STATE OF VERMONT
PUBLIC SERVICE BOARD

Amended Joint Petition of Central Vermont Public Service Corporation, Danaus Vermont Corp., Gaz Métro Limited Partnership, Gaz Métro Inc., Northern New England Energy Corporation for itself and as agent for Gaz Métro Limited Partnership's parents, Green Mountain Power Corporation and Vermont Low Income Trust for Electricity, Inc. for approval of: (1) the merger of Danaus into and with Central Vermont, (2) the acquisition by Northern New England of the common stock of Central Vermont, (3) the amendment to Central Vermont's Articles of Association, (4) the merger of Central Vermont into and with Green Mountain, and (5) the acquisition by VLITE of a controlling interest in Vermont Electric Power Company, Inc.	)	Docket No. 7770

REBUTTAL TESTIMONY OF

ROBERT B. HEVERT

ON BEHALF OF THE PETITIONERS

February 15, 2012

Summary of Testimony

Mr. Hevert responds to certain issues raised in the Direct Testimony of Dr. Wilson and Mr. Gorman relating to the construct and mechanics of the Petitioners' proposed savings sharing plan. He then responds to certain policy issues raised by Dr. Wilson, Mr. Gorman, and Mr. Goulding related to the sharing plan. Mr. Hevert concludes that the sharing plan represents an appropriate allocation of benefits between customers and shareholders, provides necessary incentives to efficiently and effectively pursue merger-related cost savings, and is generally consistent with the terms of plans approved in prior utility mergers.

REBUTTAL TESTIMONY OF

ROBERT B. HEVERT

ON BEHALF OF THE PETITIONERS

I. INTRODUCTION

1. Q. What is your name and business affiliation?

A. My name is Robert B. Hevert. I am Managing Partner of Sussex Economic Advisors, LLC, and an Executive Advisor to Concentric Energy Advisors, Inc., of Marlborough, MA.

2. Q. Please describe your educational background.

A. I hold a Bachelor's degree in Business and Economics from the University of Delaware, and an MBA with a concentration in Finance from the University of Massachusetts. Additionally, I hold the Chartered Financial Analyst designation.

3. Q. Please describe your experience in the energy and utility industries.

A. I have worked in regulated industries for over twenty-five years, having served as an executive and manager with consulting firms, a financial officer of a publicly-traded natural gas utility, and an analyst at a telecommunications utility. In my role as a consultant, I have advised numerous energy and utility clients on a wide range of financial and economic issues including corporate and asset-based transactions, asset and enterprise valuation, transaction due diligence, and strategic matters. As an expert witness, I have provided testimony in over 80 proceedings regarding various financial and regulatory matters, including the quantification of

post-merger synergies, before numerous state utility regulatory agencies and the Federal Energy Regulatory Commission ("FERC"). A summary of my professional and educational background, including a list of my testimony in prior proceedings, is included in **Exh. Pet.-RBH-1** to my Rebuttal Testimony.

4. Q. Have you previously testified before the Vermont Public Service Board ("Board")?

A. Yes, I provided testimony in Docket No. 7627 on behalf of Central Vermont Public Service Company ("CVPS"), Docket Nos. 7175 and 7176 on behalf of Green Mountain Power Company ("GMP"), and Docket Nos. 7109 and 7160 on behalf of Vermont Gas Systems Inc. ("VGS").

5. Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. My Rebuttal Testimony is submitted on behalf of the Petitioners[1] in response to certain arguments contained in the testimonies of Mr. Michael P. Gorman on behalf of International Business Machines Corporation, Dr. John W. Wilson on behalf of the Department of Public Service ("Department"), and Mr. A.J. Goulding on behalf of Ampersand Gilman Energy, LLC (together, the "Other Witnesses").

[1] The "Petitioners" are defined as Central Vermont Public Service Corporation, Danaus Vermont Corp., Gaz Métro Limited Partnership, Gaz Métro inc., Northern New England Energy Corporation for itself and as agent for Gaz Métro Limited Partnership's parents, Green Mountain Power Corporation and Vermont Low Income Trust for Electricity, Inc. (*see* the Amended Joint Petition dated September 28, 2011 in Docket No. 7770).

6. Q. What are your principal observations and conclusions?

A. Based on the analyses described throughout my Rebuttal Testimony, my principal observations and conclusions are as follows:

- The Petitioners' merger savings sharing plan ("Sharing Plan") related to the proposed transaction between CVPS and GMP ("the Merger") represents an appropriate allocation of benefits between customers and shareholders, provides necessary incentives to efficiently and effectively pursue Merger-related cost savings, and is generally consistent with plans approved in prior utility mergers. This is particularly true in light of the Petitioners' commitment to no layoffs as a means of achieving savings, even though forced workforce reductions are a frequent component of utility mergers.

- Dr. Wilson's criticisms of the Sharing Plan are unfounded, and his proposed use of a double leverage adjustment is inconsistent with both financial literature and prior merger orders.

- Mergers entail non-routine risks for utilities that are not reflected in the risks underlying authorized equity returns. Consequently, I disagree with Dr. Wilson's position on this issue and conclude that a just and reasonable rate of return does not adequately motivate a utility to pursue cost savings through mergers.

- Mr. Gorman incorrectly suggests that the surviving utility (the post-merger combination of GMP and CVPS is referred to herein as the "Combined Company") would recover all merger integration and consolidation costs from customers, while customers would receive only a share of merger savings in the first six years after the Merger. Under the Sharing Plan cost savings calculation methodology, merger savings are calculated net of merger consolidation and integration costs; thus, the Combined Company will recover merger integration and consolidation costs only to the extent it actually achieves cost savings calculated under the Sharing Plan. This component of the Sharing Plan is similar to plans in other approved utility mergers.

- Mr. Goulding incorrectly claims that the Combined Company's Return on Equity ("ROE") should be lowered to reflect the reduction in risk and increased access to capital that result from its larger size relative to CVPS and GMP on a standalone basis. My analyses demonstrate that while the Combined Company may be larger than each of its constituent parts, it remains substantially smaller than its peers.

