes. On June 16, 2016, Empire's shareholders voted to approve the Agreement associated with proposed transaction. Shareholders approved the merger agreement with approximately 95.5 percent of the votes cast at the shareholder meeting voting in favor of the merger proposal. The votes cast represented approximately 70.8 percent of Empire's outstanding common stock as of May 2, 2016, the record date for the special shareholder meeting. The Commission must take into consideration the clear desire of the shareholders in evaluating this transaction.

TRANSITION PROCESS

Q. IN HIS REBUTTAL TESTIMONY (PAGE 7, LINE 21 – PAGE 9, LINE 30), OPC WITNESS MARKE SUGGESTS THAT THE CLAIMS OF A "SEAMLESS TRANSITION" MAY BE ERRONEOUS. HOW DO YOU RESPOND TO THAT SUGGESTION?

A. I continue to believe that the transfer of control will be a seamless transition. I base this on two factors – First, as was indicated in the Joint Applicants' direct testimony, nothing needs to change as a part of this transfer of control. The Empire corporate entity will remain in place (with the same name), the assets Empire owns will not change, and the current Empire employees will continue to do their jobs utilizing the same processes as today. Because this is a share purchase and not an asset purchase, the transition is much more straightforward than might be seen in other circumstances. Second, as Mr. Pasieka has stated on pages 6-7 of his Direct Testimony, Liberty Utilities Co. ("Liberty Utilities") has a demonstrated history of successful utility transitions, both in Missouri and elsewhere.

OPERATIONS GOING FORWARD

Q. OPC WITNESS PFAFF SUGGESTS THAT THERE IS A CONTRADICTION BETWEEN THE JOINT APPLICANTS' STATEMENT THAT "THE DAY-TO-DAY OPERATIONS OF EMPIRE IN MISSOURI WILL CONTINUE AS THEY HAVE IN THE PAST," AND THAT "AFTER THE CLOSE OF THE TRANSACTION AND DURING THE NORMAL COURSE OF THE BUSINESS, LU CENTRAL WILL CONSIDER WHETHER THERE WILL BE ANY CHANGES TO SUCH OPERATIONS." (PAGE 12, LINES 1-14) DO YOU AGREE THAT THERE IS A CONTRADICTION?

A. No. As explained, immediately after the close of the proposed transaction above, the day-to-day operations of Empire will continue as they have in the past. The same call center representatives that answer customer calls before the transaction close will answer customer calls after the transaction. The same yellow line trucks that restore and extend service to customers before the transaction closes will meet customer needs after the transaction closes. Having said this, day-to-day operations will continue to be reviewed, as they would be even without the proposed transaction. Any potential for changes in the future do not represent a public detriment associated with the proposed transaction, as it is no different from the situation as it exists today.

Q. SIMILARLY, OPC WITNESS PFAFF SUGGESTS THERE IS A DEFICIENCY IN THE APPLICATION BECAUSE THE COMPANIES HAVE INDICATED THAT PLANNED REPORTING RELATIONSHIPS ARE STILL BEING WORKED OUT (PAGE 15, LINE 1-6). WHAT IS THE STATUS OF THIS PROCESS?

A. As of this time, the companies have exchanged organizational structure documents and we are making good progress towards developing integration plans. Primary to the development of the integration plans is the underlying promise that there will be no involuntary reductions of Empire employees, as outlined in the merger application.

Q. WILL THE REPORTING RELATIONSHIPS IMPACT EMPIRE'S PROVISION OF SAFE AND ADEQUATE SERVICE?

A. No. The assets, employees, and expertise necessary to provide safe and adequate service will remain in place, regardless of eventual reporting relationships. However, I would further comment that this is an area that is traditionally left to the management of the company. Similar to the day-to-day operations described above, Empire always has the discretion to examine and change, if desired, its reporting relationships. This is a part of utility operations over which the Commission has not attempted to exercise control - nor should it.

Q. MR. PFAFF SUGGESTS THAT BECAUSE CURRENT EMPIRE EMPLOYEES MAY BECOME EMPLOYEES OF LIBERTY UTILITIES SERVICE CORPORATION[1], AND THE ORGANIZATIONAL REPORTING STRUCTURE, ULTIMATE DECISION-MAKING PROCESS, AND DECISION-MAKERS MAY CHANGE, THAT EMPIRE WILL FUNDAMENTALLY CHANGE. (PAGE 14, LINES 17-21) DO YOU AGREE WITH THIS?

A. I do agree that Empire will fundamentally change. We will no longer be a publicly traded utility with responsibility for debt and equity in the broader capital markets.

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[1] Mr. Pfaff's reference to the company as "Liberty Utilities Service Corporation" is incorrect. The name of the company is Liberty Utilities Service Corp.

Empire will be an indirect subsidiary of Algonquin. However, the underlying mission of our employees to provide safe and reliable service to our customers will not change. I anticipate that the vast majority of the employees, including the senior management team, will be the same employees responsible for providing safe and adequate service, at the rates determined by the Commission to be just and reasonable. That is what Empire's customers should expect.

