STATE OF VERMONT
PUBLIC SERVICE BOARD

Joint Petition of Central Vermont Public Service Corporation, Danaus Vermont Corp., Northern New England Energy Corporation for itself and As agent for Gaz Métro Limited Partnership and Its 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

PREFILED TESTIMONY OF

JOHN W. WILSON

ON BEHALF OF

THE DEPARTMENT OF PUBLIC SERVICE

January 20, 2012

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1 ## I. QUALIFICATIONS

2 **Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.**

3 A. My name is John W. Wilson. I am President of J.W. Wilson & Associates,
4 Inc. Our offices are at 1601 North Kent Street, Suite 1104, Arlington,
5 Virginia, 22209.

6 **Q. PLEASE OUTLINE YOUR EDUCATIONAL BACKGROUND.**

7 A. I hold a B.S. degree with senior honors and a Masters Degree in Economics
8 from the University of Wisconsin. I have also received a Ph.D. in Economics
9 from Cornell University. My major fields of study were industrial organization
10 and public regulation of business, and my doctoral dissertation was a study of
11 utility pricing and regulation.

12 **Q. HOW HAVE YOU BEEN EMPLOYED SINCE THAT TIME?**

13 A. After completing my graduate education I was an active duty U.S. Army
14 officer. While in the Army I served as an Assistant Professor of economics at
15 the United States Military Academy, West Point, New York. In that capacity, I
16 taught courses in both economics and government. While at West Point, I also
17 served as an economic consultant to the Antitrust Division of the United States
18 Department of Justice.

1 After leaving West Point, I was employed by the Federal Power Commission
2 ("FPC"), first as a staff economist and then as Chief of FPC's Division of
3 Economic Studies. In that capacity, I was involved in regulatory matters
4 involving most phases of FPC regulation of electric utilities and the natural gas
5 industry. Since 1973 I have been employed as an economic consultant by
6 various clients, including federal, state, provincial and local governments,
7 private enterprise and nonprofit organizations. This work has pertained to a
8 wide range of issues concerning public utility regulation, insurance rate
9 regulation, antitrust matters, valuation and other economic and financial
10 analysis. In 1975 I formed J.W. Wilson & Associates, Inc., a Washington,
11 D.C. corporation.

12 **Q. WOULD YOU PLEASE DESCRIBE SOME OF YOUR ADDITIONAL**
13 **PROFESSIONAL ACTIVITIES?**

14 A. I have authored a variety of articles and monographs, including a number of
15 studies dealing with utility regulation, antitrust enforcement and economic
16 policy. I have consulted on regulatory, financial and competitive market
17 matters with the Federal Communications Commission, the National Academy
18 of Sciences, the Ford Foundation, the National Regulatory Research Institute,
19 the Electric Power Research Institute, the National Association of Regulatory
20 Utility Commissioners ("NARUC"), the Edison Electric Institute ("EEI),the

1 U.S. Department of Justice Antitrust Division, the Federal Trade Commission
2 Bureau of Competition, the Commerce Department, the Department of the
3 Interior, the Department of Energy, the Small Business Administration, the
4 Department of Defense, the Tennessee Valley Authority, the Federal Energy
5 Administration, and numerous state and provincial agencies and legislative
6 bodies in the United States and Canada.

7 Previously, I was a member of the Economics Committee of the U.S. Water
8 Resources Council, the FPC Coordinating Representative for the Task Force
9 on Future Financial Requirements for the National Power Survey, the Advisory
10 Committee to the National Association of Insurance Commissioners (NAIC)
11 Task Force on Profitability and Investment Income, and the NAIC's Advisory
12 Committee on Nuclear Risks.

13 In addition, I have testified as an expert witness in court proceedings dealing
14 with competition, valuation and regulation and on regulatory matters before
15 more than 50 Federal and State regulatory bodies throughout the United States
16 and Canada. I have also appeared on numerous occasions as an expert witness
17 at the invitation of U.S. Senate and Congressional Committees dealing with
18 antitrust and regulatory legislation. In addition, I have been retained as an
19 expert on regulatory matters by more than 25 State and Federal regulatory
20 agencies. I have also participated as a speaker, panelist, or moderator in many

1 professional conferences and programs dealing with business regulation,
2 financial issues, economic and energy policy and antitrust matters. I am a
3 member of the American Economic Association and an associate member of
4 the American Bar Association and the ABA's Antitrust, Insurance and
5 Regulatory Law Sections.

6

7 **II. OVERVIEW OF TESTIMONY**

8 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS**
9 **PROCEEDING?**

10 A. I am presenting testimony in this proceeding on behalf of the Department of
11 Public Service.

12 **Q. PLEASE SUMMARIZE YOUR TESTIMONY?**

13 A. My testimony in this case concerns issues regarding the proposed acquisition
14 of Vermont's largest electric utility, Central Vermont Public Service Corp.
15 ("CVPS"), by Gaz Métro Limited Partnership and its affiliates ("The
16 Company" or "Gaz Métro")[1], which also own Green Mountain Power
17 ("GMP"), Vermont's second largest electric utility, and Vermont Gas Systems,

[1] Technically, CVPS would be acquired by Gaz Métro subsidiary Northern New England Energy Corporation ("NNEEC"), which is the corporate parent of GMP.

1 Inc., the State's only retail gas distribution utility. Gaz Métro's acquisition
2 plan contemplates the merger of CVPS and GMP, with GMP being the
3 surviving electric utility subsidiary serving approximately 70 percent of
4 Vermont's retail electric load. The merger would also bring together CVPS
5 and GMP ownership and control of Vermont's electric transmission
6 infrastructure through their combined ownership shares of Vermont Electric
7 Power Company ("VELCO"), which manages and operates these facilities.
8 The Company has proposed to divest some shares of VELCO to mitigate this
9 aspect of the merger.

10 My testimony addresses the reasonableness of the proposed sale and merger
11 transaction, including its costs, benefits and projected economic savings.
12 Particular attention is directed to evaluating the proposed allocation of claimed
13 merger benefits and savings between the surviving company's owners and
14 ratepayers. This includes consideration of Gaz Métro's acquisition financing
15 and the appropriateness of the Company's plan to recover its merger-related
16 costs, including the merger acquisition premium paid to CVPS shareholders
17 from Vermont ratepayers. Consideration is also directed to the appropriateness
18 of and need for specific additional "ring-fencing" conditions as merger
19 mitigation.

20

1 **III. SHARING MERGER SAVINGS**

2 **Q. DOES THE COMPANY CLAIM THAT THE PROPOSED MERGER**
3 **WILL RESULT IN SUBSTANTIAL COST SAVINGS?**

4 **A.** Yes. According to the Company's filing it is expected that the proposed
5 merger will result in cumulative cost savings of $226.4 million over ten years
6 from 2013 through 2022. (See Prefiled Testimony of Dawn D. Bugbee at 3).
7 Annually, these expected savings start at $6.5 million in year 1 (2013) and
8 increase to $24.0 million in year 5 (2017), and then increase more gradually
9 (primarily due to assumed inflation) to $31.0 million in year 10 (2022). (See
10 Exh. Pet.-DDB-2)

11 **Q. DOES THE COMPANY PROPOSE TO REFLECT THESE COST**
12 **REDUCTIONS IN RATES CHARGED TO CUSTOMERS?**

13 **A.** Yes. The Company does propose to reflect cost reductions in rates, but only
14 gradually over time. During the first two years the Company proposes to retain
15 90 percent of the projected cost savings as extra profit. During the next two
16 years they propose to retain 80 percent. During years 5 and 6 they propose to
17 retain 67 percent. Finally, after year 6, they propose to fully reflect cost
18 reductions in rates.

1 **Q. DOES THIS ASSURE THAT RATES WILL GO DOWN OVER TIME?**

2 **A.** No. There is no assurance that rates will go down, but the reflection of cost
3 reductions in rates does mean that rates should be expected to be lower by that
4 amount than they otherwise would have been.

