

Exhibit No:  
Issues:

Witness:  
Type of Exhibit:

Sponsoring Party:  
Case No:

Date Testimony Prepared:

Vern J. Siemek  
Rebuttal  
Testimony  
Aquila Networks  
GR-2004-0072  
February 13, 2004

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. GR-2004-0072**

**FILED<sup>3</sup>**

**JUN 21 2004**

**Missouri Public  
Service Commission**

**REBUTTAL TESTIMONY**

**OF**

**VERN J. SIEMEK**

**ON BEHALF OF**

**AQUILA, INC.  
d/b/a  
AQUILA NETWORKS – MPS  
and  
AQUILA NETWORKS – L&P**

**Omaha, Nebraska  
February 2004**

**BEFORE THE PUBLIC SERVICE COMMISSION**

Exhibit No. 21  
Date 3/3/04 Case No. GR-2004-0072  
Reporter XF

State of Nebraska     )  
                                  ) ss  
County of Douglas    )

AFFIDAVIT OF Vern J. Siemek

Vern J. Siemek, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony and schedules entitled "Rebuttal Testimony of Vern J Siemek"; that said testimony was prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

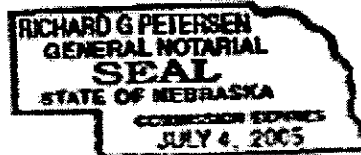
Vern J. Siemek

Subscribed and sworn to before me this 10<sup>th</sup> day of February, 2004.

Richard G. Petersen  
Notary Public

My Commission expires:

2/10/04



OF THE STATE OF MISSOURI  
REBUTTAL TESTIMONY OF VERN J. SIEMEK  
ON BEHALF OF AQUILA, INC.  
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P  
CASE NOS. GR-2004-0072

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is Vern J. Siemek. My business address is Aquila, Inc., 1815 Capitol  
3 Avenue, Omaha, Nebraska, 68102-4914.

4 Q. ARE YOU THE SAME VERN J. SIEMEK WHO SPONSORED DIRECT  
5 TESTIMONY IN THIS CASE ON BEHALF OF AQUILA, INC. ("AQUILA")  
6 BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION  
7 ("COMMISSION")?

8 A. Yes.

9 I. PURPOSE AND SUMMARY OF REBUTTAL TESTIMONY

10 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

11 A. My rebuttal testimony will respond to the various witnesses who urge rejecting  
12 ANY sharing of the continuing synergies resulting from the UtiliCorp (now  
13 Aquila)/St. Joseph Light & Power ("L&P") merger. Those witnesses include Mark  
14 Oligschlager of Commission Staff ("Staff"), and Ted Robertson of the Office of  
15 the Public Counsel ("OPC"). Both take the position that the continuing and  
16 essentially undisputed synergies created by the L&P merger should be assigned  
17 100% to customers. They apparently believe that customers should realize  
18 100% of the continuing benefits despite the fact that Aquila is responsible for  
19 both the merger and the synergies, and that customers have contributed little to  
20 the costs to accomplish either of these.

1

**II. MERGER SYNERGIES TO BE SHARED**

2 **Q. PLEASE REVIEW THE SOURCE OF THE SYNERGIES TO BE SHARED**  
3 **WHICH GIVES RISE TO THIS ISSUE.**

4 A. Economies of scale from the Aquila/L&P merger created savings for Aquila's  
5 MPS operating division by spreading Aquila's fixed support costs over the larger  
6 base of operations and customers, which reduced support costs significantly for  
7 MPS.

8

**III. OPPOSITION TO SHARING**

9 **Q. WHAT IS YOUR UNDERSTANDING OF THE BASIS FOR THESE WITNESSES**  
10 **REFUSAL TO PROPOSE A SHARING OF ANY OF THE SYNERGIES**  
11 **BETWEEN AQUILA AND ITS CUSTOMERS?**

12 A. *First of all, their positions are not based on the details of the merger savings*  
13 *calculations or the Company's rationale. Despite months of investigation, none*  
14 *of the witnesses who actually reviewed the calculations objected to or expressed*  
15 *serious concerns based on the details or the rationale of calculating the*  
16 *synergies.*

17 **Q. WHAT THEN IS THE BASIS OF THEIR OBJECTION TO SHARING?**

18 A. *The witnesses list various concerns. NONE, however, are legitimate grounds for*  
19 *denying the shareholders of Aquila a share in the continuing synergies created*  
20 *by the merger. Many of their concerns are simply "generic" complaints they*  
21 *would have about any merger and do not relate to Aquila's proposal in this case.*

22 **Q. CAN YOU SUMMARIZE THE REASONS OFFERED BY THE STAFF, AND**  
23 **OPC IN OPPOSING ANY SHARING THE SYNERGIES FROM THE MERGER?**

1 A. Yes. Having been involved with this issue since the merger filing in 1999, it is  
2 clear that, despite testimony to the contrary in the merger case, there is basically  
3 no situation under which Staff or OPC could ever support sharing continuing  
4 synergies (much less cost recovery) in any meaningful sense. Despite Staff's  
5 claimed 'adherence' to their 'principles', they have ignored their own positions  
6 from the merger case both in the last MPS electric rate case and in this rate  
7 proceeding.

8 **Q. WHAT IS THE BASIS FOR YOUR IMPRESSION OF STAFF'S ACTIONS ON**  
9 **THE L&P MERGER SYNERGIES?**

10 A. Aquila has modified its proposals to share in the synergies several times in the  
11 course of the merger case and the last two MPS electric rate cases. Aquila has  
12 modified its proposals in response to issues raised by the Staff in order to  
13 attempt to craft a proposal that meets Staff's criteria. Every time Aquila modifies  
14 its proposals, Staff finds new objections on top of the original ones. The  
15 impression is that Staff indicates that if Aquila does one thing more, our proposal  
16 will be acceptable. When we do that one thing more, or eliminate the cause of  
17 the Staff's issue, Staff develops a new issue that then prevents their acceptance  
18 of our newly revised proposal. In other words, Aquila moves closer to Staff, but  
19 Staff moves further away. It is clear that Staff will not be satisfied no matter how  
20 many modifications Aquila makes to its proposals to share synergies except to  
21 drop them entirely.

22 **Q. CAN YOU PROVIDE DETAILS OF THE EVOLUTION OF AQUILA'S**  
23 **PROPOSAL'S TO ACCOMMODATE STAFF'S CONCERNS?**

1 A. Yes. Rebuttal Schedule VJS-1 lists the history of the Staff's objections to  
2 Aquila's evolving proposal on sharing merger synergies from the merger case to  
3 this rate proceeding. A quick review indicates where Aquila has eliminated  
4 various elements raised by Staff to attempt to craft an equitable sharing proposal  
5 that Staff could accept. Each time, Staff has either reneged on prior parameters  
6 (in the last electric rate proceeding) or raised new issues to prevent any  
7 compromise (in this rate proceeding). It is not possible to reach a compromise  
8 with a party that moves away during attempts to compromise.

9 **IV. REBUTTAL IN GENERAL**

10 **Q. HOW DO YOU RESPOND GENERALLY TO THE VARIOUS ISSUES RAISED?**

11 A. There are several responses I will use in my rebuttal testimony.

12 1. Simply summarizing the Staff and intervenors' positions highlights the inequity  
13 of their 'principles'. The summary above exposes Staff's position so that the  
14 Commission can make a reasoned decision based on the true facts and  
15 equitable treatment.