Q. IS IT REASONABLE TO EXPECT A LACK OF CHANGE IN THE ABSENCE OF THE PROPOSED TRANSACTION?

A. No. It is a great misunderstanding of Empire and the industry to suggest that in the absence of this proposed transaction there would be no change in regard to Empire. As I described above, the industry has undergone significant change in recent years. In addition, Empire's officers have changed many times over the years. I am not the first president of this corporation, nor will I be the last. I answer to a Board of Directors that has changed many, many times over the years, and I answer ultimately to shareholders, the composition of which changes to some extent on a daily basis.

<u>OFFICER FIDUCIARY DUTIES</u>

Q. AS TO DECISION-MAKING IN THE CURRENT ORGANIZATION, OPC WITNESS PFAFF SUGGESTS AS FOLLOWS:

> **CURRENTLY, THE EMPIRE DISTRICT ELECTRIC COMPANY IS THE ULTIMATE PARENT COMPANY OF ALL EMPIRE COMPANIES. THIS MEANS THAT CRITICAL DECISIONS OF EMPIRE—NAMELY, THE STRATEGIC DIRECTION OF THE COMPANY, AS WELL AS DECISIONS REGARDING THE ALLOCATION OF CAPITAL—ARE MADE AT EMPIRE'S**

HEADQUARTERS IN JOPLIN BY INDIVIDUALS WHO WORK FOR EMPIRE AND HAVE A FIDUCIARY DUTY ONLY TO EMPIRE, AND HAVE AN INTIMATE KNOWLEDGE OF THE UNIQUE CONSIDERATIONS OF EMPIRE. (PAGE 14, LINES 11-16)

IS THIS AN ACCURATE STATEMENT OF THE SITUATION AS IT EXISTS TODAY – DO THESE PERSONS HAVE A FIDUCIARY DUTY "ONLY TO EMPIRE"?

A. I suppose it depends on whether the use of "Empire" in this context includes its shareholders. Corporate directors and officers owe fiduciary duties to the corporation and its shareholders.

Q. IS THIS PROPOSED TRANSACTION A RESULT OF THE BOARD OF DIRECTORS' AND THE OFFICERS' FIDUCIARY DUTIES TO EMPIRE AND ITS SHAREHOLDERS?

A. Yes. As stated earlier, a corporate Board of Directors' primary duty is to the shareholders of the organization.

Q. WILL THE FIDUCIARY DUTIES OF EMPIRE'S OFFICERS CHANGE AFTER THE CLOSING OF THE PROPOSED TRANSACTION?

A. Yes and no. An Empire officer's fiduciary responsibility will still be to the shareholders after closing. However, the shareholders to whom that duty is owed will change from a group of public shareholders today to a single private shareholder after closing.

EMPLOYMENT ISSUES

Q. OPC WITNESS ARA AZAD SEEMS TO CRITICIZE THE PROPOSED TRANSACTION BOTH BECAUSE SHE THINKS LABOR SAVINGS WILL NOT BE AS GREAT AS EXPECTED (PARTIALLY BECAUSE THE JOINT APPLICANTS STATE THERE WILL BE NO INVOLUNTARY JOB LOSSES) AND BECAUSE SHE BELIEVES THERE IS A COST TO THE POSSIBILITY OF FEWER POSITIONS AT EMPIRE WITHIN THE STATE OF MISSOURI. (PAGE 28, 17 – PAGE 30, LINE 4) HOW DO YOU RESPOND TO THESE ISSUES?

A. Ms. Azad does not seem to know whether she is concerned about rates (which could arguably be lessened by a reduction of employees, if accomplished without an impact on safe and adequate service) or economic development (which might benefit from an increase in Missouri-based employees).

I must say that Empire gave both of these subjects some consideration in reaching the Agreement that is before the Commission. Part of the reason that this merger partner is right for Empire is that it offers both economies of scale and the opportunity for Missouri, and more specifically Joplin and the southwest part of the state, to benefit from a more substantial and regionally significant utility operation.

Q. WHAT HAS BEEN EMPIRE'S EXPERIENCE OVER THE LAST SEVERAL YEARS IN REGARD TO EMPLOYMENT?

A. Empire's employment levels have remained relatively constant at a level of about 750 employees for several years. We typically have very low turnover with most of it happening due to retirement. As of July 1, we have had approximately 35 employees announce their departure during 2016. About 30 of those are retirements.

Q. AS A STAND-ALONE COMPANY, HAS THERE BEEN MUCH OPPORTUNITY FOR EMPIRE TO GROW ITS WORK FORCE IN SOUTHWEST MISSOURI OVER THE LAST SEVERAL YEARS?

A. No. As the Commission is aware, we have had numerous rate cases resulting from required capital investments. Knowing that rates have needed to increase due to investments in environmental controls, we have attempted to control costs including not adding additional employees.

Q. DOES THE PROPOSED TRANSACTION CHANGE THAT SITUATION?

A. Potentially. As we look at the broader Liberty Utilities and Algonquin operations, it is probable that we will provide some services from Joplin for these other operations. We are working to identify those specific services in the transition process that is currently underway.