5 **Q. HOW DOES THE COMPANY PROPOSE TO DETERMINE THE**
6 **AMOUNT OF COST REDUCTIONS ATTRIBUTABLE TO THE**
7 **MERGER AND INTEGRATION OF CVPS AND GMP?**

8 **A.** The Company's proposal is to first establish benchmark cost levels for certain
9 costs based on a June 2012 test year reflecting what those costs would be
10 without the merger. These benchmark 2012 costs would then be extrapolated
11 into future years, adjusting for inflation. After the merger, efforts would be
12 made to reduce these specified costs, and differences between actual (hopefully
13 reduced) costs and the extrapolated benchmark costs in each year would be the
14 estimated merger-induced cost savings. A good example of how this would
15 work is provided in Attachment A.AARP:PET.GMP.2-17a, which shows the
16 Company's calculated cost savings attributed to the 2007 Gaz Métro
17 acquisition of GMP. While the cost accounts targeted for reduction in this case
18 are different, the methodology for measuring cost savings is essentially the
19 same.

1 **Q. WHAT REASON DOES THE COMPANY GIVE FOR PROPOSING TO**
2 **RETAIN THE MAJORITY OF COST REDUCTIONS AS EXTRA**
3 **PROFIT DURING THE FIRST SIX YEARS FOLLOWING THE**
4 **MERGER?**

5 **A.** According to the Company this is a necessary "inducement" for investors to
6 pursue savings and other benefits for customers.

7 As stated in A.OMYA:PET.1-54, savings sharing is appropriate
8 because, in light of the potential that any acquisition premium and
9 transaction costs will not be recovered in rates, there would be little
10 incentive for utilities to pursue mergers and the associated customer
11 benefits without such sharing.

12 A.DPS:PET.1-58; see also Prefiled Testimony of Mary G. Powell & Lawrence J.
13 Reilly at 10.

14 **Q. IS IT ACCURATE TO STATE THAT ANY ACQUISITION PREMIUM**
15 **WILL NOT BE RECOVERED IN RATES?**

16 **A.** As I will discuss below, while it is the case that the Company is not planning to
17 include its acquisition premium in rate base as a recoverable plant investment
18 cost, it apparently does intend to recover an approximately equivalent amount
19 from ratepayers using alternative means.

20 **Q. WHAT "SHARING" IS PROPOSED?**

1 **A.** As noted above, the Company proposes to retain most merger savings benefits
2 as extra profit for the first six years following the merger. After that,
3 customers would receive the benefit of any on-going cost reductions.
4 According to the Company's calculations, the end result over ten years is
5 estimated to be $82.4 million of projected cost savings for the Company and
6 $144.0 million for ratepayers.

7 **Q. IS THIS A FAIR DEPICTION OF THE RELATIVE**
8 **CUSTOMER/COMPANY BENEFITS?**

9 **A.** No. For one thing, the Company's extra profits occur much sooner than most
10 of the consumer cost savings benefits. On a present value basis (using the
11 Company's 8% discount rate) the Company's benefits over the first six years
12 would be $63.7 million as compared to $19.1 million for consumers.[2] Over the
13 full ten years, the present value of benefits for consumers is $82.8 million
14 ($101 million with a 5% discount rate). The Company's estimated merger-
15 related cost savings (nominal and present value) for each year and its proposed
16 allocation of these calculated annual amounts to the Company and ratepayers
17 are shown in Exhibit JWW-1[3].

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[2] With a 5% discount rate the six-year totals would be $21.4 million for consumers and $69.8 million for the Company.

[3] Note that in calculating discounted present values in Exhibit JWW-1 I have used a mid-year convention in recognition of the fact that savings occur throughout the year and not at the end of the year.

1 Another reason why the simple summation of allocated nominal merger
2 savings estimates over ten years may not be the most reasonable depiction of
3 relative Company and ratepayer merger benefits is that estimates of what is
4 really a merger benefit can be expected to be more reliable over the short term
5 (when most benefits are allocated to the Company) than they are for distant
6 years (when ratepayers are allocated most of their benefits). This is somewhat
7 mitigated by the Company's explicit guarantee of the savings it proposes to
8 provide to ratepayers.[4] Also, it is possible that some of the cost savings that
9 the Company classifies as merger-induced economies in future years would
10 have occurred even without the merger in those more distant years (year 7 and
11 beyond) when the ratepayer benefit allocation is the greatest.

12 **Q. ARE THERE SPECIFIC EXAMPLES OF CLAIMED MERGER COST**
13 **SAVINGS THAT MAY VERY LIKELY OCCUR WITHOUT THE**
14 **MERGER?**

15 **A.** Yes. For example, according to the Company's estimates, substantial merger-
16 induced cost savings are attributable to "Information Technology Initiatives."
17 However, according to KMPG, who provided Gaz Métro with due diligence
18 analysis in conjunction with the contemplated acquisition of CVPS:

[4] While this "guarantee" is beneficial, quantifying what are really merger-related benefits in more distant time periods is less certain than in earlier post-merger years.

1 The [CVPS] IT budget as a percentage of the company's revenue has
2 been between 50% and 100% higher than the Utilities industry
3 average in 2009, 2010 and 2011. Another benchmark shows that
4 CVPS spends an average of $36,000 per employee in IT,
5 representing four times the Utilities industry average in IT spending.
6 From our experience … CVPS uses several types of technology and
7 does not seem to have chosen IT standards … (See
8 CONFIDENTIAL Attachment A. DPS.PET.GMP.1-28.1 at 28)

9 In view of these observations by KPMG, it seems likely that a substantial part
10 of the Company's estimated post-merger IT cost savings should have been
11 expected to occur independent of the merger, and certainly in less than ten
12 years. This is an example of one way in which the Company's rationale and
13 timing of shared cost savings may unduly favor the Company and overstate
14 actual merger benefits accruing to consumers.

15 **Q. ARE THERE OTHER CLAIMED MERGER-INDUCED COST**
16 **SAVINGS IN THE COMPANY'S ESTIMATED $226 MILLION**
17 **AMOUNT THAT WOULD LIKELY ACCRUE TO RATEPAYERS**
18 **ABSENT THE PROPOSED MERGER?**

19 A. Very likely there are. For example, under GMP's existing Alternative
20 Regulation Plan ("ARP") the amounts recoverable from ratepayers in base
21 rates associated with all costs other than those recoverable under the Power
22 Adjustor ("Non-Power Supply Costs") shall be limited by a Non-Power Cost
23 Cap expressed in the following formula:

1 ((Current Non-Power Costs) x (1 + CPI-NE - 1% Productivity
2 Adjustment + Non-Power Supply Cost Incentive Adjustment)) +
3 Capital Spending Adjustment + Exogenous Changes (if any) +
4 Incremental ROE Adjustment (if any).

5 Thus, annually calculated non-power cost recovery adjustments are limited to
6 include a 1% productivity deduction. This is a cost reduction that ratepayers
7 would enjoy regardless of the merger. It does not appear that the Company's
8 estimate of merger-related cost savings recognizes that this productivity
9 adjustment would be a future consumer cost saving independent of the merger.
10 In order to recognize that this portion of expected future cost reductions is not
11 dependent on the merger, the annual benchmark cost adjustment should reflect
12 the 1 percent productivity gain as well as inflation.

13 More generally, it may be questionable to assume that none of the cost savings
14 that may be immediately enhanced by the merger would have been entirely
15 unattainable over a longer ten year period of time absent the merger. This
16 timing consideration is particularly important under the Company's proposed
17 cost sharing formula as most of the ratepayers' share reflects estimated savings
18 in later years (year 7 and thereafter).

19 **Q. WHAT IS YOUR ASSESSMENT OF THE COMPANY'S ARGUMENT**
20 **THAT ITS PROPOSAL TO ALLOW THE RECOVERY OF EXTRA**
21 **PROFITS FOR SIX YEARS AS A MERGER BENEFIT SHARING**

1 **MECHANISM IS A NECESSARY INDUCEMENT TO MOTIVATE**
2 **THE COMPANY TO PURSUE THESE SAVINGS FOR THE BENEFIT**
3 **OF CONSUMERS?**

4 A. While it is understandable that the Company would like to find alternative
5 ways to recover its merger acquisition premium (and, as I will discuss below,
6 such a recovery mechanism may be warranted under certain circumstances that
7 the Board may determine exist in this case), the argument that profits above a
8 just and reasonable rate of return are needed to induce optimal performance by
9 a public utility is, in essence, simply an argument that the utility's allowed rate
10 of return is inadequate and below the cost of capital. The regulatory compact
11 under which all firms awarded a public utility monopoly franchise operate is
12 that the optimal pursuit of the public's interest and ratepayer benefit is the
13 essential *quid pro quo* owed by the firm to the public in exchange for the
14 public's grant of the public utility franchise and authorization for the firm to
15 charge just and reasonable compensatory rates, inclusive of the opportunity to
16 earn a fair rate of return, for the provision of essential public services. This is
17 the same return that can be achieved by a successful firm in a competitive
18 market, and it is therefore the regulatory standard intended to induce similarly
19 successful results in regulated markets. A greater return than this would be a
20 windfall exceeding the cost of equity capital. And, while windfalls are

1 sometimes achieved in mergers and acquisitions and by firms with unregulated
2 market power, more than a compensatory fair return should certainly not be
3 considered essential in order to motivate the entrepreneurial pursuit of
4 corporate growth. This is especially so for public service monopolies which
5 have been established for the specific purpose of pursuing any available
6 windfalls for the benefit of their customers. If the rate of return that can be
7 expected by a successfully merged firm is just and reasonable, no further
8 incentive should be required in order to motivate best efforts in pursuit of the
9 public interest.

