

THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

BEFORE COMMISSIONERS: MICHAEL LENNEN, CHAIRMAN
RICHARD C. (PETE) LOUX
PHILLIP R. DICK

IN THE MATTER OF THE JOINT APPLICATION)
OF THE KANSAS POWER AND LIGHT COMPANY)
AND THE GAS SERVICE COMPANY FOR A) DOCKET No.
CERTIFICATE AUTHORIZING THE KANSAS) 138,495-U
POWER AND LIGHT COMPANY TO ISSUE)
PROMISSORY NOTES AND FOR AN ORDER)
AUTHORIZING THE KANSAS POWER AND LIGHT)
COMPANY TO ACQUIRE ALL OF THE COMMON)
STOCK OF THE GAS SERVICE COMPANY.)

JOINT SUBMISSION BY KPL AND GAS SERVICE
PURSUANT TO ORDER OF SEPTEMBER 20, 1983

ON SEPTEMBER 20, 1983, THE STATE CORPORATION COMMISSION OF THE STATE OF KANSAS, UPON THE JOINT APPLICATION OF THE KANSAS POWER AND LIGHT COMPANY ("KPL") AND THE GAS SERVICE COMPANY ("GAS SERVICE"), AUTHORIZED THE ACQUISITION BY KPL OF THE COMMON STOCK OF GAS SERVICE FOR \$16.00 CASH PER SHARE. IN THAT ORDER, THE COMMISSION DIRECTED KPL AND GAS SERVICE TO PROVIDE, WITHIN ONE HUNDRED TWENTY (120) DAYS OF THE TRANSACTION'S CLOSING, A LEGAL ANALYSIS OF WHETHER THE COMMISSION SHOULD CONSIDER ADJUSTING THE RATE BASE OF GAS SERVICE TO REFLECT THE PURCHASE PRICE OF GAS SERVICE COMMON STOCK. THE CLOSING DATE OF THE TRANSACTION WAS DECEMBER 28, 1983. KPL AND GAS SERVICE HEREWITH SUBMIT THIS LEGAL ANALYSIS IN COMPLIANCE WITH THE COMMISSION'S ORDER.

I. INTRODUCTION

KPL ACQUIRED GAS SERVICE STOCK IN A TWO-STEP CORPORATE PROCEDURE. FIRST, KPL PURCHASED THE STOCK TENDERED BY GAS SERVICE SHAREHOLDERS PURSUANT TO KPL'S TENDER OFFER. SECOND, TO OBTAIN THE REMAINING GAS SERVICE SHARES, KPL MERGED INTO GAS SERVICE A NEWLY-FORMED, WHOLLY-OWNED SUBSIDIARY OF KPL, KP&L ACQUISITION CORP. KPL THEREBY BECAME THE OWNER OF 100% OF THE OUTSTANDING GAS SERVICE COMMON STOCK. ALL GAS SERVICE SHAREHOLDERS RECEIVED \$16.00 PER SHARE. THE TRANSFER OF COMMON STOCK OWNERSHIP WAS EFFECTED AT APPROXIMATELY 89% OF NET BOOK VALUE.

~~GAS SERVICE WAS THE SURVIVING CORPORATION OF THE MERGER WITH~~
~~KPL ACQUISITION CORP.~~, AND IS NOW OPERATED AS A WHOLLY-OWNED
SUBSIDIARY OF KPL. THE ACQUISITION HAS NOT CHANGED THE CAPITAL
STRUCTURE OF GAS SERVICE. BECAUSE GAS SERVICE IS THE SURVIVING
CORPORATION, ALL OF ITS CORPORATE RIGHTS, POWERS, PRIVILEGES, AND
FRANCHISES REMAIN UNDISTURBED. THE CERTIFICATES OF CONVENIENCE
AND NECESSITY GRANTED TO GAS SERVICE BY THE COMMISSION AND ALL
THE COMMISSION'S ORDERS PERTAINING TO GAS SERVICE REMAIN IN FULL
FORCE AND EFFECT. ALL OF GAS SERVICE'S CONTRACTUAL RIGHTS AND
LIABILITIES CONTINUE.

II. A STOCK PURCHASE CANNOT AFFECT VALUATION OF THE RATE BASE
BECAUSE THERE IS NO TRANSFER OF UTILITY PROPERTY X

THE COMMISSION HAS THE "DUTY TO ASCERTAIN THE REASONABLE
VALUE OF ALL PROPERTY OF ANY [REGULATED PUBLIC UTILITY] WHENEVER
IT DEEMS THE ASCERTAINMENT OF SUCH VALUE NECESSARY IN ORDER TO
ENABLE THE COMMISSION TO FIX FAIR AND REASONABLE RATES...."
K.S.A. 66-128. THE RATE BASE OF A PUBLIC UTILITY REPRESENTS THE
REASONABLE VALUE OF ALL PROPERTY WHICH IS IN SERVICE AND DEVOTED
TO THE PUBLIC USE. SOUTHWESTERN BELL TELEPHONE CO. V. KANSAS
STATE CORPORATION COMMISSION, 192 KAN. 39, 386 P.2D 515 (1963).¹
BECAUSE THE VALUE OF THE CORPORATION'S PROPERTY REMAINS UNCHANGED
AS THE CORPORATION'S STOCK IS BOUGHT AND SOLD, THE TRANSFER OF A
UTILITY'S STOCK, THE INDICIA OF OWNERSHIP IN A CORPORATE ENTITY
WHOSE STOCKHOLDERS ARE SEPARATE AND DISTINCT FROM THE ENTITY IT-
SELF, DOES NOT AFFECT THE VALUE OF ITS PROPERTY IN SERVICE AND
DEVOTED TO THE PUBLIC USE. THUS, NO RECALCULATION OF THE UTILI-
TY'S PROPERTY, OR RATE BASE, IS APPROPRIATE.

THE CURRENT RATE BASE OF GAS SERVICE IS DERIVED FROM THE
ORIGINAL COST OF THE PROPERTY WHEN FIRST DEDICATED TO PUBLIC

¹THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT TO THE
U.S. CONSTITUTION REQUIRES REGULATORS TO FIX RATES THAT AS A
MINIMUM "ENABLE THE COMPANY TO OPERATE SUCCESSFULLY, TO MAINTAIN
ITS FINANCIAL INTEGRITY, TO ATTRACT CAPITAL, AND TO COMPENSATE
ITS INVESTORS FOR THE RISKS ASSUMED...." FEDERAL POWER COMMISSION
V. HOPE NATURAL GAS CO., 320 U.S. 591, 605 (1944).

