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Witness:	*Charles R. Hyneman*
Sponsoring Party:	*MoPSC Staff*
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Case No.:	*ER-2001-672*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

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Missouri Public Service Commission

UTILICORP UNITED INC.
d/b/a MISSOURI PUBLIC SERVICE

CASE NO. ER-2001-672

Jefferson City, Missouri
January 2002

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UTILICORP UNITED INC.

d/b/a MISSOURI PUBLIC SERVICE

CASE NO. ER-2001-672

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. Are you the same Charles R. Hyneman who filed direct testimony in this case?

A. Yes I am.

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

A. The purpose of this testimony is to respond to the direct testimony of Company witness Gary L. Clemens concerning UtiliCorp United Inc.'s (UtiliCorp or Company) position on recognizing the revenue requirement impact in this case of UtiliCorp's merger with St. Joseph Light & Power Company (SJLP). UtiliCorp merged with SJLP effective December 29, 2000. This merger was approved by the Commission in Case No. EM-2000-292. SJLP is now an operating division of UtiliCorp.

Q. What is the Company's position on recognizing the revenue requirement impact of the SJLP merger in this rate case?

A. Mr. Clemens explains this position on pages 3 through 5 of his direct testimony. He states that because the merger has only been in effect for a short time, the Company's preferred position is to treat the merger as if it did not happen. This means for the purposes of this rate case, UtiliCorp did not allocate corporate overhead costs to the SJLP operating division and did not reflect the existence of any joint dispatch savings for Missouri Public Service (MPS) and SJLP generating units. UtiliCorp's position has the impact of artificially increasing the revenue requirement for the MPS operating division in this rate case.

Mr. Clemens also states that if the Staff pursues the integration of SJLP (reflects the reduction in corporate overhead costs to MPS by allocating a pro rata share of these expenses to SJLP and includes the impact of joint dispatch savings) in this case, then the Company's position is to seek rate recovery of the merger's transition costs, transaction costs and a portion of the merger premium/acquisition adjustment.

Q. Please summarize the Staff's position on this issue.

A. Staff witness Mark L. Oligschlaeger explains the Staff position on this issue beginning on page 26 of his direct testimony. To summarize, the Staff recommends that the impact of the SJLP merger should be reflected in this case. To do otherwise would be to set MPS's electric utility rates based on something other than its actual cost of providing service.

However, UtiliCorp's merger and acquisition costs (merger premium, acquisition adjustment and transaction costs) should not be included in MPS's cost of service in this case. UtiliCorp has the opportunity to recover these types of costs through the phenomenon known as "regulatory lag." Merger transition costs (costs to achieve the merger), to the extent these costs exist in a rate case test year, should generally be recovered in rates through an amortization to expense in the income statement.

Q. Please provide a summary of your rebuttal testimony?

A. My rebuttal testimony is focused on the following five main points:

> 1. UtiliCorp could have used the pooling of interests accounting method to record the SJLP merger. By doing so it would not have incurred a merger premium nor recorded an acquisition adjustment.
>
> 2. The merger premium and transaction costs incurred from this merger were incurred solely for the benefit of the shareholders of UtiliCorp and SJLP. Therefore, the shareholders, not UtiliCorp's ratepayers should be responsible for paying for these benefits.
>
> 3. A significant portion of the merger premium UtiliCorp paid to the former SJLP shareholders represents a gain on the sale of utility assets. This Commission has traditionally required that the gain on sale of assets be recorded below the line for ratemaking purposes. Recovery of a merger premium/acquisition adjustment in rates would reverse this policy and allow ratepayers to share in the gain on sale of utility assets.
>
> 4. Allowing direct recovery of a merger premium or acquisition adjustment in rates would signify a shift from cost-based regulation to market-based regulation in Missouri.
>
> 5. A significant portion of the merger premium UtiliCorp paid to the former SJLP shareholders represents payment of a control premium and payments for future nonregulated income sources. Direct recovery of the SJLP merger premium would force SJLP's ratepayer to pay for these nonregulated benefits.

I will begin with a description of the accounting rules for mergers and acquisitions, including a description of the benefits of the pooling of interests accounting method. I will also explain the reason why UtiliCorp changed from its original decision to account for the SJLP merger as a pooling of interests to accounting for the merger as a purchase. 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 costs.

In the acquisition adjustment section of my testimony, I will describe the two components of the acquisition adjustment (gain on sale and merger benefits or goodwill) that UtiliCorp proposes to recover from its ratepayers and which party primarily benefits from UtiliCorp incurring this acquisition adjustment.

MERGER ACCOUNTING

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

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

Goodwill is the difference between the amount paid to acquire a group of assets and the current fair market value (FMV) of the individual assets. The asset referred to as goodwill is only created in mergers or acquisitions accounted for under purchase accounting rules. Under purchase accounting rules, acquired assets are recorded at the usually higher fair market values (stepped-up basis), while the pooling of interest accounting rules required assets to be recorded at existing historical cost less accumulated depreciation; thus, there is no goodwill to be recorded. The numerical difference between an acquisition adjustment and goodwill is:

Acquisition Adjustment	=	(Purchase Price – NBV)
Goodwill	=	(Purchase Price – FMV)

As an example, assume the following facts: XYZ Company purchases ABC Company for $1 million. The fair market value of ABC Company's assets is $800,000 and the NBV of these assets 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. 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	$ 700,000
Total Assets	$1,000,000

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

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

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

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

APB 16 – POOLING OF INTERESTS AND PURCHASE

Q. At the time UtiliCorp acquired SJLP, please describe how companies were required to account for mergers and acquisitions in financial records.