Q. HAVE THE JOINT APPLICANTS MADE ANY FURTHER COMMITMENTS THAT EXHIBIT THIS FOCUS ON JOPLIN AND SOUTHWEST MISSOURI?

A. Yes. On July 19, 2016, the Joint Applicants filed a Stipulation and Agreement they executed with the City of Joplin. That Stipulation included a variety of commitments related to Empire's presence, the continued employment of persons, and corporate involvement in Joplin. These commitments should be more than sufficient to address the concerns that OPC witness Azad expresses in regard to Empire's employees and the economic impact the employees and the proposed transaction have on the State of Missouri.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

AFFIDAVIT

STATE OF MISSOURI)
) ss
COUNTY OF Jasper)

I, Brad P. Beecher, state that I am employed by The Empire District Electric Company as President and Chief Executive Officer; that the Surrebuttal Testimony attached hereto has been prepared by me or under my direction and supervision; and, that the answers to the questions posed therein are true to the best of my knowledge, information and belief.

Brad Beecher

Subscribed and sworn to before me this 1st day of August, 2016.

NOTARY PUBLIC
NOTARY SEAL
STATE OF MISSOURI

JANET L. HUNLEY
My Commission Expires
September 20, 2019
Jasper County
Commission #15243846

Janet L. Hunley
Notary Public

My Commission Expires:

September 20, 2019

SUR. SCHEDULE BPB-1

Expanding Deals, Shrinking Companies

After twenty years of consolidation, the industry looks distinctly different.

By Tom Flaherty and Owen Ward

The power and natural gas utilities industry in the U.S. was built by consolidation of a host of far-flung entities leading to the emergence of the very large holding companies of the 1920s and early 1930s. Though the large holding companies were dismembered shortly after this period, for decades companies followed their own paths of investment and growth to build the industry we recognize today.

But over the last twenty years, the power and gas sectors have experienced an upheaval in composition and ownership.

Consolidation reemerged as a means to grow scale and add strength and diversity and has reshaped these sectors, rendering them almost unrecognizable from what existed just two decades ago. And there does not appear to be any confluence of policy, market, or industry evolution that may constrain further shrinkage of the companies that exist today.

The few large companies continue to build an appetite to expand. The smallest of companies continue to offer tempting opportunities for roll-up.

Shifts in Consolidation Rationale

When industry consolidation really gained traction in the mid-1990s, most observers believed it was a natural consequence of a restructuring industry. State regulatory commissions and legislatures were tinkering with the design of the traditional integrated model to enable more competition.

A sister industry – telecom – had progressed in the 1980s through stages. From divestment to stand-alone business creation, to line of business expansion, to roll-up and reconsolidation in the early 1990s.

The 1982 announced break-up of AT&T signaled a new era for telecom with a focus to technology deployment, product development, and price and value-based marketing. It also shook utility industry foundations, which had been thought to be largely locally-controlled rather than endangered by Federal level policies.

While the utility sector had experienced a modest degree of consolidation in the 1980s and 1990s, the traditional sector of almost a hundred individual power companies and fifty-plus local gas distribution companies, LDCs, was largely unaffected. But utilities were facing an uncertain restructuring of the long-standing integrated model, to forms where no experience existed. A blueprint from which to navigate was not available, even internationally.

Today the focus has returned to building scale, as well as enhancing market access, financial stability, asset portfolio mix, and customer scale.

There was a growing realization that unbundling would create new, but smaller business units that required scale to succeed. And that an anticipated ubiquitous competitive environment would place a premium on retail capabilities, funding, and talent not possessed by the industry.

Combined, these challenges presented threats to which the utilities had few answers. And which were only exacerbated when it was rumored that other non-industry competitors – such as from oil and gas, telecom, and retail – were taking an interest in this unbundled industry.

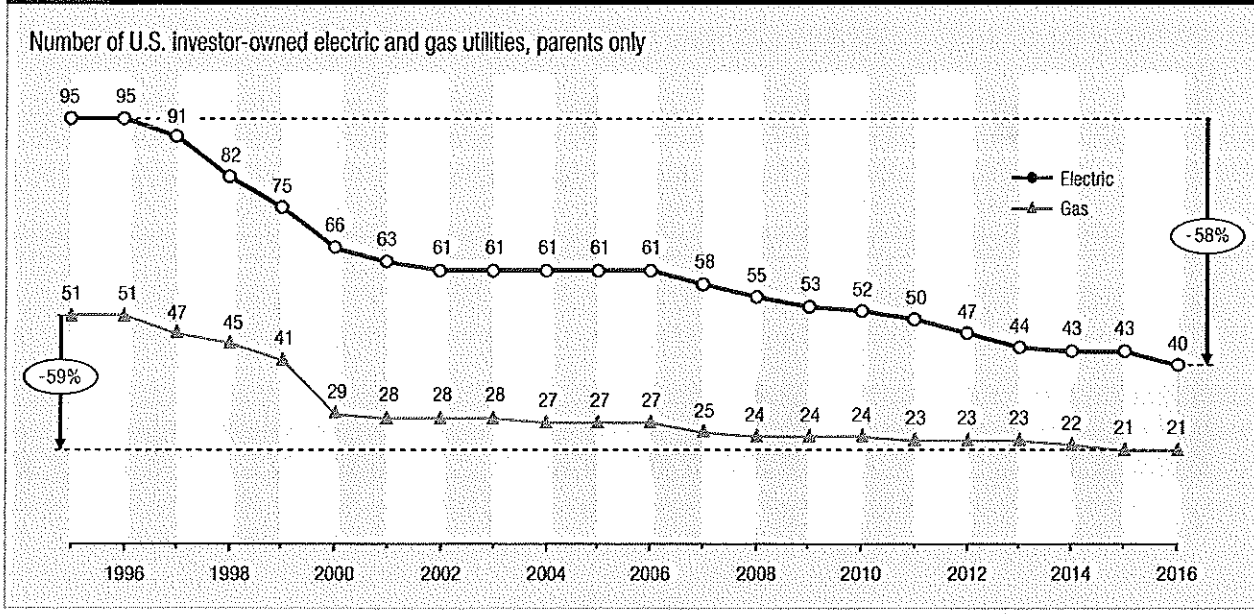
Consequently, the industry turned to consolidation as an option to preserve its independence. And from 1995 through today the industry has not stopped consolidating with a slow, but steady decline in the number of stand-alone power and gas utilities. See Figure 1.