USE. THE PURCHASE OF ITS STOCK DOES NOT AFFECT ORIGINAL COST. A NEW STOCKHOLDER DOES NOT PURCHASE THE ASSETS OF THE CORPORATION. NOR DOES A CHANGE IN, OR SUBSTITUTION OF STOCKHOLDERS ESTABLISH A NEW BUSINESS ENTITY. TRANSFER OF OWNERSHIP OF COMMON STOCK DOES NOT AFFECT THE OWNERSHIP OF THE CORPORATION'S PROPERTY, WHICH STILL BELONGS TO THE CORPORATION.²

IN A STOCK TRANSFER, NO ASSETS ARE REMOVED FROM PUBLIC SERVICE OR TRANSFERRED TO ANOTHER BUSINESS ENTITY. THE SAME ASSETS WILL CONTINUE TO BE USED TO PROVIDE THE SAME SERVICES TO THE SAME RATEPAYERS AND THE ASSETS WILL REMAIN SUBJECT TO THE SAME RATE-MAKING JURISDICTION OF THE SAME REGULATORS. THIS CONTINUITY MAKES A RECALCULATION OF GAS SERVICE'S RATE BASE INCONGRUOUS.

ASIDE FROM THE LEGAL ISSUES RAISED BY THE COMMISSION'S INQUIRY, REVALUATION OF UTILITY PLANT MEASURED BY THE PRICE PAID FOR COMMON STOCK WOULD PRODUCE PRACTICAL DIFFICULTIES OF POTENTIALLY SIGNIFICANT DIMENSIONS. REVALUATION, WHETHER ON A STOCK ACQUISITION OR PURCHASE OF UTILITY ASSETS, ~~WOULD~~ ULTIMATELY TEND TOWARD HIGHER COSTS TO CONSUMERS, SINCE IT WOULD PROVIDE NO INCENTIVE TO MAKE ACQUISITIONS AT LESS THEN BOOK VALUE. IF IT IS APPROPRIATE TO WRITE DOWN RATE BASE WHEN STOCK IS PURCHASED BELOW BOOK VALUE, IT WOULD BE EQUALLY CORRECT TO WRITE UP RATE BASE WHEN THE STOCK IS ACQUIRED AT A PREMIUM. THIS PROBLEM WILL BE EXPANDED ON IN THE DISCUSSION THAT FOLLOWS

IT SHOULD BE BORNE IN MIND THAT, EXCEPT FOR THE MAGNITUDE OF THE TRANSACTION, KPL'S ACQUISITION OF GAS SERVICE'S OUTSTANDING COMMON STOCK IS NO DIFFERENT IN KIND FROM DAY TO DAY TRADING BY SMALLER INVESTORS. THE PRICE IS, IN BOTH INSTANCES, BASED ON AN EVALUATION OF THE EARNING POWER OF THE ASSETS OF THE UTILITY AS

²CF. RE ROCHESTER GAS & ELECTRIC CORP., 41 PUB. UTIL. REP. (PUR) 4TH 463 (N.Y. P.S.C. 1981) (ASSETS OF MERGED UTILITY VALUED AT BOOK VALUE BEFORE MERGER RATHER THAN MUCH LOWER MARKET VALUE OF STOCK RECEIVED IN EXCHANGE); RE COMMONWEALTH EDISON CO., 66 PUB. UTIL. REP. (PUR) 3D 417 (F.P.C. 1966) (ASSETS OF MERGED UTILITY ACCOUNTED FOR AT BOOK RATHER THAN HIGHER PURCHASE PRICE).

THOSE ASSETS ARE EMPLOYED AND TREATED FOR RATEMAKING PURPOSES. THIS INVESTOR EVALUATION BECOMES NOT ONLY FRUITLESS, BUT COUNTER-PRODUCTIVE IF IT IS USED AFTER THE FACT TO REVALUE THE RATE BASE UPON WHICH A FAIR RATE OF RETURN IS DETERMINED.

THE FACTS OF THIS CASE ARE VERY SIMILAR TO THOSE OF IN RE TOWNE HILL WATER CO., 422 A.2D 927 (VT. 1980). THERE ALL OF THE STOCK OF A UTILITY WAS ACQUIRED BY A SOLE STOCKHOLDER FOR \$27,025, SUBSTANTIALLY LESS THAN THE NET ORIGINAL COST OF THE PLANT AND EQUIPMENT OF \$41,194. UPON THE UTILITY'S REQUEST FOR A RATE INCREASE, THE PUBLIC SERVICE BOARD DETERMINED THAT THE AMOUNT OF THE STOCKHOLDER'S INVESTMENT WAS INDICATIVE OF THE VALUE OF THE PROPERTY DEVOTED TO PUBLIC SERVICE AND RECALCULATED THE RATE BASE TAKING INTO ACCOUNT THE PURCHASE PRICE OF THE STOCK. ON APPEAL, THE VERMONT SUPREME COURT REVERSED, HOLDING THAT CONSIDERATION OF THE STOCK'S PURCHASE PRICE WAS IMPROPER. THE COURT REJECTED THE BOARD'S CONCLUSION THAT THE PURCHASE PRICE OF THE UTILITY'S STOCK REFLECTED THE VALUE OF THE UTILITY'S PROPERTY. ~~THE COURT DECLINED TO TREAT THE PURCHASE OF STOCK AS A PURCHASE OF PROPERTY.~~

THE BOARD'S FINDING THAT THE STOCKHOLDER'S INVESTMENT IN THE COMPANY WAS LESS THAN THE HISTORIC COST IS NOT GERMANE TO THE DETERMINATION OF A RATE BASE. THE PROPERTY IN QUESTION WAS NOT ACQUIRED [AT THE TIME OF THE STOCK TRANSFER]. ORIGINAL ACQUISITION AND DEVOTION TO PUBLIC USE IS THE TIME OF "INVESTMENT" IN THAT PROPERTY. THE STOCKHOLDER PURCHASED STOCK EXPECTING A REASONABLE RETURN ON THAT INVESTMENT, NO MORE AND NO LESS. WHETHER HE PURCHASED THE STOCK AT A DISCOUNT OR AT A PREMIUM IS IRRELEVANT.