16 2. I will also illustrate Staff's inconsistency from Aquila case to Aquila case.  
17 Staff has regressed from a position of encouraging a synergies sharing  
18 proposal for three to ten years if appropriate (in the merger case) to wanting  
19 to claim 100% of the synergies after year one (in the last MPS electric case)  
20 to now wanting to claim 100% of the continuing synergies in what the Staff  
21 would call year four.

22 Even in the merger case, Staff recognized that unrelated cost increases  
23 may hamper the realization of synergies and would need to be considered

1 even under their alternative proposal that relied on inadequate regulatory lag.

2  
3 Regulatory lag itself is NOT an equitable method to share savings when  
4 the synergies created are ongoing. This inequity is because those continuing  
5 synergies are passed on 100% to customers periodically and thus are no  
6 longer shared. Sharing synergies through the regulatory lag process as  
7 suggested by the Staff in that manner is clearly one-sided.

- 8 3. Aquila's proposal is an evenhanded and equitable method to reasonably  
9 share in the continuing synergies Aquila is creating. It requires NO elaborate  
10 tracking models. It does NOT require any review of nor ask for ANY recovery  
11 of the costs to achieve the merger. The economies of scale are a  
12 straightforward calculation that has been described in other jurisdictions as  
13 too simple to be disputed. Even after calculating only some of the synergies,  
14 Aquila proposed to retain only 50% of those acquisition-related savings to  
15 benefit shareholders for creating those savings. And HALF of that would be  
16 used to establish a low income assistance program!

17 **V. DETAILED RESPONSES**

18 **Q. PLEASE DESCRIBE THE POSITIONS THAT THE STAFF AND OPC HAVE**  
19 **STATED TO CONFUSE THE ISSUE AND GIVE YOUR DETAILED RESPONSE**  
20 **TO EACH.**

21 ***Position No. 1: REGULATORY LAG IS THE CURE-ALL***

22 Staff claims regulatory lag is a meaningful way for Aquila to share in the  
23 continuing synergies Aquila created, especially since it has been three years

1 since the merger. (Staff witness Oligschlager, page 5 lines 1 to 23, and page 8  
2 lines 15-19)

3 **Response to No. 1:** Regulatory lag is a wholly inadequate method to  
4 achieve any meaningful sharing in merger savings, particularly when the  
5 synergies are long-term and will continue for years. When rates are established  
6 in each rate case, which give 100% of the synergies to the customers, any  
7 “sharing” goes away. However, neither the synergies nor the related costs  
8 disappear anywhere nearly as quickly as the regulatory lag ‘sharing’.  
9 Compare this to including the costs of a generating facility in rates. Both the  
10 merger synergies and the costs of the facility occur for an extended period of  
11 time. No one would seriously advocate eliminating the cost recovery of a  
12 generating plant because three years had elapsed – how could three years be an  
13 adequate period for sharing merger synergies that create long-term and  
14 continuing savings?

15 Even disregarding the inherent shortfalls in this application of regulatory  
16 lag, there are even more compelling reasons to reject it in this case. That is the  
17 fact that Aquila has not realized any significant positive synergies to date. Staff,  
18 in the merger case, acknowledges that extenuating circumstances should be  
19 considered in designing equitable sharing plans, even plans based on regulatory  
20 lag. A quick review of the surveillance reports on MPS and L&P operations filed  
21 monthly with this Commission indicate that returns on equity since 2000 have  
22 averaged 4.24% for MPS and a negative 1.23% for L&P, which are both far  
23 below even the inadequate return on equity proposed by the Staff in this case.



1       **Position No. 2: SYNERGIES ARE JUST TOO HARD TO CALCULATE**

2       Staff and OPC claimed generically that it is too difficult to estimate the total  
3       synergies. (Staff witness Oligschlager, page 6, lines 3 thru 14; OPC witness  
4       Robertson, page 32, lines 19-20)

5       **Response to No. 2:** Aquila did NOT propose 50% of TOTAL synergies –  
6       instead, Aquila’s proposal involves just those that are clear economies of scale  
7       for support costs. Aquila proposes to share only 50% of these identified  
8       synergies, and half of those will benefit low-income customers. Even if synergies  
9       from the straightforward calculations were overstated by 100%, customers would  
10      still benefit because the other synergies would still result in rates lower than rates  
11      absent the merger. Once again, no one has actually challenged the details of the  
12      identified synergies in this case.

13             Aquila has not attempted to identify and claim half of the TOTAL  
14      synergies, because of the similar concerns voiced in the past. Instead, Aquila  
15      has limited the synergies to those that are clear from economies of scale and that  
16      were validated by Staff calculations in the prior MPS electric rate case. The  
17      remaining synergies accrue 100% to the benefit of the customers.

18             It is interesting that Staff now makes the generic claim that it is too difficult  
19      to estimate the synergies using this method, since Staff calculated the synergies  
20      in a similar manner in the last MPS electric rate case in attempting to claim 100%  
21      of the merger synergies in that case.

22      **Position No. 3: ACQUISITION COSTS SHOULD NEVER BE PAID**

1 Staff and OPC propose that acquisition costs should not be recoverable because  
2 acquisition costs are never allowed in rates, were too high because Aquila should  
3 have used pooling accounting, and because Aquila should have assigned costs  
4 to nonregulated businesses. (Staff witness Oligschlager page 4 lines 11-13,  
5 page 6 lines 17-22, and page 7, lines 1-14; OPC witness Robertson pages 28 to  
6 32; pooling- Staff witness Oligschlager page 7 line 15 to page 8, line 2;  
7 nonregulated – Staff witness Oligschlager page 8 lines 3 to 14, OPC witness  
8 Robertson page 32 lines 13-17)

9 ***Response to No. 3:***

10 1. Aquila has NOT asked for cost recovery of acquisition costs – Aquila  
11 has asked only to share in the synergies Aquila created by the merger. OPC  
12 witness Robertson even agreed that no such costs are being requested on page  
13 29 of his testimony!

14 2. Pooling was not available to Aquila, and in fact was banned by the US  
15 accounting rulemakers within a year of the acquisition as not reflective of the  
16 economic realities of business combination. Accounting experts in the merger  
17 case testified that the economic substance of pooling is essentially the same as  
18 purchase accounting. [See attached Rebuttal Schedule VJS-2.]

19 3. Nonregulated businesses were either insignificant or the benefits from  
20 the value of generation are already reflected in the electric synergies created by  
21 joint dispatching which are proposed to be shared in the electric case.

22 ***Position No. 4: ACTUAL COSTS OF SERVICE ARE THE HOLY GRAIL***

1 Staff states that only ACTUAL costs of service can be reflected in rates, not  
2 synergies. (Staff witness Oligschlager page 8, lines 20-23 to page 9, line 1)

3 **Response to No. 4:** Staff has frequently deviated from the actual costs of  
4 service when the results aligned with Staff 'principles'. The deviations are  
5 caused by such mechanisms as averaging costs over various periods (such as  
6 three years, five years, three years and nine months, five years and three  
7 months), switching from cash to accrual to cash for pension expense, altering  
8 income tax calculations, etc. Such an elastic view of 'actual' cost of service can  
9 be adjusted to achieve a desired result.

10 **Position No. 5: SPECULATION**

11 Staff alleges that synergy sharing MIGHT result in some revenues that could  
12 offset some of the Acquisition Premium and Transaction costs. (Staff witness  
13 Oligschlager, page 9 lines 1-4 and page 9, lines 14-16)

14 **Response to No. 5:** Sharing synergies is sharing synergies- end of story! If that  
15 sharing results in upsides that COULD offset some of the many downsides built  
16 into the regulatory process, Staff's concern is still irrelevant. SOME of the  
17 sharing MIGHT pay for costs not recovered in rates, or MIGHT pay for cost  
18 increases due to inflation, or MIGHT pay a return on future investments.

19 Staff doesn't seem as concerned that five year averaging in other Staff  
20 adjustments MIGHT result in legitimate current levels of cost NOT being  
21 recovered or charged to customers.

22 **VI. STAFF'S CONSISTENT 'PRINCIPLES' (AND THEIR RESULTS)**

1 Q. IS CONTINUED ADHERENCE TO THE SAME 'PRINCIPLES' ALWAYS A  
2 GOOD THING?

3 A. No, blind adherence to the same principles is not necessarily a good thing- it just  
4 means that one ignores new facts and circumstances. For example, treating  
5 illnesses by bleeding was a consistent application of medical principles in the 18<sup>th</sup>  
6 century. In the Civil War, it took four years and countless lives to prove that  
7 charging entrenched positions was suicidal, even though it was consistent with  
8 military principles of the day. The principle that the earth is flat is another good  
9 example of a principle that finally gave way to actual circumstances.

10 Q. HAS THE APPLICATION OF STAFF'S 'PRINCIPLES' REMAINED CONSTANT  
11 AS THEY RELATE TO THIS MERGER?

12 A. No, not from my vantage point.

13 Q. WHAT WERE STAFF'S 'PRINCIPLES' IN THE MERGER CASE?

14 A. In the merger case, Staff indicated that it would be receptive to a plan to share  
15 synergies over three to ten years, although the Staff preferred regulatory lag as a  
16 method to share synergies.

17 Staff witness Oligschlaeger, in rebuttal testimony in the Merger Case, page  
18 32-33, lines 21-22 and lines 1-6, "Q. How would the Staff define a fair  
19 percentage of merger savings to be passed on to customers of merged  
20 utilities? A. In past merger applications, the Staff has expressed the opinion  
21 that at least **50%** of total merger benefits should be reflected in customer  
22 rates over the long term if a specific "regulatory plan " for a merger is to be  
23 adopted. The Staff also has stated that **if utilities propose to assign less**  
24 **than half** of total merger savings to customers through a regulatory plan,  
25 then the company should state compelling reason why the public interest  
26 would justify that result."

27  
28 That quote indicates that retention of 50% of the synergies is the standard (over  
29 the long term).

1 Staff witness Proctor's example on page 17, line 4 in rebuttal testimony in  
2 the Merger Case cites "...that there will be a 50% sharing between  
3 shareholders and ratepayers...."

4  
5 Staff witness Proctor in rebuttal testimony in the Merger Case, page 49, line  
6 11 repeats, "The 50% of these synergies going to ratepayers can then be  
7 allocated..."

8  
9 Staff witness Proctor in rebuttal testimony in the Merger Case. Page 13,  
10 lines 7-8, "...that there will be a 50% sharing between shareholders and  
11 ratepayers ..."

12  
13 Staff witness Oligschlaeger in rebuttal testimony in the Merger Case, page  
14 33, line 20-22, "...the Staff would recommend that any "guarantee" should  
15 encompass 50% of the estimated merger savings claimed by the Joint  
16 Applicants for the first ten years of the conclusion of the merger."

17  
18 Clearly, at the merger, Staff felt that sharing 50% of the merger savings was the  
19 appropriate standard.

20 **Q. DID STAFF ADDRESS THE SITUATION WHERE STRAIGHT APPLICATION**  
21 **OF REGULATORY LAG DID NOT RESULT IN A FAIR SHARING OF MERGER**  
22 **SAVINGS TO A UTILITY?**

23 **A.** Yes. Staff witness Oligschlager, in rebuttal testimony in the Merger Case, page  
24 48, lines 14 to 21 specifically addressed that situation.

25 "Q. Are there instances in which regulatory lag may not provide for a fair  
26 sharing of merger savings to a utility?

27 A. That is possible. In particular, when a company undergoing a merger  
28 faces increasing revenue requirements even when estimated net merger  
29 savings are factored in, rate increase cases may serve to pass on  
30 achieved merger savings to customers without a chance for the utilities  
31 to retain a share of merger savings for a reasonable period. In these  
32 instances, the Staff would not be opposed in concept to proposals by  
33 utilities to 'share' merger savings in the context of a rate proceeding."

34  
35 **Q. DID STAFF LAY OUT ANY GENERAL GUIDELINES ABOUT A SHARED**  
36 **SYNERGIES APPROACH IN THAT SITUATION?**

1 A. Yes. Staff witness Oligschlager, in rebuttal testimony in the Merger Case, page  
2 48, line 22 to page 49, line 9 indicates:

3 "Q. How would the Staff view such proposals if they were made by UCU  
4 [now Aquila] in future rate proceedings?

5 A. The Staff's position on such proposal would depend upon the specific  
6 facts and circumstances surrounding the request at that time. Any future  
7 Staff consideration of merger savings sharing proposals would be tied to  
8 production of evidence demonstrating incremental net customer benefits  
9 that can clearly be tied to the SJLP [L&P] merger, and that would not  
10 have been possible without the merger occurring. The amount of any  
11 savings retained by the utility should not be tied to the amount of the  
12 consideration paid by UCU [Aquila] for the SJLP [L&P] properties (i.e.,  
13 the acquisition adjustment). Finally, the Staff would evaluate the past  
14 ability of UCU [Aquila] to retain merger savings through means of  
15 regulatory lag before considering any proposals to share merger savings  
16 in rate cases."

17  
18 **Q. DOES AQUILA'S CURRENT PROPOSAL REFLECT THIS GUIDANCE FROM**  
19 **THE STAFF?**

20 A. Yes. Aquila's current proposal is clearly based on these guidelines proposed by  
21 the Staff:

- 22 1. Aquila did have increasing revenue requirements despite  
23 estimated net merger savings, so had no chance to retain a share  
24 of merger savings for a reasonable period. (evidenced by the  
25 surveillance reports that averaged 4.24% for MPS and a negative  
26 1.23% for L&P)
- 27 2. It is clear that the customer benefits are tied to the merger, and  
28 would not have been possible without the merger.
- 29 3. The savings are not based on the consideration paid by Aquila.
- 30 4. Aquila's past ability to retain merger savings through regulatory  
31 lag has been minimal.

1 Q. WHAT WERE STAFF'S 'PRINCIPLES' IN THE LAST MPS ELECTRIC RATE  
2 CASE?

3 A. In the MPS electric rate case based on 2001 (and updated to September 30,  
4 2002) Staff claimed 100% of the synergies from the merger from economies of  
5 scale. The merger had closed January 1, 2001 and operations were not even  
6 fully integrated at the time of the mid-2001 MPS filing. In other words, despite  
7 the clear lack of any reasonable opportunity to realize many of the synergies, the  
8 'principle' of achieving lowest rates regardless of the inequity cost was actually  
9 used. This violation of Staff's regulatory lag 'principle' was justified by referring to  
10 the merger synergies as cost reallocations and avoiding any direct reference to  
11 the merger. This was despite testimony in the Merger Case (Staff witness  
12 Featherstone rebuttal, page 37, lines 11-14) that

13 "... the addition of a new division, such as SJLP, will cause a re-allocation of  
14 the total corporate costs among the divisions of UCU, with existing divisions  
15 such as MPS benefiting at some level of pre-existing corporate costs are  
16 allocated to SJLP after the merger."  
17

18 Q. WHAT IS STAFF'S POSITION IN THIS RATE CASE?

19 A. That regulatory lag will yield the correct answer, in spite of the obvious lack of  
20 any material realization of synergies by Aquila during the three years since the  
21 merger. A quick review of the surveillance reports filed monthly by MPS during  
22 2001 through August of 2003 indicates that the ROE's achieved by MPS  
23 averaged 4.24% and a negative 1.23% for L&P. These returns are far lower than  
24 the inadequate return being recommended by the Staff in the current case.

25 Staff and OPC in both cases also neglected to adhere to their 'principle'  
26 that transition costs should be allowed by failing to propose any adjustment to

1 recognize those costs – the need for which was created by their recommended  
2 rejection of ANY sharing in synergies.

3 **VII. THE EQUITY OF SHARING SYNERGIES**

4 **Q. YOU HAVE EXPLAINED IN DETAIL THE SEVERAL TYPES AND SOURCES**  
5 **OF SAVINGS FROM THE L&P MERGER TO MPS COSTS. IF SOME**  
6 **PORTION OF THOSE SAVINGS WERE TO BE RETAINED BY AQUILA**  
7 **INSTEAD OF ALSO BEING PASSED ON TO BENEFIT MPS, HOW WOULD**  
8 **YOU CHARACTERIZE THIS SITUATION?**

9 A. It is equitable for Aquila to retain a portion of those savings because the  
10 shareholders of Aquila created those savings by bringing about the acquisition  
11 and they should benefit from those savings. Retaining 50% of the savings for  
12 Aquila is a reasonable portion of the savings, especially when half of that savings  
13 is directed to the low income assistance program.

14 **Q. ARE THERE PRECEDENTS FOR SHARING MERGER AND ACQUISITION-**  
15 **RELATED SAVINGS?**

16 A. Yes, there are many recent precedents for sharing the savings from mergers or  
17 acquisitions cited in my direct testimony. Many are more clear than this proposal  
18 because the acquisitions occurred in a single regulatory jurisdiction. All  
19 acknowledge that the savings created by acquisitions are equitably shared in  
20 some ratio between the customers and the shareholders that created the  
21 savings. Sharing synergies from retaining benefits created by mergers is allowed  
22 in many jurisdictions. It is generally considered superior to recovering the actual



1 costs of an acquisition because customers pay only if savings are actually  
2 created by the merger.

3 **VIII. THE CONSEQUENCES OF NOT SHARING**

4 **Q. WHAT HAPPENS IF 100% OF THE MERGER-RELATED SAVINGS ARE**  
5 **UTILIZED TO REDUCE THE COSTS OF MPS?**

6 A. Economically, shareholders end up absorbing the costs that produced the  
7 savings for the customers. This is clearly not equitable since the parties  
8 benefiting from the cost savings do not share the costs. In addition, passing on  
9 all of the savings to customers will deter future acquisitions and the savings  
10 created by them.

11 **Q. WHAT RISKS HAVE AQUILA SHAREHOLDERS ASSUMED AS A RESULT**  
12 **OF THIS ACQUISITION?**

13 A. Considerable financial risk has been incurred. Aquila must convince its  
14 shareholders and the financial markets that the savings resulting from the  
15 acquisition are adequate to sustain the additional capital costs incurred to  
16 accomplish the merger. Failure to do so injures shareholder value. It is not  
17 enough to demonstrate that the savings have been created. Some of those  
18 savings must be retained by shareholders to offset the added capital costs of the  
19 transaction. The savings method chosen ensures that customers will not be  
20 burdened with those additional costs unless the savings are demonstrable. It  
21 also provides a strong signal to management and investors to create current and  
22 future savings that will benefit both customers and shareholders.

1           If the shareholders do not retain some portion of merger savings,  
2 companies will be less likely to pursue mergers that could ultimately benefit  
3 customers by lowering their costs. Customers receive no such savings if no  
4 mergers occur, so allowing the shareholders to retain a portion of the savings is a  
5 reasonable and equitable method to lower costs to customers.

6                           **IX. THE CONSEQUENCES OF SHARING SYNERGIES**

7 **Q.   HOW DO CUSTOMERS BENEFIT IF THE SHAREHOLDERS RETAIN THE**  
8 **PROPOSED SHARE OF ACQUISITION SAVINGS?**

9 A.   Currently, under Aquila's proposal, all customers will benefit from the 50% of total  
10 merger-related savings still reflected in the test period. The customers helped by  
11 the low income assistance program will also benefit from the 25% of the savings  
12 assigned to that program. The customers share in those savings despite not  
13 contributing to their creation.

14 **Q   WHAT IS THE LIKELY IMPACT IF THE COMMISSION ADOPTS AQUILA'S**  
15 **POSITION?**

16 A.   MPS customers, including customers helped by the low income assistance  
17 program, will realize a significant share of the savings created by this merger. At  
18 a minimum they receive 75% of the identified synergies, and receive 100% of  
19 synergies not included specifically in economies of scale.

20           Companies will be encouraged to pursue merger transactions that will  
21 ultimately provide additional economic benefits to customers, knowing that  
22 shareholders will also share in the economic benefits. Shareholders will be much  
23 more likely to accept the costs and risks of merger transactions if it is clear that

1 the savings have an economic value to the shareholders as well as the  
2 customers. Adopting Aquila's proposal sends a clear signal to utilities currently  
3 operating in Missouri that mergers that make economic sense will not be  
4 prevented or made less economic by regulatory actions.

#### 5 X. SUMMARY

- 6 1 No witnesses who investigated the calculations had any specific concerns  
7 with the synergies, so the synergies are real and they are long-term and  
8 continuing.
- 9 2 Many of the synergies disputed in other cases (gas costs, procurement  
10 efficiencies, etc) are actually reflected 100% to the benefit of customers.
- 11 3 Regulatory lag is NOT an equitable compensation for creating and  
12 sustaining continuing and long-term synergies when neither MPS or L&P  
13 earned their allowed rates of return.

#### 14 XI. CONCLUSION:

##### 15 Q. WHAT IS YOUR CONCLUSION?

16 A. Staff and intervenors' issues are not based on facts but appear instead to be  
17 stated as a means to distract the Commission from considering the equity of  
18 Aquila's reasonable and evenhanded proposal to share in the synergies Aquila  
19 created.

20 The acquisition of L&P has created significant savings to MPS from economies of  
21 scale for support costs. Those savings were created by Aquila with considerable  
22 effort, cost and risk. It is fair and equitable that Aquila retain 50% of the savings

1 created from that acquisition to both reward and compensate Aquila for creating  
2 the savings, even more so with half of those retained savings directed to the low  
3 income assistance program. The retention should be accomplished by reflecting  
4 MPS pro forma adjustments retaining a portion of the savings.

5 **Q DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?**

6 **A. Yes.**

**Elimination of Staff Objections  
by Aquila's Evolving Synergies Sharing Proposals**

Staff Objections- Merger Case	Aquila Proposal in 2001 MPS Elec Case	Staff Objections- 2001 MPS Elec Case	Aquila Rebuttal- 2001 MPS Elec Case	Aquila Proposal in 2003 MPS Case	Staff Objections - 2003 MPS Case	Aquila Rebuttal- 2003 MPS Case
1 5-year freeze too long	ELIM	No issue	No issue	No issue	No issue	No longer an issue by Staff
2 Guaranteed savings too small	ELIM	No issue	No issue	No issue	No issue	No longer an issue by Staff
3 Premiums, Transaction Cost not in rates	ELIM	Premiums, Transaction Cost not in rates	Note A	ELIM	Premiums, Transaction Cost not in rates	No issue - Not requested
4 Some transition costs not in rates	ELIM	Some transition costs not in rates	Note A	ELIM	Some transition costs not in rates	No issue - Not requested
5 Pooling increased premium cost	ELIM	Pooling increased premium cost	Note A	ELIM	Pooling increased premium cost	No issue - Not requested
6 All savings too difficult to calculate	Didn't quantify	STAFF calculated merger synergies	Accepted revised Staff numbers!	Staff method used- didn't ask for 100% of all synergies	All savings too difficult to calculate	Staff method used- didn't ask for 100% of all synergies
7 Tracking modeling too complex	ELIM No new model used	No issue	No issue	No issue	Tracking modeling too complex	Used Staff methodology!
8 Ignores MPS cost reductions due to reallocating support costs	Filed MPS using Staff's regulatory lag approach to avoid issue	<b>Support reallocations to new divisions are NOW not merger-related</b>	Pointed out contradictions to Staff Merger Case testimony	Directly addressed allocation savings with 50% customer, 25% low-income, and 25% Aquila proposal.	ELIM	No issue - synergies shared 50% customers-25% low-income customers-25% Aquila
9 "Make-believe" costs in MPS rates	<b>Result of any sharing mechanism, which are acceptable to Staff</b>	Actual costs not reflected	<b>Result of any sharing mechanism, which are acceptable to Staff</b>	<b>Result of any sharing mechanism, which are acceptable to Staff</b>	Actual costs not reflected	<b>Result of any sharing mechanism, which are acceptable to Staff</b>
10 Sharing approach acceptable under certain conditions	Used more restrictive regulatory lag to reduce controversy	See cost reallocations	Consider alternative in rebuttal	<b>Basis for proposal</b>	Regulatory lag has now shared enough in 3 years	Equitable sharing not realized in 3 years, as anticipated in Staff Merger Case testimony. Staff considered 10 years as acceptable.
11					Shared synergies might result in recovering costs.	Sharing means sharing - NOT cost recovery!
<b>POSITION:</b>	<b>APPROACH:</b>	<b>POSITION:</b>	<b>REBUTTAL:</b>	<b>APPROACH:</b>	<b>POSITION:</b>	<b>ANALYSIS:</b>
13 Prefer regulatory lag if not prevented by other costs, but sharing approach acceptable (50% minimum) for 3-10 years.	Filed under Staff's most restrictive Regulatory Lag approach to reduce controversy - 1st year not reasonable to give 100% of synergies	Claimed 100% of all synergies after one year by now rejecting allocations of costs as merger-related	Staff Inconsistent with Merger Case, so use as filed. OR reflect agreed transition costs OR Share Synergies at 70-30 or 50-50	Shared synergies on Staff calculation methodology at 50% (customers)-25% (low income customers)-25% (Aquila) starting in year 4	Sharing 3 years through regulatory lag is sufficient!	Regulatory lag as Staff proposes is inadequate. Aquila's proposal is now more favorable to customers than original Staff Sharing approach in Merger Case, but Staff continues to object and find new issues.
Note A: Aquila proposals make this objection irrelevant - not asking for recovery of any of these costs.						

Exhibit No.:  
Issue: Purchase Accounting &  
Deferred Taxes  
Witness: Robert C. Kehm  
Sponsoring Party: UtiliCorp United Inc.  
Case No.: EM-2000-292  
Date Prepared: June 26, 2000

MISSOURI PUBLIC SERVICE COMMISSION  
Case No. EM-2000-292

Surrebuttal Testimony

of

Robert C. Kehm

Jefferson City, Missouri

**SURREBUTTAL TESTIMONY  
ROBERT C. KEHM**

**UTILICORP UNITED INC.  
CASE NO. EM-2000-292**

**TABLE OF CONTENTS**

	PAGE
I. ECONOMICS OF BUSINESS COMBINATION ACCOUNTING.....	2
II. COULD UTILICORP HAVE USED POOLING?.....	6
III. INCOME TAXES.....	15

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI  
SURREBUTTAL TESTIMONY OF ROBERT C. KEHM  
ON BEHALF OF UTILICORP UNITED INC.  
CASE NO. EM-2000-292**

1 Q. What is your name?

2 A. Robert C. Kehm

3 Q. What is your business address?

4 A. My business address is 2301 McGee Street, Suite 400 Kansas City, Missouri 64108.

5 Q. What is your present occupation and work experience?

6 A. I am a Certified Public Accountant and a partner with Arthur Andersen LLP ("Arthur  
7 Andersen"). I joined Arthur Andersen in December 1972. I became a partner in 1984. I  
8 have served a number of investor-owned utilities, including UtiliCorp United Inc.  
9 ("UtiliCorp") and St. Joseph Light & Power Company ("SJLP"). I am a member of the  
10 American Institute of Certified Public Accountants and the state CPA societies of  
11 Missouri, Kansas, and Nebraska. I am licensed to practice in the states of Missouri,  
12 Kansas, Nebraska, Minnesota, and North Dakota.

13 Q. What is your educational background?

14 A. I graduated from the University of Nebraska – Lincoln with an undergraduate degree in  
15 business and a Masters degree in accounting.

16 Q. Do you have experience with mergers and acquisitions?

17 A. Yes, I have worked on numerous mergers and acquisitions, including several for  
18 UtiliCorp. This work has included, among other matters, due diligence assignments,



1 transaction structuring and determination of the appropriate accounting treatment for  
2 business combinations.

3 Q. Are you familiar with the proposed UtiliCorp acquisition of SJLP?

4 A. Yes, I am familiar with the transaction. I previously served as the audit engagement  
5 partner for UtiliCorp and SJLP when the acquisition was announced. Currently I serve as  
6 the audit engagement partner for SJLP.

7 Q. What is the purpose of your surrebuttal testimony?

8 A. The purpose of my testimony is to address certain accounting matters raised by Mr.  
9 Charles R. Hyneman for the Missouri Public Service Commission Staff ("Staff") in his  
10 rebuttal testimony, with a specific focus on the question of "pooling" versus "purchase"  
11 as it relates to the acquisition adjustment issue.

12 ECONOMICS OF BUSINESS COMBINATION ACCOUNTING

13 Q. What methods can be used by a company to account for a business combination?

14 A. Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations*  
15 provides two methods to account for a business combination. These are the purchase  
16 method and the pooling-of-interests ("pooling") method.

17 Q. Please explain the primary differences between the two methods.

18 A. The pooling method is intended to present as a single interest two or more common  
19 stockholder interests that were previously independent. A pooling is a stock-for-stock  
20 transaction, meaning the acquiror must use its stock to acquire the stock of the acquiree.  
21 The combined entity values the assets and liabilities of the combining enterprises at  
22 historical cost. Goodwill is not recorded as an asset in business combinations accounted

1 for using this method. In order to apply the pooling method, a business combination  
2 must meet a very specific and restrictive set of criteria. Business combinations that do  
3 not meet all of the pooling criteria are required to use the purchase method.

4 In the purchase method, the acquiror can use cash or stock to effect the combination. The  
5 assets acquired and liabilities assumed of the acquiree company are recorded at their fair  
6 values, rather than historical cost. Goodwill is recorded for the difference between the  
7 consideration paid and the fair value ascribed to the assets and liabilities. Similar to a  
8 pooling, a purchase can be a stock-for-stock transaction.

9 Q. How does a purchase transaction differ economically from a pooling transaction?

10 A. Assuming all things are equal, with the exception of not meeting all the pooling criteria, a  
11 purchase transaction will have the exact same economics as a pooling transaction. In  
12 other words, it will not differ economically.

13 Q. What do you mean by the "same economics?"

14 A. The economics of a business combination equal the amount a willing buyer is willing to  
15 pay a willing seller for its business. If this amount is in excess of the fair value of the net  
16 assets of the business, goodwill is created. This is true in all acquisitions, whether  
17 accounted for as a purchase or pooling. The fact that purchase accounting gives financial  
18 statement recognition to the goodwill does not impact the economics of the transaction.  
19 Similarly, the fact that pooling does not recognize goodwill does not change the  
20 economics of the transaction.

21 Q. Can you illustrate this point?

22 A. Yes. To illustrate this point, I refer to the proposed acquisition of SJLP as follows:

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27

	<u>December 31, 1999</u>	
	(Amounts in thousands, except per share amounts)	
	<u>Pooling</u>	<u>Purchase</u>
Consideration per share of SJLP	\$ 23.00	\$ 23.00
Shares of SJLP outstanding	<u>8,268</u>	<u>8,268</u>
Total consideration	\$190,164	\$190,164
Less: Estimated fair value of SJLP (1)	<u>96,188</u>	<u>96,188</u>
Estimated goodwill acquired	<u>\$ 93,976</u>	<u>\$ 93,976</u>

(1) Assumes the net book value and fair market value of SJLP's net assets are the same.

The above example demonstrates the following:

1. The economics of the transaction are the same: UtiliCorp is paying the same for SJLP, whether or not it is accounted for as a pooling or a purchase.
2. Goodwill is created in both a pooling and a purchase. However, if pooling is used, the goodwill is ignored in the future financial statements of UtiliCorp. This creates an optical illusion. Pooling appears to be a less expensive transaction – no goodwill is shown in the financial statements. However, as the example indicates, that is not the case. The pooling method created the same amount of goodwill as the purchase method.

Q. On page 10, lines 3-7 of Mr. Hyneman's rebuttal testimony, he concludes that the pooling-of-interests method is the preferable method of accounting for a business combination. How do you respond?

A. I do not agree.

Q. Why not?

A. I do not know what criteria Mr. Hyneman is using to conclude that pooling is "preferable." There is considerable discussion regarding whether or not pooling is even appropriate, let alone preferable. This debate is a continuation of arguments raised in

1 1970 when APB 16 was issued. In issuing APB 16, the Accounting Principles Board did  
2 not conclude that pooling was "preferable". In fact, that document outlined the defects of  
3 pooling. The most serious defect identified was that the pooling method did not  
4 recognize the economic substance of the transaction. It also ignores the current market  
5 value of the assets underlying the transaction.

6 The APB also identified the fact that the pooling method was restrictive – it limited  
7 actions companies could take for the betterment of the businesses prior to or after the  
8 transaction. In the current era of change, I do not believe any accounting method which  
9 restricts a company's current and future flexibility to make business decisions could be  
10 deemed to be "preferable".

11 Q. How does pooling restrict a company's flexibility?

12 A. The pooling criteria limit the actions a company can take for a period of two years before  
13 and after the transaction. I will address this in more detail later in my testimony.

14 Q. Are the reported results of operations different if the transaction is a pooling compared to  
15 a purchase transaction?

16 A. Yes. Pooling produces a more favorable book accounting answer than does a purchase  
17 because it ignores the increased depreciation caused by reporting assets at their higher fair  
18 value and the amortization of goodwill. Goodwill is the amount a company is willing to  
19 pay to acquire another company over the fair value of its assets and liabilities. In a  
20 purchase transaction, goodwill is recorded and amortized over a future period. In a  
21 pooling transaction, goodwill is not recorded.

1 Conventional wisdom has held that the equity market for companies whose mergers were  
2 accounted for as poolings was stronger than for those who used the purchase method. A  
3 more significant analysis may conclude otherwise. For example, Mr. Hyneman  
4 references an article "Say Goodbye to Pooling", *CFO Magazine*, February, 1997 in his  
5 testimony on page 13, line 12 to support the prefer ability of pooling. This same article  
6 states the following:

7 According to a growing body of academic research, however, avoiding goodwill through  
8 poolings actually has no positive effect on share prices. In fact, in some cases, the  
9 opposite is true. A recent paper by Michael Davis, associate professor of accounting at  
10 Lehigh University, for example, points out that the stocks of companies that use purchase  
11 accounting show better aggregate performance in the short term (six months) and no  
12 difference in the longer term (one to three years) than companies that have combined  
13 through the pooling method. In addition, the study, which was published in the *Journal*  
14 *of Applied Corporate Finance*, showed that poolers frequently bend over backwards,  
15 often incurring extra costs, to meet the 12 pooling conditions. *Even worse, poolers as a*  
16 *group pay much larger premiums over current market valuations--in one study by Davis,*  
17 *up to 200 percent higher-- than do purchase-method buyers, as the lack of goodwill*  
18 *amortization and the rising value of their stock allows them to pay more for the*  
19 *marginally better reported earnings per share. (emphasis added)*

20 COULD UTILICORP HAVE USED POOLING?

21 Q. What types of assistance has Arthur Andersen provided to UtiliCorp related to this  
22 transaction?

23 A. I and others in my firm have had discussions with UtiliCorp personnel concerning the  
24 structure of this transaction.

25 Q. Has Arthur Andersen provided any written advice to UtiliCorp specifically as it relates to  
26 pooling criteria?

27 A. No. UtiliCorp did not request and we did not provide any written advice regarding the  
28 application of the pooling criteria to this transaction. We did, however, review and

1 provide comments on a document prepared by Mr. Streek and shown on Schedule DJS-2  
2 to his direct testimony.

3 Q. Is it unusual for a client to not request a formal pooling study when a pooling is initially  
4 contemplated?

5 A. No, it is not unusual at all. Given the complexities of the pooling rules, it is time  
6 consuming and expensive for a company to have a study performed. When a company  
7 determines it is unlikely that one of the criteria will not be met, it is not necessarily  
8 prudent to expend additional resources and time to evaluate all the criteria, since failure  
9 to meet any of the criteria will preclude pooling.

10 Q. Are you familiar with the criteria required to be met in order to apply the pooling method  
11 to a business combination?

12 A. Yes. I have been involved in numerous proposed transactions for a variety of companies  
13 that intended to apply the pooling method. I am also familiar with the process of pre-  
14 clearing pooling issues with the SEC. I have had the opportunity to pre-clear issues with  
15 them and in some instances, our clients were successful with their arguments.

16 Q. Could you please provide some background regarding the complexities of the pooling  
17 method?

18 A. In 1970, the Accounting Principles Board issued *APB 16: Business Combinations*. This  
19 accounting standard provided two acceptable methods for accounting for a business  
20 combination. In general, the pooling method was designed to address the unique "merger  
21 of equals" business combination, in which theoretically the companies acquire each other.  
22 If the transaction met an extensive set of criteria, they could apply the pooling method.

1        If these criteria were not met, a company would need to apply the purchase method. The  
2        acceptance of two methods of accounting for business combinations was a compromise  
3        solution. Both methods had their proponents and detractors. The APB goes so far as to  
4        identify the "defects" of each method.

5    Q.    You stated that pooling requires a company to meet an extensive set of criteria. How  
6        many general criteria are there?

7    A.    There are twelve general criteria as defined in APB No. 16, paragraphs 46-48. The  
8        twelve general criteria address three broad principles. First of all, the combining  
9        companies must be independent prior to the transaction. Secondly, a pooling must be a  
10       stock-for-stock transaction. Lastly, there must be an absence of future planned  
11       transactions that would alter the character of the combining businesses. APB 16 was a  
12       compromise of differing views, and, as a result, some of the requirements are arbitrary.  
13       Consequently, the rules have a great deal of room for interpretation that has subsequently  
14       developed through practice.

15   Q.    Does the Securities and Exchange Commission ("SEC") have a role in regards to these  
16        pooling criteria?

17   A.    Yes. The SEC has taken upon itself the responsibility of developing interpretations to  
18        these rules. SEC opinions regarding pooling matters tend to govern the application of  
19        pooling rules to mergers of SEC registrants. In recent years, the SEC has continued to  
20        narrow its interpretations of the pooling rules. This has resulted in a complex set of SEC  
21        interpretations serving as the authoritative basis for multi-billion dollar transactions.

1        These narrow interpretations have made the ability to pool much more difficult and  
2        constraining.

3        I believe the current SEC view on poolings is that every merger is a purchase unless  
4        proven otherwise. Therefore, companies expecting to complete a pooling can expect  
5        conclusions for all the criteria to be subject to significant challenge. Failure to apply the  
6        pooling rules based on the SEC's interpretation could result in financial hardship if the  
7        SEC ultimately rejects a company's proposed pooling and forces a subsequent  
8        restatement.

9    Q.    In order to qualify for pooling, how many of the criteria must be met?

10   A.    All of the criteria must be met in order to apply the pooling method.

11   Q.    Do some of these criteria restrict the flexibility of a company?

12   A.    Many of the criteria are restrictive. As a general rule, a company that wishes to pool  
13        must refrain from certain actions that may result in an alteration of equity or a disposition  
14        of assets for a period of two years before initiation until two years after the  
15        consummation of a pooling transaction. In essence, a company is handcuffed during this  
16        time period. In the current business environment, this four-year period is a significant  
17        amount of time. During this period, it is not unreasonable to conclude that a company  
18        may be restricted from taking actions to improve the financial health of the organization  
19        in order to preserve a pooling transaction and avoid the financial hardship of restating  
20        previously issued financial statements.

21   Q.    Did UtiliCorp take any action that precluded it from using the pooling-of-interests  
22        method of accounting?



1 A. Yes. As Mr. Streek reported in his direct testimony (page 3 lines 21-22), UtiliCorp  
2 issued stock options to employees in November, 1998. This represented an "alteration of  
3 equity" under APB 16, paragraph 47, which is prohibited. Paragraph 47c states:

4 None of the combining enterprises changes the equity interest of the voting  
5 common stock in contemplation of effecting the combination either within two  
6 years before the plan of combination is initiated or between the dates the  
7 combination is initiated and consummated; changes in contemplation of effecting  
8 the combination may include distributions to stockholders and additional  
9 issuances, exchanges, and retirements of securities.

10 Q. In regards to paragraph 47c above, what does "in contemplation" mean?

11 A. In the literal sense, "in contemplation" would indicate a lack of independence between  
12 two or more events. One action is made with the intent of impacting another. In apb 16,  
13 "in contemplation" suggests that a company might act to improve its position or the  
14 relative position of its owners. This would be contrary to pooling because the concept of  
15 pooling is the combining of economic interests as though the two companies had always  
16 been together.

17 Q. Has the sec indicated its position regarding "in contemplation"?

18 A. Yes. Subjective concepts, such as "in contemplation of", naturally generate differences in  
19 practice. The SEC appears to be attempting to maximize uniformity in the application of  
20 the pooling rules. The SEC has indicated it spends a significant amount of time  
21 addressing this issue as it relates to the alteration of equity interests. Given the subjective  
22 nature of "in contemplation," the SEC relies extensively on the timing of an event  
23 characterized as an alteration in equity interests. As a general rule, anything falling  
24 within two years of the transaction is presumed to be "in contemplation" of the

1 transaction. It is increasingly difficult to disprove this presumption the closer the event  
2 occurs to the actual transaction.

3 Q. What is your understanding of the sec staff's views regarding the impact of "in  
4 contemplation" specifically as it relates to the alteration of equity interests?

5 A. It is my understanding that the SEC staff takes the position that any change in equity  
6 interests that occurs within two years of initiation of a business combination is presumed  
7 to have been made in contemplation of the combination. In other words, any action  
8 which would result in an alteration of equity in contemplation of the combination would  
9 preclude pooling.

10 Q. Has Arthur Andersen published an interpretation of this?

11 A. Yes. Arthur Andersen has issued a publication which presents an interpretation of this  
12 concept. These interpretations are intended to present our understanding of current  
13 practice. Interpretation 47c-18 of *Accounting for Business Combinations, ninth edition*  
14 addresses the issuance of options, the key considerations of which are summarized as  
15 follows:

- 16 1. Awards or grants made within two years are presumed to be in contemplation of a  
17 combination.
- 18 2. The presumption (in contemplation of the combination) may be overcome if  
19 awards or grants are made under pre-existing plans, and are granted under normal  
20 terms of the plan and in normal amounts. In assessing this, the SEC staff  
21 considers this historical pattern of awards under the plan.
- 22 3. In some situations, factual evidence may support a contention that an issuance  
23 was not in contemplation. Such factual evidence must be clear; the closer the  
24 issuance to the initiation of the combination, the more difficult for any factual  
25 evidence to be persuasive.

1           4. Once an issuance is determined to be in contemplation, the change can only be  
2           "cured" by rescinding the options so long as no option holder has exercised any of  
3           the options issued.

4 Q.     Could the UtiliCorp stock option award be presumed to be in contemplation of the  
5           acquisition?

6 A.     Yes. UtiliCorp issued a stock option award under its 1991 Employee Stock Option Plan  
7           in November of 1998. During the week of November 9, 1998, SJLP representatives  
8           contacted UtiliCorp. By the end of November, UtiliCorp had expressed its intent to make  
9           a bid for SJLP. This is an extremely tight timeline between the award issuance and the  
10          initiation of discussions with SJLP. Clearly, a presumption exists that this award was in  
11          contemplation of the combination. UtiliCorp would bear a heavy burden in proving  
12          otherwise.

13 Q.     Are you aware of any other factual information, other than the timeline included in the  
14          joint proxy statement/prospectus dated May 6, 1999 and the information supporting Mr.  
15          Hyneman's timeline on page 25 of his testimony, that could clearly demonstrate that the  
16          stock options were not issued in contemplation of the acquisition?

17 A.     I am not aware of any other substantive, factual information which could clearly refute  
18          the "in contemplation" presumption.

19 Q.     You stated above the presumption (in contemplation of the combination) may be  
20          overcome if awards or grants are made under pre-existing plans, and are granted under  
21          normal terms of the plan and in normal amounts. Could you please explain what this  
22          means?

1 A. The SEC staff has developed a model for determining whether an award can be  
2 considered "normal". In assessing the "normality" of a stock option award, the SEC staff  
3 looks to the historical pattern of awards. This includes the following:

- 4 1. Who is receiving the awards.
- 5 2. What are the sizes of the awards by employee levels within a company.
- 6 3. Timing of awards.
- 7 4. Terms of the awards, including exercise price, vesting and exercise period.

8 Q. Did UtiliCorp conclude that the award was normal?

9 A. No, it did not.

10 Q. Do you concur with UtiliCorp's opinion?

11 A. Yes, I believe it would be very difficult to prove that the 1998 option award would meet  
12 the definition of "normal". Mr. Hyneman's own testimony suggests that the award was  
13 not "normal" when he states on page 27, line 25 through page 28, line 4:

14 . . . it would be reasonable for the SEC to take into consideration that, unlike most  
15 companies' stock option plans, UtiliCorp's Employee Stock Plan is unusual and options  
16 under this plan are not intended to be issued on a regular basis . . . irregular issuances of  
17 stock options should be considered normal because this conforms to the plan's intent and  
18 the plan's history.

19 I believe the SEC staff would have agreed with Mr. Hyneman: The award was unusual  
20 (only one award in previous 6 years) and the issuances were irregular (no systematic  
21 pattern for granting the award). Accordingly, the SEC staff would have rejected the  
22 notion that the plan was "normal".

23 Q. You have stated that 1.) A presumption exists that the award was in contemplation of the  
24 acquisition, 2.) The presumption cannot be overcome because of the proximity of the

1 option award date to the acquisition agreement, and 3.) It is your belief that the SEC  
2 would not consider the option awarded in November, 1998 to be normal. Can this  
3 problem be "cured"?

4 A. Technically, it can be cured. UtiliCorp could have rescinded the options. However, from  
5 a practical business standpoint it is not curable as UtiliCorp stated in response to Staff

6 Data Request No. 167:

7 The only cure would have been rescinding or canceling the options. The  
8 Company did not feel this would have been in the best interest of employee  
9 morale and there were still uncertainties with regard to the eventual  
10 consummation of the transaction.

11 Q. What would the impact of the share rescission have been to the employees?

12 A. If the option award had been rescinded, the employees would have forfeited the rights to  
13 1,278,713 options. While they vest in one year, they do not expire until 10 years  
14 following issuance. To an employee, these options have unknown future potential value.  
15 UtiliCorp would have been precluded from issuing or promising (written or unwritten)  
16 any additional compensation to the employees in exchange for the rescission.

17 Q. On pages 28 and 29 of Mr. Hyneman's testimony, he suggests that the reason UtiliCorp  
18 may not be pursuing pooling more aggressively is its intent to sell the generation assets of  
19 SJLP at some point in the future. Could this preclude pooling?

20 A. Yes, selling assets can preclude pooling. However, the relative size of SJLP to UtiliCorp,  
21 makes it unlikely that a disposition of certain assets would preclude pooling. The  
22 significance of a disposal is generally evaluated in terms of the assets, revenues, and  
23 earnings. Significance is also evaluated in terms of the gain or loss on the disposition.

24 The disposition of SJLP generating assets would not be considered significant and would

1 not preclude pooling unless the gain or loss on the sale exceeded 10% of UtiliCorp's  
2 earnings.

3 Q. On page 23, lines 25-27, Mr. Hyneman states that "UtiliCorp should have vigorously  
4 presented its case to the SEC that the November 1998 stock option issuance was not done  
5 "in contemplation" of the merger." Could UtiliCorp have taken this issue to the sec for  
6 pre-clearance?

7 A. Yes, they could have taken this issue to the SEC for pre-clearance.

8 Q. What would have been the likely outcome of that effort?

9 A. In my opinion it is unlikely that the outcome would have been successful. Based on my  
10 experience and the recent actions of the SEC, the presumption of "in contemplation"  
11 caused by actions taken by a company in the six months prior to the announcement of a  
12 merger are extremely difficult to overcome. UtiliCorp would not likely have been  
13 successful.

14 Given the circumstances, I believe UtiliCorp acted in a prudent manner in addressing this  
15 pooling concern by acknowledging the inability to use the pooling method early, rather  
16 than dedicate additional resources to address all the pooling criteria, identify all the  
17 potential issues requiring SEC clearance, and present its case to the SEC. This process  
18 have been expensive, time-consuming, and most likely not successful.

19 INCOME TAXES

20 Q. As currently structured, the merger of UtiliCorp and SJLP is a tax-free merger under IRC  
21 Section 368(a)(1)(a). On page 69 and 70 of Mr. Hyneman's testimony, he asserts that if

1 the merger is determined to be taxable the deferred taxes of SJLP may be lost. Is this  
2 true?

3 A. No. UtiliCorp is acquiring the stock of SJLP. This includes all the deferred tax assets  
4 and liabilities of SJLP. The ultimate determination of the transaction as being taxable or  
5 non-taxable will not impact the fact that the deferred tax assets and liabilities of SJLP  
6 were acquired by UtiliCorp and will survive the transaction.

7 Q. Does this conclude your surrebuttal testimony?

8 A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of )  
UtiliCorp United Inc. and St. Joseph )  
Light & Power Company for Authority to )  
Merge St. Joseph Light & Power Company ) Case No. EM-2000-292  
with and into UtiliCorp United Inc., and )  
in Connection Therewith, Certain Other )  
Related Transactions. )

County of Jackson )  
State of Missouri )

AFFIDAVIT OF ROBERT C. KEHM

Robert C. Kehm, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled surrebuttal testimony; that said testimony was prepared by him and or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

*Robert C. Kehm*

Robert C. Kehm

Subscribed and sworn to before me this 11th day of June, 2000.

*M. Claire Fitzsimmons*  
Notary Public

