

STATE OF VERMONT
PUBLIC SERVICE BOARD

In Re: Joint Petition of Central Vermont Public)
Service Corporation ("CVPS"), Danaus)
Vermont Corp., Northern New England Energy)
Corporation ("NNEEC") for itself and as agent)
for Gaz Metro Limited Partnership and its)
parents, Green Mountain Power Corporation)
("GMP") and Vermont Low Income Trust for)
Electricity, Inc. ("VLITE"), for approval of:)
(1) the merger of Danaus into and with CVPS;)
(2) the acquisition by NNEEC of CVPS and)
certain other Vermont companies; (3) the)
amendment to CVPS's Articles of Association;)
(4) the merger of CVPS into and with GMP;)
and (5) the acquisition by VLITE of a controlling)
interest in Vermont Electric Power Company, Inc.)

PSB Docket No. 7770

PREFILED REBUTTAL TESTIMONY AND EXHIBITS OF
NORA MEAD BROWNELL ON BEHALF OF
VERMONT ELECTRIC POWER COMPANY, INC. AND VERMONT TRANSCO LLC

MARCH 8, 2012

Ms. Brownell's rebuttal testimony responds to proposals regarding the ownership and governance of VELCO advanced by Washington Electric Cooperative, Inc. and Stowe Electric Department. Ms. Brownell describes the serious and long lasting effects on Vermont, Vermont ratepayers, and VELCO's current shareholders that would likely result from significant involvement in the ownership or governance of VELCO by the State. She also points out that other proposals presented by intervenors seem designed to address issues other than the one the merger of VELCO's two largest shareholders creates – the potential for a "tyranny of the majority."

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1 Q. Please state your name, occupation and business address.

2 A. My name is Nora Mead Brownell and my business address is 500 Montgomery St., Suite
3 400, Alexandria, VA 22314. I am co-founder of ESPY Energy Solutions, LLC, a
4 business providing strategic planning, marketing, business, regulatory, and technical
5 expertise to energy utilities, energy equipment manufacturing and supplying companies,
6 Smart Grid manufacturers and service providers, and financial institutions evaluating
7 investments in the energy sector.

1 Q. Did you prefile testimony in this proceeding previously?

2 A. Yes. I prefiled direct testimony in this case on January 20, 2012 to describe the
3 regulatory framework in which Vermont Electric Power Company, Inc. and Vermont
4 Transco LLC operate and to address issues related to their governance.

5
6 Q. What is the purpose of your rebuttal testimony?

7 A. My testimony responds to proposals regarding the ownership and governance of VELCO
8 advanced by Washington Electric Cooperative, Inc. and Stowe Electric Department. I
9 describe the serious and long lasting effects on Vermont, Vermont ratepayers and
10 VELCO's current shareholders that would likely result from significant involvement in
11 the ownership or governance of VELCO by the State. I also point out that other proposals
12 presented by intervenors not only will create more problems than they solve, but seem
13 designed to address issues other than the one the merger of VELCO's two largest
14 shareholders creates - the potential for a "tyranny of the majority."

15
16 Q. What is your reaction to the proposal by witnesses for Washington Electric Cooperative
17 that the Vermont Public Service Board should consider municipalizing VELCO and or
18 Transco?

19 A. Washington Electric Cooperative, Inc. ("WEC") appears to offer its support for a
20 proposal that would, at a minimum, transform VELCO from a private, shareholder-
21 owned company into a quasi-state owned company, and, at most, seek to accomplish a
22 full taking of VELCO by the state. (*See*, Testimony of Avram Patt, page 11, line 5 and
23 *See also*, Thomas Kandel, page 7, line 18). WEC suggests that such an entity could be

1 governed in the manner proposed by Professor Dworkin in his testimony on behalf of the
2 DPS, whereby General Good Directors would be appointed to the VELCO board of
3 directors by a state nominating board. WEC acknowledges, however, that as a small
4 utility it does not possess the resources to fully examine the issues which would arise
5 from such an action. (Testimony of Avram Patt, page 12 line 8-11)

6 My opinion of WEC's proposal is that an attempt by Vermont to take over
7 VELCO or to convert it into a quasi-public entity would be ill-advised. It would likely
8 have serious and long-lasting effects on Vermont, Vermont ratepayers and VELCO's
9 current shareholders, and no such drastic action is required to address the narrow
10 corporate governance issue posed by the proposed merger - the potential for tyranny of
11 the majority.

12 I understand that hearings were recently held in the Vermont legislature regarding
13 a proposal to study the potential acquisition of a majority share of VELCO by Vermont.
14 It is clear from analysis that has been done on the question of State ownership or the
15 creation of a State transmission authority that the State cannot fiscally afford these
16 options and that both options would severely damage the State. The State could lose one
17 or more of its triple-A ratings and cause an increase to Vermont's cost to raise capital
18 funds for many years into the future. *See* Exhibit VELCO-NMB-6, a copy of the written
19 testimony of Vermont's financial advisor before the Senate Finance Committee on
20 February 28, 2012. *See also* Exhibit VELCO-NMB-7. Moreover, the State, like any
21 other investor, could lose the capital it invests in the company and, under limited
22 circumstances, could face additional litigation risks in connection with the acts or
23 omissions of VELCO.