Id. AT 929. THE COURT WAS NOT CONVINCED BY THE BOARD'S CONTENTION THAT THE NET ORIGINAL COST RATE BASE VALUATION WOULD ALLOW THE WATER COMPANY A WINDFALL. IT REASONED THAT THE RATE BASE IS ONLY ONE VARIABLE: "IT IS SIMPLY IMPOSSIBLE TO MEASURE WHETHER A GIVEN RATE OF RETURN IS REASONABLE OR UNREASONABLE WHOLLY WITHOUT REFERENCE TO A RATE BASE." Id.

111. EVEN IF STOCK PURCHASE COULD BE EQUATED WITH ASSET PURCHASE, RATE BASE SHOULD REPRESENT ORIGINAL COST WHEN ASSETS FIRST DEDICATED TO PUBLIC SERVICE BY GAS SERVICE

EVEN IF THE NATURE OF THIS TRANSACTION COULD BE DISREGARDED AND TREATED AS A PURCHASE OF THE ASSETS OF GAS SERVICE, THERE SHOULD BE NO CHANGE IN THE RATE BASE IN RECOGNITION OF THE GENERAL RULE THAT THE RATE BASE REPRESENTS THE ORIGINAL COST OF UTILITY PROPERTY WHEN DEDICATED TO PUBLIC USE REGARDLESS OF THE PRICE AT WHICH IT IS PURCHASED BY ANOTHER UTILITY. SEE RE SOUTHWESTERN BELL TELEPHONE CO., 19 PUB. UTIL. REP. (PUR) 4TH 1, 11 (KAN. S.C.C. 1977). ACCORD MONTANA POWER CO. V. FERC, 599 F.2D 295 (9TH CIR. 1979); RE UTAH POWER AND LIGHT CO., 53 PUB. UTIL. REP. (PUR) 4TH 461, 469 (UTAH P.S.C. 1983); RE DAVENPORT WATER CO., 76 PUB. UTIL. REP. (PUR) 3D 209, 217 (IA. S.C.C. 1968).

IN KANSAS THE RATE BASE IS NOT RECALCULATED EVEN WHEN THE ASSETS ARE PURCHASED AT LESS THAN THE ORIGINAL COST. IN RE SOUTHWESTERN BELL TELEPHONE CO., THIS COMMISSION DETERMINED THAT THE REASONABLE VALUE OF PROPERTY PURCHASED FROM OTHER UTILITIES WAS NOT ITS PURCHASE PRICE BUT RATHER THE HIGHER ORIGINAL COST TO THE FIRST ENTITY WHICH DEVOTED THE PROPERTY TO PUBLIC SERVICE. 19 PUB. UTIL. REP. (PUR) 4TH AT 11. THE COMMISSION ACCEPTED STAFF'S PROPOSED ADJUSTMENT TO INCREASE THE UTILITY'S RATE BASE FROM THE PURCHASE PRICE OF PROPERTY ALREADY DEVOTED TO PUBLIC SERVICE TO ITS ORIGINAL COST WHEN FIRST DEVOTED TO PUBLIC SERVICE. THE COMMISSION CONSIDERED THE INCREASE TO BE "A TRADITIONAL ADJUSTMENT WHICH RECOGNIZES FOR RATE-MAKING PURPOSES THAT THE RATE BASE SHOULD BE THE ORIGINAL COST OF PLANT WHEN DEDICATED TO PUBLIC USE REGARDLESS OF PRICE AT A SUBSEQUENT SALE." ID. ACCORD, PROVIDENCE GAS CO. V. BURMAN, 376 A.2D 687 (R.I. 1977) (PROPERTY INCLUDIBLE IN RATE BASE AT BOOK VALUE, NOT LOWER PURCHASE PRICE).

THIS CARRYOVER OF BOOK VALUE IS AN APPROPRIATE VALUATION METHOD BECAUSE ORIGINAL COST IS AN APPROPRIATE DETERMINANT OF REASONABLE VALUE, AND BECAUSE THE PURCHASE PRICE OF GAS SERVICE'S

STOCK DOES NOT ACCURATELY REFLECT THE VALUE OF ITS ASSETS. FIRST, EVEN ASSUMING THAT THE PURCHASE PRICE OF GAS SERVICE'S ~~STOCK ACCURATELY REFLECTED THE MARKET VALUE OF ITS ASSETS~~ THERE IS NO SOUND REASON FOR DEVIATING FROM THE ORIGINAL-COST OR BOOK VALUE METHODOLOGY ADOPTED OR GIVEN GREAT WEIGHT IN KANSAS AND MOST OTHER JURISDICTIONS. SEE, E.G., FEDERAL POWER COMMISSION V. HOPE NATURAL GAS CO., 320 U.S. 591 (1944); RE SOUTHERN BELL TELEPHONE & TELEGRAPH CO., 30 PUB. UTIL. REP. (PUR) 4TH 261 (S.C. 1979); RE NEW YORK TELEPHONE CO., 84 PUB. UTIL. REP. (PUR) 3D 321 (N.Y. 1970); RE PACIFIC TELEPHONE & TELEGRAPH CO., 53 PUB. UTIL. REP. (PUR) 513 (CAL. 1964); SOUTHWESTERN BELL TELEPHONE CO. V. KANSAS STATE CORPORATION COMMISSION, 192 KAN. 39, 386 P.2D 515 (1963). THE PRIMARY REASON FOR THE GENERAL PREFERENCE OF THE NET BOOK VALUE OVER MARKET VALUE IS THAT IT IS READILY ASCERTAINABLE WHILE MARKET VALUE IS MUCH MORE DIFFICULT TO COMPUTE. KANSAS PLACES GREAT VALUE ON THE ORIGINAL COST OF UTILITY PROPERTIES PRECISELY BECAUSE IT IS READILY ASCERTAINABLE. SEE, E.G., RE SOUTHWESTERN BELL TELEPHONE CO., 34 PUB. UTIL. REP. (PUR) 3D 257 (KAN. S.C.C. 1960), AFF'D, SOUTHWESTERN BELL TELEPHONE CO. V. KANSAS STATE CORPORATION COMMISSION, 192 KAN. 39, 386 P.2D 515 (1963); RE UNITED TELEPHONE CO. OF KANSAS, 27 PUB. UTIL. REP. (PUR) 3D 128 (KAN. S.C.C. 1958). BECAUSE THE MARKET VALUE OF ASSETS SELDOM CHANGES PRECISELY IN ACCORDANCE WITH DEPRECIATION, DEPRECIATED ORIGINAL COST IS OFTEN NOT AN ACCURATE PROXY OF CURRENT FAIR MARKET VALUE. NONETHELESS, ORIGINAL COST ACCOUNTING IS EMPLOYED TO AVOID THE DIFFICULTIES OF MORE SUBJECTIVE METHODS OF PROPERTY VALUATION. THE USE OF THE DEPRECIATED ORIGINAL COST VALUATION METHOD PROVIDES AN OBJECTIVE METHOD OF VALUATION WITHOUT THE NEED FOR INDEPENDENT ASSESSMENTS OF THE FAIR MARKET VALUE OF ACQUISITIONS. *

