Exhibit No.:
Issues: Merger Premium
Witness: Charles R. Hyneman
Sponsoring Party: MoPSC Staff
Type of Exhibit: Rebuttal Testimony
Case No.: EM-96-149

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

UNION ELECTRIC COMPANY

CASE NO. EM-96-149

Jefferson City, Missouri
May 1996

Exhibit No. 4
Date 9-5-96 Case No. EM-96-149
Reporter KS

NP

****<u>Denotes Highly Confidential Information</u>****

REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

UNION ELECTRIC COMPANY

CASE NO. EM-96-149

Q. Please state your name and business address.

A. Charles R. Hyneman, State Office Building, 615 East Thirteenth Street, Kansas City, Missouri 64106.

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

A. I am an Assistant Manager of the Accounting Department, Kansas City Office, with the Missouri Public Service Commission (Commission).

Q. Please describe your educational background and work experience.

A. I graduated from Indiana State University in May 1985 with a Bachelor of Science degree in Accounting. I also earned a Masters of Business Administration degree from the University of Missouri - Columbia in December of 1988. I am a licensed Certified Public Accountant in the state of Missouri.

In May 1985, I was commissioned as an officer in the United States Air Force. I served from 1985 to 1989 as a Missile Combat Crew Commander at Whiteman Air Force Base (AFB) near Warrensburg, Missouri. After being promoted to the rank of Captain in 1989, I was selected to be an instructor in strategic missile operations at Vandenberg AFB, California. I left the Air Force in December 1992 and joined the Commission in April 1993.

Q. Describe the nature of your duties since joining this Commission.

A. I have assisted, conducted and supervised audits and examinations of the books and records of public utilities operating within the state of Missouri. I have participated in examinations of electric, industrial steam, natural gas, telecommunications and water and wastewater companies. I have been involved in cases concerning proposed rate increases, earnings investigations, acquisitions and certifications cases.

Q. Have you previously filed testimony before this Commission?

A. Yes. I have filed testimony before this Commission in the following utility rate cases:

TR-93-181	United Telephone Company of Missouri
ER-94-163	St. Joseph Light & Power Company
HR-94-177	St. Joseph Light & Power Company
GR-95-160	United Cities Gas Company

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Union Electric Company (Union Electric or UE) regarding its proposal to merge with CIPSCO Incorporated (CIPSCO). Specifically, my testimony will:

1. Describe the accounting method that UE and CIPSCO are proposing to use to account for the merger (the pooling of interests method);

2. Describe the purchase method of accounting for mergers;

3. Contrast the pooling of interests method with the purchase method;

4. Explain how UE calculated a "merger premium";

5. Describe how UE proposes to account for the "merger premium";

6. Discuss the impact of the "merger premium" on Ameren Corporation's (Ameren) pro forma earnings per share calculation;

7. State why UE believes the "merger premium" should be included in rates; and

8. Summarize why I believe the "merger premium" should not be included in rates.

Q. How are companies required to record a business combination (merger) for financial accounting purposes?

A. There are two strikingly different sets of accounting procedures which are used to record mergers on the books of the combined business entity. These two accounting procedures are referred to as the *purchase* method and the *pooling of interests* method (pooling method or pooling).

The authoritative generally accepted accounting principle (GAAP) on mergers is Accounting Principles Board Opinion No. 16 (APB 16) entitled *Accounting for Business Combinations.* The pooling method is required when certain criteria regarding the nature of the consideration given and the circumstances of the exchange are met. If the pooling method criteria are not met, the purchase method of accounting must be used to record the merger. Company witness Warner L. Baxter attached as Schedule 1 to his direct testimony the specific criteria from APB 16 which must be met to use the pooling method.

Q. Does UE have a choice of using either the pooling method or the purchase method?

A. Technically, no. However, since the pooling method is more advantageous to the shareholders of combining companies (as will be shown later in my testimony), a company can structure the terms of a merger to meet the requirements of a pooling and, therefore, record the merger as a pooling.

Q. How can a company structure a merger transaction to qualify for pooling treatment?

A. The pooling method requires that the acquiring company issue common stock to acquire no less than 90 percent of the common stock of the acquired company. This is referred to as a "stock swap". Assuming a company complies with the other pooling requirements, it can decide to merge with a company by issuing stock instead of debt and/or cash and qualify for pooling treatment.