- Finally, my testimony demonstrates that a variety of sharing mechanisms have been employed in prior utility mergers, driven by the reality that no two mergers are identical and the specific sharing elements adopted reflect the circumstances of each case. That being said, the merger cases I reviewed

suggest there are common parameters regarding: the allocation of cost savings between customers and shareholders, the method for calculating merger-related savings, and the duration and timing of the sharing mechanism. Based on that analysis, I conclude that the specific components of the Sharing Plan are generally consistent with those of prior utility mergers.

7. Q. Have you prepared any Rebuttal Exhibits?

A. Yes. My analyses and recommendations are supported by the data presented in **Exh. Pet.-RBH-2** through **Exh. Pet.-RBH-5**, which have been prepared by me or under my direction.

8. Q. How is the balance of your Rebuttal Testimony organized?

A. The remainder of my Rebuttal Testimony is organized as follows:

- Section II provides a summary of the Sharing Plan;
- Section III contains my response to certain issues raised by Dr. Wilson and Mr. Gorman relating to the construct and mechanics of the Sharing Plan; and
- Section IV contains my response to certain policy issues raised by Dr. Wilson, Mr. Gorman and Mr. Goulding related to the Sharing Plan.

II. OVERVIEW OF PETITIONERS' SHARING PLAN

9. Q. Please first provide a brief description of the Merger.

A. As discussed in the Amended Joint Petition dated September 28, 2011, Gaz Métro Limited Partnership ("Gaz Métro") would acquire CVPS, and merge that company into GMP. The context and expected benefits of the Merger are discussed in more detail in the Direct Testimony of Mary G. Powell and Lawrence J. Reilly dated September 2, 2011.

10. Q. Please now provide a brief overview of the Sharing Plan.

A. As described in the Amended Joint Petition dated September 28, 2011, the Petitioners propose to implement a structure whereby Operating and Maintenance ("O&M") cost savings associated with the Merger would be shared between the Combined Company's customers and shareholders for the first six years after the Merger is completed. Thereafter, all such savings would benefit customers.[2] The Petitioners anticipate achieving merger-related savings through more efficient distribution of resources, equipment and facilities throughout the combined service territory, reduced regulatory costs, improved purchasing leverage with vendors, and natural turnover in staff, without engaging in employee layoffs, other than certain executive officer positions.[3] The Combined Company commits to delivering $144 million in merger-related cost savings for customers over the first ten years of the Sharing Plan, and expects substantial savings to accrue to the benefit of its customers thereafter.[4]

---

2 Amended Joint Petition dated September 28, 2011 in Docket No. 7770, at 5.
3 Direct Testimony of Mary G. Powell and Lawrence J. Reilly, at 10-11 (Powell).
4 *Id.* at 13.

11. Q. What is the purpose of the Sharing Plan?

A. As indicated by Ms. Powell,[5] the Sharing Plan is designed to provide reasonable incentives to pursue transactions that provide customer benefits which otherwise would not occur. The Sharing Plan also creates a direct financial incentive for management to quickly and efficiently realize merger efficiencies by sharing the benefits of merger savings between the Combined Company and its customers, and at the same time keep the Combined Company's commitment to no non-executive layoffs or forced employee relocations. As discussed in more detail below, the Sharing Plan provides customers with an assured level of savings, while providing CVPS and GMP the opportunity to earn a return commensurate with the timing and nature of risks associated with the integration of utility operations.

12. Q. What are the key features of the Sharing Plan?

A. The Sharing Plan includes three key structural elements:

1. The allocation of merger savings between the shareholders and customers of the Combined Company;
2. The timing and duration of savings sharing; and
3. The methods used to calculate merger savings.

---

5 *Id.*

13. Q. Please first describe the allocation of merger savings under the Sharing Plan.

A. The Sharing Plan provides for shareholders and customers to share in calculated merger savings in each of the first six years after the Sharing Plan is adopted, and for customers to receive 100% of savings after year six and beyond. The sharing of savings varies during the term of the Sharing Plan, beginning with an allocation of 90% to the Combined Company, and 10% to customers for the first two years. In the third and fourth years, savings are allocated on an 80%/20% basis (Combined Company/customers); in the fifth and sixth years 67% of savings are allocated to the Combined Company and 33% to customers. Beginning in the seventh year, all savings are allocated to customers. On a present value basis, approximately 57% of the expected O&M savings derived from the Merger accrue to the benefit of customers.[6]

14. Q. Please further discuss the assured level of savings that customers would accrue under the Sharing Plan.

A. As noted above, the Sharing Plan provides that by the end of ten years, customers will have received $144 million in allocated merger savings benefits. If, however, at the end of ten years that level of savings has not been realized, the Combined Company would file a plan for Board review and approval to ensure customers receive the $144 million of guaranteed merger savings.[7] While the Sharing Plan provides an assured level of savings for customers, shareholders have no assurance of realizing merger savings benefits.

---

6 Rebuttal Testimony of Robert J. Griffin.

7 Direct Testimony of Mary G. Powell and Lawrence J. Reilly, at 13 (Powell).

15. Q. Please further describe the timing and duration of the Sharing Plan.

A. As noted earlier, the Sharing Plan provides for an increase in the allocation of merger savings to customers throughout the first six years and a full allocation to customers thereafter. This "front end loading" of sharing to shareholders provides a strong incentive to realize merger savings as soon as possible through focused management attention. This structure also reflects – and allocates principally to shareholders – the risk involved in realizing the merger savings; the complexity of planning and executing the integration of two separate utilities means that merger savings are more difficult to achieve in the earlier years of the integration process, especially in the context of a no layoff or mandatory relocation policy.