THE UNFORTUNATE RESULT OF UTILIZING PURCHASE PRICE IN THIS CASE WOULD BE TO ENCOURAGE THE FUTURE TRANSFER OF PROPERTIES AT A PREMIUM ABOVE ORIGINAL COST REGARDLESS OF FAIR MARKET VALUE. FOR

EXAMPLE, HAD KPL PAID ABOVE BOOK VALUE FOR GAS SERVICE'S STOCK, GAS SERVICE'S RATE BASE WOULD HAVE INCREASED, RESULTING IN GREATER COSTS TO CONSUMERS. ONE REASON FOR THE APPLICABILITY OF ORIGINAL COST CONCEPT TO ACQUISITIONS WAS TO PREVENT UTILITIES FROM ARTIFICIALLY INFLATING THEIR RATE BASES BY ACQUIRING PROPERTIES AT UNREALISTICALLY HIGH PRICES. SEE RE UNITED GAS PIPE LINE CO., 25 F.P.C. 26, 64 (1961). EXCEPTIONS TO ORIGINAL COST VALUATION WHERE THE PURCHASE PRICE OF ASSETS EXCEEDS NET BOOK VALUE GENERALLY REQUIRE A SHOWING THAT BENEFITS ACCRUE TO THE ACQUIRING PUBLIC UTILITY AND ITS RATEPAYERS SUFFICIENT TO JUSTIFY DEVIATION FROM ORIGINAL COST. SEE, E.G., MISSISSIPPI EX REL. ALLAIN V. MISSISSIPPI PUBLIC SERVICE COMMISSION; RE PUBLIC SERVICE CO. OF NORTH CAROLINA, 55 PUB. UTIL. REP. (PUR) 4TH 53 (NO. CARO. U.C. 1983); RE DAVENPORT WATER CO., 76 PUB. UTIL. REP. (PUR) 3D 209 (1A. S.C.C. 1968); RE MONMOUTH CONSOLIDATED WATER CO., 75 PUB. UTIL. REP. (PUR) 3D 225 (N.J.P.U.C. 1968).

SECOND, ~~THE~~ PURCHASE PRICE OF THE COMMON STOCK OF GAS SERVICE WAS A COMPOSITE OF MANY FACTORS, INCLUDING CREDIT WORTHINESS, MARKET VALUE, EARNINGS, SALES, MANAGEMENT, REPUTATION WITH REGULATORS AND THE PUBLIC, AND GENERAL BUSINESS PROSPECTS.³ IN THIS CASE, THE MARKET VALUE OF THE STOCK WAS INFLUENCED MORE BY THE POOR FINANCIAL RECORD OF GAS SERVICE THAN BY THE VALUE OF THE ASSETS DEVOTED TO PUBLIC USE. THE FACT THAT GAS SERVICE STOCK ONLY COMMANDED A PRICE LESS THAN NET BOOK VALUE

³IT IS UNIFORMLY RECOGNIZED THAT THE PURCHASE PRICE OF UTILITY PROPERTY DOES NOT REFLECT ITS MARKET VALUE. SEE E.G., STATE EX REL. SOUTHWESTERN BELL TELEPHONE CO. V. MISSOURI PUBLIC SERVICE COMMISSION, 262 U.S. 276, 292 (1923) (BRANDEIS, J., CONCURRING OPINION) ("IT IS IMPOSSIBLE TO FIND AN EXCHANGE VALUE FOR A UTILITY, SINCE UTILITIES, UNLIKE MERCHANDISE OR LAND, ARE NOT COMMONLY BOUGHT AND SOLD IN THE MARKET."); ARIZONA CORPORATION COMMISSION V. ARIZONA WATER CO., 335 P.2D 412 (ARIZ. 1959) (PUBLIC UTILITIES NOT ROUTINELY SOLD ON MARKET; MARKET VALUE DEPENDENT UPON REGULATED RATE OF RETURN; LARGE TAX SAVINGS FACTOR IN BELOW BOOK PURCHASE PRICE). SEE ALSO, TOWN OF JAMESTOWN V. KENNELLY, 100 A.2D 649 (R.I. 1953) (PURCHASE PRICE ONE FACTOR; PROPERTY'S FAIR VALUE EQUALLED 165% OF PURCHASE PRICE).

SHOULD NOT BAR KPL FROM THE RIGHT TO A REASONABLE RETURN ON THE FAIR VALUE OF THE UNDERLYING PROPERTY.

IV. DEVALUATION OF GAS SERVICE RATE BASE TO REFLECT CURRENT STOCK VALUE CONSTITUTES UNCONSTITUTIONAL TAKING

PARTICULARLY IN A REGULATED INDUSTRY THERE IS THE ADDITIONAL PROBLEM OF THE INTERDEPENDENCE BETWEEN RATES AND MARKET VALUE. SPECIFICALLY, THE MARKET VALUE OF AN ASSET DEPENDS UPON THE REVENUE IT GENERATES, AND IN A REGULATED INDUSTRY THE AMOUNT OF REVENUE IS DEPENDENT ON THE LEVEL OF RATES SET BY REGULATORS. SEE HOPE NATURAL GAS CO., 320 U.S. AT 601. IF GAS SERVICE'S RATE BASE WERE WRITTEN DOWN TO 80% OF NET BOOK VALUE TO REFLECT THE VALUE OF ITS STOCK IN 1983, THE MARKET WOULD DROP TO COMPENSATE FOR GAS SERVICE'S REDUCED EARNING POWER. THIS WOULD IN TURN PRODUCE A FURTHER REDUCTION IN RATE BASE TO THE NEW MARKET VALUE WHICH WOULD CAUSE A STILL FURTHER REDUCTION OF EARNING POWER AND THUS OF MARKET VALUE. SUCH A SELF-FULFILLING PROPHECY EVENTUALLY DRIVES THE MARKET VALUE TO ZERO AND DESTROYS THE UTILITY. THIS INTERDEPENDENCE BETWEEN RATES AND MARKET VALUE COULD RENDER THE ADJUSTMENT OF GAS SERVICE'S ASSETS TO THE MARKET VALUE OF STOCK AN UNCONSTITUTIONAL TAKING WITHOUT COMPENSATION.