10

11 ## IV. ADDITIONAL MERGER PROFITS

12 **Q. OTHER THAN THE ALLOWANCE OF EXTRA PROFITS THAT**
13 **WOULD FLOW FROM THE COMPANY'S "SHARED COST**
14 **SAVINGS" PROPOSAL, ARE THERE ANY OTHER SUBSTANTIAL**
15 **"WINDFALLS" OR EXTRA PROFITS THAT MAY BE ANTICIPATED**
16 **AS A RESULT OF THE PROPOSED MERGER?**

17 **A.** Yes. According to its Rating Agencies Presentation (HIGHLY
18 CONFIDENTIAL Attachment A. IBM:PET.GMP.1-26.1 at 10), Gaz Métro
19 inc. "Plans to fund [acquisition] equity through double leverage (50/50)."

1 Under the Company's planned equity acquisition funding, at least half of the
2 required capital ($262 million) would come from debt issued at the GMI level.
3 Indeed, according to the planned funding details outlined in this document and
4 in HIGHLY CONFIDENTIAL Attachment A.IBM:PET.GMP.1-27.6 at 9, at
5 least part of the remaining $262 million of equity funding may also be derived
6 from lower cost, non-common equity capital sources, including a short term
7 credit line. While these funding sources all have substantially lower costs than
8 common equity capital, the Company plans to treat its debt-funded acquisition
9 of CVPS as common equity capital for ratemaking purposes.

10 **Q. WHAT DOES "DOUBLE LEVERAGE" MEAN, AS THE COMPANY**
11 **HAS USED THAT TERM?**

12 **A.** When a subsidiary company's equity capital is funded by debt issued at the
13 parent company level, the consolidated financial structure is often referred to
14 as "double leverage." The leverage is doubled because parent company equity
15 is leveraged to acquire debt to fund the parent's equity investment in the
16 subsidiary, and then this "equity" investment in the subsidiary is again
17 leveraged to fund the subsidiary's own debt. Double leverage permits the
18 subsidiary's equity to be financed with the parent's lower cost debt rather than
19 with a higher cost equity capital issue. Double leverage is often viewed as
20 financially risky because there is less ultimate investor equity (and more debt)

1 supporting the overall enterprise than would be the case without double
2 leverage.

3 **Q. IS DOUBLE LEVERAGE CAPITALIZATION A COMMON FUNDING**
4 **STRATEGY IN PUBLIC UTILITY FINANCE?**

5 **A.** Not nearly as much as it used to be in the United States. Many years ago, in
6 the 1920s and 1930s, double and triple leverage financing was frequently used
7 by U.S. public utility holding companies such as Sam Insull's Commonwealth
8 Edison Company in Chicago, which, through the use of double leverage,
9 owned a $500 million utility "empire" (in those days) with only $27 million of
10 actual equity capital. Other large double leveraged public utility holding
11 companies were the Electric Bond and Share Company (EBASCO) and the
12 Stone & Webster Companies. All of these went bankrupt during the Great
13 Depression as their double leveraged capital structures collapsed, which led to
14 Congressional passage of the Public Utility Holding Company Act and its
15 enforcement by the Securities and Exchange Commission.

16 In more recent times, AT&T used double leverage to fund investments in its
17 Bell Operating Company subsidiaries (as did GTE). This led to the
18 implementation of "double leverage adjustments" by public utility regulators in
19 setting allowed rates of return in many states. These double leverage
20 ratemaking adjustments recognized actual utility debt costs, including the cost

1 of parent debt used to fund subsidiary equity, and deprived the double
2 leveraged companies of the extra returns that would have been earned by
3 obtaining equity return allowances on capital that was actually funded at debt
4 cost levels. Consequently, today the large public utility holding companies, at
5 least in the United States, generally do not issue debt at the parent company
6 level and they no longer use double leverage financing.

7 **Q. DOES THE COMPANY'S FILING IN THIS CASE INDICATE THAT IT**
8 **EXPECTS THE BOARD TO MAKE A DOUBLE LEVERAGE**
9 **RATEMAKING ADJUSTMENT?**

10 **A.** No. The Company clearly expects to earn a rate of return based on a capital
11 structure with approximately 50 percent equity capital, even though it intends
12 to finance the CVPS equity acquisition with at least 50 percent debt – which is
13 in addition to CVPS's own debt to be assumed by the surviving operating
14 utility.

15 **Q. WHY IS THE USE OF DOUBLE LEVERAGE FINANCING, AS THE**
16 **COMPANY PLANS, A REGULATORY ISSUE IN THIS CASE?**

17 A. Most fundamentally, it is an issue because if, as the Company expects, an
18 equity return is subsequently allowed on the debt-funded portion of Gaz
19 Métro's equity investment in CVPS, ratepayers will be charged more than the

1 Company's actual capital cost, resulting in additional profit. It is also an issue
2 because leveraged debt financing can increase overall financial risk. As I
3 explain below, the financial risk concern can be largely dealt with in this case
4 by appropriate ring-fencing. The matter of ratepayer cost and Gaz Metro's
5 additional profit from double leverage financing should be considered in
6 conjunction with evaluating merger benefits and the allocation of these benefits
7 to ratepayers. In any case, it is important to recognize the benefits flowing to
8 the Company from the use of double leverage financing when evaluating the
9 proposed merger. It is also necessary to put certain ring-fencing measures in
10 place to protect ratepayers from potential negative effects, as I discuss later in
11 this testimony.

12 **Q. HAVE YOU ESTIMATED THE AMOUNT OF EXTRA PROFIT THAT**
13 **THE COMPANY WILL EARN IF IT FINANCES THE CVPS EQUITY**
14 **ACQUISITION WITH DOUBLE LEVERAGE FINANCING, AS**
15 **PLANNED, AND THE BOARD IMPLEMENTS RATES THAT**
16 **INCLUDE A COMMON EQUITY RETURN ALLOWANCE FOR THAT**
17 **PART OF THE EQUITY ACQUISITION FUNDED WITH DEBT**
18 **CAPITAL?**

19 **A.** Yes. According to the CVPS annual base rate filing of November 1, 2011, the
20 Company's adjusted rate base for the rate year 2012 was $497.8 million and

1 common equity was 52.8 percent of capitalization. If the Company earns the
2 expected 2012 after tax common equity return allowance of 9.93 percent on the
3 50% portion of this equity acquisition that is debt-funded (assuming a 4.5%
4 debt cost[5]), the extra annual profit flowing from this double leverage financing
5 will be at least $16,018,786.

6 (.0993/(1-.405) - .045) x $497,800,000 x .528/2 = $16,018,786[6].

7 Over a ten year period this would amount to a present value gain (with an 8%
8 discount rate) of $111.7 million ($126.7 million with a 5% discount rate). If
9 this is to occur, it certainly represents a very substantial financial gain and a
10 major inducement for the Company to pursue and complete the merger.

11 **Q. CONSIDERING THE EXTRA PROFIT FROM BOTH RETAINED**
12 **COST SAVINGS BENEFITS AND DOUBLE LEVERAGE FINANCING,**
13 **WHAT ARE THE COMPARATIVE RATEPAYER AND COMPANY**
14 **BENEFITS FROM THE MERGER?**

15 **A.** Over the first six years, the present value (at 8%) of Company net benefits is
16 $140.6 million compared to $19 million for ratepayers. Over the longer 10

[5] As stated in Gaz Métro's most recent annual shareholders report: "On November 11, 2011, GMi entered into a note purchase agreement with investors, by way of a private placement, in anticipation of a later issuance of notes secured by Gaz Métro, for a total capital amount of US$260.0 million, in two series of US$130.0 million each. These notes will bear 3.86% and 5.06% annual interest and will mature 10 and 30 years following their issuance, respectively. The proceeds of the issuance will be loaned to Gaz Métro on conditions similar to those of the secured notes in order to partially finance the acquisition of CVPS shares…"

[6] The combined income tax loading is 40.5 percent of taxable income, assuming a 35% federal income tax rate and an 8.5% state income tax rate.