In the last twenty years, the power utilities sector and the number of stand-alone LDCs have both shrunk by more than half. As the power utilities sector began its slow crawl toward consolidation in the late 1990s, observers began to wonder just how far this restructuring stage would go. And how long it would last.

One very visible observer coined the phrase "50 in 5." It became a mantra for a substantially smaller industry in a very short time. The estimate may not have been realized as stated. But the direction of this prediction was never in doubt.

Tom Flaherty is a partner with Strategy& – a part of the PwC network – who has focused on utility growth strategy, mergers and acquisitions (M&A), and business transformation for over forty years. He has been involved with approximately eighty percent of utility M&A stock transactions greater than a billion dollars in the U.S., and supported clients in Great Britain, Italy, Spain, France, Argentina, Venezuela, Australia, and Canada in consolidation or carve-out assignments. He has also provided expert testimony in more than thirty jurisdictions on utility combinations and benefits. **Owen Ward**, a director at Strategy&, has worked on numerous utility M&A and corporate strategy and growth assignments and contributed to this article.

FIG. 1 THE SHRINKING FACTOR

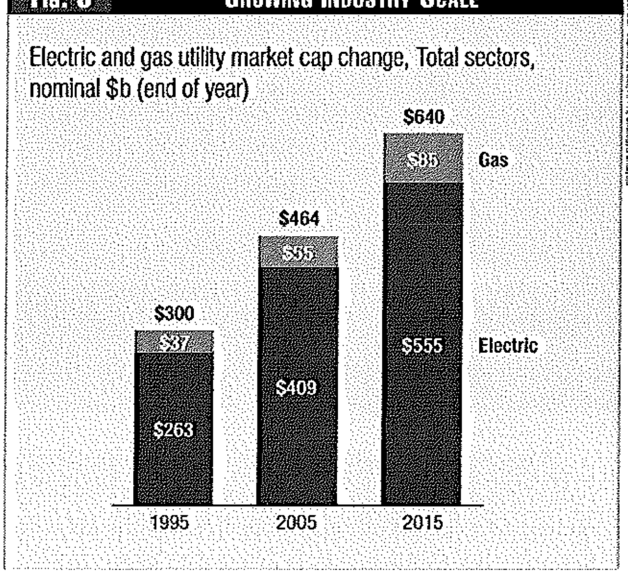


Source: S&P Capital IQ, EEI, APPA, Strategy& analysis

FIG. 2 CONSOLIDATION RATIONALE

	~1995 – 1999	~2000 – 2004	~2005 – 2009	~2010 – 2015
Era	**'Competitiveness and Convergence'**	**'Rationalization and Roll-up'**	**'Reengagement and Opportunism'**	**'Fortification and Positioning'**
Key Drivers	■ Deregulation ■ Value Chain ■ Prioritization	■ Recession ■ Back-to-Basics ■ Private equity	■ Business models ■ Infrastructure build ■ Liquidity challenges	■ Valuation gaps ■ Portfolio mix ■ Cost curve
Attributes	■ Proximate territories ■ Control premiums ■ Extended approvals	■ Non-regulated realignment ■ Cash generation focus ■ Asset value harvesting	■ Step-out transactions ■ Market presence 'footprint' ■ Regulatory aggressiveness	■ Regional alignment ■ Scale and strength focus ■ Capabilities leverage