Q. Do UE and CIPSCO propose to account for the merger as a pooling of interests for financial reporting purposes?

A. Yes. UE witness Baxter states on page 4 of his direct testimony that the pooling method will be followed for financial reporting purposes. The receipt by UE and CIPSCO of a letter from their respective accountants stating that the merger will qualify for the pooling of interests method is a condition precedent to the consummation of the merger.

Q. Describe the pooling of interests method of accounting for mergers.

A. The fundamental idea underlying the pooling method is that no actual purchase and sale of a business takes place. The two companies involved are considered as combining their ownership interests and managerial abilities to form one economic entity. Net assets (total assets minus total liabilities) of the combining companies are carried forward at book (historical cost) values. The separate income statements of the combining companies are simply combined and shown as income of one economic entity.

In a pooling, the net assets of the companies remain intact and are combined. The stockholder groups also remain intact and are combined. Aggregate income is not changed since total resources are not changed. Poolings are intended to present as a single interest two stockholder groups which were previously independent and the combined rights and risks represented by those groups. Stockholder groups neither withdraw nor invest assets but, in effect, exchange voting common stock in a ratio that determines their respective interests in the combined corporation. The current fair value of the common stock issued and the current fair value of the acquiring firm's net assets are ignored in a pooling of interests.

The stockholders' equities of the separate companies are also combined in a pooling. The combined corporation records as equity, the common stock and paid-in capital in excess of par value of outstanding stock of the separate companies. Similarly, retained earnings of the separate companies are combined and recognized as retained earnings of the combined corporation.

Q. Does APB 16 consider a merger accounted for as a pooling to be an acquisition of one company by another or on acquisition of assets?

A. No. APB 16 does not describe pooling mergers as "acquisitions" because the meaning of the word acquisition is inconsistent with the pooling of interests method of accounting.

Q. Describe the purchase method of accounting for mergers.

A. The purchase method accounts for mergers as the acquisition of one company by another. The acquiring company records as its cost the acquired assets less liabilities assumed. The difference between the cost (amount paid) of the acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill.

Accounting for a merger by the purchase method follows the principles of historical-cost (original cost) accounting to record acquisitions of assets and issuances of stock and account for assets and liabilities after the acquisition.

Q. What is the difference between the pooling method and the purchase method of accounting?

A. The fundamental difference between the two methods used to account for business combinations is that, under the *purchase* method, the ownership rights in an acquired company pass to the acquiring company; a sale and a purchase of assets takes place. In contrast, under the *pooling* method, the owners of the combining companies merge their ownership interests in the stock of those companies to form a newly combined economic entity. There is no transfer of ownership rights, and no sale or purchase takes place.

I will use the following example to illustrate the conceptual differences between a purchase and a pooling. A purchase is shown for both a regulated utility and a non-regulated company to help illustrate the difference. There is no difference in the recording of a pooling for a regulated utility and a non-regulated company.

<u>Purchase--Non-regulated Company</u>

Company A acquires Company B by paying $1,000,000 in cash. The book value of Company B's net assets is $700,000. An independent appraisal of Company B's net assets shows a fair value of $900,000. The substance of this transaction is illustrated in the following journal entry:

Net Assets of Company B (fair value)	$900,000	
Goodwill	100,000	
Cash		$1,000,000

To record merger with Company B as a purchase.

This journal entry shows that in a purchase, when the purchase price exceeds the book value of net assets, the assets are "written-up" and recorded at their fair values ($900,000). The difference between the purchase price and the recorded fair value of net assets is recorded as an intangible asset called goodwill.

Goodwill is subsequently amortized as an expense to the income statement on a straight-line basis over a period of years, having the effect of decreasing net income. Also, since certain depreciable assets have been recorded at the higher fair value (as opposed to book value), depreciation expense in a purchase will be higher than in a pooling, also having a negative effect on net income.

<u>Purchase–Regulated utility company</u>

The journal entry to record this transaction for a regulated utility company is as follows:

Net Assets of Company B (original-cost)	$700,000	
Acquisition Adjustment	$300,000	
Cash		$1,000,000

Electric utilities subject to Federal Energy Regulatory Commission (FERC) jurisdiction must record the difference between the amount paid to acquire a company and the historical cost values on the acquired company's books as an acquisition adjustment. The amount of the acquisition adjustment is amortized as an expense on the income statement (either above or below-the-line depending on Commission treatment) having the effect of reducing net income.