1 In addition to the direct risks to Vermont of potential lawsuits and of its credit
2 rating being affected, significant state involvement in VELCO ownership or governance
3 would pose financial risks for VELCO that could affect Vermont ratepayers. VELCO is
4 not currently an organization with state-appointed or state-affiliated directors. Instead it
5 is a “private, for-profit, business corporation organized pursuant to Title 11A of the
6 Vermont Statutes Annotated and has the rights and obligations established by law in that
7 title,” as Mr. Mullet notes in his testimony on behalf of VPPSA.

8 As described in my direct testimony, there are multiple risks to changing the
9 nature of the organization from a private, for-profit business corporation to one with state
10 affiliation, including the increasing concerns of investors and the public with
11 governments becoming involved in high-risk ventures beyond their core competency. To
12 understand the basis for these concerns one need only look to the recent financial collapse
13 of the City of Harrisburg and the crisis in Jefferson County, Alabama. The experiences of
14 the State of California, which guaranteed energy contracts and saw its own General
15 Obligation (GO) ratings fall in the aftermath of the electricity crisis
16 (<http://www.treasurer.ca.gov/ratings/history.asp>), the City of Philadelphia with its history
17 of unfortunate interventions in its Philadelphia Gas Works,¹ and the City of Burlington
18 with its Burlington Telecom venture provide examples of the damaging effects of

¹ "Formed in 1835 by City ordinance, Philadelphia's gas utility originally operated under private management, but soon was absorbed by the City under a board of trustees and subsequently placed under the Department of Public Works. In 1897, the City contracted with the United Gas Improvement Co. to operate PGW. This arrangement retained City ownership and lasted until 1972, when the City transferred that responsibility to the Philadelphia Facilities Management Corp. a not-for-profit entity that is now one of several overseeing PGW."

1 government activity in arenas where governments have little or no experience. Ironically,
2 at this time when some are discussing the possible takeover of VELCO by the State of
3 Vermont, a financial adviser hired by the City of Philadelphia has concluded that the city
4 should try to sell the Philadelphia Gas Works.

5 Ultimately, electric ratepayers would pay the bill for Vermont undertaking the
6 risk involved in owning, financing and operating VELCO as rates or taxes or both would
7 likely increase so that the drain resulting from a VELCO takeover would not divert
8 resources from other activities. It is for these reasons that the United States has relied
9 primarily on private ownership of utilities and created a regulatory system to oversee
10 those utilities with multiple layers of protection for the public interest subject to judicial
11 review. Through this system decisions on important utility issues are made and reviewed
12 by independent bodies according to a public interest standard, while private interests
13 shoulder the financial risks associated with ownership and management.

14 It is likely that the same risks demonstrated by the examples above would be
15 present if Vermont created a state authority to take over the services provided by VELCO
16 and Transco. State authorities like these are usually created by special legislation and are
17 run by a board of directors. Such authorities exercise authority in certain prescribed
18 matters and are usually required to support themselves through property taxes, other
19 forms of collection, or fees for services. However, even if a state authority had bond-
20 issuing power, it is possible, and even likely, that credit analysts would perceive the
21 authority's debt as the State's responsibility.

22 If the State assumed a role as the appointment authority for all or a substantial
23 portion of the board of directors and management of VELCO, the result could be similar.

1 The assumption by credit agencies and lenders might be that the State is in control, even
2 if Vermont has not written the check to formally own the companies' equity, because
3 political appointees would control the board, its decisions and, ultimately, the operations
4 of VELCO and Transco.

5
6 Q. What legal issues stand out, if any, when discussing the above options for municipalizing
7 VELCO and/or Transco?

8 A. The legal issues generated by a proposal to municipalize VELCO and/or Transco are
9 almost too plentiful to enumerate, and I am not an attorney. But, first and foremost, I
10 suggest there is an issue of a State "taking" of private property. This issue has been
11 raised by Kenneth Nolan of the Burlington Electric Department (BED). Mr. Nolan points
12 out in his testimony that a political appointment process giving Vermont a significant
13 percentage of board members is "really a proposal for a state takeover of VELCO without
14 the actual purchase of the company." (Testimony of Kenneth Nolan, page 15, line 7-8) I
15 agree with Mr. Nolan's assessment. VELCO's shareholder have certain rights and
16 responsibilities, and these proposals seek to materially diminish or eliminate some of the
17 shareholders' statutory rights - including their rights under Vermont law to elect directors
18 of their choosing.

