

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

**SURREBUTTAL TESTIMONY OF
JOHN W. WILSON
ON BEHALF OF
THE DEPARTMENT OF PUBLIC SERVICE**

March 8, 2012

J.W. Wilson & Associates, Inc.
Economic Counsel
1601 North Kent Street · Rosslyn Plaza C · Suite 1104 Arlington, VA 22209

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

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

4 **Q. WERE YOUR QUALIFICATIONS AND YOUR PROFESSIONAL**
5 **BACKGROUND SUMMARIZED IN YOUR DIRECT TESTIMONY**
6 **WHICH WAS FILED IN THIS CASE ON BEHALF OF THE**
7 **DEPARTMENT OF PUBLIC SERVICE ON JANUARY 20, 2012?**

8 A. Yes; they were.

9 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

10 A. In this surrebuttal testimony I respond to a number of the arguments made in the
11 rebuttal testimony of Petitioner witnesses Bugbee, Powell/Reilly, Otley and
12 Hevert.

13 **Q. WHILE MS. BUGBEE HAS AGREED WITH MOST OF YOUR**
14 **PROPOSED RING-FENCING CONDITIONS, THERE ARE SEVERAL**
15 **WITH WHICH SHE DISAGREES. DO YOU HAVE ANY RESPONSE TO**
16 **HER ARGUMENTS?**

17 A. Yes. First, in response to the proposed ring-fencing requirement that GMP, its
18 parent and Gaz Métro shall provide the Board and the Department unrestricted

1 access to all written information provided to common stock, bond, or bond rating
2 analysts, which directly or indirectly pertains to GMP, its parent, Gaz Métro or to
3 any affiliate that exercises influence or control over GMP, Ms. Bugbee contends
4 that this requirement should be limited to the combined company as it would be
5 burdensome and of limited benefit to require NNEEC and Gaz Métro to provide
6 “all information provided to their debt and equity investors and to their rating
7 analysts.” (See Bugbee rebuttal at 3) This objection misstates the proposed
8 requirement which relates not to all information provided to investors but only to
9 that information provided to rating analysts which pertains to GMP and its
10 affiliates that exercise influence or control over GMP. Moreover, since Gaz Métro
11 and NNEEC are the source of all GMP equity capital and since their financial
12 circumstances will impact GMP’s own security ratings, such information is likely
13 to be highly pertinent to the Board’s future knowledge and oversight of GMP’s
14 financial circumstances. For the same reasons, this information requirement
15 should pertain to analysts of common equity capital as well as debt. While all
16 reporting requirements entail some effort, it is doubtful that requiring the provision
17 of this information to the Board (information which is already being provided to
18 security analysts) would be overly burdensome.

19 Ms. Bugbee also presents a limited objection to the ring-fencing proposal that
20 would require the Board’s prior and specific authorization for the transfer, merger,

1 sale, lease, encumbrance or other disposal of GMP's utility property which (a) has
2 a net book value in excess of \$1,000,000 which is included in Vermont rate base,
3 and (b) has costs recovered through rates regulated by the Board. In her view,
4 there should be only a "notification" requirement, and it should apply only to
5 property with a net book value in excess of \$10 million. (See Bugbee rebuttal at 3
6 – 4) Ms. Bugbee would also limit a Board approval requirement only to a
7 property sale or lease with a net book value exceeding 10 percent of the combined
8 company's utility property (nearly \$100 million), as is now required under 30
9 V.S.A. 109. While it may be appropriate for the Board to consider a trigger
10 amount greater than \$1 million, there is a significant difference between
11 "notification" and "approval." While the PSB may conclude that notice is
12 adequate, an approval requirement provides an additional measure of protection
13 that should be considered.

14 Finally, Ms. Bugbee objects to the proposed requirement that if any utility assets
15 that are pledged or encumbered to secure debt issuances are divested, the debt
16 must 'follow' the assets and be divested as well. According to Ms. Bugbee, this
17 requirement is unworkable because the Company's debt is secured by a blanket
18 first mortgage lien on all utility property and because the mortgage indenture does
19 not permit such debt retirement absent the payment of a significant penalty. (See
20 Bugbee rebuttal at 4) Likewise, she contends that a similar requirement for a

1 proportionate amount of unsecured debt to follow divested assets would be
2 unworkable because unsecured debt is not tied to specific property. (See Bugbee
3 rebuttal at 5) While the argument pertaining to the Company's first mortgage lien
4 may prove to be a controlling consideration in some instances under current lien
5 provisions, the requirement that debt follow assets has been an important ring-
6 fencing requirement elsewhere. Ms. Bugbee's concern in this case may be
7 accommodated by providing that in such circumstances, the Board may waive the
8 first mortgage debt divestiture requirement or adjust its timing consistent with
9 existing debt retirement schedules and the public interest. Ms. Bugbee's
10 corresponding argument with respect to divestiture or retirement of unsecured debt
11 is less compelling as the proposed requirement does not involve a specific
12 property tie but relates to proportionality.