In this example, the acquisition adjustment ($300,000) includes the increase in the appraised value of net assets over the book value ($900,000 - $700,000) and the difference between the purchase price and the appraised fair value of net assets ($1,000,000 - $900,000), referred to as goodwill.

If the amortization of the acquisition adjustment to the income statement is treated above-the-line (included in cost of service) for ratemaking purposes, the effect on net income of the purchase method for both regulated and non-regulated companies would be the same. The net result is that net income will be reduced by a total of $300,000 over a period of years.

Pooling

Assume the same facts as in the purchase example, except that instead of paying cash, Company A issues 10,000 shares of its $1 par common stock to acquire all of the outstanding common stock of Company B. A journal entry reflecting the substance of this transaction is shown below:

Company B Net Assets (historical cost)	$700,000	
Common Stock (10,000 shares X $1)		10,000
Additional Paid-in Capital		690,000
To record merger with Company B as a pooling of interests		

This journal entry shows that in a pooling, the fair value of assets acquired ($900,000) is ignored and the actual price paid to Company B shareholders is ignored. For example, assume that the market price of Company A stock was $100 per share. The "cost" to Company A to acquire Company B is 10,000 shares times $100 per share, or $1,000,000. This $1,000,000 cost is not reflected anywhere in Company A's financial statements. Only one cost is relevant in a pooling, and that is historical (original) cost.

This example also shows that no goodwill is recorded in a pooling and therefore, there is no negative impact on net income. Also, since the book value of assets acquired are not "written-up" to their fair values, a pooling avoids the higher depreciation expense that would be recognized in a purchase transaction.

Q. What is the most important difference between the purchase accounting method and the pooling accounting method?

A. The most important difference between the two methods is that the pooling method does not allow for the recording of any merger-created asset to account for the difference between the amount paid to acquire a company and the value of the acquired company. No acquisition adjustment or goodwill asset is recorded in a pooling. Since there is no merger-created asset to amortize to expense on the income statement, there is no negative impact on net income.

Q. Why do companies prefer the pooling method over the purchase method?

A. On page 2 of Company witness Douglas W. Kimmelman's direct testimony, he states that nearly all utility combinations are effected as a stock swap, and use the pooling of interests accounting method for the transaction. One reason for this is that the pooling method tends to result in higher net income, and lower depreciation and amortization expense for the combined company than it would if accounted for as a purchase. Therefore, management or owners of companies may frequently prefer the pooling method to account for mergers.

On page 3 of his direct testimony, Mr. Kimmelman goes on to describe advantages of the pooling method as listed below:

1. Less costly than a cash transaction as it does not leverage the company;
2. It is tax-free to the shareholders; and
3. Does not involve the booking of goodwill, that when amortized, increases expenses.

Q. In the example you used to illustrate the difference in accounting for pooling and purchases, you stated that in a pooling, the actual price paid is ignored. How did UE determine its cost to acquire all of the outstanding common shares of CIPSCO?

A. Through negotiations, UE and CIPSCO agreed to indirectly exchange one share of CIPSCO common stock for 1.03 shares of UE stock. The valuation date was

August 11, 1995. On that date, CIPSCO had 34,069,542 shares of common stock outstanding. Since the shareholders of CIPSCO indirectly receive 1.03 shares of UE stock for each share of CIPSCO stock outstanding, UE will have to issue 35,091,628 (34,069,542 X 1.03) shares to acquire the net assets of CIPSCO.

The market price of UE stock on August 11, 1995 closed at $35.375 per share. This price per share times the amount of stock to be issued (35,091,628) equals the total cost of CIPSCO stock of $1,241,366,350.

Q. Will this cost of $1,241,366,350 appear anywhere on the financial statements of the new holding company, Ameren Corporation?

A. No. As shown in my previous example, this cost is not reflected in the accounting for the merger under the pooling of interests method. In response to Staff Data Request No. 94, UE provided the following pro forma journal entry to record the merger on the books of Ameren Corporation:

Investment in UE, CIPS and CIPSCO	$2,970,729,000	
Common Stockholders' Equity		$2,970,729,000

This journal entry simply combines the existing stockholders' equity of the two companies ($2,319,197,000 for UE and $651,532,000 for CIPSCO). If the journal entry were recorded separately for UE and CIPSCO, the journal entry to record the investment in CIPSCO would be:

Investment in CIPSCO	$651,532,000	
Common Stockholders' Equity		$651,532,000

This journal entry shows that UE is required to record the investment in CIPSCO at its book value and the cost of the investment ($1,241,366,350) is ignored.