1 year period that the Company has proposed for analysis (with no additional
2 cost savings benefits being retained by the Company after year 6), and
3 assuming that all estimated cost savings are actually attributable to the merger,
4 the estimated present value of ratepayer benefits is $83 million whereas the
5 estimated Company benefits are $175 million. This is a minimum Company
6 benefit estimate, as rate base is projected to increase significantly over the
7 decade, the equity capital portion of acquisition funding is likely to be less than
8 50 percent and double leverage benefits are likely to continue well beyond the
9 first ten years.

10 **Q. HOW DOES THE COMPANY'S "EXTRA PROFIT" BENEFIT**
11 **COMPARE WITH THE ACQUISITION PREMIUM THAT IT IS**
12 **PAYING TO CVPS STOCKHOLDERS?**

13 **A.** The Company estimates that the acquisition premium is approximately $200
14 million. In addition, it is paying a $19.5 million breakup fee to Fortis and it
15 expects change in control costs in the range of $3 to $6 million.
16 (A.DPS:PET.1-62) Consequently, the ratemaking treatment that is being
17 requested in conjunction with merger approval would substantially compensate
18 the Company for its acquisition premium and other merger-related costs.[7]

[7] With a 5% discount rate, the present value of Company's extra profit from double leverage financing and shared cost savings would be at least $197 million over ten years and $274 million over 20 years.

1

2 **V. REGULATORY STANDARDS**

3 **Q. IS THE RECOVERY OF ACQUISITION PREMIUMS AND**
4 **ACQUISITION COSTS FROM RATEPAYERS THE ACCEPTED**
5 **NORM IN PUBLIC UTILITY ACQUISITIONS AND MERGERS?**

6 **A.** No. Acquisition premiums do not represent a contribution of capital to public
7 service. Instead, they represent a purchase by the acquiring company of
8 whatever legal interests in the properties were possessed by the seller. Utility
9 investors are not generally compensated for buying utility enterprises from
10 their previous owners any more than they are compensated for the prices at
11 which they may have bought public utility common stock. Instead, they are
12 compensated for devoting capital to public service.

13 Acquisition premiums commonly occur in corporate takeovers and in the sale
14 of pre-existing business property. From an accounting perspective, acquisition
15 premiums are the difference between the pre-transaction book value of net
16 assets and the transaction value of net assets based on the price the acquiring
17 firm pays to buy them. Acquisition premiums have often been an important
18 issue in the sale of public utility property because of our system of public
19 utility regulation, under which the corporate owners of public utility property

1 are typically entitled to charge rates that earn a fair rate of return on (and
2 recover the depreciation of) utility rate base. Because public utility rate base is
3 primarily comprised of investments in public utility property, the valuation of
4 public utility property is central to the regulatory determination of utility
5 company rates and income.

6 **Q. WHAT IS THE HISTORY OF ALLOWING OR DENYING THE**
7 **RECOVERY OF ACQUISTION PREMIUMS FROM RATEPAYERS IN**
8 **PUBLIC UTILITY REGULATION?**

9 **A.** The issue of recovering acquisition premiums from ratepayers became a
10 significant point of dispute in the 1920s and 1930s as utility plant was often
11 bought and sold between utility companies and even between affiliates within
12 public utility holding company corporate structures at prices that escalated over
13 time. Under the "fair value" standard of ratemaking that generally prevailed at
14 that time, regulators often considered market transaction prices in arriving at a
15 fair rate base value. This encouraged the sale of utility property, and in some
16 cases its resale, at ever escalating prices resulting in progressively higher utility
17 rates over time for consumers. As a consequence, the mere selling of property
18 could inflate utility property "value" and raise utility rates and profits. Such
19 utility asset sales, especially when they occurred between affiliates in a holding
20 company were simply financial transactions with no service improvements,

1 economies or betterments – all that transpired was a bookkeeping accounting
2 entry.

3 **Q. WHAT WAS THE RESULT OF THESE PRACTICES?**

4 **A.** This widespread abuse, especially between affiliates within public utility
5 holding companies, was one of the important motivations behind
6 Congressional passage in 1935 of the Public Utility Holding Company Act as
7 Title I of the Federal Power Act.[8] This landmark legislation indicated that the
8 property and plant in an electric utility's "Electric plant in service" account and
9 in its subaccounts should reflect original cost and that original cost should be
10 identified as cost to the first owner placing the property in public utility use.
11 Thereafter, both federal and state regulatory commissions embodied these
12 original cost principles in uniform systems of account. These accounts were
13 put into effect by the Federal Communications Commission for interstate
14 telephone companies in 1936 and by the Federal Power Commission ("FPC")
15 for interstate electric utilities in 1937 and for interstate natural gas pipeline
16 companies in 1940. Most state commissions adopted similar original cost
17 accounting for intrastate regulatory purposes shortly thereafter. Because the
18 regulatory adoption of these original cost principles occurred shortly before the
19 Supreme Court's *Hope Natural Gas* decision (which freed regulators from the

[8] 15 U.S.C.A. 79, 49 Stat. 803 (1935). Title I, Public Utility Holding Company Act of Public Utility Act, 1935.

1 confinement of "fair value" rate base), it enhanced the rapid implementation of
2 original cost for ratemaking purposes.

3 Regulators were ultimately unanimous in finding that original cost means the
4 first original cost of an asset when first devoted to public utility service, rather
5 than a transfer price to a new property owner. Whereas *actual cost* in another
6 accounting context may mean cost to the current owner of the property,
7 *original cost* in regulatory terms means the "first" original cost of the property
8 acquired by a public utility. Public utility property that is sold and acquired by
9 a new owner is thus recorded in rate base at the cost to the preceding owner
10 who first devoted it to public utility service. Specifically, the FPC defined
11 *original cost* as "… the cost of such property to the person first devoting it to
12 public service."[9]

13

14 **VI. ACQUISITION PREMIUM RECOVERY**

15 **Q. DOES THE COMPANY PROPOSE TO REFLECT THE ORIGINAL**
16 **COST OF THE PROPERTY THAT IT IS ACQUIRING FROM CVPS**
17 **AS ITS CONTINUING RATE BASE VALUE?**

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[9] Federal Power Commission, *Uniform System of Accounts Prescribed for Public Utilities and Licensees*, effective January 1, 1937, definition 29, p.6. The same FPC definition applies to natural gas plants.

1 **A.** Yes**.** The analysis supporting the Company's filing in this case recognizes that
2 its acquisition premium and acquisition costs may not be included in rate base
3 and that the recovery of these costs cannot be accomplished in that way. While
4 that is appropriate, the proposed recovery of these same costs through the
5 alternative mechanisms of shared savings and double leverage financing
6 should be evaluated carefully as the cost consequences to ratepayers are much
7 the same.

8 **Q. WHAT ARE THE REASONS FOR QUESTIONING THESE**
9 **ALTERNATIVE METHODS OF RECOVERING ACQUISITION**
10 **PREMIUM COSTS FROM RATEPAYERS?**

11 **A.** Today and for more than half a century, acquisition premiums paid for public
12 utility property, the difference between a new owner's acquisition price and the
13 property's original cost when first dedicated to public use, are generally
14 excluded from costs to be recovered from ratepayers. As I will discuss below
15 there are circumstances in which exceptions to this practice may be appropriate
16 and those circumstances may exist in this case. Nonetheless, the fundamental
17 reason for this customary exclusion of acquisition premiums in setting public
18 utility service rates is the public policy goal of establishing just and reasonable
19 rates.