In addition, as explained in the Direct Testimony of Ms. Powell and Mr. Reilly, the six-year duration of the Sharing Plan reflects, in part, the Combined Company's commitment to optimizing the post-merger workforce through natural attrition, rather than through forced staff reductions.[8] While certainly beneficial to many constituent groups, that process does reflect a higher degree of uncertainty in achieving savings than the more direct and customary approach of planned workforce restructuring. Moreover, once fully realized the merger savings are largely recurring; beginning in the seventh year, those recurring savings accrue entirely to the benefit of customers. Thus, the six year sharing term and proposed sharing allocations strikes a balance of offering a meaningful financial incentive for investors to undertake the Merger while assuring significant benefits for customers and other constituent groups.

---

[8] *Id.* at 10, 13.

16. Q. Please describe the methods used to calculate merger savings under the Sharing Plan.

A. As explained in the Direct Testimony of Robert J. Griffin on behalf of the Petitioners in this case, for the first six years the Sharing Plan provides for the base rates of the Combined Company to be set in the same manner as they currently are set under GMP's Alternative Regulation Plan, except for an adjustment to O&M costs.[9] In general terms, the Sharing Plan first establishes the combined O&M costs of the pre-merger utilities assuming the Merger had not occurred (*i.e.*, estimate a "but-for" the merger O&M cost component of base rates equal to the forecast combined O&M costs of GMP and CVPS as stand-alone entities). The "but-for" O&M costs will be calculated based on a calendar 2011 test period, with adjustments based on traditional regulatory principles other than known and measurable changes relating to the Merger. The same level of "but for" O&M costs would be included in subsequent base rate filings, with an adjustment to reflect the change in the Consumer Price Index for All Urban Consumers (CPI-U), Northeast for the previous twelve months.

The Sharing Plan calculates merger savings each year by comparing the calculated "but-for" O&M component of base rates to the Combined Company's actual O&M costs. For the first six years of the Sharing Plan, the customers' share of the savings will be returned through a bill credit at the same time as the Earnings Sharing Adjustor. The O&M cost adjustment to base rates would no longer be used in years seven through ten, as base rates would reflect the Combined Company's actual O&M costs. The Combined Company would, however, continue

[9] Direct Testimony of Robert J. Griffin, at 2.

to track merger savings to ensure that customers realize at least $144 million in ten year cumulative merger savings. The Petitioners expect total cumulative savings over the first ten years of over $226 million.[10]

III. SHARING PLAN METHODOLOGY ISSUES RAISED BY OTHER WITNESSES

17. Q. Please briefly describe Dr. Wilson's concerns with the proposed Savings Sharing Plan.

A. Dr. Wilson's primary concern appears to relate to the distribution of benefits between customers and shareholders during the first six years following the Merger. In that regard, Dr. Wilson suggests that the Petitioners' depiction of the Sharing Plan is unfair because the benefits realized by Gaz Métro would occur sooner than most of the consumer cost saving benefits.[11] Dr. Wilson also takes issue with the reliability of merger savings calculations over a long period, suggesting that:

> ...estimates of what is really a merger benefit can be expected to be more reliable over the short term (when most benefits are allocated to the Company) than they are for distant years (when ratepayers are allocated most of their benefits).[12]

---

10 Direct Testimony of Dawn D. Bugbee, at 3.
11 Direct Testimony of John W. Wilson, at 9.
12 *Id.* at 10.

18. Q. What is your response to Dr. Wilson's position relating to timing and duration of the Sharing Plan?

A. I disagree with this position for two reasons.[13] First, the Combined Company will bear the majority of the savings risk during the first six years following the Merger. Before demonstrating why this is so, it may be helpful to briefly summarize the post-merger integration process.

As explained in the Direct Testimony of Brian Otley in this case, the adjacent service territories of GMP and CVPS will allow management of the Combined Company to provide service more efficiently by identifying ways to consolidate operations of the two separate companies:

The GMP and CVPS functions that will be consolidated include (but are not limited to):

1. Finance;
2. Legal/Regulatory;
3. Power Planning & Supply;
4. Communications & External Affairs;
5. Human Resources & Training;
6. Field Operations, including transmission, distribution, substation operations, power production, control center, safety, and environmental; and

[13] Mr. Otley's rebuttal testimony addresses Dr. Wilson's claim that near-term savings projections are more accurate.

7. Support Operations, including engineering, information technology, facilities, security, fleet, metering, customer accounting, customer contact center, customer management, and purchasing.[14]

Mr. Otley describes a three phased planned consolidation process occurring over several years. The first phase involved communication to stakeholders prior to the CVPS shareholder vote to approve the acquisition. Phase two, comprised of integration planning, is occurring between the time of the vote and actual financial closing. The third phase would involve integration activities beginning the day after closing:

> The third phase of the integration will begin the day after the acquisition closes and continue for a number of years until the consolidation is complete. Based on the integration model to be utilized, integration activities may last up to seven years after transaction close.[15]

While Mr. Otley describes an integration and consolidation process extending as long as seven years post-Merger, the Petitioners have committed that, except for certain executive positions, there will be no forced workforce reductions associated with the Merger. Rather, as explained in the Direct Testimony of Ms. Powell and Mr. Reilly, the Combined Company plans to achieve labor cost savings solely through normal retirement and natural turnover over time.[16]

The first reason I disagree with Dr. Wilson is that the Combined Company will bear the majority of the savings risk during the first six years. As Ms. Powell and Mr. Reilly point out, the commitment not to realize cost savings by layoffs (other than some executive positions) reduces

---

14 Direct Testimony of Brian Otley, at 6.
15 *Id.* at 8.
16 Direct Testimony of Mary G. Powell and Lawrence J. Reilly, at 10 (Powell).

the ability to achieve savings during the initial period when most of the savings are allocated to the Combined Company. Research on prior utility mergers indicates that employee layoffs have represented a significant component of merger-related cost savings in other utility mergers and labor cost savings associated with layoffs can be achieved very early in the integration process.[17] By committing to no layoffs other than at the executive level, the Petitioners have forfeited the ability to realize significant and relatively certain near-term cost savings relied on in other utility mergers.

19. Q. Are there examples of other transactions in which shareholders received the initial merger benefits followed by benefits accruing to customers?

A. Yes, there are. In 2000, Energy East Corporation acquired CTG Resources, Inc. The State of Connecticut Public Utilities Regulatory Authority ("SCPURA") provided the incentive for Energy East to maximize merger benefits by sharing earnings above the allowed ROE between shareholders and customers.[18] Specifically, the allowed sharing allocated: a) the first 200 basis points, 75% to shareholders, 25% to customers; b) the next 400 basis points 50% to shareholders, 50% to customers; and c) earnings more than 600 basis points above the allowed ROE of 10.80%, 25% to shareholders, 75% to customers. Regarding that sharing structure, SCPURA noted that an appropriate sharing mechanism should achieve an incentive to maximize synergy savings.

---

[17] For example, as discussed later in this testimony, six of the eight mergers cited by Mr. Michael P. Gorman in Exhibit MPG-1 of his Direct Testimony filed in this case contain language that indicates plans for significant labor reductions occurring early in the integration process.

[18] SCPURA Docket No. 99-08-09, Commission Order, at 4.

20. Q. What is the second reason you disagree with Dr. Wilson's position regarding the Sharing Plan methodology?

A. Dr. Wilson suggests that customers are harmed because savings are shared for six years before they are flowed through 100% to customers. By providing for near-term shared savings, however, the Sharing Plan encourages the Combined Company to maximize ongoing savings, which flow entirely to customers by year seven, as quickly and efficiently as possible. Consequently, customers directly benefit from the incentive to accelerate the timing and level of benefits realized by the Merger.

21. Q. Are there examples of utility mergers in which merger savings were shared over a multi-year period?

A. Yes, there are. In the 1993 acquisition of Gulf States Utilities by Entergy Corporation, for example, non-fuel merger savings were shared between customers and shareholders for eight years. During that period, verified non-fuel savings were shared equally between shareholders and customers for the first three years, and in years four through eight, the shareholders' portion was reduced by $2.6 million per year (approximately $1.3 million in Texas).[19] More recently, the proposed merger between Duke Energy and Progress Energy, includes a guaranteed savings amount of $650 million resulting from fuel-related savings, together with a smaller amount of non-fuel O&M savings, that would be shared with retail customers over a five-year period.[20]

---

19 Public Utilities Commission of Texas, Docket No.11292, Final Order, at 47-48.

20 North Carolina Utilities Commission, Docket Nos. E-2, Sub 998 and E-7, Sub 986, Settlement Agreement, at 2.

These are just two examples of merger savings being shared over a period of several years, similar to the six year period proposed by the Petitioners (after which all merger savings flow through to customers).

22. Q. Please now summarize Mr. Gorman's concerns with the Sharing Plan methodology.

A. Mr. Gorman suggests that customers are entitled to receive all merger-related savings because the Combined Company will recover all merger integration and consolidation costs from customers, and therefore the proposed Sharing Plan should be rejected.[21] In particular, Mr. Gorman claims that:

> Under the Petitioners' proposed modified ARP, merger I&C costs will be included in O&M expense and recovered directly from customers before any consideration of merger-related savings is made. As such, customers will fully pay all merger-related costs, and therefore are fully entitled to all merger-related savings. The Petitioners are not at risk of producing merger savings to recover merger I&C costs, and therefore are not entitled to any merger-related savings.[22]

23. Q. What is your response to Mr. Gorman on that point?

A. Mr. Gorman's position that the Combined Company will recover all merger integration and consolidation costs from customers is incorrect. As indicated in Ms. Bugbee's Rebuttal Testimony, merger-related costs that are not assigned entirely to the Combined Company are shared with the customers in the same proportion as the savings are shared. Thus the merger savings and costs are treated in a symmetrical manner. Moreover, as Mr. Griffin

---

21 Direct Testimony of Michael P. Gorman, at 3.
22 Direct Testimony of Michael P. Gorman, at 5.

points out,[23] in any year in which integration-related cost increases exceed integration-related savings, the incremental costs will not be included in rates. As such, the Combined Company will be able to recover merger integration and consolidation costs only to the extent it actually achieves cost savings calculated under the Sharing Plan.

Moreover, Mr. Gorman fails to consider that in order to complete this transaction, Gaz Métro will pay a significant acquisition premium and incur substantial transaction costs. Petitioners do not seek to recover the acquisition premium or transaction costs in rates. Nevertheless, these costs are significant, and necessary for Gaz Métro to incur in order for customers to realize the benefits to the Merger. It is, therefore, fair and reasonable to provide Gaz Métro with an opportunity to share in the savings that the transaction will enable. Doing so encourages utility consolidations, which provide significant benefits to customers.

24. Q. Are there other bases on which Mr. Gorman suggests the Sharing Plan should be rejected?

A. Yes, there are. For example, Mr. Gorman states that:

> [t]he Petitioners' proposed shared savings methodology is not based on bonafide and verifiable merger savings. Rather, merger savings are based on projections of what operations and maintenance ("O&M") expenses might have been had the merger not occurred, relative to actual O&M expenses incurred after the merger. The Petitioners' profits should not be enhanced by such non-verifiable claims of merger savings.[24]

---

[23] Exh. Pet.-RJG-4.

[24] Direct Testimony of Michael P. Gorman, at 3.

25. Q. Is this an appropriate reason to reject the Sharing Plan?

A. No, it is not. As a practical matter, estimated savings calculations by definition must be based on a comparison between actual and hypothetical expected costs and any savings calculation will reflect this. Moreover, my review of past utility mergers suggests that the Combined Company's approach to calculating estimated savings is reasonable and consistent with other cases.

26. Q. Did you conduct any research to compare the construct of the Sharing Plan to the approach other utilities have taken to merger savings sharing?

A. Yes, I did. My research primarily relied upon a database of utility mergers maintained by SNL Financial. That database was screened to develop a subset of mergers that were largely comparable to the proposed merger in this proceeding based on the following criteria:

1. Transactions completed in the last ten years in the continental United States;
2. Acquisition value of greater than $100 million; and
3. Involved the acquisition/merger of a regulated electric or natural gas utility.

Those criteria identified 38 separate transactions, with some requiring approval in multiple jurisdictions. In each case, the relevant commission orders, and at times, testimony and other case documents such as settlement agreements were reviewed.

27. Q. What conclusions were you able to reach based on that research?

A. I found that the key components of the Sharing Plan proposed by the Petitioners fall in line with most of the merger cost savings sharing mechanisms included in the comparable transactions. Those components include a merger cost savings sharing mechanism that provides:

1. An incentive for utilities to create savings to benefit both customers and shareholders;
2. Quantified costs savings and calculation methods; and
3. A defined time frame for sharing merger-related cost savings.

28. Q. Please discuss your conclusion regarding the first element, *i.e.*, cost savings sharing as an incentive to benefit both customers and shareholders.

A. Other regulatory commissions have recognized the importance of sharing savings between customers and shareholders; both for the benefit of customers as well as to compensate shareholders for the additional risk they are being asked to bear. As such, several of the cases included a sharing mechanism between customers and shareholders. Many cases include a mechanism that permits the utility to keep a portion of future, merger-related cost reductions, through a comparison of pre-merger and actual, post-merger costs. Other cases permit the utility to keep a portion of earnings above a pre-specified benchmark, such as through an earnings sharing mechanism in which case the sharing occurs if the earned ROE[25] is in excess of a predetermined benchmark. Other cases involve a rate freeze (which permits the utility to keep savings relative to its pre-merger cost of service) or a specified rate reduction (which permits the

[25] Throughout my Rebuttal Testimony, I interchangeably use the terms "ROE" and "Cost of Equity."

utility to keep savings above those reflected in the rate reduction). A sample of cases is included in **Exh. Pet.-RBH-2**. Thus, regulatory commissions have accepted the premise that in order to accept the risks and costs associated with generating merger-related savings, utilities should be provided with the ability to share in benefits, and the reasonable opportunity to recover the costs necessary to achieve the savings.

While multiple approaches to sharing merger savings between customers and shareholders have been applied, the particular circumstances of the merger drove the approach. That is, just as the proposed Sharing Plan is particular to the circumstances facing GMP and CVPS, the structures applied in prior transactions likewise address the parties' specific circumstances. That said, there are structures that are common to utility mergers, and which suggest that the Sharing Plan is consistent with industry convention.

By way of example, when the merger of Providence Gas Company, Valley Gas Company, and Bristol and Warren Gas Company into Southern Union Company was approved, the determination of the sharing mechanism was deferred to a subsequent rate case. In the subsequent rate case, the issue of sharing merger savings was considered simultaneously with the revenue requirement determination. While that transaction addressed the sharing of merger benefits, it did so in a manner somewhat different than the proposed Sharing Plan. Given that each transaction is unique, my research focused on identifying the general parameters of approved transactions.

29. Q. Please summarize your conclusion regarding the second element, *i.e.*, the methods used to quantify merger-related savings.

A. As indicated above, the cases that address shared savings do so by comparing pre-merger and post-merger costs, by permitting the utility to keep all or part of earnings above a specified benchmark or by permitting the utility to keep savings above those reflected in a rate freeze or rate reduction. The cases that compare pre-merger and post-merger costs incorporate a mechanism similar to the proposed Sharing Plan, involving a comparison of actual and pre-merger O&M or non-fuel costs, and are therefore similar to the proposed Sharing Plan.

30. Q. Finally, please discuss your conclusions relating to the third element, *i.e.*, duration of savings sharing you observed.

A. The duration of savings sharing ranged from one to 40 years, although the norm was in the three to ten year range. After the savings sharing period 100% of merger savings accrue to customers. Both of those parameters are similar to the Petitioners' Sharing Plan, in which there is defined sharing over a six-year period, with 100% of merger savings accruing to the customers after that time.

IV. POLICY ISSUES RAISED BY THE OTHER WITNESSES

31. Q. What policy concerns does Dr. Wilson raise with the Merger in general and the Sharing Plan specifically?

A. Dr. Wilson notes several concerns with respect to policy implications of the Merger and Sharing Plan. In particular, Dr. Wilson states that the Petitioners should not share in any of the Merger savings because:

1. If the rate of return that can be expected by a successfully merged firm is just and reasonable, no further incentive should be required in order to motivate best efforts in pursuit of the public interest;[26] and
2. The Merger creates excess profits that equate to a windfall for the Combined Company derived predominantly from Gaz Métro's proposed use of double leverage to finance the Merger.

32. Q. Do you agree with Dr. Wilson's position that a just and reasonable rate of return is all that is required to incent utilities to merge?

A. No, I do not. As noted earlier, mergers entail risk that is borne by shareholders and for which shareholders should be compensated. Merger planning, execution and integration are not routine utility activities, such as power procurement, and as such, merger risks are not reflected in the risk underlying the authorized utility Cost of Equity. Moreover, the Petitioners are not seeking recovery of transaction-specific risks and costs, including breakup fees and

[26] Direct Testimony of John W. Wilson, at 14.

acquisition premiums. In the event of a failed merger, shareholders bear the costs, not the customers.

33. Q. What role does the use of "double leverage" play in Dr. Wilson's conclusions regarding excess profits arising from the proposed merger?

A. Dr. Wilson claims that the Combined Company will achieve a substantial windfall or extra profit, because it will earn an equity return on the portion of its equity investment funded debt, which should be considered in evaluating the sharing of benefits between the Combined Company and customers.[27] Dr. Wilson suggests that the presumed benefits of double leverage should be recognized in the allocation of merger cost savings, assuming it will not be reflected in the Combined Company's rates.[28] As discussed below, however, there is no basis for a double leverage rate adjustment and therefore no basis for modifying the proposed Sharing Plan.

34. Q. What is Dr. Wilson's definition of "double leverage"?

A. As Dr. Wilson explains in his Direct Testimony:

> When a subsidiary company's equity capital is funded by debt issued at the parent company level, the consolidated financial structure is often referred to as "double leverage." The leverage is doubled because parent company equity is leveraged to acquire debt to fund the parent's equity investment in the subsidiary, and then this "equity" investment in the subsidiary is again leveraged to fund the subsidiary's own debt.[29]

---

27 Direct Testimony of John W. Wilson, at 17-18.
28 *Id.*
29 *Id.* at 15.

35. Q. Do you agree with Dr. Wilson's position that rates should be adjusted to reflect the presumed effect of double leverage?

A. No, I do not. In essence, Dr. Wilson claims that a Double Leverage Approach should be used to estimate the cost of capital. Such an approach is inconsistent with widely accepted practice of utilizing the "Stand-Alone approach," which treats the utility subsidiary as its own company. Under the Stand-Alone approach, the cost of capital is determined using the subsidiary's own capital structure and cost of debt and equity; the Cost of Equity is estimated by reference to a proxy group of firms of comparable risk. Importantly, the Stand-Alone Approach recognizes that the return should be based on the relative risk of the investment rather than the source of financing.

36. Q. Is it appropriate to use the double leverage approach to estimate a utility's Cost of Equity or to adjust rates in the context of a merger?

A. No. This approach is flawed from several theoretical and practical perspectives. Long established academic literature has thoroughly discussed the flaws associated with the double leverage approach. For example:

1. Pettway and Jordan (1983), and Beranek and Miles (1988) point out the flaws in the double leverage argument, particularly the excess return argument, and also demonstrate that the "stand-alone" method is the superior approach.
2. Rozef (1983) discusses the ratepayer cross-subsidies of one subsidiary by another when employing double leverage (Dr. Wilson does not address this, but it is further reason why double leverage adjustments are not warranted).

3. Lerner (1973) concludes that the returns granted to equity investors must be based on the risks to which the investors' capital is exposed and not the investors' source of funds.

In summary, long-standing research establishes that the Cost of Equity capital is the risk-adjusted opportunity cost to the investors and not the cost of the specific capital sources being employed by investors. In that regard, the *Hope* and *Bluefield* doctrines are clear that appropriate considerations in determining cost of capital are the alternatives available to investors and the risks associated with those alternatives. The source of funding and the cost of funds used to finance the investment do not determine the required return. As noted by Dr. Roger A. Morin:

> Carrying the double leverage standard to its logical conclusion leads to even more unreasonable prescriptions. If the common shares of a subsidiary were held by both the parent and by individual investors, the equity contributed by the parent would have one cost under the double leverage computation while the equity contributed by the public would have another.

Dr. Morin expands further on the nature of double leverage:

> Just as individual investors require different returns from different assets in managing their personal affairs, why should regulation cause parent companies making investment decisions on behalf of their shareholders to act any differently? A parent company normally invests money in many operating companies of varying sizes and varying risks. These subsidiaries pay different rates for the use of investor capital, such as long-term debt capital, because investors recognize the differences in capital structure, risk, and prospects between the subsidiaries. Yet, the double leverage calculation would assign the same return to each activity, based on the parent's cost of capital. Investors recognize that different subsidiaries are exposed to different risks, as evidenced by the different bond ratings and cost rates of operating subsidiaries. The same argument carries over to common equity. If the cost rate for debt is different because the risk is

different, the cost rate for common equity is also different and the double leverage adjustment shouldn't obscure this fact. [30]

37. Q. Does double leverage adjustment treat publicly-held utilities and utility subsidiaries of holding companies in a consistent manner?

A. No, it does not. Estimating the Cost of Equity using one method for publicly held utilities and another for utilities owned by a holding company is inconsistent with financial theory and discriminates against the holding company form of ownership. Two utilities identical in all respects but their ownership format should have the same cost rates, yet this would not be the case under the double leverage adjustment.[31] From the perspective of capital markets, the notion that an asset (in this case, utility company equity) would have a different value depending on how different investors finance their investment would violate the "law of one price," which states that in an efficient market, identical assets would have the same price.

38. Q. Is there additional evidence from academic literature supporting your position that the Cost of Equity is determined by its use, not its source?

A. Yes, there is. For example, in *Principles of Corporate* Finance, 8th edition, Brealey, Myers, and Allen state at page 234:

> In principle, each project should be evaluated at its own opportunity cost of capital; the true cost of capital depends on the use to which the capital is put. If we wish to estimate the cost of capital for a particular project, it is project risk that counts.

Likewise, in *Modern Corporate Finance, 1st edition*, Shapiro states at page 276:

---

30 New Regulatory Finance, Roger H. Morin, PhD, at 523.
31 *Id.* at 524.

> Each project has its own required return, reflecting three basic elements: (1) the real or inflation-adjusted risk-free interest rate; (2) an inflation premium approximately equal to the amount of expected inflation; and (3) a premium for risk. The first two cost elements are shared by all projects and reflect the time value of money, whereas the third component varies according to the risks borne by investors in the different projects. For a project to be acceptable to the firm's shareholders, its return must be sufficient to compensate them for all three cost components. This minimum or required return is the project's cost of capital and is sometimes referred to as a hurdle rate.
>
> The preceding paragraph bears a crucial message: The cost of capital for a project depends on the riskiness of the assets being financed, not on the identity of the firm undertaking the project.

39. Q. From a practical perspective, have other regulatory bodies rejected the use of the double leverage approach?

A. Yes. In the vast majority of the merger cases I reviewed, there was no double leverage adjustment applied, and, in fact, several regulators expressly rejected such an adjustment.

For example, the Maryland Public Service Commission specifically rejected the use of double leverage in a 2007 rate proceeding, stating:

> We reject People's Counsel's proposed capital structure [reflecting a double leverage adjustment] because it suffers from numerous flaws. First, it assumes that the rate of return depends on the source of capital rather than the risks faced by the capital.[32]

The Alberta Energy and Utilities Board described the stand-alone principle as follows:

---

[32] Maryland Public Service Commission, Order No. 81517, Case No. 9092, *In the Matter of the Application of Potomac Electric Power Company for Authority to Revise its Rate and Charges for Electric Service and for Certain Rate Design Changes*, July 19, 2007. Clarification added.

> This first application of the stand-alone principle is designed to remove the effects of diversification by utilities into non- regulated activities. Using the stand-alone principle in this case, a utility is regulated as if the provision of the regulated service were the only activity in which the company is engaged. This application of the principle ensures that the revenue requirement of regulated utility operations is not influenced up or down by the operations of a parent or "sister" company. Thus, the cost (or revenue requirement) of providing utility service reflects only the expenses, capital costs, risks and required returns associated with the provision of the regulated service.[33]

The Washington Utilities and Transportation Commission ("WUTC") rejected the application of a double leverage adjustment for PacifiCorp. In that case, the WUTC rejected the use of double leverage, stating:

> The ring fencing provisions required by our final order in Docket UE-051090 insulate PacifiCorp and its customers from risks and financial distress at the MEHC level. Nonetheless, after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for customers the cost and tax benefits of that financing. The Company's expert witness argues this may violate the familiar principle in utility law that financial benefits should follow burden of risks. We agree. If the risks and costs of activities at the parent-level are born exclusively by shareholders—because customers are insulated from them by the ring fence—then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities.[34]

In the same case, the WUTC cited the FERC's position on the use of double leverage in support of its decision:

> The FERC does not embrace the concept of double leverage. For purposes of calculating rate of return for wholly owned subsidiaries, FERC uses the stand-alone capital structure and return on equity of the subsidiary so long as the subsidiary issues its own debt, maintains its own credit ratings and meets other standards related to equity ratio. The courts have upheld this policy. *See Missouri Pub. Serv. Comm'n v. Federal Energy Reg Comm'n, 215 F.3d 1, 342 U. S. App. D.C. 1* (D.C. Cir. June 27, 2000).[35]

---

33 Alberta Energy and Utilities Board, Decision 2001-92, December 12, 2001, at 25.
34 Washington Utilities Transportation Commission, Docket No. UE 050684, Order No. 4, at 103-104.
35 Washington Utilities Transportation Commission, Docket No. UE 050684, Order No. 4, at 105.

40. Q. Are there specific reasons, in addition to generally accepted financial theory and past precedent, that Dr. Wilson's double leverage adjustment is inappropriate?

A. Yes, there are. First, the Combined Company will have an actual capital structure dedicated to its Vermont business. Second, the Petitioners have indicated they are prepared to accept numerous ring-fencing provisions that will ensure that the Combined Company will not be affected by a parent company with slightly more leverage in its capital structure.

41. Q. Putting aside issues relating to financial theory and prior merger transactions, do you agree with Dr. Wilson's calculation?

A. No, I do not. As shown in **Exh. Pet.-RBH-3**, Dr. Wilson's calculation assumes that the Combined Company would retain the pre-tax portion of incremental revenue requirements associated with the presumed effect of double leverage. On an after-tax basis, the incremental effect would be approximately $6.5 million dollars less (on a nominal, annual basis) than Dr. Wilson suggests. In any event, as discussed above, there is no basis to apply any such adjustment, whether pre-tax or after-tax.

42. Q. Now turning to Mr. Gorman, what policy concerns does he raise with respect to the Sharing Plan?

A. Mr. Gorman provides a summary of several merger proceedings that the Petitioners noted in support of the Sharing Plan (*see* Exhibit MPG-1).[36] Based on his review of those cases, Mr. Gorman suggests that regulators have approved merger provisions that created

[36] Direct Testimony of Michael P. Gorman, Exhibit MPG-1.

risk to the utility of fully recovering its merger-related costs, tied largely to its ability to realize expected merger-related savings.[37] Mr. Gorman states that in such instances, utilities were not given full merger cost recovery assurance without a demonstration of actual merger-related savings. Finally, Mr. Gorman claims that the cases authorized rate reductions, caps, or freezes as components of their approvals of utility mergers, rather than the comparison of pre-merger and post-merger costs used in the proposed savings sharing plan.

43. Q. What is your response to Mr. Gorman's claim?

A. Mr. Gorman's concern relating to recovery of costs in excess of savings is fully addressed in the proposed savings sharing plan. In particular, in any year in which integration-related cost increases exceed integration-related savings, the incremental costs will not be included in rates. Thus, the Combined Company's merger-related costs will be recovered only if there are merger-related savings.

There also are important differences between this case and the cases cited by Mr. Gorman, which involved rate reductions, rate caps, and/or rate freezes. First, in six of the eight mergers the utilities' estimation of merger savings included upfront employee reductions. Upfront employee reductions would allow the utilities to realize merger cost savings quickly and reduce the risk of not recovering their merger-related costs. Second, I note that the method of calculating the cost savings in these mergers is similar to that of the Sharing Plan; there is a baseline cost of service projection representing the "but-for" cost of service that would have prevailed absent the merger,

[37] Direct Testimony of Michael P. Gorman, at 9.

which is then compared to actual costs incurred by merged company. In that important respect, the transactions identified by Mr. Gorman are consistent with the proposed Sharing Plan

44. Q. Finally, turning to the testimony of Mr. Goulding filed in this case, what policy concerns does Mr. Goulding have with the Sharing Plan?

A. Mr. Goulding proposes a reduction to the Combined Company's ROE due to its larger size and based on certain comments made in the Direct Testimony of witnesses Powell and Reilly. Specifically, Mr. Goulding reasons that if the Merger is approved, the Combined Company's allowed ROE should be reduced to reflect the reduction in risk he believes will result from the Combined Company's larger size relative to the stand alone entities (*i.e.,* CVPS and GMP, respectively).[38]

45. Q. Do you agree with Mr. Goulding's proposed Return on Equity reduction for the Combined Company?

A. No, I do not. Mr. Goulding bases his position on the "perceived reductions in risk in the Combined Company and the increased access to capital as a result."[39] To support that position, Mr. Goulding refers to statements made by witnesses Powell and Reilly in their Direct Testimony citing greater access to capital and liquidity. While witnesses Powell and Reilly's statement points to one of many opportunities the Combined Company may access to achieve cost savings, Mr. Goulding has introduced no evidence to support the position that the Combined

---

38 Direct Testimony of A.J. Goulding, at 6-7.
39 Direct Testimony of A.J. Goulding, at 7.

Company's enhanced access to capital warrants a reduction in the return required by equity investors.

46. Q. Does Mr. Goulding provide any evidence that investors necessarily would require a lower return for the Combined Company relative to GMP and CVPS?

A. No, he does not. Mr. Goulding's position appears to be predicated on the theory that because the Combined Company would be larger than CVPS and GMP on a standalone basis, its Cost of Equity necessarily would be lower. In that regard, I agree that the financial and academic communities have long accepted the proposition that the Cost of Equity for small firms is subject to a "size effect."[40] While empirical evidence of the size effect often is based on studies of industries beyond regulated utilities, utility analysts also have noted the risks associated with small market capitalizations. Specifically, Ibbotson Associates noted:

> For small utilities, investors face additional obstacles, such as smaller customer base, limited financial resources, and a lack of diversification across customers, energy sources, and geography. These obstacles imply a higher investor return.[41]

Small size, therefore, leads to two categories of increased risk for investors: (1) liquidity risk (*i.e.,* the risk of not being able to sell one's shares in a timely manner due to the relatively thin market for the securities); and (2) fundamental business risks.

---

[40] *See* Mario Levis, The record on small companies: A review of the evidence, Journal of Asset Management2, March 2002, at 368-397, for a review of literature relating to the size effect.

[41] Michael Annin, Equity and the Small-Stock Effect, Public Utilities Fortnightly, October 15, 1995.

At issue, however, is not whether the Combined Company is larger than each of the merged companies, but rather whether the increase in size has a meaningful effect on its Cost of Equity, based on a proxy group of the Combined Company's peers.

47. Q. Have you conducted any analysis of the size of the Combined Company relative to a peer group of comparable companies?

A. Yes, I have. I compared key metrics of the Combined Company with a proxy group of similar risk companies. Specifically, I compared the electric sales revenue, electric sales volume, and electric customer count of the Combined Company to those metrics for proxy companies. The proxy group that I relied on for that analysis is the proxy group that I proposed in Docket No. 7176. In that case, I estimated the Cost of Equity based on a proxy group that included the nine companies identified in Table 1, (below).

Table 1: Proxy Companies

Company	Ticker
Alliant Energy	LNT
DTE Energy	DTE
Energy East	EAS
Empire District Electric	EDE
Northeast Utilities	NU
Pinnacle West	PNW
PNM Resources	PNM
Progress Energy	PGN
Xcel	XEL

Since that time, Energy East was acquired by Iberdrola, and therefore cannot be used as a comparable company in my analysis in this case. My analysis compares the relative size of the Combined Company to a proxy group that is comprised of the remaining eight companies from the proxy group that I relied on in Docket No. 7176.

48. Q. How does the Combined Company's electric utility compare in size to the proxy companies based on those metrics?

A. The Combined Company's electric utility operations are significantly smaller than the median of the proxy group companies' electric utility operations in terms of the number of customers, total sales volume and annual revenues. The results of this analysis are presented in **Exh. Pet.-RBH-4**.

49. Q. Have you conducted any additional analysis of the Combined Company's electric operations relative to the proxy companies?

A. Yes, I have. As shown in **Exh. Pet.-RBH-5**, I estimated the implied market capitalization for the Combined Company's electric operations (*i.e.*, the implied market capitalization if the Combined Company's electric utility operations were a stand-alone, publicly traded entity), and compared that to the median market capitalization of the proxy companies.

50. Q. How did you estimate the implied market capitalization for the Combined Company's electric operations?

A. I estimated the implied market capitalization of the Combined Company by applying the median market-to-book ratio for the proxy group of 1.44 to the total equity of the Combined Company's electric utility operations of $480.3 million.[42] The implied market capitalization based on that calculation is $692.8 million, which is far below the proxy group median of $5.687 billion.

51. Q. Have you considered the relative size of the Combined Company in the context of the relative Return on Equity?

A. Yes. In its Risk Premia Over Time Report: 2011, Morningstar Inc. ("Morningstar") presents its calculation of the size premium for deciles of market capitalizations relative to the S&P 500 Index. An additional estimate of the size premium associated with the Combined Company, therefore, is the difference in the Morningstar size risk premia for the proxy group median market capitalization relative to the implied market capitalization for the Combined Company.

As discussed above, and as shown on **Exh. Pet.-RBH-5**, the median market capitalization of the proxy group was approximately $5.69 billion, which corresponds to the 3rd decile of Morningstar market capitalization data. Based on the Morningstar analysis, that decile has a size premium of 1.01% (or 101 basis points). The implied market capitalization for the Combined

---

[42] Green Mountain Power Corporation, FERC Form 1, November 28, 2011, at 112. Central Vermont Public Service Corporation, FERC Form 1, April 15, 2011, at 112.

Company's electric utility operations is approximately $693 million, which falls within the 8th decile and corresponds to a size premium of 2.65% (or 265 basis points). The difference between those size premia is 164 basis points (265 basis points less 101 basis points).

52. Q. Please summarize your conclusions regarding the relative size of the Combined Company and its effect on the Cost of Equity.

A. As discussed above, the Combined Company is smaller than the median of the proxy group in terms of the number of customers, electric sales volume and total revenue from electric operations. In addition, comparing the implied market capitalization of the Combined Company to the proxy group demonstrates that the Combined Company's implied market capitalization is lower than the median of the proxy group. Consequently, even considering the incrementally larger size of the Combined Company relative to its standalone components, investors still would require a substantial size premium relative to peer companies. As such, I disagree with Mr. Goulding's suggestion that the post-Merger authorized Return on Equity should be reduced as a result of its larger size relative to the standalone entities.

53. Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does.