Q. Under the pooling method, how did UE determine the value of the CIPSCO's shares acquired?

A. UE determined this value by multiplying the $29.625 per share closing market price of CIPSCO stock on the valuation date (August 11, 1995) times the number of shares outstanding on that date (34,069,542). This value is $1,009,310,182.

Q. How does UE propose to recognize the $232,056,168 difference between the amount "paid" to acquire the outstanding shares of CIPSCO ($1,241,366,350) and the market value of CIPSCO stock on the valuation date ($1,009,310,182)?

A. UE refers to the $232,056,158 difference as a "merger premium" and is proposing to recover this premium in rates for regulatory accounting purposes, and not recognize this premium for financial accounting purposes.

Q. Will the "merger premium" that UE is proposing to recover for ratemaking purposes be reflected in any UE or Ameren Corporation balance sheet or income statement account?

A. No. The only place on the balance sheet where a "merger premium" could be reflected is in the pro forma adjustment to the combined Common Stock and Other Stockholders' Equity accounts. This adjustment merely reflects a reclassification between these two accounts to comply with accounting rules that require the Common Stock account to be shown at par value. This adjustment has no effect on total stockholders' equity.

Q. How does Ameren propose to account for the "merger premium" for financial reporting purposes?

A. In response to Staff Data Request No. 94, UE stated that the "merger premium" will not be recorded on the books of UE or CIPSCO. Accounting rules (APB 16) do not allow for the recording of any premium on the company's books and records. No intangible asset is allowed to be recognized and no amortization of the "merger premium" to the income statement is allowed. According to the balance sheet and income statement accounts of Ameren, the "merger premium" will not exist.

Q. How does Ameren propose to account for the "merger premium" for regulatory accounting purposes?

A. For regulatory accounting (and ratemaking) purposes, UE is proposing to defer and amortize this "merger premium" to cost of service on a straight line basis over ten years. The amortized amount of the "merger premium" will be added to depreciation and amortization expense in the annual "Earnings Report" for the twelve months ending June 30 submitted to the Commission under the current Experimental Alternative Regulation Plan established in Case No. ER-95-411. In effect, UE proposes to charge the "merger premium" as an expense to ratepayers just like any other operating expense.

Q. Why does UE believe Missouri ratepayers should pay for the "merger premium"?

A. In his direct testimony, Mr. Kimmelman stated that Ameren shareholders will expect a fair return on their investment so as to not dilute the value of their current holdings.

He believes there will be a dilutive effect on the shareholders' investment if they are not allowed a return on the "merger premium".

Q. Explain the concept of "dilution" if the "merger premium" is not recovered in rates.

A. Dilution can be defined as a decrease, loss, or weakening of a financial statement related item. For example, if more common shares are issued, the equity interest represented by each common share is reduced. The dilution referred to by Mr. Kimmelman relates to earnings per share (EPS). EPS is equal to net income divided by the number of common shares issued and outstanding.

Q. Explain UE's position on dilution if the "merger premium" is not recognized for ratemaking purposes.

A. In response to Staff Data Request No. 165, Mr. Kimmelman provided a calculation that shows how the merger will cause a dilution in EPS to UE shareholders. His calculation is based on the first year of actual combined operations (1997) as follows:

Projected Income to UE	**___________**
UE pre-merger shares outstanding	**__________**
UE EPS without merger (projected)	**_____**
Projected Combined Income	**___________**
Combined Shares outstanding	**__________**
Combined EPS (projected)	**_____**

From this calculation on projected future earnings, UE shareholders' earnings will decrease by **____** per share.

Q. Does you agree with the calculation of dilution in EPS?

A. No, I do not. The calculation does not recognize the increase in net income from merger cost savings. By not including these savings, combined net income, and therefore combined EPS are understated.