COMMON STOCKS, PREFERRED STOCKS AND FIRST MORTGAGE BONDS OF ALL PUBLICLY HELD UTILITIES IN KANSAS, INCLUDING KPL, ARE BOUGHT AND SOLD NEARLY EVERY DAY AT PRICES WHICH FLUCTUATE NEARLY EVERY DAY. SOME ARE TRADED ABOVE BOOK VALUE AND SOME BELOW BOOK VALUE. COMMISSION CONSIDERATION OF A RATE BASE ADJUSTMENT IN THIS CASE WOULD, IF PERMITTED TO STAND, LOGICALLY DICTATE SIMILAR ADJUSTMENTS--UP OR DOWN--FOR EACH UTILITY REGULATED BY THE COMMISSION IN EACH RATE CASE. THE COMMISSION, OF COURSE, HAS NEVER BASED RATE BASE VALUATION ON THE FLUCTUATING TRADING PRICE OF A UTILITY'S STOCKS OR BONDS. CLEARLY, IT SHOULD NOT CONSIDER SUCH UNWARRANTED AND UNLAWFUL ADJUSTMENTS FROM HENCEFORTH.

THIS INQUIRY HAS CONFIRMED THE PROPRIETY OF COMMISSION USE OF ORIGINAL COST AS THE BASIS OF THE VALUE OF PROPERTY DEVOTED TO UTILITY SERVICE.

WHEREFORE, KPL PRAYS THAT THE COMMISSION NOT COMMENCE PROCEEDINGS TO CONSIDER WHETHER OR NOT THE RATE BASE OF GAS SERVICE SHOULD BE ADJUSTED IN ORDER TO REFLECT THE COST OF ASSETS PURCHASED.

DATED AT TOPEKA, KANSAS THIS 20 DAY OF APRIL, 1984.

THE KANSAS POWER AND
LIGHT COMPANY AND THE GAS
SERVICE COMPANY

BY David S. Black
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ATTORNEYS FOR THE KANSAS POWER
AND LIGHT COMPANY AND THE GAS
SERVICE COMPANY

Larry ✓
Phil

RECEIVED

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

JAN 24 1989

In the matter of U.S. Water Lexington,)
Missouri, Inc. to file tariffs designed)
to effectuate a general revenue increase)
attributable to the meter rate for water)
service provided to customers inside and)
outside of the City of Lexington,)
Missouri.)

ACCOUNTING DEPT.
PUBLIC SERVICE COMMISSION

Case No. WR-88-255

INITIAL BRIEF OF
U.S. WATER/LEXINGTON, MISSOURI, INC.

FILED

JAN 23 1989

PUBLIC SERVICE COMMISSION

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January 23, 1989

"normal" years. There can be no dispute that 1987 is abnormal with 20.3 percent, and any use of that year's figures will unreasonably skew the percentages. The manager of USW has testified that it has little or no funds with which to pursue major construction activity in 1989, absent almost all of the rate increase request being granted (Exhibit 9, p. 2), so there is no competent and substantial evidence that 1989 and future years will be a repeat of 1987. The evidence requires that the Commission find 12 percent to be an appropriate percentage to utilize for this purpose.

IV. Negative Acquisition Adjustment

Staff calculated \$1,601,987 as a reasonable figure for net original cost rate base for USW, and USW has not challenged that figure in this case. However, Public Counsel proposes, by imputing interest to the promissory note representing the majority of the purchase price of USW from Missouri Water Company, to reduce net rate base by \$382,312. When given full effect, this reduces the revenue requirement of USW by \$74,079 when a 12.25 percent return is considered and income taxes are computed based upon 100 percent equity. USW opposes this adjustment. The Staff is not proposing any acquisition adjustment.

In essence, the Public Counsel proposes that the ratepayers be given the benefit resulting from the fact that this utility was arguably purchased for less than depreciated original cost. Since the Public Counsel is opposed to having the ratepayers bear any

responsibility in the opposite situation, i.e. where a utility is purchased for more than net original cost, the Public Counsel position on this issue may be succinctly put as follows: "Heads, the ratepayers win; tails, the shareholders lose."

USW believes that it is inappropriate for the Commission to accept the Public Counsel's proposal for several reasons. First, and obviously of great importance to USW, is that acceptance of the proposal would financially cripple the company because it would - wipe out almost all of the increase in rates that even the Staff is proposing here. Considering the current cash flow position of USW as testified to by its accountants, such an action would cause very serious consequences.

Second, the acceptance of the proposal is not appropriate ratemaking treatment either in general, or in this specific instance. As explained by Mr. Drees in his rebuttal testimony (Exhibit 6), the Commission specifically approved the sale of this utility from Missouri Water Company to U.S. Water/Lexington, Missouri, Inc. in Case No. WM-84-37, by Order dated October 21, 1983.⁶ That the sale price was below the net book value of the assets was clearly stated in the fourth paragraph of the order, so all parties were aware of that. The sale-price was stated as \$1,186,139 plus accounts receivable. The net book value of the assets was \$1,207,014. The order went on to state that the sale would result in a small loss to Missouri Water Company, and that

⁶ A copy of the order appears as Schedule 1 to Exhibit 19.

its shareholders would bear that loss and incur the tax effect of the sale. (Order, p. 1)

Further, the materials furnished to the Commission clearly stated that the parties did not intend to treat the transaction in the manner proposed by Mr. Riley here. Mr. Drees provided copies of those accounting materials in his Schedule LFD-4.1 and 4.2 attached to Exhibit 6. Beginning at the bottom of Schedule LFD-4.1 appears the following text:

The purchase price described in the foregoing is less than the "rate base" of the assets acquired as determined by the Missouri Public Service Commission (PSC). Management does not intend to discount the purchase obligation to present value as required by generally accepted accounting principles. If the notes were stated at present value, the cost of utility plant would be reduced by approximately \$425,000. ... Should the PSC elect to reduce the Company's "rate base" to cash expended plus the present value of the purchase obligation, projected levels of revenue would be adversely affected and projected operating results and cash increase might be materially overstated.

Thus, the very argument that Mr. Riley is making here five years later was explicitly laid out for the Commission. It was put on notice that any reduction in rate base on this basis would adversely affect projected revenues. This supports the statements made by Mr. Drees that if the investor had known this acquisition adjustment were going to be made, he would have been advised not to make the purchase. (Tr. 202)

Instead, the Commission in its Order made no mention of requiring the rate base to be reduced due to the sale price, or to consider the present value of the non-interest bearing note. Instead, it made a specific finding of the rate base, and

specifically approved the sale at the specified sale price. And conspicuously absent from the Order of October 21, 1983 was the usual disclaimer concerning an order's impact for ratemaking purposes. Thus, USW believes that the Commission fully understood the special circumstances surrounding these properties; that Missouri Water was so anxious to rid itself of them that it took a loss on the sale and that special financing with a non-interest bearing note was appropriate to achieve a sale of the properties. - For the Commission to find exactly to the contrary five years later would be to perpetrate the cruelest of hoaxes.

As mentioned, a negative acquisition adjustment would not be appropriate for general ratemaking principles either. Mr. Drees provided a brief review of the situations which gave rise to the "original cost when first devoted to public service" rules. (Exhibit 6, p. 6) This principle has served to protect ratepayers from utilities selling at inflated prices and then seeking to have the regulators revalue the properties at the higher level, just to produce greater profits. Although there are always exceptions, Mr. Drees concludes that sales of utility property at higher than net book value should be borne by the shareholders. USW is under the impression that is the general principle utilized by this Commission, although there may have been a few exceptions.

A review of authorities from other jurisdictions highlights the beneficial effect of the original cost principles. In Re New York Telephone Company, 5 PUR 3d 53 (1954), the New York Public Service Commission was faced with a utility's arguments that it

should consider evidence of market value in rate base evaluation. This Commission emphasized the unacceptable circularity in valuing the property of an earnings-related enterprise on the basis of purchase price. It said, at p. 44:

Long and well-established fundamentals should not be lightly brushed aside in the absence of the most compelling reasons or clearly demonstrable error.

In competitive enterprise, free from regulation, the value of any commercial property is usually measured by its capitalized prospective earnings. In the utility field, of course, there is no free competition.

In determining the value of a telephone company's plant, we cannot use the standards of competition in the industry because these do not exist. There is however, another standard of competition and that is competition in the money market for capital. If the rates fixed are too low and the income is insufficient, there will be a flight of capital from the telephone industry to other types of investment. The converse is equally true.

The Court in Vincennes Water Supply Company v. Public Service Commission, P.U.R.1930B, 216, 219-220, 34 F.2d 5, rejected the use of market value of securities in determining the value of utility property.

Such questions as capitalization and the amount and kind of securities and the market value of the same, can have, in any event, only remote evidential value. In many instances, capitalization bears no particular relation to invested or present value, and the market price of securities depends upon the rates charged for service. If rates are lowered by regulatory bodies, the market value of securities will fall. If rates are raised, within reasonable limits, the value of securities will rise. As pointed out by some Commission, to determine the value of a public utility for rate-making purposes, the using of the market value of securities to make such determination, would involve reasoning in a circle. It is usually now held to be not a legal basis for determining present value, as is pointed out in the case of Monroe Gas Light & Fuel Co. v. Michigan Public Utilities Commission (D.C. 1923) 292 Fed. 139, 150 PUR 1923E, 66T."

If the purchaser paid too much for his stock, the public should not, as a result, be imposed upon by rates

to fix a reasonable return upon such purchase price. If the purchaser paid too little, he is entitled to the benefit of his bargain. To determine value from the purchase price of stock at private sales is, as indicated above, to reason in a circle, for if rates charged be unreasonably low, the value of the property upon that basis is depressed; if unusually high, it is inflated. The test always is the present fair value of the property. As the Supreme Court says in the case of McCardle v. Indianapolis Water Co. (1926) 272 U.W. 499, 410, 71 L.Ed. 154, PUR 1927A, 15, 23, 47 S.Ct. 144, 148, "It is well established that value of utilities properties fluctuate, and that owners must bear the decline and are entitled to the increase." (emphasis supplied)

- More recently, the Vermont Supreme Court said in Re Towne Hill Water Co., 422 A.2d 927 (1980):

Generally rate base is determined by the formula that so-called historical or original cost plus capital improvements minus depreciation equals the net value of the property. Using the cost of the 1973 acquisition of the capital stock would substitute a new original cost

... The Board's finding that the stockholder's investment in the company was less than the historic cost is not germane to the determination of a rate base. The property in question was not acquired in 1973. Original acquisition and devotion to public use is the time of "investment" in that property. The stockholder purchased stock expecting a reasonable return on that investment, no more and no less. Whether he purchased the stock at a discount or a premium is irrelevant.

We are unimpressed by the Board's contention that calculating a rate of return on the rate base which the Company argues for will allow the Company a windfall. It is simply impossible to measure whether a given rate of return is reasonable or unreasonable wholly without reference to rate base.

We therefore have several valid arguments for rejecting the Public Counsel's position on this issue: (1) the specific terms of the sale of these properties were approved by the Commission five years ago, with all relevant facts disclosed, and no mention by the Commission of any negative acquisition adjustment (2) the

circularity of reasoning inherent in deviating from net original cost valuation of rate base, not to mention the demands that would be placed on the Commission by other utilities for corresponding treatment if that were to occur; (3) the reasoning expressed that if an investor pays too much, the ratepayer is shielded, while if the investor pays "too little", he should be entitled to the benefit of his bargain; and finally, (4) that the impact of such an adjustment on this utility would be extremely severe and mean that it would not be able to meet its debt service payments.

V. Management Fee

As indicated earlier, there was a "management fee" discussed and approved in the October 1983 order approving the sale and transfer. On page 2 of the order, the Commission specifically recognized how the management agreement would function and how the fee would be calculated:

U.S. Utilities Management & Services, Inc. will manage the water facilities under the agreement and will receive a fee equal to the lesser of: 15 percent of the actual costs of providing water service to the customers of the system, the rate of return on equity allowed by the Commission, or the cash available after the payment of all expenses of operation, exclusive of the management fee itself. (Exhibit 6, pp. 9-10)

The management agreement itself was made a part of the record in WM-84-37, and was described in the direct testimony of Frank Hawkins. (Exhibit 6, p. 10) The agreement has been in place, and payments have been made from USW to U.S. Utilities Management & Services, Inc. ("the management company") since the inception of

DATA INFORMATION REQUEST
UTILICORP UNITED, INC.
MISSOURI PUBLIC SERVICE DIVISION
CASE NO. ER-90-101

REC'D

Requested From: Brad Lewis

Date Requested: March 6, 1990

MAR 06 1990

Information Requested:

GLC

Provide the most complete available written overall corporate strategy statement for Utilicorp, including explanations of strategy changes that have occurred since the inception of the Utilicorp name change and a statement of any anticipated future changes in corporate strategy that are now planned.

Requested By: Michael L. Brosch

Information Provided: SEE ATTACHED

The attached information provided to the consultants and technical staff of the Office of the Public Counsel in response to the above data information request is accurate and complete, and contains no material misrepresentations or omissions, based upon present facts of which the undersigned has knowledge, information or belief. The undersigned agrees to immediately inform the consultant and technical staff of The Office of the Public Counsel if, during the pendency of Case No. ER-90-101 before the Commission, any matters are discovered which would materially affect the accuracy or completeness of the attached information.

If these data are voluminous, please (1) identify the relevant documents and their location (2) make arrangements with requester to have documents available for inspection in the Utilicorp United, Inc., Missouri Public Service Division, Kansas City, Missouri office, or other location mutually agreeable. Where identification of a document is requested, briefly describe the document (e.g., book, letter, memorandum, report) and state the following information as applicable for the particular document: name, title, number, author, date of publication and publisher, addresses, date written, and the name and address of the person(s) having possession of the document. As used in this data request the term "document(s)" includes publication of any format, workpapers, letters, memoranda, notes, reports, analyses, computer analyses, test results, studies or data, recordings, transcriptions and printed, typed or written materials of every kind in your possession, custody or control or within your knowledge. The pronoun "you" or "your" refers to Utilicorp United, Inc., Missouri Public Service Division and its employees, contractors, agents or others employed by or acting in its behalf.

Date Response Received: 3/27/90Signed By: Brad LewisPrepared By: Williams

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Requested By: Michael L. Brosch

Information Provided: The overall corporate strategy has been consistently implemented since the inception of the UtiliCorp name change. It is most comprehensively described in a speech before the NARUC by Mr. Richard C. Green, Jr. (attached). Other descriptions of strategy can be found in the company's Annual Report to Shareholders and Form 10-K.

Date Provided: March 23, 1990

FRAMING REGULATION IN AN ERA OF UTILITY TRANSITION

When UtiliCorp was formed in 1985, not many people understood what we were trying to accomplish. We had been doing business successfully for about 70 years as Missouri Public Service Company. Our mission had been to keep the lights on and the gas flowing, to make sure our rates were affordable and that our shareholders were earning reasonable returns.

Those original business objectives haven't changed under UtiliCorp. But we've added one important element. Today, we are out to become a value-added utility--a good, tough competitor in what is becoming a market-driven industry.

About five years ago we saw that we needed to react to a new reality in our industry. That reality was, and is, competition. It forced us to ask ourselves: "What is our best strategy to meet this challenge?" The answer was simple. We had to grow.

That presented us with a second question: "Should this growth occur within our industry or outside of it?" In our minds, the answer again was clear. Our best hope for success was to stay with the business we knew--the utility business.

Most everyone here has some familiarity with the forces that have changed the way that gas and electric utilities must do business today.

The electrics have been whipsawed by unstable capital markets, high interest rates, rapid inflation and volatile fuel prices. Today, we are faced with

environmental pressures and technological changes. This had a chilling effect on new power plant construction and consequently, some regions of the country now face capacity shortages. At the same time, economic conditions and federal laws have allowed the emergence of independent power producers and cogenerators that now may compete for some of the utilities' largest customers.

On the gas side, years of well-meaning but ill-conceived regulations have created great imbalances of supply and demand. In the late 1970s, artificially low prices for gas transported across state lines led to shortages on the East Coast. The resulting political pressures culminated in the Natural Gas Policy Act--a law that created some extreme pricing disparities for old and new gas. Pushed by fears of being caught again with inadequate supplies, pipelines began locking into the take-or-pay contracts that have proven to be so burdensome today. Gas utilities also face the competitive threat of losing their largest customers to system bypass.

How should regulators respond to these changing conditions? There are many compelling arguments in favor of deregulating the industry--adopting a market-based approach for dealing with these challenges. At UtiliCorp, we are not convinced that utilities can be entirely deregulated. Because gas and electricity are vital commodities, utilities will always remain under some obligation to provide service.

However, Adam Smith's invisible hand of competition is clearly at work. For that reason, flexible regulatory approaches will be necessary. At UtiliCorp,

We believe that regulations should be designed and implemented to allow for the emergence of value-added utilities. This can be accomplished through a process of re-regulation, and not necessarily de-regulation.

It is our view that the basic mission and objectives of regulation should not change significantly during this time of transition. Regulatory agencies will still strive to protect the least powerful end user. Regulation also will need to fulfill its other vital function--helping American industry remain competitive through access to reliable and reasonably priced gas and electric service.

Flexible regulatory approaches will allow utilities to compete effectively for customers, to expand their businesses in new ways and to grow through the prudent acquisition of other utilities. Regulators can best protect the public interest by moving in sync with the evolution of the industry.

What do I mean when I say re-regulation? It is simply a matter of changing perspective--an approach in which the commissions view regulation in a new light while applying the same traditional, fundamental values.

In 1983, I went to the Missouri Public Service Commission with a plan to add value for the customers and shareholders of my company. A principal component of this plan was to expand through utility acquisitions. Of course, the concern of the Missouri commission was whether this plan would be a detriment to Missouri ratepayers.