FIG. 3 GROWING INDUSTRY SCALE



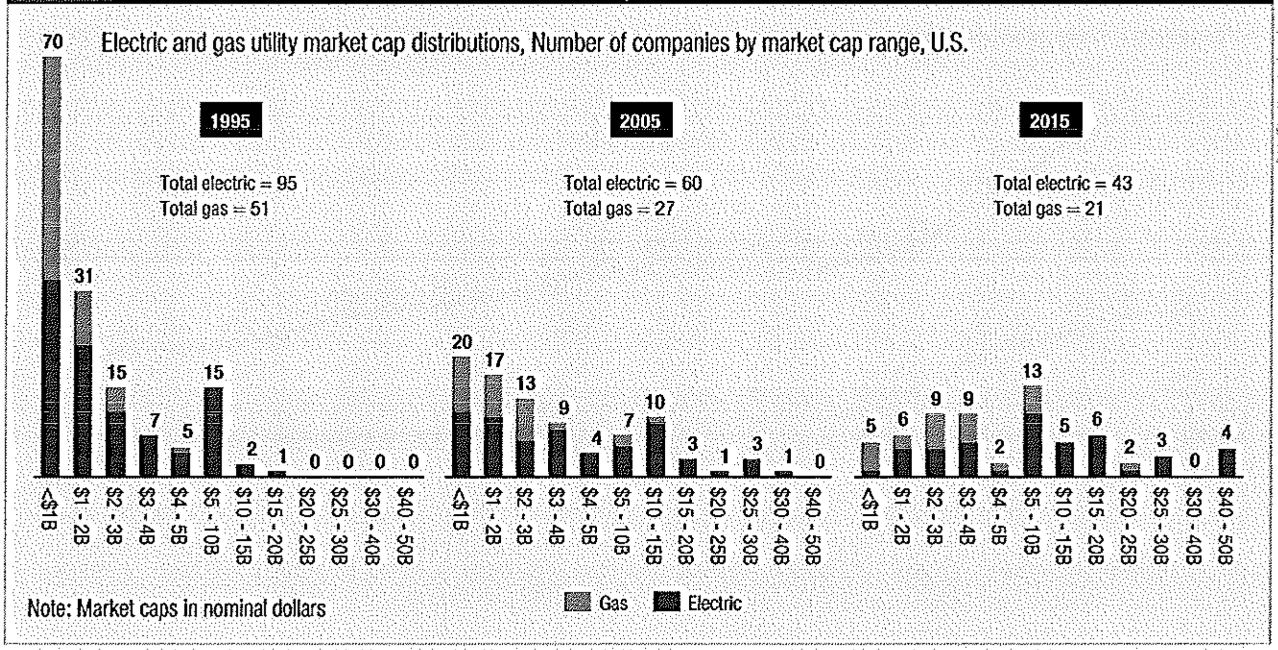
Source: S&P Capital IQ, EEI, APPA, Strategy& analysis

Over two decades, the utilities industry consolidated in waves, with 1995 and 1999 being watershed years. Each wave of consolidation reflected different drivers given market conditions at the time. In the early eras, the focus was on survival and preserving a future with convergence between power and gas, to increase customer ownership and scale emerging as a table stake for retail competitiveness.

Later, the focus shifted to opportunism, particularly after the demise of the merchant power sector that many companies entered to only find their financial strength sapped and vulnerability increased. Today the focus has returned to building scale, as well as enhancing market access, financial stability, asset portfolio mix, and customer scale. See Figure 2.

Continued consolidation can be expected and several pending deal approvals exist in mid-2016. But the drivers for further shrinkage will differ as the power and LDC sectors progress through their respective stages of maturity toward different »

FIG. 4 SHRINKING, BUT LARGER



futures, including an emerging return to convergence between the power and gas sectors.

Scale at a Different Level

Sustained industry consolidation, coupled with changes in capital investment levels over time, has dramatically reshaped the value of the utilities power and LDC sectors. During the 1995 – 2015 timeframe, the industry experienced unprecedented growth from generation additions, transmission build-out, and network modernization, with power sector capital spend topping a hundred billion dollars in 2015. Absent any consolidation, the scale of the sectors was naturally going to expand from normal organic initiatives.

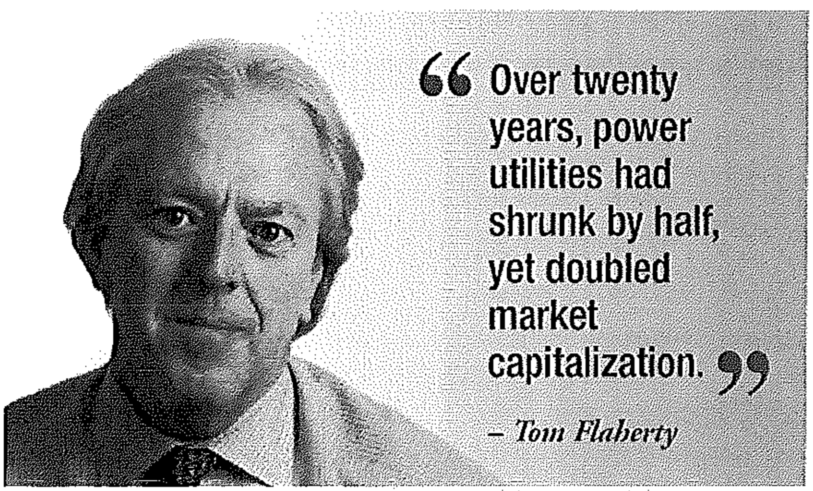
However, power and LDC utilities have substantially expanded their market capitalization over this period to levels considered unattainable not that many years ago. See Figure 3.

Total industry market capitalization for power utilities has grown from $263 billion in 1995 to $555 billion in 2015 (in nominal dollars). And this is after substantial loss of market value that occurred during the merchant meltdown of the early 2000's.

The LDC sector experienced a similar pattern growing from $37 billion in 1995 to $85 billion in 2015, despite carving-out several entities into master limited partnerships or private company acquisitions over this period. This continued valuation expansion over time reflects relative stability within the sector and attractive dividend policy maintained over the years.