19 Again I am in agreement with Mr. Mullet when he states that he "is not persuaded
20 that because an organization performs a function which is important to a constituency,
21 that constituency is entitled to share in governance of that organization." (Testimony of
22 David Mullet, page 9, line 1-3.) Whether VELCO and Transco are taken directly through
23 an outright attempt to purchase the companies or are effectively taken over by the State's

1 exercise of control over VELCO's board of directors through the untested "appointment"
2 model recommended by Professor Dworkin, these far-reaching proposals are thinly
3 veiled attempts to municipalize VELCO, fundamentally altering the ownership rights of
4 VELCO's existing shareholders. Such fundamental changes to the shareholders'
5 ownership rights, where the impetus for the change is State action, could amount to a
6 "taking" of private property by the State that would require taxpayers to compensate
7 VELCO's current shareholders.

8 Regardless whether the owners of the two largest VELCO shareholders reside
9 in Canada - one of the U.S.'s strongest allies and largest trading partners - they are
10 afforded protections under the U.S. Constitution from a taking. The owners have been
11 very clear in stating that "Transco assets are not for sale." (Testimony of Mary Powell
12 and Lawrence Reilly, page 10, line 6) If the State were to impose a governance scheme
13 that rendered VELCO's and Transco's assets or the shares held by VELCO's existing
14 shareholders virtually unsalable (like mandating that VELCO maintain a politically
15 appointed board in perpetuity), the diminution in value could also be deemed to be a
16 "taking" that could expose the State to liability to compensate VELCO's shareholders.

17
18 Q. Mr. Kandel suggests that with a public or quasi-public organizational structure VELCO
19 might be exempt from FERC regulation. To what extent are municipal utilities and
20 cooperatives exempt from FERC jurisdiction and NERC requirements?

21 A. It is true that FERC is empowered to regulate wholesale power sales, except when the
22 seller is a public agency, and that municipal electric utilities enjoy an exemption from
23 FERC's general regulation. However, Mr. Kandel's desire to restructure

1 VELCO/Transco as a quasi-public, co-operative organization (even assuming financing
2 could be found, takings issues resolved, etc.) is troubling. Without fully understanding
3 exactly how he believes that as a cooperative VELCO would be exempt from the
4 obligation to have an OATT on file with FERC or be able to avoid NERC Critical
5 Infrastructure Protections (CIP), it is impossible to give a proper opinion on his
6 assertions.

7 The more serious question is whether Mr. Kandel is suggesting that freedom from
8 oversight, regulation, market monitoring, and enforcement is a good thing. Does this
9 also suggest that it would be desirable to be free from NERC reliability rules and regional
10 planning and oversight? It seems very odd to offer this as a positive outcome,
11 particularly when Stowe Electric Department, WEC and Professor Dworkin have all
12 identified the potential danger from monopolistic behavior in the management of electric
13 transmission assets.

14
15 Q. Do you have other concerns about implementation of the ownership and governance
16 proposals advanced by WEC?

17 A. Yes. As many of the intervenors have recognized, some of the proposed actions would
18 take legislative action to implement, potentially exposing ratepayers and taxpayers (who
19 are effectively one in the same) to uncertainty and gridlock. This uncertainty could also
20 subject other shareholders of VELCO to increased risks. If issues related to these
21 proposals must be resolved before the proposed merger can be consummated, the
22 proposed merger date could be delayed, with the promised merger benefits postponed and
23 perhaps diminished. (Testimony of Mary Powell and Lawrence Reilly, page 10, lines 11-

1 14). And, as Mr. Mullet points out, there appears to be some question as to whether the
2 Public Service Board would have jurisdiction to order measures like those that WEC and
3 the DPS suggest. "Neither VELCO nor most of its shareholders are petitioners in this
4 docket. Clearly, the legislature and governor are not subject to Board jurisdiction, nor
5 could GMP reasonably be required, as a condition of Board approval, to establish a 'State
6 Transmission Nomination Board.'" (Testimony of David Mullet, page 9, line 21-24.)
7

8 Q. Would you describe further the issues regarding creditworthiness that are raised by
9 various ownership and governance proposals?

10 A. As I pointed out in my original testimony, the creditworthiness of VELCO and the State
11 of Vermont may be at issue depending upon the decisions made by the PSB in this
12 merger proceeding. In my original testimony I stated that credit agencies uniformly
13 examine the governance of a utility and the regulatory environment in which it exists
14 when determining its creditworthiness. The information cited from Dominion Bond
15 Rating Service, Standard and Poor's, Moody's and Fitch Ratings demonstrate that these
16 agencies deem stability in these areas to be highly important. The proposals regarding
17 governance offered by several intervenors in this merger, in particular WEC and the DPS,
18 will cause the ratings companies to reexamine these issues.