The Missouri commission has shown a willingness to allow us to pursue this plan because UtiliCorp made a commitment to flow only benefits to Missouri

customers and not to pass on any new problems that may arise. At no time will we jeopardize our own financial integrity. We recognize that it is vitally important not to put Missouri's sound utility infrastructure at risk.

Six years later, this commitment still stands. Our record shows we have lived up to everything we have promised. This process has worked well. By taking a different regulatory approach, the Missouri commission has allowed us to serve our customers better and build value for our shareholders.

Change and competition are happening now. It can't be stopped at this point in time. The utility industry faces the risk of having competition skim the cream business away from its customer base. State regulators have a real opportunity to set the tone on utility regulation and thereby play a part in this changing environment.

State commissions could perhaps face reductions in their jurisdictional authority if they ignore the changes that are already in motion. Partnerships need to be created between utilities and their state regulators. The traditional attitudes of each will need to change. The force that binds us together is our mutual responsibility to maintain this country's utility infrastructure to meet future needs.

This is hard work. Change does not come easily. While re-regulation will keep in place the fundamental values of regulation, it calls for us to try new approaches--to experiment. These approaches could range from flexible rate structures to the support of a specific acquisition or acquisition program.

Because any new regulatory approach cannot be guaranteed initial success, commitment will be a key ingredient in the process.

Will the same fundamental regulatory values still apply as regulators evaluate mergers and acquisitions? We believe they will. In many cases, regulators will find that a merger or acquisition represents an opportunity to drive an even better bargain for customers. They can demand improvements in service and take steps to insure prudent management of the assets for years. In many cases, a reasonable and economic rate structure can be negotiated as part of the acquisition.

Should regulators consider the economic health of the combined companies in evaluating an acquisition's impact on customers? It is our view that this may be a part of regulatory responsibility. An acquisition that weakens the financial outlook for the combined entity may very well have a long-term detrimental impact on customers. On the other hand, an acquisition that strengthens a company financially can reduce the cost of capital and indirectly benefit customers in many ways.

We are convinced that the growth strategy we've adopted is our best hope of living up to our responsibility to provide affordable and reliable utility service. We have significant new incentives to keep rates at affordable levels. Yet, There must be a balance between the demands of the customer and demands of the shareholder. Meeting the needs of one group to the exclusion of the other will ultimately hurt everyone concerned.

For several years, UtiliCorp has been aggressively seeking new utility operations in this country and other countries, and expanding in non-regulated areas of the utility business. Five years ago, this was a somewhat non-traditional approach. Today, more and more utilities seem to be adopting similar business plans. We believe it's a strategy that will best prepare us for the future.

UtiliCorp has followed a firm policy of not seeking to recover any of its acquisition-related premiums through rates. We have made a very persuasive case to investors that any premium costs or share dilution they experience will be for the short-term. We believe we can demonstrate that UtiliCorp will financially outperform the industry in the long-term.

What do I mean when I say UtiliCorp is in better position to serve its customers by building financial strength?

By becoming a larger and more diversified entity, UtiliCorp achieves economies of scale in such areas as financing costs, employee retirement and health benefits, centralized purchasing, consolidations of billing and computer services and, not insignificantly, negotiation of gas purchase contracts.

We are continually asked whether we are better off now than if we had continued to do business solely as Missouri Public Service. The answer is absolutely yes.

To illustrate that, we can point to some costs that would be very burdensome right now if Missouri Public Service was a stand-alone company. We are presently looking at financing about \$100 million for power plant life extension

and acid rain compliance projects. Because of our size, UtiliCorp can carry those costs on its books as short-term debt and convert it to long-term when interest rates and market conditions are right. As Missouri Public Service, we would have been required to finance those projects immediately with long-term debt regardless of market conditions. Those projects would have represented about a third of our total capitalization, instead of the one-eighth that we're looking at now. As you can see, our size gives us the potential to save millions of dollars.

In addition to the benefits we realize as a larger, more diversified and more competitive company, we believe our various constituencies also benefit.

Acquisitions in the utility industry truly have to be in the public interest before they can occur. We must convince customers that an acquisition won't adversely affect rates. We must convince regulators that regulated operations are not subsidizing non-regulated businesses. We must convince the respective boards of directors and shareholders that we have the financial resources to consummate a deal. And, we must convince our potential new employees that they won't lose their jobs or see their benefits reduced.

We have a deeply ingrained incentive to ensure that regulation accomplishes its mission. We are out to prove that we can do an outstanding job of managing the utility operations we acquire. Both our customers and our shareholders will benefit. We know that regulators are watching us carefully--to see that we live up to our service obligations and any other promises we have made in the process of an acquisition. In short, we are deeply committed to

serving the public interest. I can say with no hesitation that our track record proves that.

The driving force in our industry is to become more competitive by following whatever formula it takes. We are learning that we need to focus on service and the price of the product. That market-driven philosophy will create quality utilities, responsive to the needs of their customers and to the performance demands of their shareholders.

Clearly, the merger and acquisition movement will be subject to a considerable amount of regulation. Not only will state regulators pass judgement on these transactions, many constituencies will be represented through the intervention process. Again, the need for balance must be emphasized. We must submit a balanced package of benefits for everyone when pursuing a utility acquisition.

At UtiliCorp, we are now having the good fortune to see acquisition opportunities come our way because of the way we've done past transactions. We have pursued all of our opportunities on a non-adversarial basis, we have lived up to our promises and commitments and we have retained existing management and employees. Today, at any given time, we may be screening a half-dozen opportunities that are being presented to us.

Our acquisition program is not cutting into our commitment to maintain the integrity of our systems. In 1984, our construction expenditures were equal to

about 10.3 percent of revenues. In 1988, construction spending was 11.7 percent of revenues.

We are committed to improving the communities we serve through active economic development programs and civic involvement by employees. We believe that strengthening the local economies of our service areas and generally improving the quality of life will pay business dividends.

In conclusion, I would like to challenge the regulatory community to consider ratemaking approaches that will allow utilities to continue fulfilling their vital obligations. We must be allowed to become better competitors, to diversify through acquisitions and to start up non-regulated utility businesses.

My message is one of partnership. Utilities and regulators need to make the commitments necessary to deal with change. This is not an option. The process has started and the momentum is increasing. Other industries have recently gone through dramatic transitions and now it is our turn. We control very important commodities.

We would be wise to learn from the experiences of other industries as we work together to manage our time of transition so that customers, employees and shareholders all benefit.