1 **Q. DOES THE FACT THAT THERE IS A SUBSTANTIAL ACQUISITION**
2 **PREMIUM IN THIS CASE NECESSARILY MEAN THAT THE**
3 **COMPANY IS OVERPAYING IN RELATION TO THE TRUE**
4 **ECONOMIC VALUE OF CVPS?**

5 **A.** No. Because of inflation over time, the replacement cost of utility plant and its
6 economic value can increase over time in relation to its original cost. It is also
7 worth noting that CVPS received competing bids, and had accepted one – the
8 Fortis bid – that also included payment in excess of the net book value of the
9 utility.

10 **Q. WOULD SUCH AN INCREASE IN VALUE JUSTIFY THE**
11 **RECOVERY OF THE ACQUISITION PREMIUM FROM UTILITY**
12 **SERVICE CONSUMERS IN RATES?**

13 **A.** No. Even when public utility property increases in terms of replacement cost
14 and economic value over time due to inflation, the recovery of acquisition
15 premiums from ratepayers would generally be unjust and unreasonable as it
16 would effectively double charge ratepayers for such inflation costs. This is
17 quite different than inflation cost recovery in unregulated competitive markets.
18 Public utility regulators are obligated to ensure that utility property owners are
19 allowed to charge rates that provide them with a reasonable opportunity to earn
20 a fair profit on their investments dedicated to public service and, at the same

1 time, to assure that utility ratepayers are not subjected to paying rates that
2 produce excessive rates of return – i.e., excessive profits in relation to the
3 assets devoted to their utility service. It follows that when utilities or utility
4 property is sold, the cost entitled to be recovered from ratepayers is the cost
5 incurred for the public benefit – not the price paid to buy out an earlier owner's
6 financial interests.

7 **Q. IF THE ECONOMIC VALUE OF PUBLIC UTILITY PROPERTY**
8 **INCREASES OVER TIME DUE TO INFLATION, WHY WOULD THE**
9 **RECOVERY OF ACQUISITION PREMIUMS FROM RATEPAYERS**
10 **GENERALLY BE UNJUST AND UNREASONABLE AND**
11 **EFFECTIVELY DOUBLE-CHARGE RATEPAYERS FOR SUCH**
12 **INFLATION COSTS?**

13 **A.** Regardless of the whether a utility asset purchase price above original cost
14 book value is *bona fide*, allowing the acquisition premium to be recovered in
15 rates would unfairly result in double compensation for inflation. Inflation risk
16 is a most important element of the cost of equity capital when regulators set a
17 fair allowed return on equity ("ROE"). That is so because investors who
18 commit funds to long-lived utility capital investments require more
19 compensation when the risk of inflation is great than when inflation risk is
20 small.

1 If the allowed ROE is not at least equal to the rate of inflation, investors will
2 earn a negative *real* ROE over time. In order to earn a positive *real* ROE, the
3 nominally allowed ROE must exceed the rate of inflation. Therefore, in order
4 to fairly compensate public utility investors, regulatory commissions allow
5 *nominal* ROEs that include both compensation for inflation risk and a real
6 return. In other words, a 10 percent allowed ROE may be comprised of 4
7 percent for inflation risk plus a 6 percent real ROE. Investors in utility
8 property are therefore compensated for inflation through the ratemaking
9 process. To allow further compensation for inflation by permitting the
10 recovery of acquisition premiums through rates would constitute double
11 compensation for inflation by allowing utilities to capture the cost of inflation
12 twice – once on an expected basis by including the risk of inflation in the ROE
13 component of rates and again by including inflated property value in an
14 acquisition premium adder to rate base. This, in turn, would require utility
15 service consumers to pay rates that produce excessive and unreasonable ROEs
16 and investment cost recovery over time.

17 **Q. DOES SUCH DOUBLE COMPENSATION OCCUR IN COMPETITIVE**
18 **MARKETS WHEN FIRMS CHARGE COMPETITIVE PRICES THAT**
19 **ARE SUFFICIENT TO COVER PROPERTY ACQUISITION COST**
20 **PREMIUMS?**

1 **A.** No. In contrast to ratemaking practice in regulated markets, in competitive
2 markets investors are not compensated for inflation risks in advance. On the
3 contrary, competition does not allow such "double dipping." Unregulated
4 firms know that their assets will appreciate with inflation, and competition
5 forces them to accept a correspondingly lower rate of current income. Of
6 course, expected total income for these firms (current income plus asset
7 appreciation) covers the competitive firm's total cost of capital, including the
8 risk of inflation. Current earnings are only part of investor compensation in
9 unregulated markets. Additional compensation is reflected in the appreciation
10 of their business ownership interest ("capital gains") and in resale prices when
11 property or business ownership shares are sold.

12

13 **VII. THE BENEFITS EXCEPTION**

14 **Q. ARE THERE EXCEPTIONS TO THE OVERALL LOGIC OPPOSING**
15 **THE RECOVERY OF ACQUISITION PREMIUMS FROM**
16 **RATEPAYERS AS WOULD RESULT FROM THE COMPANY'S**
17 **PROPOSAL IN THIS CASE?**

18 **A.** Yes. As I said earlier, some acquisition cost recovery may be warranted under
19 certain circumstances that the Board may determine exist in this case. In fact,

1 there are a number of cases in recent years in which other state regulatory
2 commissions did determine that certain merger-created cost reductions, which
3 would not otherwise have occurred, should be shared between ratepayers and
4 utilities consistent with just and reasonable ratemaking standards. (See, for
5 example the cases listed in A.DPS:PET.1-80) Such exceptions to the general
6 rule against the recovery of acquisition premium costs from ratepayers
7 sometimes applies when an acquisition premium is offset by otherwise
8 unobtainable efficiencies that benefit consumers to an equal or greater extent
9 than the amount of the premium. This is known as "the benefits exception."
10 In such cases compensation may be justified if the acquisition premium
11 enabled public benefits (i.e., was devoted to public service) that would not
12 otherwise have been obtained. Thus, in some public utility merger or
13 acquisition cases in which it is shown that the merger or acquisition will
14 produce economies in the provision of public utility service that would not
15 have been possible but for the transaction, public utility regulators have
16 allowed the recovery through rates of some portion of the acquisition premium.
17 As explained in one historic case:

18 > Money is prudently invested, even though it is in excess of the
19 > original cost of the property purchased, … if the excess was
20 > necessary for the integration of the property into a larger and more
21 > efficient system, and if the purchase necessitating the excess did or
22 > reasonably should have resulted in public benefit by improvement of

> service to customers or in lowered rates or both better service and lowered rates.[10]

This logic appears to fit exactly with the Company's benefit sharing contentions in this proceeding. While the Board may agree and determine that is the case here, it remains that the benefits exception is not granted lightly. As the Federal Court of Appeals for the District of Columbia has stated:

> FERC has been clear that the pipeline carries the burden of proof of showing a benefits exception to justify the allowance of an acquisition premium. In order to meet this "heavy" burden, a pipeline must prove the existence of benefits to consumers that are "tangible, non-speculative, and quantifiable in monetary terms." *Kan. Pipeline Co.*, 81 F.E.R.C. at 61,018.[11]

In this case the Board may determine that a "guarantee" of an adequate amount of ratepayer benefits helps the Company carry this burden.

Q. HAS THIS BOARD ADDRESSED THE ISSUE OF ACQUISITION PREMIUM RECOVERY IN RECENT ORDERS?

A. Yes. The Board addressed this issue in part in its recent Orders in Docket No. 7688 (Order entered 7/8/2011) and in Docket No. 7660 (Order entered 6/10/2011). Docket No. 7660 concerned the sale of a hydroelectric generating plant at a price exceeding book value. While the Board recognized "the traditional unwillingness" of utility regulators to allow for the recovery of

[10] Re Louisiana Power and Light, 65 PUR(NS) 23 (La. 1946)
[11] 601 F.3d 581, 390 U.S.App.D.C. 160.

1 acquisition premiums from utility ratepayers and stated that "[n]either the
2 parties nor Board staff have been able to identify any prior Board proceeding
3 in which the Board expressly authorized a Vermont utility to recover in rates a
4 premium over book value paid to another Vermont utility…" (Order at 54), it
5 did allow for such recovery in that case. It did so in recognition of "the
6 deregulation of wholesale generation" and the distinction between those utility
7 assets that are essential to the distribution of electricity to the public
8 ("franchise assets") that must remain in the regulated environment and
9 generation assets that produce a commodity traded in a competitive wholesale
10 market. "The reality is that generation assets have a market value outside of a
11 regulated utility structure." (Order at 56) In contrast to the circumstances in
12 that case, the assets being acquired in this case are essentially "franchise
13 assets" that have little market value outside the regulated utility structure.

14 Docket No. 7688 concerned the acquisition of a distribution utility (not
15 generating plant) at a price exceeding book value, and in that case the Board
16 was not persuaded to deviate from its longstanding precedent to exclude
17 acquisition premiums from rates. While the Board agreed that the acquisition
18 was in the public interest and resulted in substantial ratepayer benefits, it
19 concluded that the specific circumstances of the acquisition "do not support a
20 deviation from longstanding Board precedent to exclude acquisition premiums

1 from rates." (Order at 13) It is important to note that, in reaching this decision,
2 the Board did not adopt an absolute prohibition of the recovery of acquisition
3 premiums in future consolidations providing efficiencies and savings for
4 ratepayers, but stated that its denial was "based on the specific circumstances
5 of this proceeding." (Id.)

6 In short, while the Board has addressed acquisition premium issues in these
7 two recent Orders, both cases were somewhat unique and do not provide
8 compelling precedent for the resolution of the acquisition premium matter in
9 this case.

10 VIII. BENEFIT SHARING MODIFICATIONS

11 **Q. ASSUMING THAT THE COMPANY'S MERGER-INDUCED COST**
12 **SAVINGS ESTIMATES ARE ACCURATE, WOULD THAT FULLY**
13 **JUSTIFY THE SHARING METHODOLOGY THAT THE COMPANY**
14 **PROPOSES?**

15 **A.** That, of course, is a judgment that the Board must make. Certain facts that I
16 have discussed indicate that the Company's proposal may be judged as
17 overreaching. First, unless it is assumed that the Board will make a double
18 leverage adjustment in setting a new allowed return on equity for ratemaking
19 purposes, it appears clear that the substantial additional profit gained through

1 the Company's planned double leverage financing of the acquisition is likely to
2 substantially offset its acquisition costs and premium over ten years and more
3 than offset them over a longer period. Second, it would seem reasonable to
4 conclude that at least some of the claimed merger savings (e.g., the reduction
5 of CVPS' high IT costs and annual productivity gains) are really cost (and rate)
6 reductions that should be expected to occur with or without the merger. Third,
7 the Company's proposed savings split during the first six post-merger years
8 (when savings are likely to be more accurately foreseeable and realistically
9 verifiable as being merger-induced) is very heavily weighted toward the
10 Company's benefit and against the ratepayer share. Fourth, it does not appear
11 that the Company's proposed method for cost savings sharing and its end result
12 properly achieves the intent of the windfall sharing mechanism mandated by
13 the Board in Docket 6460/6120.

14 **Q. WHY DO YOU QUESTION WHETHER THE COMPANY'S**
15 **PROPOSED METHOD FOR COST SAVINGS SHARING AND ITS END**
16 **RESULT PROPERLY ACHIEVES THE INTENT OF THE WINDFALL**
17 **SHARING MECHANISM MANDATED BY THE BOARD IN DOCKET**
18 **6460/6120?**

19 **A.** The windfall sharing mechanism mandated by the Board in the Docket
20 6460/6120 Order that was issued on June 26, 2001 provides that if and when

1 CVPS is acquired for a price exceeding its net book value, the premium above
2 net book value must be shared with CVPS's ratepayers up to a cap of $16
3 million, adjusted for inflation. According to the Company, the inflation
4 adjustment through July, 2011 (the month the Merger Agreement was
5 executed) raises the cap to $20,307,596. (See A.AARP:PET.1-2) The
6 Company further argues that since its cost savings sharing proposal is
7 projected to provide "Combined Company" ratepayers with cost reduction
8 benefits totaling $144 million during the first ten years following the merger,
9 the Order 6460/6120 windfall sharing mandate is thereby fulfilled.

10 **Q. DO YOU AGREE THAT THE COMPANY'S PROPOSED MERGER**
11 **INDUCED COST SHARING PLAN ADEQUATELY SATISFIES THE**
12 **ORDER 6460/6120 WINDFALL SHARING MANDATE?**

13 **A.** No. I understand that this issue will be addressed further in legal briefing, but
14 my reasons for disagreement are as follows. First, as the Company has
15 acknowledged, the Board's Order in Docket 6460/6120 requires that "the
16 benefit provided to ratepayers is in addition to (rather than a replacement for)
17 other benefits appropriately assigned to ratepayers." (See A.DPS:PET.1-50)
18 That language suggests that the Board intended that consumer benefits from
19 the windfall sharing mechanism would be in addition to merger-induced cost
20 savings, as utility ratepayers are presumptively entitled to the benefit of cost of

1 service rates. The Company, however, parses the matter by arguing that
2 mandated windfall sharing relates to the acquisition of CVPS, whereas merger
3 savings relate to the later (and separate) merger of CVPS and GMP. The
4 acquisition is simply a change in asset ownership that produces no cost
5 savings. Likewise, the Company argues that the acquisition imposes no
6 obligation to integrate CVPS and GMP following the acquisition, and it thus
7 creates no integration savings to be shared with customers as a result of the
8 acquisition. Therefore, according to the Company's logic, there are no "other
9 benefits" related to the acquisition windfall that are appropriately assigned to
10 ratepayers.

11 **Q. IS THIS LOGIC PERSUASIVE AS IT RELATES TO THE BENEFIT**
12 **SHARING ISSUES IN THIS CASE?**

13 **A.** Even if one sees the acquisition windfall and merger related cost savings as
14 separate matters, it does not seem to follow that ratepayers are not entitled to
15 both the benefits of mandated windfall sharing and merger-related cost
16 reductions. Moreover, while the acquisition of CVPS and the merger with
17 GMP may be separate legal steps in the Company's overall plan, the Company
18 has obviously packaged these together in seeking the Board's approval of both,
19 and it is not clear that acquisition approval would be as likely attainable if it
20 were to be evaluated on a stand-alone basis without any merger benefits. It

1 seems likely that this was considered by the CVPS board of directors in its
2 decision to accept the Gaz Met offer over the bid from Fortis.

3 **Q. ARE THERE OTHER QUESTIONABLE ASPECTS OF THE**
4 **COMPANY'S APPROACH TO SATISFYING THE WINDFALL**
5 **SHARING MECHANISM MANDATED BY THE BOARD IN THE**
6 **DOCKET 6460/6120 ORDER?**

7 **A.** Yes. As noted above, the Board's Order requires that the $16 million
8 obligation established as of June, 2001 be adjusted for inflation. While the
9 Company has made such an inflation adjustment from June, 2001 through July,
10 2011 (the month of merger agreement execution), their cost savings sharing
11 plan does not achieve a $20 million ratepayer benefit until 2018. It would
12 therefore seem that the inflation adjustment should extend through 2018, or
13 until the entire amount is returned to CVPS ratepayers, instead of terminating
14 in 2011. If this obligation is not considered to be part of the cost savings of the
15 merger, it should still continue to be adjusted for inflation until actually
16 returned to ratepayers.

17 **Q. IF THE BOARD IS TO APPROVE THE PROPOSED ACQUISITION**
18 **AND MERGER, ARE THERE WAYS IN WHICH THE TREATMENT**
19 **OF COST SAVINGS MIGHT BE MODIFIED SO AS TO BE MORE**
20 **EQUITABLE TO RATEPAYERS.**

1 **A.** Yes. Particularly if (as the Company apparently assumes) the Board does not
2 intend to make a double leverage adjustment in setting ROE allowances for the
3 merged Company in future rate cases, it is clear that the planned financing of
4 the acquisition will provide very substantial income (at least $16 million per
5 year) in excess of Gaz Métro's actual capital costs. For this reason alone, the
6 front-end loading of the Company cost savings share and deferment of
7 ratepayer benefits seems unnecessary. The Board may therefore wish to
8 consider a more ratepayer-friendly sharing split during the first six post-merger
9 years as opposed to the Company's proposed stepped split formula which
10 severely limits ratepayer benefits in these years. For example, especially
11 considering the Company's large double leverage financing gain, a much more
12 modest Company percentage of cost savings during these years would still
13 substantially compensate for all acquisition premium and costs. As shown in
14 Exhibit JWW-1, under the Company's sharing proposal, the Company gets
15 36.4% of total estimated cost savings benefits over 10 years and 43.5% on a
16 present value basis (8% discount). If the Company's $16 million of annual
17 double leverage financing gain is included in the totals, the Company's share
18 of the benefits (PV_8) over ten years is 67.4% ($171.2 million) and the ratepayer
19 share is 32.6 % ($82.8 million).

1 Also, as discussed above, adjustments should be made for cost savings that
2 would be likely to occur in the absence of the proposed merger. This includes
3 at least the excessive CVPS IT costs identified in the merger due diligence that
4 was done for the Company by KMPG (See CONFIDENTIAL Attachment A.
5 DPS.PET.GMP.1-28.1 at 27-28) and the one percent productivity adjustment
6 for non-power costs as incorporated in the existing Alternative Regulation
7 Plan. Further, the Board should deem it appropriate to recognize Order
8 6460/6120 windfall sharing as a requirement separate from the sharing of
9 merger-related cost savings and should require that windfall sharing benefits be
10 adjusted for inflation until returned to ratepayers.

11

12 **IX. COMPETITIVE CONSIDERATIONS**

13 **Q. ARE THERE COMPETITIVE MARKET CONSIDERATIONS THAT**
14 **ARE POTENTIALLY IMPORTANT IN CONSIDERING THIS**
15 **PROPOSED ACQUISITION AND MERGER?**

16 **A.** Yes. The consideration of competitive market impacts has traditionally been
17 an important element of merger evaluation. In the case of this merger the
18 Company has filed a market power analysis with the Federal Energy
19 Regulatory Commission ("FERC"). That analysis, which is not part of the

1 Company's filing in this case, focuses primarily on the merger's potential
2 electric generation supply market impacts, and concludes that the merger poses
3 no anticompetitive problems. This conclusion reflects the fact that neither
4 GMP nor CVPS are dominant electric power generators in New England. It
5 also reflects the assumption that ample generation imports from multiple
6 suppliers located in other New England States, New York and beyond will be
7 competitively available to fulfill future market supply requirements. While the
8 latter assumption may be overstated in the Company's FERC filing, it is
9 nonetheless my opinion that it is highly unlikely that FERC will reject the
10 merger on traditional anticompetitive grounds.

11 **Q. ARE THERE OTHER POTENTIAL COMPETITIVE MARKET**
12 **CONCERNS ASSOCIATED WITH THE MERGER?**

13 **A.** Yes. First, while it is very likely true that the Company's acquisition of CVPS
14 and its merger into GMP will not result in an unacceptable level of wholesale
15 power supply market concentration, it will eliminate meaningful "yardstick"
16 competition between CVPS and GMP within Vermont. "Yardstick"
17 competition is simply the ability of consumers and regulators to make
18 comparative performance and cost evaluations of their electric suppliers and
19 other power suppliers who are similarly situated. Future comparisons between
20 GMP and large electric power distribution companies in New England and

1 other states are not likely to be as meaningful as historic comparisons with a
2 similar small utility operating in the same state. That said, I am not aware of
3 any proposed electric utility mergers that have been turned down in modern
4 times because of reductions in "yardstick" competition.

5 Second, since Gaz Métro and its affiliates already own Vermont Gas Systems,
6 the State's only retail gas distribution utility, as well as GMP, the acquisition
7 of CVPS will therefore reduce or eliminate the potential for independent
8 "intermodal" gas/electric competition for major business and residential energy
9 needs in a significant portion of the state.

10 The remaining competitive issue that should be of particular interest to the
11 Board in this case concerns control of Vermont's high voltage electric
12 transmission network, which is managed and operated by The Vermont
13 Electric Power Company ("VELCO"). VELCO is Vermont's statewide
14 electric transmission-only company that is jointly owned by all Vermont
15 electric utilities, including CVPS, GMP, municipal distribution systems and
16 cooperatives. CVPS owns 48.5% of VELCO and GMP owns 29.5%. Thus,
17 the Company's post-merger ownership share would be 78%. VELCO is of
18 critical importance to all Vermont electricity utilities and consumers, as all of
19 the State's distribution systems acquire their generation supplies (or a large
20 portion thereof) in wholesale power markets and transmit these supplies over

1 VELCO-operated facilities to their local distribution areas. VELCO will
2 continue to be of critical importance to energy supply and development in the
3 future, both with respect to existing supplies as well as potential new supplies,
4 including the development of renewable electric resources and imports from
5 Canada and elsewhere in the Northeast. Consequently, the merged company's
6 ownership domination of VELCO is a potentially important market and public
7 policy issue resulting from the merger. I understand that the Department's
8 proposal with respect to VELCO ownership is addressed in the testimony of
9 witness Michael Dworkin.

10

11 **X. RING-FENCING**

12 **Q. WHAT IS RING-FENCING?**

13 **A.** Ring-fencing means separating something and guaranteeing its protection. The
14 term derives literally from "ring fences" which were used to confine stock on
15 farms. In public utility regulation, ring-fencing occurs when protections are
16 put in place to financially separate a regulated public utility from its
17 unregulated parent company. This is done by public utility regulators mainly
18 to protect consumers of essential public utility services from potential financial
19 instability within the parent company and other affiliates as a result of their

1 financial and business dealings. Bond rating agencies usually prefer to see
2 public utilities ring-fenced because it enhances the safety of bonds. Ring-
3 fencing is most frequently implemented by utility regulators at the time of
4 utility acquisitions or mergers. There are various utility ring-fencing success
5 stories during the past two decades, of which the most high profile is the
6 Oregon Commission's ring-fencing of Portland General Electric when it was
7 acquired by Enron in 1997. This protected Portland General Electric's assets
8 and its consumers when Enron unexpectedly collapsed and declared
9 bankruptcy at the end of 2001.

10 **Q. HAVE YOU REVIEWED THE COMPANY'S PROPOSED POST-**
11 **MERGER AFFILIATE TRANSACTIONS RESTRICTIONS?**

12 **A.** Yes. As described in the September 2, 2011 Prefiled Testimony of Dawn D.
13 Bugbee at 6-8, the Company proposes certain cost and cash flow separation
14 merger conditions similar to those that were required by the Board's March 26,
15 2007 Order in Docket No. 7213 approving Gaz Métro's acquisition of Green
16 Mountain Power. As stated in Exh. Pet.-DDB-3:

17 The purpose of this policy is (a) to avoid actual or perceived cross-
18 subsidization among and between NNEEC and its affiliates, (b)
19 ensure that transactions between Gaz Métro affiliates are carried out
20 through negotiations of arms-length contracts, and (c) ensure that
21 costs for such contracts are equitably and fairly separated and
22 recorded at cost or market, as appropriate.

1 In addition to affiliate transaction restrictions, the Company's proposal
2 provides that GMP shall remain a stand-alone company with separate corporate
3 books and records and no comingling of funds with affiliates. It also provides
4 that GMP distributions to affiliates comply with Vermont law, that
5 distributions to affiliates in excess of $100,000 require Board of Directors
6 approval, and that there be 30 days' advance notice to the Board and
7 Department if:

8 (1) the equity proportion of the capital structure of GMP varies by
9 more than three percent from the structure approved in GMP's latest
10 rate proceeding; or (2) GMP's unused, short-term borrowing
11 capacity falls below $15 million; or (3) GMP makes distributions to
12 NNEEC after GMP has been placed on Credit Watch with negative
13 implications by a ratings agency.

14 **Q. DO YOU AGREE WITH THESE RESTRICTIONS?**

15 **A.** Yes, as far as they go. However, at the present time, if the acquisition and
16 merger with CVPS is to be approved, the Board should consider the adoption
17 of additional ring-fencing measures to more fully safeguard consumer interests
18 in the merged utility's assets and financial integrity.

19 **Q. WHY SHOULD THE BOARD CONSIDER THE ADOPTION OF**
20 **ADDITIONAL RING-FENCING MEASURES AT THIS TIME?**

1 A. The Company's proposed acquisition of CVPS highlights important regulatory
2 and consumer protection issues regarding intra-corporate financial transactions
3 between Vermont's regulated utilities and their unregulated corporate
4 affiliates. These consumer protection concerns relate to affiliate financial
5 matters that could, without adequate safeguards, impose excessive and
6 unwarranted costs on the Vermont economy and on the State's utility
7 ratepayers. Moreover, as reflected in my discussion of the Company's double
8 leverage financing plan to fund the CVPS equity acquisition and rating agency
9 financing concerns discussed below, this merger is an opportune time to put
10 adequate financial protections in place so that they are there if they are
11 ultimately needed.[12]

12 **Q. IS IT REASONABLE TO EXPECT THAT RING-FENCING CAN**
13 **ADEQUATELY PROTECT VERMONT RATEPAYERS GIVEN GAZ**
14 **MÉTRO'S INTERNATIONAL STRUCTURE AND AFFILIATES?**

15 A. Yes. The State's electric utility ratepayers can be adequately protected with
16 financial ring-fencing that is thorough and comprehensive and that is
17 effectively enforced. In this regard, the most important ring-fencing
18 provisions, in addition to the affiliate transaction limitations above, are

[12] For example, Moody's most recent Credit Opinion for Green Mountain Power Corporation states that "…aggressive leveraging of GMP's capital structure or higher dividend expectations following a successful completion of its merger with CVPS could lead to negative ratings pressure." (Moody's Investor Service Global Credit Research - 02 Dec 2011).

1 limitations on dividend payments, so as to adequately protect the Vermont
2 utility's equity capital base, and limitations on any transfers of Vermont utility
3 assets or their encumbrance for other purposes in conjunction with parent or
4 affiliate financing.

5 **Q. HAVE THE MAJOR CREDIT RATING AGENCIES STRESSED**
6 **THESE SAME RING-FENCING PROVISIONS?**

7 A. Yes. There has been increasing concern by rating agencies over the impact of
8 affiliate ventures upon a utility's access to debt and equity capital and the
9 corresponding cost of such capital as well as the prospect of the utility being
10 pulled into bankruptcy by its parent's insolvency. Standard and Poors (S&P),
11 Moody's and Fitch have all affirmed that strong ring-fencing, together with
12 effective regulatory enforcement, will serve to strengthen the financial ratings
13 of utility companies, especially utility operating subsidiaries. For example,
14 S&P has stated

15 Any action that state regulators take that provides support (whether
16 legal, regulatory, financial or operational) to the utility and/or isolates
17 the utility (most importantly financial obligations) from its parent
18 company will be positive for credit.

19 Only when sufficient regulatory insulation exists will the corporate
20 credit rating (risk of default) of an operating company be separated from
21 that of the holding company.

1 The strongest means of insulation are through either regulatory or legal
2 barriers, which prevent excessive dividend upstreaming, intercompany
3 loans, or any 'non-arms length' transactions.[13]

4 All of the major rating agencies stress limitations on dividend payments to
5 parent companies as a key means of maintaining strong utility capitalization
6 and credit ratings. They also support strict limitations on affiliate loans, money
7 pools and other financial support, as well as mandated capital structure limits.
8 In order to be effective, all of these ring-fencing provisions must be
9 implemented prior to the occurrence of financial distress.

10 **Q. WHAT ARE THE ADDITIONAL RING-FENCING CONDITIONS**
11 **THAT THE BOARD SHOULD CONSIDER IN CONJUCTION WITH**
12 **MERGER APPROVAL IN THIS CASE?**

13 **A.** In addition to the conditions outlined in Exh. Pet.-DDB-3, the Board should
14 consider the following:

15 (1) A requirement that GMP shall not make any distribution to its
16 parent or to any affiliates that would cause GMP's equity capital
17 to fall below 45 percent of GMP's total capitalization without
18 first obtaining Board approval, except to the extent that the Board

[13] See: Standard & Poors, "Ring-Fencing a Subsidiary" by James Penrose, Esq., Arthur F. Simonson, Ronald M. Barone and Richard W. Cortwright, Jr., 2007 www.standardpoors.com. Also see Moody's Investors Service Announcement: Terasen, Inc., 14 October, 2005 and Fitch Ratings, Sharon Borelli, Senior Director, September 17, 2003.

1 imputes a lower equity percentage for ratemaking purposes. The
2 Board may re-examine this minimum common equity percentage
3 as financial conditions change, and may determine that it be
4 adjusted.

5 (2) A requirement that GMP, its parent and Gaz Métro shall provide
6 the Board and the Department unrestricted access to all written
7 information provided to common stock, bond, or bond rating
8 analysts, which directly or indirectly pertains to GMP, it parent,
9 Gaz Métro or to any affiliate that exercises influence or control
10 over GMP. Such information includes, but is not limited to,
11 reports provided to, and presentations made to, common stock
12 analysts and bond rating analysts. For purposes of this condition,
13 "written" information includes but is not limited to any written
14 and printed material, audio and video tapes, computer disks and
15 electronically-stored information. Nothing in this condition shall
16 be deemed to be a waiver of GMP's right to seek protection of
17 the information.

18 (3) A requirement that unless such a disclosure is determined to be
19 unlawful by the Board, GMP shall notify the Board and
20 Department of:

1 (a) Its intention to transfer an amount that is more than 10
2 percent of GMP's common equity capital to its parent or
3 affiliates (or any combination thereof) over a 12-month
4 period, at least 60 days before such a transfer begins.

5 (b) Its intention to declare a special cash dividend from GMP,
6 at least 30 days before declaring each such dividend.

7 (c) All regular common stock cash dividends from GMP
8 within 10 days after declaring each such dividend.

9 (4) To the extent that it is not already adequately covered by the
10 requirements specified in 30 VSA § 108, there should be a
11 specific requirement that without the prior and specific
12 authorization of the Board, neither GMP, its parent nor Gaz
13 Métro shall transfer, merge, sell, lease, encumber or otherwise
14 dispose of GMP's utility property which (a) has a net book value
15 in excess of $1,000,000 which is included in Vermont rate base,
16 and (b) has costs recovered through rates regulated by the Board.

17 (5) The Board should also consider applying the following principles
18 to any new financing involving utility property of GMP which (i)

1 is included in Vermont rate base, or (ii) has costs recovered
2 through rates regulated by the Board:

3 (a) Proceeds of debt that is secured by utility assets must be
4 used for utility purposes only;

5 (b) If any utility assets that are pledged or encumbered to
6 secure debt issuances are divested, the debt must
7 'follow' the assets and be divested as well. The term
8 "divested" in this context includes moving assets to both
9 affiliated and non-affiliated corporations;

10 (c) If utility assets financed by unsecured debt are divested
11 to another entity, then a proportionate share of the debt
12 also must be divested.

13

14 **XI. CONCLUSION**

15 **Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS.**

16 **A.** As discussed above, the Company's proposed acquisition of CVPS and its
17 merger into GMP raise a number of important issues for the Board's
18 evaluation. While I do not recommend that the Board deny authorization for

1 the acquisition and merger, I have suggested a number of possible adjustments
2 and conditions that the Board (and the Company) should consider.

3 First, especially in view of the double leverage financing benefit that the
4 Company expects to gain from the merger (which I estimate to be at least $16
5 million of additional profit annually), the Board and Company should
6 reconsider the equity of the proposed split and timing of merger-induced cost
7 savings benefits. Under the Company's proposal ratepayers would receive
8 only $19 million ($PV_8$) of benefits during the first six post-merger years, while
9 the Company receives $141 million of additional profits over and above its
10 "allowed" ROE. Over ten years, the split would be $175 million ($PV_8$) of
11 additional profits for the company and $83 million of cost savings for
12 ratepayers. Rather than this proposed distribution of benefits, consideration
13 should be given to a more ratepayer-friendly sharing of cost savings benefits
14 during the first six post-merger years as opposed to the Company's proposed
15 stepped split formula which severely limits ratepayer benefits in these years.
16 Especially considering the Company's double leverage financing gain, a much
17 more modest Company percentage of cost savings during these years would
18 seem to be more reasonable

19 In conjunction with modifying the cost savings split, consideration should also
20 be given to removing from the split those cost reductions, such as the ARP

1 productivity adjustment and excessive CVPS IT costs that would likely have
2 been realized by ratepayers without the merger. Likewise, the Board should
3 determine that the windfall sharing mandate imposed by the Order in Docket
4 6460/6120 must be in addition to merger cost reduction sharing.

5 Finally, as discussed immediately above, the Board should consider the
6 implementation of several additional financial ring-fencing measures,
7 including a minimum utility common equity requirement, advance notice of
8 dividend payments, preapproval for significant utility asset dispositions and
9 encumbrances and limitations on the use of any funds secured by utility
10 property.

11 **Q. DOES THIS CONCLUDE YOUR PREPARED DIRECT TESTIMONY**
12 **AT THIS TIME?**

13 **A.** Yes, it does.