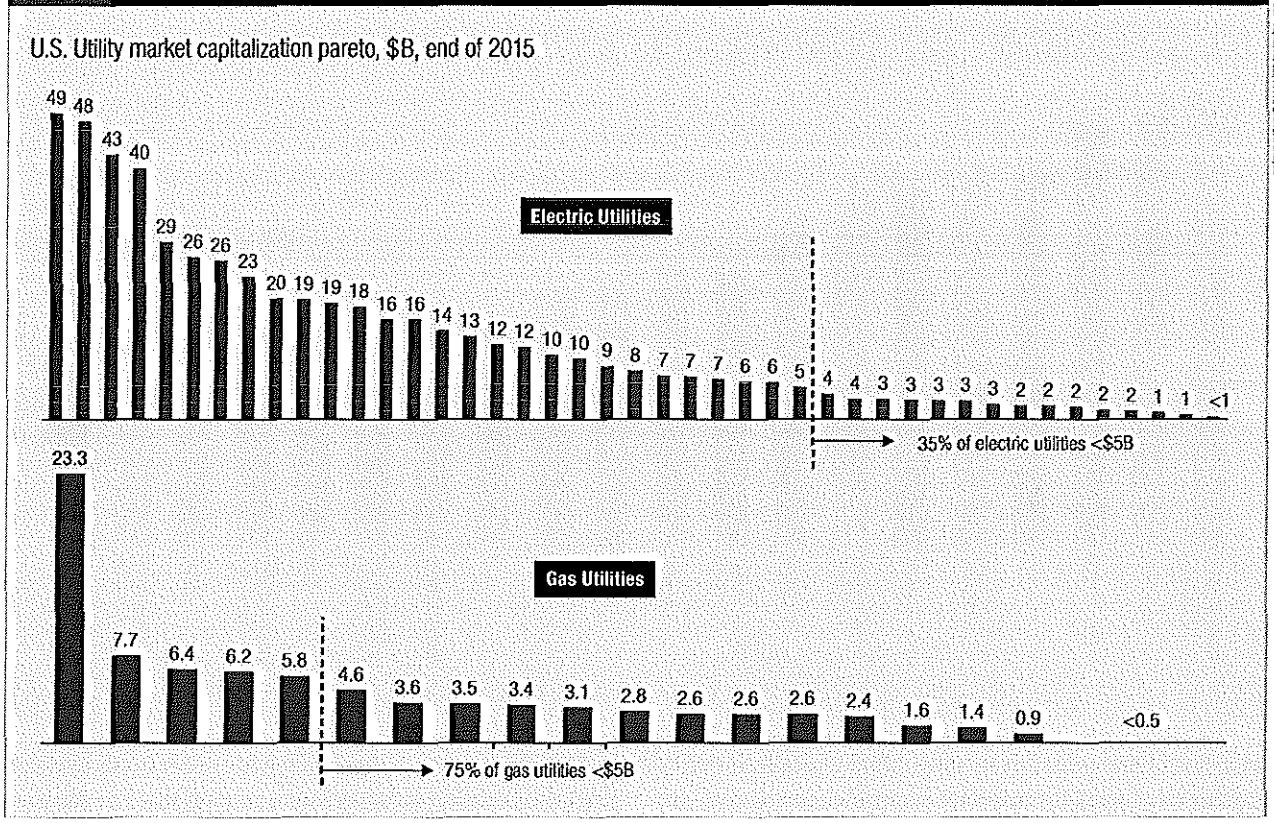
These factors sent positive signals about sector risk to investors. Sustained attractive earnings growth of four to six percent (and even higher for some companies), and yields of approximately four percent, round out a relatively lower risk source of investment.

This figure tells a remarkable story about these sectors. Market capitalization has grown by more than a hundred and ten percent for power and a hundred and thirty percent for LDCs even as some companies have gone private, been acquired by international utilities, or carved-out dimensions of their businesses like merchant power.



This has occurred during a period of declining returns on equity, due to lower debt costs and formulaic models for determining market costs of equity (that do not adequately capture business risk). Combine this outcome with lower than earned »

FIG. 5 **INDUSTRY SCALE DISTRIBUTION**



Source: S&P Capital IQ, EEI, APPA, [illegible] analysis

allowed returns – both of which can give investors pause about sector investment – and the industry has created a stable growth engine that investors can embrace.

With this increased scale and continued capital spend growth, it is likely that market capitalizations will continue to grow. However, current industry pressures, like bonus depreciation, may dampen the rate of growth. And investor sentiment shifts observed early in 2016 can impact short-term expectations and positions.

The power sector will almost certainly quickly consolidate itself to less than forty stand-alone publicly-traded companies in the U.S. in the next several years, and the LDC sector to less than twenty. Though it is unclear where this inexorable march toward industry rescaling will stop as a natural consequence of concentration equilibrium.

But the change in market capitalization over time has created some unexpected market nuances. The composition of the power and LDC sectors today is very dissimilar to that of 1995.

It is important to remember that both sectors have historically been highly fragmented in number and balkanized in footprint (dispersed without full contiguity). Beyond the pure numbers of remaining entities and their absolute scale, a different picture of relative industry structure has emerged. See Figure 4.