19 The extreme proposals offered for consideration by WEC would have particularly
20 detrimental effects for Vermont. Ignoring for a moment the issues of how recasting
21 VELCO and Transco as State-owned entities would be financed, the possible negative
22 effects of such an action would be substantial. Such an action would double the State of
23 Vermont's tax supported debt and, as I mentioned previously, could increase the State's

1 cost of capital as a result of losing one or more of its triple A credit ratings. Even if the
2 purchase were to be financed through bonds to be paid for through dividends paid in
3 respect of ownership in VELCO, the payment obligation on such bonds would ultimately
4 be attributed to the State. There are a myriad of risks associated with taking on this
5 enormous debt by Vermont.

6 The expected effect on VELCO itself under these scenarios is similar. Taking
7 VELCO from a private, for-profit, shareholder-owned company, to a State-owned or
8 quasi-public entity would certainly demand that ratings agencies re-examine their
9 evaluations of VELCO. Any scenario suggested which introduces a political element
10 into the governing and management processes of the company opens the door for
11 uncertainty. I believe this uncertainty would jeopardize the credit rating of the company
12 itself because credit agencies value the stability of the existing professional and apolitical
13 regulatory environment in which VELCO operates. The last credit report issued by
14 DBRS to VELCO/Transco this year discussed the upcoming merger. The firm noted, "It
15 is unclear what other proposals, including possible changes to VELCO's governance will
16 be offered by other parties, or what impact such proposals might have on credit
17 worthiness." *See* Exhibit VELCO-NMB-4 at 3. Credit agencies will be forced to
18 evaluate the governance structure adopted in response to the proposed merger, and these
19 reevaluations will reflect their views on any governance changes and the regulatory
20 environment in Vermont.

1 Q What is your view of the Stowe Electric Department's recommendation that VELCO's
 2 board be made up entirely of owners and that each owner have an equal voice
 3 irrespective of its ownership stake in the company?

4 A. Stowe's suggestion that an owner-populated board with one vote per owner, regardless of
 5 ownership interests, is certainly not a common or desirable model for an investor owned
 6 company. Good governance practice is for boards to comprise a majority or at least a
 7 substantial number of independent directors. The predominant model for investor owned
 8 utilities in the U.S. is to have independent directors in the majority. This is true for
 9 electric utilities, as well as local distribution companies, pipelines, communications
 10 networks, and other critical infrastructure companies. As VELCO has experienced
 11 success with its current governance model for many years, the addition of more
 12 independent members to its board would be a much less intrusive way of addressing the
 13 problem of tyranny of the majority than attempting to having all shareholders represented
 14 on the board or political appointees sitting on the board, both of which would tend to
 15 encourage the assertion of interests that are inconsistent with the directors' fiduciary
 16 duties.

17 Ms. Burt's proposal, like the proposals advanced by WEC, appears to stem from
 18 issues experienced by these entities in working with VELCO. The problems cited by
 19 Stowe and WEC as examples of harm done under the existing VELCO governance
 20 construct pertain to transmission cost allocation issues that were not resolved to their
 21 satisfaction. While cost allocation issues are hotly contested in every state, region, and
 22 national forum, they are appropriately resolved in the existing regulatory and judicial
 23 structure. Of course, participation in VELCO's Operating Committee, the New England

1 ISO Planning Committee, and associations like VPPSA or NRECA, can also help address
2 communications issues and concerns about power imbalance. They are legitimate forums
3 for advancing debate on these issues. Using trade associations or committees as a
4 collective voice on these issues is a very powerful way to magnify the influence of
5 smaller participants and to reduce their costs.

6 There is no doubt that communications, transparency, and protocols require
7 continuous review and improvement, a fact that BED and VELCO have acknowledged.
8 Perhaps VELCO can give additional consideration to enhancing the use of these channels
9 by smaller utilities so that their concerns can be heard. Nevertheless, resolving the issue
10 of an adequate voice for Vermont's small utilities does not require broad structural
11 changes or the draconian repurposing of VELCO. In that regard I agree with Mr. Nolan
12 in his testimony for BED that VELCO should seek to be "responsive to the public interest
13 and the concerns of smaller customers. However that desire must be balanced with the
14 fact that VELCO is a private corporation whose existing owners have certain rights, both
15 legal and perceptual from longstanding corporate practice." (Testimony of Kenneth
16 Nolan, page 17, line 3 (*See also*, Testimony of David Mullet, page 8, lines 2-7))

17 VELCO is a for-profit private company. It must respect its fiduciary duties along
18 with its duty to serve the public interest. These demands existed before this merger and
19 they will exist afterwards. The only issues at stake surround majority control and ways to
20 mitigate the potential "tyranny of the majority." As described in my direct testimony,
21 there are tried-and-true ways to address this issue that do much less damage to a status
22 quo that is working well for VELCO than the radical changes some parties have asked

1 the PSB to consider. There are also governance structures that are much more consistent
2 with good corporate governance than those proposed by the DPS and others.

3
4 Q. You state that these smaller utilities have protections under the regulatory scheme and/or
5 through trade associations. Do adequate protections for the public interest already exist?

6 A. There are many layers of protection to the public interest. In my earlier testimony I laid
7 out the protections that the Federal Energy Regulatory Commission provides for
8 ratepayers and utilities. (*See*, Testimony of Nora Brownell pages 8-10) VELCO is
9 required to comply with all FERC orders, rules and regulations that stem from
10 implementing the Federal Power Act. I pointed out that FERC has ample tools in its
11 arsenal to demand compliance from utilities if they are found in violation of FERC's
12 orders.

13 VELCO must similarly answer to NERC, which ensures the reliability of the
14 North American bulk power system. Regionally, the ISO-New England oversees long-
15 range planning. (Testimony of Nora Brownell, page 11.) At the state level, there are laws
16 and regulations that VELCO must adhere to and multiple regulatory bodies that oversee
17 important activities of VELCO like transmission planning and project construction,
18 which regulatory bodies include the Department of Public Service and the Vermont
19 Public Service Board. This entire regulatory framework exists to protect the public
20 interest.

21
22 Q. Stowe Electric Department asserts that it is an "anomaly" for an important function like
23 bulk electric transmission to be controlled by private interests. Do you agree?

1 A. Stowe's suggestion that the investor ownership of vital service companies is an
2 "anomaly" in the industry is difficult to understand. According to the U.S. Energy
3 Information Administration, fully 73% of the transmission ownership in the United States
4 is through investor owned utilities. Additionally, 75% of all generation and capacity in
5 the U.S. is owned by private investors. Only 15% of Americans are served by municipal
6 utilities. In 2008, investor-owned utilities served 2,229,654,009 MWhs; cooperatives
7 served 392,103,539 MWhs; and public utilities served 558,814,282.

8 So, far from being an anomaly, private ownership of utilities with the public
9 interest ensured by regulation is the prevailing model in this country. The institution of
10 this regulatory model with the "public interest standard" was designed to insure the
11 attraction of private capital to critical infrastructure and services while protecting
12 ratepayers. It has worked successfully in Vermont and throughout the U.S., and, in fact, is
13 a model emulated by other countries. (See, Testimony of Nora Brownell, pages 26-27)
14 Other models like cooperatives and municipals emerged to serve populations that were
15 unable to attract private capital and needed a different model, which was subsidized and
16 guaranteed by taxpayers. They are numerous in number, but proportionately significantly
17 smaller in asset ownership and load served, as previously mentioned.

18
19 Q. Do you believe mandating the specifics of VELCO's governance is an appropriate action
20 for the Public Service Board to take?

21 A. No, I do not. The potential for "tyranny of the majority" must be mitigated; that is
22 acknowledged by all parties. However, for an administrative body to demand that a
23 private, for-profit company fundamentally reformulate its corporate governance by

1 reconstituting its board of directors in a specific and rigid manner as a means to resolve
2 issues that can be resolved in a variety of less-intrusive, more generally-accepted ways is
3 extreme and, in my opinion, exceeds the bounds of its proper role. Certainly, there have
4 been no instances that I know of where a private, for-profit, shareholder-owned company
5 has been forced to adopt a board of directors structure that includes politically appointed
6 members, even if the regulatory body with jurisdiction had the authority to do so.

7

8 Q. Does this conclude your testimony?

9 A. Yes.

My name is Thomas Huestis and I am a partner in the firm Public Resources Advisory Group, Inc. Public Resources Advisor Group or PRAG, is headquartered in New York City was retained by the State of Vermont in 2011 as the State's financial advisor. The firm is an independent financial advisory firm, and does not engage in any form of underwriting, trading, marketing, or investing in tax-exempt securities. The firm was founded in 1985 to provide in-depth financing support to state and local governments, authorities and agencies and has continuously served governmental entities exclusively. PRAG has been consistently ranked as one of the three top national financial advisory firms over each of the past 10 years, and is a leader in providing debt and credit advice to State governments. We represent the neighboring states of New Hampshire, New York, and the Commonwealth of Massachusetts as well as other AAA rated states including the State of Georgia, and the Commonwealth of Virginia. The firm employs over 30 professionals who are drawn from diverse backgrounds, including former governmental officials, advisors, rating agency credit analysts, bond lawyers and underwriters of tax-exempt debt. Employees of the firm have a deep working knowledge of the capital markets, quantitative skills and in-depth appreciation of the unique challenges of state and local governments.

In terms of my background, I joined PRAG in 2002 as a partner and am the resident manager of the firm's Pennsylvania office. I have been an independent financial advisor with PRAG, and PRAG's leading competitor for over 20 years. Prior to joining PRAG, I was the Deputy CFO and Treasurer of the District of Columbia during its financial crisis where I was responsible for the management of the District's financial assets, all District debt offerings, including maintaining rating agency and investor relations with the public debt markets and was responsible for developing the District of Columbia's 4- year budget & financial recovery plan. Currently I am the project manager or co-project manager for clients including the states of Minnesota, Illinois, West Virginia and the State of Vermont. I have worked with Vermont on a of variety projects over the last year including working with the CDAAC committee in preparing its 2012 Report, participating in rating agency presentations and currently preparing the State's upcoming General Obligation bond sale.

Today, I have been asked to provide testimony to the Committee on the possible credit effects on the State regarding the State's proposed participation in financing 51-percent of VELCO, representing ownership interest in the management corporation responsible for Vermont's high-voltage bulk electric transmission assets. Our understanding is that (i) a financing of at least

\$500 million would be required to secure the 51% ownership interest in VELCO and that VELCO is anticipating needing an additional \$500 million to \$1 billion in new financing over the course of the next 20 years, (ii) the State is seeking the ownership interest as an investment – to participate in the dividend payments from VELCO net of paying debt service on the financing, (iii) any financing would have to be done on a taxable basis (the use of the bond proceeds does not qualify for tax-exempt debt) and (iv) that the range of financing options discussed to acquire the ownership interest have included guaranteed State financing in the form of State general obligation bonds to be issued, and a new authority or other “off balance sheet” vehicle created that would be authorized to issue bonds without State support. The balance of my testimony will summarize our views on these two options and discuss the possible credit risks associated with these types of transactions.

A \$500 million + State guaranteed general obligation bond financing, would double the State’s net tax supported debt. Although the debt service is anticipated to be initially “covered” by the dividend payment from VELCO, the sheer size of the additional bonding amount and the fact that the State would be participating in a large financial venture that it has little direct experience with (and the associated risks that I discuss later in this testimony) would create stress on its existing excellent ratings. There is a strong possibility that the State would lose one or more of its triple-A ratings and this would increase the State’s cost to raise capital funds for many years to come.

On the other end of the spectrum, the State could create new authority with bond-issuing powers without statutory State support or legal obligation. Presumably the only revenues available to this authority to repay any bonds it sold would be the dividends from ownership interests in VELCO. Other entities that have bond financed their VELCO participation include Green Mountain Power, Central Vermont Public Service, Burlington Electric Authority and VELCO itself have used additional security other than just dividend payments, including: mortgage assets, net revenues from power generation and distribution, general obligation pledges. We believe that a financing could be completed secured by just dividend payments, although at a higher cost than the State’s general obligation credit or more secured credit.

For a number of reasons, despite the absence of any legal obligation of the State to support Authority debt, we believe it is likely that the Authority and the future debt of the Authority

would ultimately be perceived as the State's responsibility by credit analysts. First, given that the purchase of the ownership interest is being considered as an investment for the State, we believe that this would tie the State closer to the Authority debt. Secondly, since the stated public purpose of the acquisition is to protect access to the State's transmission system from possible monopoly interference there would be a perception that State would need to maintain its majority ownership and therefore maintain or support future funding. Lastly, we believe that State ownership of VELCO itself (regardless of the issuer of the bonds) will invite analysts to attribute the credit of the Authority's debt to the State. One scenario that would be considered is if unanticipated events resulted in VELCO's inability to pay dividends sufficient to service the Authority's debt, future State officials would then see the need to use its credit in some way to protect its investment and maintain the purpose of the acquisition.

I will now briefly discuss some of risks associated with a financing:

- There is a risk that rating agencies will be concerned with the State participating in a large financial venture that has private business risk of which the State has little direct experience with. The State may have to respond to questions regarding why it is changing its conservative approach to debt financing.
- There is a risk that the initial cost of the State's membership units significantly exceed \$500 million.
- State of Vermont could become involved in a long-drawn out public process due to disagreements, litigation, condemnation, etc. regarding the VELCO acquisition. In this case, the State Vermont's name would be associated with a very large borrowing (regardless of the proposed bond structure used).
- VELCO's revenues are regulated and currently defined by FERC. There is a risk that future regulatory changes could affect transmission line pricing and thus revenues available for its dividend payments may not be sufficient to pay debt service.
- TRANSCO is projecting a need for significant ongoing capital investment. A new ownership structure of VELCO could negatively affect the amount and timeliness of equity contributions.
- Unanticipated events such as natural disasters, new regulations, technology changes, terrorist activities, etc., could increase VELCO's operating expenses and need for capital.

It is not certain that a new independent Authority would have access to capital markets to fund its participating share.

- VELCO/TRANSCO does not have sufficient net cash flow to fund its operating expenses, dividend payments, bond debt service and capital expenditures. VELCO/TRANSCO has been using a \$100 million external line of credit to fund its free cash flow deficits. The external facility is with one bank, has a short expiration date and no term-out provisions. There is a risk that if credit markets freeze again that the facility may not be available or not be available at the current terms which would put more pressure on the equity partner's dividends or increase equity partner funding requirements.
- It is unusual that a State would become an equity partner with private business corporations. Rating agencies would likely seek to know that the State fully understands the associated risks.
- Investors and the rating agencies are becoming more focused on governments taking large business financing risks even when the debt is estimated to be self supporting, due to the recent financial collapse of the City of Harrisburg which guaranteed a portion of a trash to energy facility (and is now in receivership) and Jefferson County Alabama which defaulted on a \$3 billion sewer utility financing.
- Regardless of the method used to finance the initial capital contribution, we assume that the State itself will be seeking ownership and control of VELCO and with ownership comes responsibilities that could result in terms of resources needed to address problems as well as financial responsibilities.

Thank you for the opportunity to present my testimony. Please know that I would be happy to address any questions that you may have.

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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

To: Senate Committee on Appropriations
From: Beth Pearce, State Treasurer
Subject: Concerns Regarding Potential VELCO Acquisition
Date: February 28, 2012

I have previously stated my concerns regarding the proposed "Study of State Ownership Interest in Vermont's Transmission Assets," namely, "up to a 51-percent ownership interest in Vermont's high-voltage bulk electric (115 kV and above) transmission assets."

Understanding that the ownership structure is somewhat more complex, hereafter for clarity I will simply refer to these assets as "VELCO." Further, for the purpose of analysis I will assume that this ownership interest will cost \$500 million, however the basis for this figure and its failure to reflect ongoing capital requirements and operating costs is one of my concerns. While the bill states "up to" 51%, I am assuming a significant level is contemplated if this proposal is seen as a means to address the governance concerns and potentially less if seen as an investment. In either case, the potential for higher requirements for acquisition costs is outlined in #4 below.

My concerns can be grouped into four categories as follows:

1. If Vermont's direct or moral obligation debt is used to acquire all or a portion of the interest in VELCO, this is likely to seriously impair to the State's future debt capacity and affordability;
2. If pension funds are used to acquire all or a portion of the interest in VELCO, this will seriously impair the funds' safety and liquidity, and will violate the prudent investor rule (i.e., the standard required by 3 V.S.A. §523) by concentrating approximately 15% of the funds in a single investment;
3. If things were to move forward, a move in the direction of a new authority or other "off balance sheet" vehicle created to acquire the interest in VELCO has been proposed. That entity's debt could be difficult to sell, and ultimately could place demands on Vermont's direct or moral obligation; and
4. The acquisition cost of \$500 million does not account for a possible higher acquisition cost based upon market value or litigation from existing owners, nor does it account for ongoing

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capital and operating costs, and associated risks of operating and maintaining transmission assets.

I discuss each of these concerns in more detail below.

Impairment to State's Debt Capacity and Affordability

As of June 30, 2011, Vermont's total outstanding general obligation debt was \$491,748,000, and this debt carried stable ratings of Aaa from Moody's Investors Service and AAA from Fitch Ratings (both the highest available) and AA+ from Standard & Poor's (the second-highest available). These ratings, along with Vermont's ability to issue debt for which the interest is exempt from both federal and Vermont income tax, enable Vermont to borrow at extremely low interest rates, and to save Vermont's taxpayers significant dollars annually in interest costs.

Vermont is one of thirteen states with at least two triple-A credit ratings, and our State's critical debt ratios generally are in the top one-third of states. Specifically, our debt per capita was \$747 (ranked 37th out of 50, where 50th is best), our debt as a percent of personal income of 1.9% was ranked 36th out of 50, and our debt service (annual principal and interest payments, currently about \$70 million) as a percent of general and transportation fund revenues was a very manageable 5.1%.

If Vermont sold \$500 million of new general obligation bonds, our debt per capita would increase to \$1,507 and our ranking would fall to 17th, our debt as a percent of personal income would increase to 3.8% and our ranking would also fall to 17th, and our debt service as a percent of revenues would at least double to 10.2% (which would rank the State 4th, below New York just above Illinois). Given this sharp deterioration in our debt ratios relative to other states, it is very likely Vermont would lose its triple-A ratings. Assuming the State were able to maintain ratings of AA, my office previously estimated that this would increase Vermont's overall borrowing costs by \$4.1 million to \$6.9 million over the life of a \$150 million bond issue (which corresponds to the current two-year debt authorization for fiscal years 2012 and 2013).

Finally, the Capital Debt Affordability Advisory Committee estimates that the State can afford to sell \$76,580,000 of general obligation bonds each year through 2022. If the State sold \$500 million of bonds all at once, this would expend over six and one-half years of debt capacity, and preclude future capital bill projects through at least 2018 and possibly longer.

Impairment to Safety and Liquidity of the Pensions

During my initial testimony to the Senate Committee on Economic Development, Housing and General Affairs, I was asked whether pension funds could be used in a VELCO acquisition. Since that time I believe there is less interest in exploring this alternative, but I thought it important to reiterate my concerns.

I urged caution about using pension funds for several reasons. First, the single most important risk management strategy of the pension funds is diversification across numerous assets classes and thousands of individual securities and holdings. The VELCO purchase would represent an unacceptable concentration of fund assets in a single investment: as of January 31, the pension funds' balance was \$3.40 billion, so a \$500 million investment would thus represent 14.7% of

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the pension funds' assets. The pensions currently are invested with 22 firms that manage 35 different funds, each of which is in turn invested in hundreds of individual securities, representing different asset types, issuers, industries, credit qualities, and geographic locations. Concentrating 14.7% of the pensions in a single asset, of a single company, in a single industry, with a single revenue source, in a single geographic location would constitute an unacceptable risk of loss, and would be at the very least a failure to adhere to the prudent investor rule, which is the standard required under Vermont statute (3 V.S.A. §523).

Second, the Teachers' and State Employees' pension funds are required to make monthly distributions to pay for retirement benefits. A VELCO investment would be very illiquid (the shares are not traded on an open market); unable to be sold without considerable advance notice, and at an indeterminate price that could be negatively impacted by how urgently the sale was required.

Third, any dividends paid from a VELCO investment would be required, under IRS rules governing pensions, to be reinvested in the pension funds for the benefit of plan participants. VELCO interests purchased with pension funds thus would not be a source of state revenues.

Difficulty of Using an "Off Balance Sheet" Vehicle

Another method to acquire VELCO's assets would be to create a new authority with bond-issuing powers. However, my understanding is that the only revenues available to this authority to repay any bonds it sold would be the dividends from ownership interests in VELCO's assets. Further, Green Mountain Power, Central Vermont Public Service and VELCO's other current owners have additional resources to pledge for bond repayment – such power sales and the ability to mortgage existing infrastructure – that would not be available to a new authority. This creates several problems.

First, it is not clear what the credit rating of a new authority's bonds would be, but it seems reasonable to conclude that the ratings would be below Vermont's ratings. Additionally, the State's bond counsel has previously opined that this acquisition would not be eligible for tax-exempt financing. As such, the interest rates a new authority would be required to pay would be in excess of Vermont's borrowing rates. Other state authorities make use of the state's moral obligation.

Second, it is my understanding from testimony Mr. Michael H. Dworkin provided to the Public Service Department on January 10, 2012, that VELCO's current owners use dividends received on their VELCO ownership interests to lower electricity rates to their customers. As such, any diversion of these dividends to repay potentially more costly bond interest could increase rates to ratepayers, and the higher the interest rate, the more pronounced the loss to ratepayers.

Third, VELCO, and by extension this new authority, would operate in a highly regulated environment. It is my understanding that rate levels are regulated by the Federal Energy Regulatory Commission (FERC), are subject to periodic review, and in some cases also subject to legal challenges. Any reduction in rate revenues could be detrimental to the assumed economic benefit of an acquisition.

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Finally, and perhaps of greatest concern, the State's financial advisor, Public Resources Advisory Group, has indicated to me that notwithstanding ownership of VELCO by a separate authority, if this authority is structured as an investment for the State, then the debt would likely be perceived ultimately as the State's responsibility by bond market participants. If the economics of the ownership interest in VELCO deteriorated in the future, I believe there would be enormous pressure placed upon the State to use either its moral obligation or general obligation debt.

Concerns Regarding Acquisition Cost

My final set of concerns regards the true cost of acquiring VELCO, and I admit upfront that this is not my area of expertise. However, from my own reading on the subject and relying on common sense, it seems that the \$500 million figure does not account for numerous considerations:

1. The market value of the asset in question could be substantially higher than the book value, especially if "guaranteed" rates of return above 10% are initially anticipated;
2. The current owners of VELCO have not indicated a willingness to sell the assets; if the State contemplates employing condemnation or eminent domain, it seems reasonable to anticipate that litigation (of indeterminate expense) could result;
3. The assets require ongoing capital investment and operating expenses; VELCO's "2009 Vermont Long-Range Transmission Plan" contemplates between \$500 million and \$1 billion of additional investments over a 20-year period, and DPS has advised in testimony that approximately \$500 million is contemplated over the next five years;
4. FERC enforces reliability standards, and provides for potentially stiff penalties -- reportedly up to \$1 million per day -- for infractions, introducing the possible need to raise additional capital; and
5. In any matter involving the amount of money in question, prudence demands that one think of unanticipated problems and worst-case scenarios. A VELCO investment would not be risk-free. Rather, the acquisition of transmission assets, the risks associated with operating and maintaining those assets, the factors negatively impacting the revenues, the business and regulatory environment, natural disasters, and the need to maintain a workforce with the specific skills required to manage these risks, are not areas of expertise for the State, and I believe we should anticipate unforeseen costs and liabilities.

Any increase in cost above the \$500 million used as the basis for this analysis would only serve to reinforce and amplify my concerns about this purchase, for the reasons outlined above. I appreciate your consideration of my concerns, and am available to discuss them in more detail at your convenience.

cc: Senate Committee on Economic Development, Housing and General Affairs
Senate Committee on Finance