Q. Please provide a calculation of projected EPS that includes the effect of merger savings.

A. The following calculation of EPS is based on the data provided by Mr. Kimmelman in his response to Staff Data Request No. 165 and data from Schedule 8 of UE witness Gary L. Rainwater's direct testimony:

$$\text{Post merger EPS} = \frac{\text{Combined Earnings} + 1/2\ \text{Merger Savings}}{\text{Common shares outstanding}}$$

Post merger EPS = (**__________** + $19,117,500) ÷ 137,254,771 = **____**

Although this calculation ignores any income tax effect, it shows the significant impact of merger savings on projected earnings per share calculations. It also shows that failure by UE to directly recover the "merger premium" in rates should not have a dilutive effect on EPS.

Q. Is it your opinion, Mr. Hyneman, that including one half of the merger savings in EPS is the proper way to calculate EPS?

A. Yes, it is. The Staff's position in this case is to allow UE the opportunity to retain approximately one-half of gross merger savings.

Q. Do you have any evidence to indicate that UE management believes there will be no dilution in projected EPS?

A. Yes. In an Investment Analyst Report prepared by Smith Barney, UE management is quoted as having indicated that it expected merger savings to offset any near term dilution and to be accretive (result in an increase) in EPS. Staff Accounting witness Cary G. Featherstone also discusses the concept of dilution in his rebuttal testimony filed in this case.

Q. Does UE provide any other rationale for proposing to include the "merger premium" in its utility rates?

A. Yes. On page 18 of his direct testimony, UE witness Rainwater states that the investment ("merger premium") should be recovered in rates for the same reasons that an investment in any aspect of UE's business would be allowed--because it was prudent.

Q,. Do you agree with Mr. Rainwater's assertion?

A. I agree that prudent, reasonable, and beneficial investments should be recovered. However, I do not agree that the "merger premium" is an investment by UE. Utility investments that provide service to ratepayers are recorded as assets. A "merger premium" is not an asset. In fact, it is prohibited from being recorded as an asset for both financial reporting (GAAP) and regulatory accounting (Uniform System of Accounts) purposes.

Q. If you wouldn't classify the "merger premium" as an investment, how would you classify the "merger premium"?

A. The "merger premium" is simply a result of an exchange of ownership interests between UE stockholders and CIPSCO stockholders. An exchange between stockholder groups is a separate and distinct transaction from the business transactions of a company.

Q. Would including recovery of the "merger premium" in rates violate a basic assumption of accounting?

A. Yes. A basic assumption of accounting is that economic activities can be identified with a particular unit of accountability. In other words, the activity of a business enterprise can be kept separate and distinct from its owners. This is referred to as the economic entity assumption. Since the "merger premium" resulted from a transaction between stockholders (owners), it should not be included in the financial operations of a company.

Q. Mr. Hyneman, do you believe that UE should be allowed to recover the "merger premium" in rates?

A. No, I do not.

Q. Please summarize the reasons why you believe the "merger premium" should not be included in rates.

A. UE chose to account for the proposed merger with CIPSCO as a pooling of interest primarily because of the financial benefits this method provides to Ameren shareholders (tax-free to shareholders, no negative impact on earnings). However, UE's proposal to seek recovery of the "merger premium" is not consistent with the basic concepts of the pooling of interests method.

The "merger premium" will not be reflected in any income statement or balance sheet account of UE, CIPSCO or Ameren. The "merger premium" is not an investment by either UE, CIPSCO or Ameren because it will not be recorded as an asset. All investments in a company are recorded as assets. The "merger premium" will not be an expense of UE, CIPSCO or Ameren because all expenses are recorded on the income statement. Because the "merger premium" is not an asset or an expense, it should not be reflected in rates.

The "merger premium" is a result of a transaction between shareholders of UE and shareholders of CIPSCO. It is not a result of a business transaction between UE and CIPSCO. If it were a business transaction, it would (as all business transactions are) be reflected in the financial records.

It is therefore my recommendation that UE not be allowed to recover the "merger premium".

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 Union Electric Company for an order authorizing: (1) certain merger transactions involving Union Electric Company; (2) the transfer of certain assets, real estate, leased property, easements and contractual agreements to Central Illinois Public Service Company; and (3) in connection therewith, certain other related transactions.	)	Case No. EM-96-149

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Charles R. Hyneman, 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 17 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 7 day of May, 1996.

J. Kay Niemeier
Notary Public

J KAY NIEMEIER
NOTARY PUBLIC STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. FEB. 26,2000

My Commission Expires: