

1 **Q. Many of the costs you have been discussing will be included in the Company's**  
2 **calculations of "goodwill" for accounting purposes. The remainder of the "goodwill"**  
3 **calculations relate to the acquisition premium which is being paid to the Florida**  
4 **Progress shareholders. Can you elaborate?**

5 A. Yes. An acquisition premium arises when an acquiring firm pays an amount in excess of book  
6 value to acquire the stock of another firm. In the present context, standard accounting practice  
7 requires that "goodwill" be recorded on the consolidated company's books as a result of the  
8 merger. The goodwill is equal to the price paid for FPC stock, plus various transaction and  
9 transition costs, plus the book value of FPC's assets (net of liabilities). A large amount of  
10 "goodwill" results from this transaction because FPC's stock is being sold at a price which  
11 greatly exceeds book value.

12  
13 **Q. Can you illustrate this concept with some numbers?**

14 A. Yes, the table below illustrates the goodwill calculations. CP&L is offering \$54 per share for  
15 FPC. As of December 31, 1999, FPC had 98,454,089 shares outstanding [1999 FPC 10K].  
16 Therefore, the purchase price is approximately \$5.32 billion. As I explained earlier, Mrs.  
17 Hancock estimated transaction costs of \$35 to \$40 million, and transition costs of \$110 to  
18 \$125 million. The sum of the two midpoints of these ranges is \$155 million. The book values of  
19 FPC's assets and liabilities, as of December 31, 1999, were \$6.53 billion and \$4.52 billion,  
20 respectively. As shown, given these numbers, the amount of goodwill that will be placed on  
21 CP&L Energy's books is approximately \$3.46 billion.

22

1 **Table 1**  
2 **(000)**

3

4 Purchase Price	\$5,317,000
5 Merger Costs	\$ 155,000
6 FPC Liabilities	\$4,520,000
7 FPC Assets	(\$6,528,000)
8 Goodwill	\$3,464,000

9

10 This illustration demonstrates that the “goodwill” capitalized in this transaction includes the  
11 transaction and transition costs discussed above, but the most important variable is the extent to  
12 which the purchase price for the FPC stock exceeds book value.

13  
14 **Q. What has the Company proposed regarding the recovery of this premium?**

15 A. Mrs. Hancock states:

16  
17 The merger and the ability to work toward the achievement of reductions in  
18 operating costs for both CP&L and Florida Power could not be realized unless  
19 CP&L incurred the costs included in goodwill. It would be appropriate for  
20 CP&L and Florida Power to seek recovery of goodwill amortization from  
21 customers who have benefited (sic.) from the related savings. Accordingly,  
22 both entities will offset any savings with the goodwill amortization to the extent  
23 they can demonstrate clearly that such savings were realized as a result of this  
24 business combination. For that reason, a pro forma adjustment reflecting  
25 goodwill amortization may be made in future rate proceedings in which rates are  
26 required to be supported by a cost-of-service study. [Hancock Direct, p. 13]  
27

28 **Q. Do you agree that the goodwill should be recovered from ratepayers?**

29 A. No. This “premium” is a negotiated amount paid by one set of shareholders to another set of  
30 shareholders. Ratepayers do not share in the benefit of rising stock prices, and they shouldn’t  
31 be required to pay higher rates merely because the stock market is currently valuing utilities at

1 well above book value. Ratepayers had no part in deciding whether to acquire FPC, they have  
2 not benefited from the rise in share prices which underlies the goodwill calculations, and they  
3 had no part in determining the premium which would be paid in order to acquire FPC. In turn,  
4 ratepayers should not be expected to reimburse any portion of the goodwill which arises due to  
5 the fact that the purchase is occurring at a level well in excess of book value.

6  
7 Furthermore, the additional debt which is being incurred in order to finance this transaction will  
8 place some additional risk on ratepayers. With a more leveraged capital structure, the  
9 Company may find it more difficult to raise additional capital on favorable terms, should this  
10 prove necessary in the future. In turn, this creates the potential for placing an additional cost  
11 burden on ratepayers, if future capital requirements cannot be met as cost-efficiently in the  
12 future.

13  
14 Since ratepayers will inevitably and unavoidably incur some additional risks as a result of this  
15 transaction, it would be particularly inappropriate to also ask them to reimburse a portion of the  
16 goodwill which arises from the transaction.

17  
18 **Q. Are there additional reasons for not recognizing goodwill for rate-making purposes in**  
19 **this particular situation?**

20 A. Yes. First, the goodwill that arises in this situation is attributable to CP&L's desire to gain  
21 control of a Florida utility; it is not logically attributable to the Company's North Carolina  
22 operations.

23  
24 Second, a major motivation for this merger is CP&L's desire to reposition itself as a diversified  
25 southeastern super regional energy company. It is willing to pay a premium price for the FPC  
26 stock because the transaction moves it down the road towards this overall corporate goal. This  
27 goal was established for the benefit of CP&L's shareholders, not its ratepayers, and costs that

1 are incurred in striving towards this overall corporate goal should not be the responsibility of  
2 North Carolina ratepayers.

3  
4 Third, to the extent the premium price being paid for FPC is economically justified, most of the  
5 justification can be traced to the enhanced potential for robust profits from unregulated  
6 operations in the future. Given this potential for generating profits in the future, CP&L's  
7 management and shareholders may be willing to pay a hefty premium to gain control of FPC.  
8 But, that does not mean that ratepayers should be forced to share a portion of the goodwill  
9 burden. Since ratepayers will not share in any profits which arise as the Company's unregulated  
10 operations expand, they certainly should not be asked to pay a portion of the price which is  
11 being paid to make the merger possible.

12  
13 **Q. What about Mrs. Hancock's claim that, without the merger and its associated**  
14 **premium, there would be no merger savings?**

15 A. While there is some merit to this reasoning it does not provide adequate justification for  
16 requiring ratepayers to reimburse a portion of the goodwill, even on a contingent basis. For one  
17 thing it is not necessarily true that all of the savings Mrs. Hancock has identified can only be  
18 achieved as a result of the merger. At least some of these efficiencies might be achieved through  
19 other means.

20  
21 For example, management is budgeting millions of dollars for improved information  
22 technologies. If a similar, or even lesser, amount were expended on upgrading CP&L's existing  
23 information technologies, it is possible that some of the same long term cost savings could be  
24 achieved without a merger. Similarly, some of the savings are attributable to intensive research  
25 which is helping to identify the "best practices" of each firm, so that inefficiencies can be  
26 squeezed out and operational improvements achieved. However, "best practices" can be  
27 identified without necessarily having to merge corporations. For instance, consultants can be

1 hired who specialize in identifying inefficiencies and helping to improve systems. Another option  
2 would be to work out contractual arrangements with one or more utilities in other parts of the  
3 country, in which the firms would agree to share their knowledge with each other, and share the  
4 benefits of whatever efficiencies and insights are gained through the arrangements.

5  
6 I am not suggesting that the efforts being expended by CP&L's management to wring cost  
7 savings out of this merger are trivial, or that the efficiencies gained will be unimportant. I am  
8 simply trying to emphasize that these savings do not provide an adequate justification for  
9 burdening ratepayers with any of the goodwill that will arise from this merger, if it is approved.  
10 At least some of the cost savings which CP&L will achieve as a result of the merger could  
11 potentially be achieved even without paying the acquisition premium or effectuating the merger.

12  
13 **Q. Do you have any concerns about the approach suggested by Mrs. Hancock, in which**  
14 **she proposes to include goodwill as an offset to merger savings, only to the extent the**  
15 **Company can “demonstrate clearly that such savings were realized as a result of this**  
16 **business combination”?**

17 A. I will concede that this suggestion has some intuitive appeal, and may appear equitable at first  
18 glance. However, upon careful reflection I believe it is unworkable, and does not provide a  
19 viable solution to the goodwill issue.

20  
21 In addition to the various concerns I have already discussed, it will be extremely difficult, if not  
22 impossible, to separately identify merger related savings, and distinguish them from savings that  
23 would have resulted from CP&L's existing obligation to provide service efficiently.

24 Furthermore, by offsetting future alleged “savings” with a portion of the goodwill, the Company  
25 would effectively prevent customers from gaining the economic benefit of the efficiencies which  
26 it eventually achieves. The approach described by Mrs. Hancock also has the potential to be  
27 unfair to ratepayers if CP&L reorganizes some of its operations in a way that eliminates some

1 jobs and creates others, or if it takes other steps that effectively cut costs in some areas while  
2 increasing costs in other areas. Any attempt to identify merger-related cost savings and offset  
3 them against goodwill would be fraught with risks for ratepayers, and could easily degenerate  
4 into a system which is biased in favor of shareholders and against ratepayers.

5  
6 Finally, without an extraordinarily intrusive program of intensive auditing, it would be nearly  
7 impossible for the Public Staff or the Commission to verify the savings figures put forth by the  
8 Company. While it will be a relatively simple matter to determine what level of costs are being  
9 incurred, it will be far more difficult, or impossible, to accurately determine whether, or to what  
10 extent, this actual level of post-merger costs is less than the hypothetical costs that would have  
11 been incurred absent the merger.

12  
13 In my view, ratepayers should not be precluded from eventually sharing in the benefit of cost  
14 decreases which result from the merger, since it is impossible to completely shield them from  
15 the offsetting costs and risks associated with the merger.