A. Companies were required to comply with Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations*, as promulgated by the Financial Accounting Standards Board (FASB).

Q. Please provide a general description of APB 16.

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

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

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

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

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

After the valuation adjustments from book value to fair value are made, any amount of the purchase price that has not been allocated in revaluing the assets is recorded as a separate intangible asset called goodwill. For utility companies, 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. Generally, utilities are not permitted to revalue their assets in any type of ownership change, but must use the original cost of the investments as the value of the assets on their books. The acquisition adjustment is used to reflect the difference between the original cost of the assets and the purchase price paid to acquire those assets.

Q. Why were the pooling accounting rules very different from purchase accounting rules?

A. When stock is the primary consideration in a merger (as it was in the UtiliCorp/SJLP merger), the stockholders in the acquired company become stockholders in a bigger combined company. If other conditions are met, the merger is considered more of a combining of ownership interests (pooling of interest) than an actual purchase of assets (purchase).

Pooling of interest accounting 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 but merely exchange common stock in a ratio that determines their respective interests in the combined corporation. This is why the primary requirement to use pooling accounting is the exchange of common stock. 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 was the primary consideration in the UtiliCorp/SJLP merger?

A. With the exception of fractional shares, common stock was the only consideration paid in the SJLP merger. This is referred to as a stock-for-stock transaction, or a "stock swap."

Q. Did SJLP's Board 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 saw the merger as a "joining of shareholder interests," as opposed to a sale of the Company to UtiliCorp. At page 8 of his direct testimony in Case No. EM-2000-292, Mr. Terry F. Steinbecker, SJLP's then President and Chief Executive Officer (CEO), and member of the Board of Directors, described 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.

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

A. Yes. APB 16 required 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 violated or did not meet any of the 12 pooling conditions, the merger was required be accounted for by using purchase accounting rules.

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

A. A pooling of interests 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 that violate the intent of a pooling of interest are transactions or events 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 would prevent pooling of interests accounting.

Q. Has the FASB changed the authorized methods of accounting for mergers since the close of the SJLP merger?

A. Yes. On July 20, 2001, the FASB issued Statement No. 141 (FAS 141), *Business Combinations* and Statement No. 142 (FAS 142), *Goodwill and Other Intangible Assets*. FAS 141 requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase method of accounting. FAS 142 requires that goodwill no longer be amortized to earnings, but remain on the balance sheet at the original amount recorded, subject to periodic reviews for impairment. For most companies, including UtiliCorp, amortization of goodwill ceased on January 1, 2002.

Q. Did the FASB's issuance of FAS 141 have any effect on UtiliCorp's decision on which accounting method to use to record the SJLP acquisition?

A. No. FASB Statement 141 only applies to business combinations initiated after June 30, 2001. The SJLP merger was completed on December 29, 2000.

BENEFITS OF POOLING OF INTERESTS ACCOUNTING

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

A. For many companies, especially utility companies, the pooling of interests method was considered preferable to the purchase method.

Q. Please explain.

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 was considered the preferred method of accounting for mergers.

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

In this case, because UtiliCorp recorded the merger with SJLP as a purchase instead of a pooling, it is attempting to recover the acquisition adjustment. UtiliCorp's decision not to use the pooling of interests method to record the merger results in a potential detriment to MPS's ratepayers. This detriment will occur if MPS's ratepayers are required to pay higher rates than they would, had the merger been recorded as a pooling of interests. That is, the Staff believes the merger will have a detrimental impact on MPS's ratepayers under either of the scenarios presented in Mr. Clemens' direct testimony in this case (i.e., either acting as if the merger had not occurred, or UtiliCorp seeking recovery of the merger acquisition adjustment). Under UtiliCorp's preferred method of proceeding as if the merger did not occur, MPS's ratepayers are charged higher overhead costs (no overhead burden is allocated to SJLP) and there is no recognition of actual joint dispatch savings. Under UtiliCorp's alternative method, there is explicit rate recovery of a portion of the acquisition adjustment.

Q. Please continue with the reasons why the pooling of interests method was considered the preferred method of accounting for utility mergers.

A. For utility companies that used purchase accounting, the amortization of an acquisition adjustment creates an additional expense that puts a downward pressure on earnings. Recognition of an acquisition adjustment creates a need for additional revenues and/or cost reductions in an amount equal 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 or implicit ratemaking treatment of an acquisition adjustment. As described earlier, there would be no issue of an acquisition adjustment or merger savings in this rate case had UtiliCorp recorded the SJLP merger as a pooling of interests, which it had the ability, but chose not to do.

Utility companies suffer under purchase accounting rules because, in addition to the financial burden of the merger premium, the accounting method may result in the utility proposing recovery of an acquisition adjustment. Proposing acquisition adjustment recovery will lead to the incurrence of significant extra costs in creating a regulatory plan with a merger savings tracking mechanism and the likelihood of fully litigated regulatory proceedings.

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

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

[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 and tax free to shareholders of both companies. Western included the following condition in its proposal to acquire control of KCPL:

> 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 14 of his direct testimony in Case No. EM-2000-292, UtiliCorp witness John W. McKinney made the assertion that regardless of whether or not the 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 may be correct in theory that a merger premium could exist in a pooling of interests merger. However, this theoretical merger premium is not relevant to any issue presented to the Commission in UtiliCorp's merger application case, Case No. EM-2000-292, nor is it relevant to any issue in this rate 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 intangible asset to include in rate base and earn a financial return and there is no asset to amortize to expense, there is no additional financial impact in a pooling of interests merger. With the exception of a potential offsetting entry in the equity accounts, there is absolutely no recognition of a merger premium in any of the financial books and records of any company, regulated or unregulated. As will be described below, even UtiliCorp's CEO, Mr. Richard C. Green, Jr., recognized that there is a clear difference between the two merger accounting methods from an earnings and ratemaking perspective.