In the mid-1990s, the industry market capitalization for the power sector was approximately two hundred and sixty billion dollars, and the sector numbered just under a hundred companies. But the distribution of these companies illustrated a more even scale composition within the sector with a robust middle market.

By 2005, far fewer companies existed within the sector as some companies had merged up, some had restructured and lost market capitalization, and some had simply experienced adverse market outcomes or low growth.

By 2015, this picture had further changed with the scale of power utilities having reached its pinnacle to date and its lowest number of incumbents (prior to deals approved in 2016).

Thus over twenty years, power utilities had shrunk by half, yet doubled market capitalization.

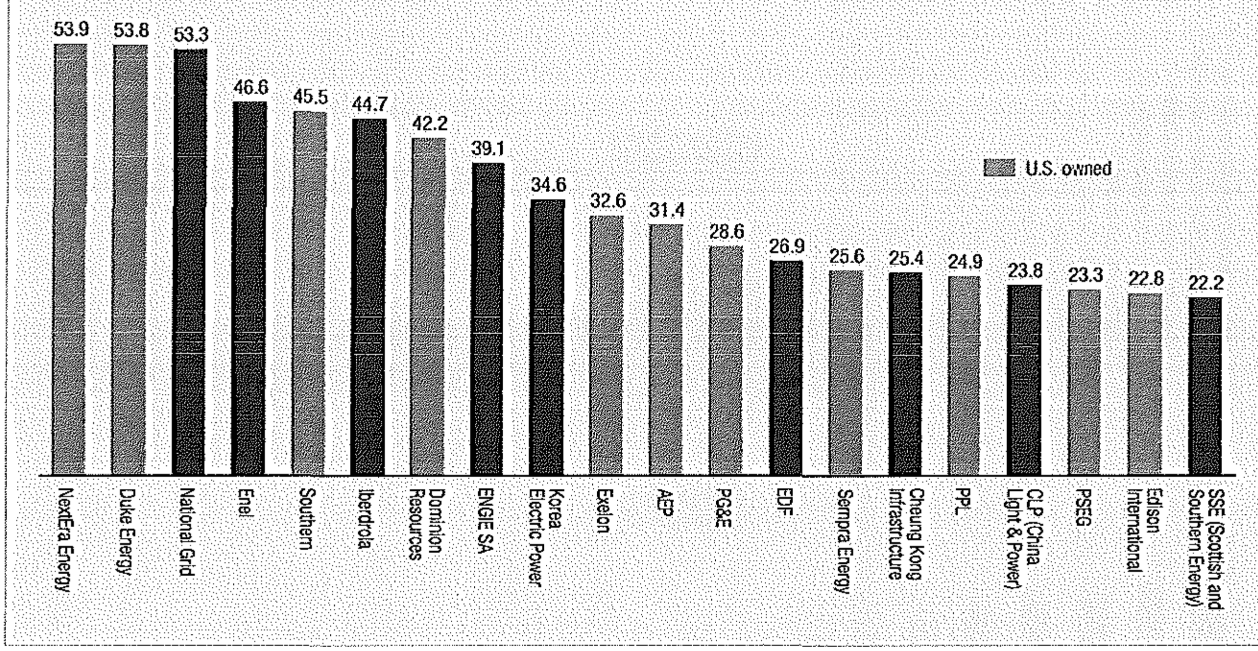
For the LDC sector, a similar pattern followed, though the scale of the sector is well below that of power utilities and the number of entities was never as large. In the mid-1990s the industry market capitalization for the LDC sector was approximately thirty-seven billion dollars and the sector numbered right at fifty-one companies.

But the distribution of these companies illustrated a more divergent scale composition within the sector. By 2015 this picture had further changed with only twenty-one LDCs remaining and the sector having shrunk by sixty percent in composition, yet also doubling market capitalization.

Yet how the power and LDC utilities sectors got to their respective positions varied greatly. The LDCs did not have the benefit of sustained capital expenditure programs over a diverse

Fig. 6 **Relative Global Scale**

Largest electric and gas utilities, Global, by market capitalization ($B), April 2016



Source: S&P Capital IQ, EEI, APPA, Strategy& analysis

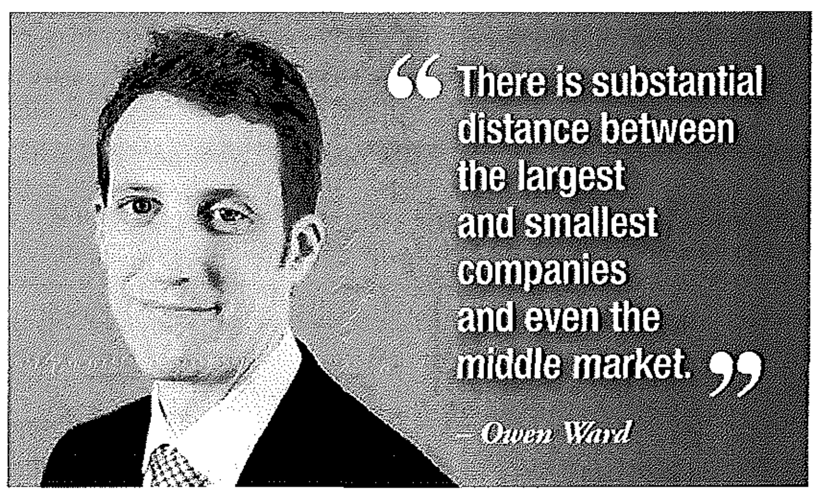
set of asset types until just recently. More typically, historical growth was fueled by customer extension, conversion, and territory growth.

In the last few years this growth has reflected large, multi-year capital programs directed at replacing old cast iron and steel mains. These programs total hundreds of millions and even billions by company given system age and asset condition.

A more obscure outcome of this consolidation and market capitalization has been the resulting industry composition in both the power and LDC utilities sectors. In the power sector approximately thirty-five percent of the total industry has a market capitalization of less than five billion dollars, covering fifteen companies. In gas, the number of entities less than five billion dollars is sixteen, or seventy-five percent of the sector. See Figure 5.

This outcome is creating an effect where there is substantial distance between the largest and smallest companies and even the middle market. There are still a number of mid-caps in the power sector. But many of the original companies have disappeared as the sectors have redefined themselves into a few very large-scale multi-state entities with several companies close to ten million customers and a bulge of smaller rural entities with less than two hundred thousand customers. For LDCs, the market is essentially comprised of small market caps.

This phenomenon brings a telling perspective to these sectors given the historical industry fragmentation that has occurred and the dispersion of these companies from both scale and location perspectives:



- First, the scale of the top-end of the industry suggests that a number of these companies may not be as able to successfully compete as may be required.
- Second, many of these companies may remain untouched by consolidation given their location and or low level of growth.
- Third, those companies with meaningful scale and a willingness to sell may find a robust buyer's market of all types given the results of recent auctions.

(Cont. on page 78)

Expanding Deals, Shrinking Companies

(Cont. from p. 15)

■ Finally, all but one of the LDCs is still small relative to their counterparts in the power sector. Thus, the wave of consolidation has not crested in either sector and opportunities abound to incumbent utilities, financial sponsors and international acquirors.

The New Super Competitors

The decades long expansion of utilities market capitalization not only impacts how the industry has been transformed within the U.S., it also changes how the U.S. industry compares to foreign utilities. In 2005, only five utilities within the U.S. were large enough to claim a spot among the top twenty utilities in the world. Most European companies and some Asian utilities were well above the scale of the largest U.S. entities.

But by 2010, this relative positioning had changed. And in 2015, eleven U.S. utilities were within the top twenty global utilities ranking and the sector maintained a significant proportion of the top of the list. See Figure 6.

While U.S. companies are no longer pursuing international acquisitions and foreign asset ownership, this scale positioning creates advantages in other ways. The largest U.S. companies now command even greater prestige among the international community of utilities.

In addition, the U.S. utilities have the financial capacity to consider larger and broader capital programs in adjacent areas, such as pipelines and liquefied natural gas, in areas where foreign competitors or sovereign funds may have been sponsors in the past. And U.S. utilities also have the balance sheet strength to compete with foreign acquirors that venture into the U.S., to establish a beachhead through acquisition of companies strategically important to existing incumbents.

As of early 2016, ten U.S. power utilities exceeded twenty billion dollars in market capitalization, with several at or above fifty billion dollars. With this heavy distribution of companies typifying this sector, those largest companies have the financial firepower to pursue further large consolidation opportunities, including very large scale options.

Several of these entities also have some degree of business diversity that provides a hedge against segment volatility or unfavorability.

This level of scale also provides the cash flows that sustain future core business growth. It will be in future baseload generation, expanded transmission interconnection and renewal, accelerated system replacement or modernization, and entry by acquisition or investment into broader business segments like pipelines, storage and beyond-the meter related businesses.

Largest companies have financial firepower to pursue further large consolidation opportunities, including very large scale options.

Since 1995, both the power and LDC utility segments have sharply grown. And they have become more concentrated at the large and small scales of the spectrums.

An almost doubling of market capitalization scale has enabled these sectors to build sustainable growth platforms, with a number of companies having completed multiple acquisitions. With this scale-based distribution in place, the industry can anticipate growth in the number of fifty billion dollar market capitalization companies, some shake-out among the ten to twenty billion dollar companies, and contraction among those companies with less than five billion dollars in scale.

As we have learned over the last twenty years, scale will continue to matter in the future as the U.S. industry marches further toward further concentration. While we can't foresee what optimum level of industry concentration may emerge, we can anticipate that the historical catalysts of the past two decades will continue and be joined by others yet to be conceived. ■

Notable State Orders

(Cont. from p. 71)

to testimony by the utility, that the payment of dividends lowered the equity component of the utility's capital structure. This effectively reduced the impact that higher equity costs have on base rates.

As in the asset decision making process, the commission refrained from inserting itself in the decision-making process as regards the allocation of earnings between investment and shareholder payouts. But the commission did put the company on notice that certain events will receive considerable attention, especially in cases where asset management concerns are front and center.

Re Indianapolis Power & Light Company, Cause Nos. 44576, 44602, March 16, 2016 (Ind.U.R.C.). ■