Q. Are there examples where electric utilities 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, four senior company executives have advised the Commission that no acquisition premium results in mergers accounting for as a pooling of interests.

As previously discussed, in June 1996, Mr. Richard C. Green, Jr., Chairman of the Board and CEO of UtiliCorp and Mr. A. Drue Jennings, then 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:

> 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]

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

> 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.

Finally, 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 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.

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

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

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

UTILICORP/SJLP MERGER ANNOUNCED AS A POOLING OF INTERESTS

Q. Please describe how the UtiliCorp/SJLP merger was originally announced as a pooling of interests.

A. 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 (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. . . .

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 have been waived at UtiliCorp's discretion. Paragraph 7.02(f), Accounting Treatment, of the 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. Did UtiliCorp later change the accounting of the merger from the pooling of interests method to the purchase method?

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 would 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 this merger from a pooling of interests to the purchase method of accounting?

A. Mr. Dan Streek, UtiliCorp's chief financial officer addressed this issue at page 3 of his direct testimony in Case No. EM-2000-292. Mr. Streek stated that the March 5, 1999 Merger Agreement was announced as 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, prevented this merger from being recorded as a pooling of interests.

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 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 Executive Stock Plan are intended to make sure the executives are focused on creating long-term shareholder value because 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 is to "heighten our collective focus on UtiliCorp's stock price" (response to Staff Data Request No. 260 in Case No. EM-2000-292).

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

A. It is the Staff's opinion that the benefits of a 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 UtiliCorp's ratepayers to have to absorb the 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 the "alteration of equity interest" condition of a pooling of interest 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 done "in contemplation" of the merger be overcome?

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

Also, 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.

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

A. No. In response to Staff Data Request No. 167 in Case No. EM-2000-292, Mr. Jerry 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."

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

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 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 the merger announcement with the stock option issuance, it had the burden to prove that the November 1998 stock option issuance was not done in contemplation of the SJLP merger. However, the Staff believes that because of the serious consequences of losing the ability to use the pooling of interests accounting method (imposition of a then estimated $97 million acquisition adjustment and a potential $133 million after-tax increase in SJLP's cost of service over 10 years) 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 merger.

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?

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 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. Yes. According to the information provided in response to Staff Data Request No. 260, 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 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?

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]

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

A. Yes. The following timeline shows that the November 1998 issuance of stock options could not have been done in contemplation of the SJLP acquisition. 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:

> 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)
>
> November 2, 1998 – Stock options issued (Staff Data Request No. 260)
>
> Week of November 9, 1998. - Morgan Stanley initially contacted the potential bidders (joint proxy statement/prospectus dated May 6, 1999, page 15)

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.
>
> 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. Did the November 1998 stock option issuance 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 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 in that case, UtiliCorp stated 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."

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, in that there is no schedule for regularly granting stock options.

A brochure entitled "The UtiliCorp Stock Option Plan, 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 options. 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.

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 (such as the November 1998 issuance) should be considered normal. The November 1998 option issuance should be considered normal because it conforms to the plan's intent and the plan's history of irregular option issuances.

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

A. Yes. The 12 pooling of interests conditions prevents companies using this accounting method from engaging in certain types of transactions. For example, APB 16 paragraph 48c precluded a company using the pooling of interests accounting method from disposing of a significant part of the assets of the combining companies within two years after the combination, other than disposals in the ordinary course of business. Since UtiliCorp considered selling some or all of SJLP'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 had an effect on 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 generation assets after the acquisition.

A. UtiliCorp's Internet website (utilicorp.com) under Investor Information: Presentations, included the Company's 1999 Year-end Review Conference Call with financial analysts, held on February 8, 2000 (February 2000 Conference Call). Mr. Robert Green, UtiliCorp's President and Chief Operating Officer, discussed the potential sale of the generation assets acquired from SJLP:

> 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.

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.

Q. In this testimony are you saying that the Staff considers the pooling of interests method of accounting preferable to purchase accounting for financial accounting purposes?

A. No. This testimony is not concerned with which accounting method is theoretically the better method for financial accounting purposes. There are strong arguments to be made for both methods, and both methods have weaknesses. The point of this testimony is that the pooling of interests accounting method was available when UtiliCorp merged with SJLP. UtiliCorp had the option to choose the pooling method that would have eliminated the existence of an acquisition adjustment. UtiliCorp, for whatever reason(s), decided to abandon the pooling method and use the accounting method that requires the recognition of an acquisition adjustment and its attendant negative regulatory issues.

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. The merger premium and transaction costs are "ownership" costs. Transition costs 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 acquiring company's balance sheet. Both the USOA and GAAP require that transaction costs be treated the same as the merger premium.

Transition costs are also referred to as "cost to achieve." 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. Generally, 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 board of directors in their fiduciary duty to the company 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. (Because of the relatively small size of the SJLP merger, a UtiliCorp shareholder vote was not required). The merger is approved, if, and only if, both owner groups believe it is in their best interests. In this merger, the SJLP shareholder group and the UtiliCorp Board of Directors (acting for the UtiliCorp shareholders) decided that the $23 per share price for each SJLP common share was in the best interests of the respective shareholder group.

Ratepayer interests are not considered in the decision to buy (acquiring utility) or sell (acquired utility). Ratepayer interests are not considered because the structure of a merger agreement and the initial approval of the merger going forward is an ownership decision. Ratepayers, as nonowners, 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 in the structure of the terms and conditions of a merger.

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, SJLP's Board of Directors paid its financial advisor, Morgan Stanley, approximately $2.6 million (response to Staff Data Request No. 44, Case No. EM-2000-292) to provide an opinion if the $23 per SJLP common share offer price from UtiliCorp was fair, from a financial point of view, to SJLP's shareholders. This cost is clearly not related to providing utility service more efficiently, but is only incurred to protect the financial interests of the shareholders in the merger transaction. Because the merger premium and transaction costs incurred in this merger were incurred solely to benefit both SJLP and UtiliCorp shareholders, as owners, these costs should not be directly reflected in UtiliCorp's utility rates borne by UtiliCorp'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 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 benefit the shareholders though regulatory lag until these savings are reflected in rates in a rate proceeding or an earnings/revenues 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.

Q. Is there any validity to a claim that merger premiums and transaction costs are no different from other costs incurred to run a utility more efficiently, such as a renegotiation of a purchase power contract, or a corporate reorganization?

A. No. Merger premiums and transaction costs are incurred only by the explicit approval of the shareholders (or board of directors acting in the fiduciary 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 efficiently and, therefore, are not analogous to reorganizations or renegotiations of purchased power contracts, which are designed to run utility operations more efficiently. Transition costs are the only type of merger costs incurred to run the utility more efficiently and these types of costs are analogous to contract renegotiations and reorganizations.

ACCOUNTING FOR THE SJLP PURCHASE

Q. How much did UtiliCorp to pay to acquire SJLP?

A. According to the Company's response to Staff Data Request Nos. 130 and 381, UtiliCorp paid $190.2 million to acquire the 8.27 million outstanding common shares of SJLP at December 29, 2000 and incurred $5.6 million in transaction costs, which includes the legal and banker fees necessary to complete the transaction. Adding the $5.6 million transaction costs to the purchase price of $190.2 million results in a total purchase price of $195.8 million.

Q. Please explain why you are including transaction costs in the purchase price?

A. Both GAAP and the FERC USOA require that transaction costs be included along with the purchase price to determine the overall cost to acquire plant assets.

Q. Is the actual purchase price of $195.8 similar to the estimated purchase price during the pendancy of Case No. EM-2000-292, UtiliCorp's merger application case before this Commission?

A. Yes. The estimated purchase price was $193.2 million ($188.6 million stock cost plus an estimated $4.6 million transaction costs.) However, while there was not much of a change from the estimated to the actual purchase price, there was a significant change in the amount of the acquisition adjustment. The estimated acquisition adjustment was $97 million and the actual amount determined after merger closing was $114.3 million. This increase is primarily attributable to a decrease in the book value of SJLP's net assets from an estimated $96.2 million to an actual $81.5 million.

In this testimony, however, I will continue to use the estimated purchase price of $193.2 million and the estimated acquisition adjustment amount of $97 million.

Q. Why are you continuing to use the estimated SJLP purchase price and acquisition adjustment numbers instead of the updated actual amounts?

A. For the purposes of this testimony it is important to use the financial costs of the merger that existed at the time UtiliCorp decided to merge with SJLP. These are the costs that influenced UtiliCorp's decision to complete the merger and the decision to seek rate recovery of the merger premium/acquisition adjustment from its ratepayers.

Q. Please explain the calculation of the estimated acquisition adjustment UtiliCorp recorded on its balance sheet to recognize the SJLP acquisition.

A. This calculation is shown below:

Cost to Purchase SJLP	$193.2 million
Less Est. Book Value of SJLP's Assets:	- 96.2 million
Estimated Acquisition Adjustment	$ 97 million

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

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

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

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

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

A. The amortization of the acquisition adjustment depends on the actions of the utility's 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 was the estimated annual amount of acquisition adjustment amortization expense that will be recorded by SJLP?

A. The annual amount of acquisition adjustment amortization expense that UtiliCorp proposed to charge to earnings is approximately $2.4 million ($97 million acquisition adjustment divided by UtiliCorp's proposed 40 year amortization period).

Q. What are the income tax implications of UtiliCorp's amortization of the acquisition adjustment?

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 impact on net income (after taxes) of the acquisition adjustment amortization expense, the before-tax amortization has to be grossedup for income taxes to reflect the non-deductibility of the acquisition adjustment. Therefore, the annual amortization of $2.4 million must be multiplied by 1.6231 (1/1- .3839% SJLP effective tax rate) to calculate the total impact of the amortization on SJLP's net income. The <u>annual</u> cost to SJLP due to the non-deductibility of the acquisition adjustment is $1.5 million [($2.4 million x 1.6231 = $3.9 million); ($3.9 million - $2.4 million) = $1.5 million].

Q. Explain how UtiliCorp proposes to recover the SJLP acquisition adjustment.

A. In its merger application case, No. EM-2000-292, UtiliCorp proposed a five-year rate freeze for its SJLP division in which it intends to retain 100 percent of any realized merger savings to offset the cost of the acquisition adjustment. In years 6 through 10 after merger closing, UtiliCorp proposed explicit rate recovery from SJLP ratepayers of 50 percent of the rate base return on the acquisition adjustment and 50 percent return of the acquisition amortization expense, including the negative income tax effect, which significantly increases this expense.

In this rate case, UtiliCorp is seeking explicit recovery of its SJLP acquisition adjustment from MPS's ratepayers only if the Staff seeks, which it does, to reflect the actual revenue requirement impact of the SJLP merger on MPS's cost of service. UtiliCorp has not been clear on exactly how much of the acquisition adjustment it is seeking in the case.

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

A. Yes.

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

A. Similar to the FASB's previous 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.

ACQUISITION ADJUSTMENT

Q. Now that you've explained how the estimated merger premium was calculated, please describe the reasons why UtiliCorp's stockholders were willing to pay an estimated $92.4 million merger premium (acquisition adjustment less estimated transaction costs) above net book value to acquire SJLP.

A. The estimated $92.4 million merger premium consists of two separate components. The first component represents payment of an approximate $44.8 million gain (current market value less net book value) on the sale of SJLP's assets. The second component of the merger premium is the amount of money above market value that UtiliCorp determined it should pay for SJLP. This amount, $47.6 million, represents payment for what UtiliCorp believes will be the benefits of the merger, including a control premium payment to SJLP's shareholders.

SJLP Net Book Value:	$96.2 million
Increase in market value of SJLP assets	$44.8 million
Market value of SJLP assets	$141 million
UtiliCorp Payments above SJLP market value	$47.6 million
SJLP Purchase Price (excl transaction costs)	$188.6 million

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

UtiliCorp's Board of Directors, acting in their fiduciary responsibility to UtiliCorp's shareholders, had to decide how much <u>above market value</u> it would recommend that UtiliCorp's shareholders pay for SJLP. In making this recommendation, UtiliCorp's Board of Directors considered the financial benefits it can extract from SJLP's operations over and above what SJLP will generate as a stand-alone utility. It also had to decide how much it would be willing to pay to SJLP's shareholders to convince them to give up total control of SJLP's business operations.

Because UtiliCorp's Board of Directors decided to pay approximately $188.6 million for a company with a <u>market</u> value of $141 million, the Board determined that the value of the SJLP merger benefits was at least $47.6 million ($188.6 million purchase price less $141million market value). This $47.6 million is essentially what is referred to (respecting nonregulated 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 assets as "probable future economic benefits 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 $47.6 million payment for the "goodwill" portion of the acquisition adjustment is expected to provide additional cash flows to UtiliCorp, mostly to its nonregulated operations.

Q. The merger premium to be incurred by UtiliCorp was estimated to be approximately $92.4 million. You just explained how $47.6 million of the $92.4 million acquisition premium represents the estimated present value of merger benefits. What does the remaining $44.8 million of the acquisition premium represent?

A. The approximate $44.8 million difference between SJLP's market value and its book value represents an unrealized gain on the sale of SJLP properties that will be realized by SJLP'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.

<u>GAIN ON SALE OF ASSETS</u>

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

A. Yes.

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

A. No. The increase from book value to fair value of SJLP's assets reflects gains that have not been recognized in SJLP's books and records. For example, if SJLP had sold plant assets (constituting an operating unit or system), a gain on the sale would have been 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, but are treated "below-the-line" and accrue to the sole benefit of the utility's shareholders. Therefore, UtiliCorp's regulated customers should not be held responsible to UtiliCorp (as the acquirer of the company) for the realized gains on the sale of the assets paid to SJLP's shareholders (as sellers of the company).

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 them 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 UtiliCorp'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 appropriate for utility ratemaking, are appropriately used by nonregulated companies who account for a merger or acquisition using purchase accounting rules. It is appropriate for nonregulated companies to revalue assets acquired in a merger to current market value because they are not a party to a regulatory process that provides assurances that the historical (book) cost of a utility investment will have the opportunity to 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 did UtiliCorp justify its proposal in Case No. EM-2000-292 to have ratepayers pay for a significant portion of its costs to acquire SJLP?

A. The basis of UtiliCorp's proposal to recover the merger premium in rates (in Case No. EM-2000-292) is that its customers will benefit from merger savings. However, as described in the direct testimony of Staff witness Mark L. Oligschlaeger in this case, UtiliCorp will be able to retain, by means of regulatory lag, a significant portion of any merger savings from the SJLP transaction as long as SJLP's rates following the merger are not changed.

Also, a significant portion of UtiliCorp's estimated merger savings are associated with SJLP's generation assets. According to Mr. Robert Green, 75 percent of the synergies and efficiencies of the SJLP and Empire District Electric Company (Empire) acquisitions by UtiliCorp were going to come from the "supply side" or generation assets (February 2000 Conference Call). (UtiliCorp's merger with Empire, although approved by this Commission, was terminated by UtiliCorp prior to closing). As noted above, and as will be discussed later in my testimony, UtiliCorp has expressed a desire to sell SJLP's 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 UtiliCorp's customers that did 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 excess costs could be better controlled by regulatory authorities as to their ultimate disposition.

Q. Is the basis for the concern relative to the 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. Yes. In my opinion, 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 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 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. In its subsequent Missouri rate cases, SWEN attempted to recover the acquisition adjustment in gas rates from its Missouri customers, but was not successful. The Commission has more recently approved the sale of ANG's Missouri gas properties to Atmos Energy Corporation (Atmos). In the Unanimous Stipulation and Agreement reached among the parties to Case No. GM-2000-312, which has been approved by the Commission, Atmos agreed not to seek recovery of the acquisition adjustment it will pay to SWEN for the ANG properties.

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 ANG would roll into rate base each time the properties are bought and sold, resulting in a gross distortion of utility rates. This example of what could have happened 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.

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 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."

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 24 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 its 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. 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 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 acquisition adjustment paid to acquire SJLP. Assume further that in 2003, UtiliCorp sells SJLP'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 its cost of service.

If it is fair for UtiliCorp to charge the cost of the acquisition adjustment to its ratepayers, then it is fair for UtiliCorp to credit its ratepayers with any gain on the sale of these assets. This is certainly the position that the Staff would recommend in such a situation.

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 UtiliCorp's ratepayers are required to pay for the acquisition adjustment in rates, for ratemaking purposes they conceptually become owners, as they are forced to pay the ownership costs of acquiring the property. As "owners," UtiliCorp's ratepayers would be entitled to share in any future gains on sales of utility assets along with UtiliCorp shareholders.

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

A. No. UtiliCorp's position (as described in the direct testimonies of UtiliCorp witnesses Robert Green and John McKinney in Case No. EM-2000-292) 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 during the SJLP merger case was described by UtiliCorp witness 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.
> [McKinney Transcript, pages 65-66.]

In Case No. EM-2000-292 in a March 23, 2000 transcribed interview with the Staff, SJLP witness Terry Steinbecker, SJLP's Chairman and CEO, 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. [Steinbecker Transcript, pages 84-85.]

Q. Is there a very real possibility that UtiliCorp will eventually sell SJLP's generation assets at a substantial gain?

A. Yes. As described earlier, UtiliCorp was considering selling SJLP'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 recent generation asset sales transactions was 2.15 times book value. If SJLP's generation assets were sold for 2.15 times book value (as estimated by UtiliCorp), UtiliCorp would recognize a gain of approximately $63 million. Also, in April 1998 a management consulting firm, Scott, Madden & Associates, Inc. issued a report to SJLP's Board of Directors stating that SJLP's generation assets were worth significantly more that the current book value of the assets.

Q. Have you updated you analysis of the current market value of generation assets?

A. No. Such an analysis would not be relevant. What is relevant is the market value of the generation assets at the time UtiliCorp sought to merger with SJLP. The market value at that time is what provides insights into the motivation behind the merger.

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 utility shareholders and ratepayers.

CONTROL PREMIUM AND MERGER BENEFITS TO UTILICORP

Q. Earlier, you explained that $47.6 million of the $92.4 million merger premium is the approximate difference between the book (historical cost) value of SJLP and the market value of the company. Can you explain why UtiliCorp was willing to pay $47.6 million above SJLP's then current market value to acquire the company?

A. Yes. The three components of a merger 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 appreciation on assets from book (historical cost) to market value appreciation. This amount, approximately $44.8 million, represents 48 percent of the total merger premium of $92.4 million paid for SJLP. The other 52 percent consists of UtiliCorp's payment to SJLP'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 SJLP's assets.

Q. What is a control premium?

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 the UtiliCorp/SJLP merger, the control premium often refers to the payment for both control of the company and the other expected merger 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) enjoy certain valuable rights that a minority owner (SJLP's shareholders who become UtiliCorp shareholders) do 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 the 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. 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, <u>especially when we can do all that and still control the assets."</u>(Emphasis Added)

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, UtiliCorp will completely control the Board of Directors and all of the officer level positions of the combined utility, as no SJLP officer will be retained. UtiliCorp will make all decisions relating to these mergers, thus controlling all aspects of the combination. In order to convince SJLP's Board of Directors to give up all control of the company, 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 SJLP?

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 fact that no SJLP board members became UtiliCorp board members was one such dynamic. The additional compensation demanded by SJLP because of this control-related decision by UtiliCorp is unknown.

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

A. By acquiring SJLP, the Staff believes that UtiliCorp is positioning itself to be a stronger competitor in the future deregulated energy industry. In its 1998 Annual Report to Shareholders, Mr. Richard Green, UtiliCorp's Chairman and CEO, described the acquisition of SJLP as a "growth step." Mr. Green also described UtiliCorp's strategy to ensure long-term growth is to "go after customers with urgency, providing specialized products, services and pricing for each market." In deciding to purchase SJLP for $188.6 million, UtiliCorp determined that the benefit of being a stronger competitor in a deregulated energy market, potential merger savings, and the potential financial benefits to UtiliCorp's nonregulated affiliates was worth the $47.6 million above SJLP's then current market value to acquire the company.

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

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

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

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

Also, Jerry Cosley, a UtiliCorp spokesman, described UtiliCorp's proposed 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."

Q. Should the reasons why UtiliCorp acquired SJLP 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 the UtiliCorp/SJLP merger, are a strengthening of UtiliCorp's competitive position in a deregulated environment and the creation of additional revenues to UtiliCorp's nonregulated investments, then the costs to secure these benefits should be absorbed by the primary beneficiaries – UtiliCorp's shareholders.

Q. You described how the Staff believes that a prime motivation for acquiring SJLP is for UtiliCorp to gain size and scope to position itself for financial success in a deregulated energy industry. Is this how UtiliCorp portrayed the motivation behind this merger in its direct testimony in Case No. EM-2000-292?

A. No. In order to put its best argument for acquisition adjustment recovery before the Commission, UtiliCorp had to focus its testimony in Case No. EM-2000-292 on the central theme of how significant merger benefits would flow to SJLP's customers.

Q. Other than the benefit of an enhanced competitive position in a deregulated energy market, what other benefits to UtiliCorp's nonregulated affiliates did it believe would occur as a result of the SJLP acquisition?

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

Q. Is access to captive utility customers to generate additional revenue for *nonregulated 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, described the 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].

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

A. Yes. In a March 15, 2000 Conference Call with Salomon Smith Barney (March 2000 Conference Call) found in UtiliCorp's Internet website under Investor

Information, Presentations, Mr. Robert Green described how UtiliCorp intends to break apart some of SJLP's embedded utility businesses and reposition them as nonregulated 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" SJLP's embedded assets and businesses?

A. Yes. However, before I describe how UtiliCorp intends to disaggregate the assets currently owned by SJLP 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.
>
> **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 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 described 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 to Shareholders page 5). In the February 2000 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 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 2000 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.

UtiliCorp leveraged its investment in West Virginia Power to secure a long-term benefit for its nonregulated Energy Merchant Business subsidiary, Aquila.

Q. Did UtiliCorp intend to leverage its investment in SJLP to benefit its nonregulated affiliate companies?

A. Yes. Also in the February 2000 Conference Call, Mr. Robert Green described UtiliCorp's strategy of leveraging regulated utility assets to enhance its nonregulated investments as "take advantage of our network position to pursue growth opportunities." Consistent with this strategy, the Staff believes UtiliCorp intends to leverage SJLP's regulated utility assets to secure financial benefits to its Specialized Services business (Quanta and telecommunications investments) and its Energy Delivery Networks (ServiceOne).

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

A. As of December 31, 2000, UtiliCorp has an investment interest in Quanta of approximately $712 million. 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) in September 1999. Quanta terminated the agreements with UtiliCorp in December 2000 for a $28.6 million buyout payment. 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>
> 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. Under the Strategic Agreement, UtiliCorp was contractually obligated to treat Quanta as the preferred contractor for all of its utility construction and maintenance work. While the agreement was in effect (September 1999 – December 2000), Quanta paid UtiliCorp $9.3 million annually for among other things, assisting Quanta in acquiring outsourced electric utility construction and maintenance business.

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

> Under the terms of the Strategic Alliance Agreement, UtiliCorp will use the Company, subject to the Company's ability to perform the required services, as a preferred contractor in outsourced power transmission and distribution infrastructure construction and maintenance and natural gas distribution construction and maintenance in all areas serviced by UtiliCorp, provided that the Company provides such services at a competitive cost. The Strategic Alliance Agreement has a term of six years.
>
> The Company also entered into a Management Services Agreement with UtiliCorp. Under the Management Services Agreement, to the extent mutually agreed upon by the parties, UtiliCorp will provide advice and services including financing activities; corporate strategic

> planning; research on the restructuring of the utility industries; the 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.
>
> 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 2000 and March 2000 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 2000 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 2000 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.

Because UtiliCorp designated Quanta as a "preferred contractor" for utility construction and maintenance projects, UtiliCorp's purchase of SJLP (and its future construction and maintenance projects) would have the effect of increasing 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 SJLP's construction and maintenance projects), it will also benefit from the revenues (nonregulated) paid to UtiliCorp from Quanta for management services.

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 nonregulated 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

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

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

A. As described in its 1999 Annual Report to Shareholders, 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. 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 2000 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. Did UtiliCorp plan to enter the domestic telecommunications business using the assets acquired from SJLP and Empire?

A. Yes. In the February 2000 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 merged 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. Joe 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.]

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

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 SJLP's telecommunication assets, or how much of the $44 million above current market value that UtiliCorp estimated it would pay for SJLP that should be attributed to these assets. However, the amount could be substantial.

Q. Please explain.

A. In the February 2000 Conference Call, Mr. Robert Green said that UtiliCorp invested approximately $15 million in its Australian telecommunications operations and these operations now have a value of $300 million. He also said "in St. Joe I think we're looking at putting $4 million into the business to fund their expansion. We've laid a little fiber in Colorado and it's just single digits in terms of millions, with very high returns." UtiliCorp's Australian telecommunications operation has a valuation of 20 times investment ($300/$15).

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

A. Yes. In May 1998, UtiliCorp sold 42 percent 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 2000 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 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.

Q. Does the acquisition of SJLP's approximately 70,000 regulated utility customers potentially provide benefits to UtiliCorp's nonregulated 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 nonregulated company that provides home warranties, service contracts, appliance repairs and heating and cooling services. According to UtiliCorp's 2000 Annual Report to Shareholders, ServiceOne serves about 156,000 contract customers in seven states, both inside and outside UtiliCorp's regulated utility service territories.

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

A. Yes. Attached as Schedule 1 and Schedule 2 to this testimony are UtiliCorp advertisements promoting the SJLP brand name. These advertisements which promote EnergyOne's heating and air conditioning business and the sale of heat pumps, are included as Exhibit 1 and Exhibit 2 to Case No. EC-2002-278, a complaint against UtiliCorp filed by Missouri Coalition for Fair Competition. One advertisement asks "Looking For a Heating and Cooling Dealer You Can Trust?" and right below these words is the brand name "St. Joseph Light & Power and EnergyOne."

Q. Why does UtiliCorp continue to use the SJLP brand name?

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

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

> *Annually, Light & Power ranks among the nation's most reliable utilities in quality of service.
>
> *For value, our electric prices are among the lowest when compared to other national and area utilities, and our natural gas prices also are competitive.
>
> *Our most distinguishing trait is the commitment we bring to our tasks -- good service to customers through continued innovation and responsiveness.

In marketing its nonregulated products through ServiceOne, UtiliCorp is be able to benefit from this customer-utility relationship. Presumably a customer generally will be more likely to do business with a company that he/she has had a personal relationship with for many years over a company with which no such relationship exists. When UtiliCorp purchased the assets of SJLP, it is also purchased the SJLP brand name, an intangible asset that has the potential to provide benefits to UtiliCorp's nonregulated ServiceOne subsidiary.

Q. Is this intangible asset, SJLP brand name, recognized as an asset by UtiliCorp?

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

Q. Please summarize your rebuttal testimony.

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 $97 million SJLP acquisition adjustment it could have retained the use of the pooling of interests method of accounting. 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.

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 anticipated strategic shareholder merger benefits include:

(1) maintain control of all the operations of the combined company;

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

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

(4) ownership of telecom assets which are expected to lead to significant returns to its non-regulated operations;

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

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

(7) access to an existing customer base in which it can use SJLPs 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.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of the Tariff	)	
Filing of Missouri Public Service (MPS)	)	
A Division of UtiliCorp United Inc., to	)	Case No. ER-2001-672
Implement a General Rate Increase for Retail	)	
Electric Service Provided to Customers in the	)	
Missouri Service Area of MPS	)	

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Charles R. Hyneman, being of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 10 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

Charles R. Hyneman

Subscribed and sworn to before me this 7th day of January 2002.

Toni M Charlton

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

What is a PowerTech Dealer

Authorized PowerTech℠ Dealers are those heating and cooling contractors that St. Joseph Light & Power believes will best meet the standards of excellence that our customers deserve. Specifically, each dealer must meet the following criteria:

- Licensed to install and recover refrigerants based on EPA requirements.
- Attend SJLP-sponsored training classes, including our specialized training program for heat pump installations.
- Have an on-going commitment to managing their business and customer service practices in a professional manner, with a focus on quality, fairness and accuracy.

uthorized PowerTech Dealers are evaluated annually by t. Joseph Light & Power to make sure they continue to ieet these strict qualifications.

Schedule 1

Why should I go with an Authorized PowerTech Dealer?

When you purchase equipment from an Authorized PowerTech Dealer, you have three key advantages over other contractors:

1. **Low-cost financing**. Only available through PowerTech Dealers, qualified customers may finance a central air conditioning or heat pump system through SJLP with terms up to seven years and no money down. Billing will appear on your monthly SJLP statement.*
2. **Free inspection**. St. Joseph Light & Power performs a free system inspection on all new heat pump systems sold and installed by your Authorized PowerTech Dealer.
3. **Comfort Pledge®**. When you purchase a heat pump system from a PowerTech Dealer and finance with SJLP, you get the unique Comfort Pledge that guarantees your comfort*.
4. **Free Five-Year parts and labor warranty**. PowerTech Dealers will provide a free five-year parts and labor warranty on all qualifying heat pump installations.

As part of the Authorized PowerTech Dealer criteria, you also have the assurance that the dealers we select must be well-established with a firm commitment to stand behind their work. Please ask each dealer for specific warranties or guaranties on the equipment they sell.

How do I find an Authorized PowerTech Dealer in my area?

St. Joseph Light & Power has PowerTech dealers located throughout our service area.
To find your PowerTech dealer, simply call your St. Joseph Light & Power Consumer Market Representative at 800-526-3348.

* Certain conditions apply. Ask your Authorized PowerTech Dealer for details

St. Joseph Light & Power
POWERTECH
Authorized Dealer

Meet your Authorized PowerTech℠ Dealer.

St. Joseph Light & Power has taken all the legwork out of shopping for a heating and cooling dealer that you can trust. Just ask us for our list of exclusive Authorized PowerTech Dealers; dealers that are screened and trained to be the "best in class." So you can count on quality work and professional service every time.

St. Joseph Light & Power

POWER

ST. JOSEPH LIGHT & POWER

ENERGYONE.

A Division of UtiliCorp United

SMART. SIMPLE. ENERGY.℠

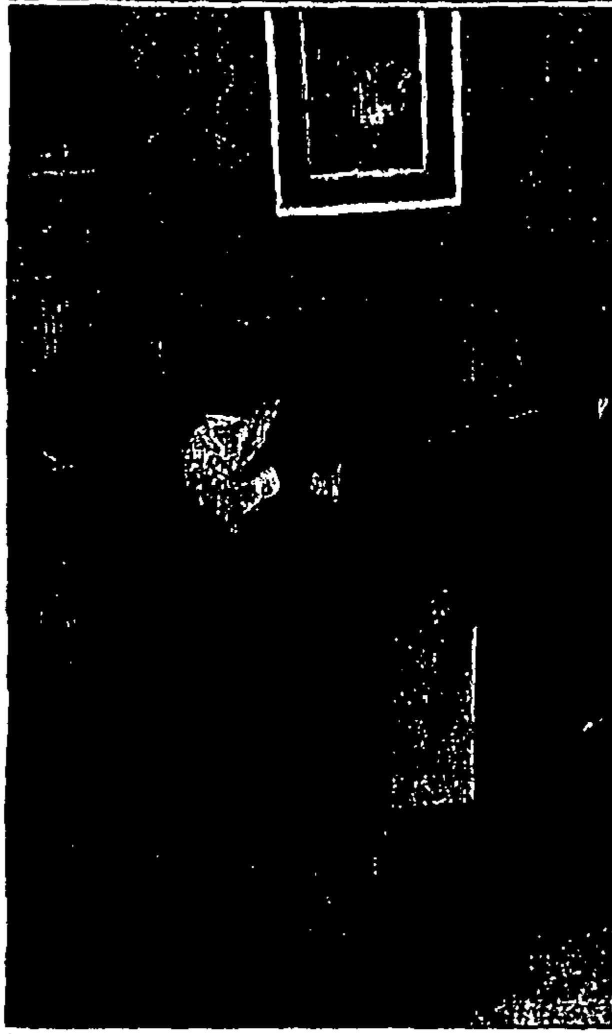
Looking For A Heating And Cooling Dealer You Can Trust?

EXHIBIT 1

ST. JOSEPH LIGHT & POWER

ENERGYONE.

A Division of UtiliCorp United



Schedule 2