13 **Q. PETITIONER WITNESS POWELL TAKES EXCEPTION TO YOUR**
14 **TESTIMONY THAT THE COMPANY'S PROPOSED SAVINGS SPLIT**
15 **DURING THE FIRST SIX POST-MERGER YEARS (WHEN SAVINGS**
16 **ARE LIKELY TO BE MORE ACCURATELY FORESEEABLE AND**
17 **REALISTICALLY VERIFIABLE AS BEING MERGER-INDUCED) IS**
18 **VERY HEAVILY WEIGHTED TOWARD THE COMPANY'S BENEFIT**
19 **AND AGAINST THE RATEPAYER SHARE, AND THAT THERE ARE**
20 **WAYS IN WHICH THE TREATMENT OF COST SAVINGS MIGHT BE**

1 **MODIFIED SO AS TO BE MORE EQUITABLE TO RATEPAYERS. (SEE**
2 **POWELL/REILLY REBUTTAL AT 5) IS HER ANALYSIS OF THIS**
3 **MATTER ACCURATE?**

4 A. No. First, Ms. Powell does not include the Company's very large double leverage
5 financing benefit (\$16 million per year) in her analysis. Second, her conclusion
6 that the Company receives only 43% of the cost sharing benefit over ten years
7 does not give consideration to the time value of money and the fact that the
8 Company's benefits are projected to occur much earlier in time (and thus have
9 greater economic value) than later ratepayer benefits. Considering both the
10 Company's proposed cost savings split and the double leverage financing benefit,
11 under the Company's proposal ratepayers would receive only \$19 million (PV₈) of
12 benefits during the first six post-merger years, and then only if savings are actually
13 achieved in those years; meanwhile, the Company would receive a much greater
14 percentage of any generated savings in addition to its double leverage benefit,
15 which could result in total in nearly \$150 million of additional profits over and
16 above its "allowed" ROE during the same period. While I agree that the Company
17 does bear certain risks of achieving its projected cost savings in years 1 – 6 as
18 proposed that risk does not apply to the double leverage financing benefit, which
19 is the largest part of the Company's gain and which continues indefinitely. Given

1 these undisputed benefit values,¹ it seems clear that consideration of a more
2 ratepayer friendly benefit split is in order. This could take the form of increasing
3 the nominal benefits to ratepayers, shifting ratepayer benefits to earlier years,
4 guaranteeing on an annual basis ratepayer benefits, or some combination of all of
5 these.

6 **Q. PETITIONER WITNESS OTLEY DISPUTES YOUR TESTIMONY THAT**
7 **IN VIEW OF OBSERVATIONS BY KPMG, IT SEEMS LIKELY THAT A**
8 **SUBSTANTIAL PART OF THE COMPANY'S ESTIMATED POST-**
9 **MERGER INFORMATION TECHNOLOGY ("IT") COST SAVINGS**
10 **SHOULD HAVE BEEN EXPECTED TO OCCUR INDEPENDENT OF THE**
11 **MERGER, AND IN LESS THAN TEN YEARS. (SEE OTLEY REBUTTAL**
12 **TESTIMONY AT 3 – 5) IS THERE ANY MERIT TO HIS TESTIMONY?**

13 **A.** There may be. My testimony in this regard presented an illustration that relied
14 upon Gaz Métro's due diligence analysis as provided in discovery. As I stated:
15 "according to the Company's estimates, substantial merger induced cost savings
16 are attributable to 'Information Technology Initiatives.' However, according to
17 KMPG, who provided Gaz Métro with due diligence analysis in conjunction with
18 the contemplated acquisition of CVPS:

¹ As I discuss below, the Company has addressed the \$16 million annual double leverage financing benefit, pointing out that this is incremental before tax income that may generate a \$6.5 million incremental income tax liability. It is, of course, true that all incremental income, including retained cost savings, is taxable. That, however, does not mean that these amounts are not income or that consumers do not have to pay the full before tax amount.

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 of
10 the Company's estimated post-merger IT cost savings should have been expected
11 to occur independent of the merger" (Wilson direct testimony at 10-11)

12 I accepted this due diligence analysis as provided by the Petitioners. If it is not
13 accurate, as Mr. Otley now claims, then it may be the case that there will be
14 legitimate IT cost savings as a result of the merger. My point, however, was not
15 to quantify the specific cost reductions over time that should not be counted as
16 merger benefits, but to observe that various efficiency gains should be expected
17 over time with or without the merger. As I stated, it is possible that some of the
18 cost savings that the Petitioners classify as merger-induced economies in future
19 years would have occurred even without the merger in those more distant years
20 (year 7 and beyond) when the ratepayer benefit allocation is the greatest. Whether
21 or not KPMG's observations regarding CVPS IT costs are factually accurate, this
22 serves as an illustration of the importance of reviewing claimed cost savings
23 carefully.

1 Q. HAVE YOU ALSO REVIEWED MR. HEVERT'S REBUTTAL
2 TESTIMONY?

3 A. Yes; I have.

4 Q. MR. HEVERT TESTIFIES THAT HE DISAGREES WITH YOUR
5 TESTIMONY THAT A DOUBLE LEVERAGE APPROACH SHOULD BE
6 USED TO ESTIMATE THE COST OF CAPITAL AND THAT RATES
7 SHOULD BE ADJUSTED TO REFLECT THE EFFECT OF DOUBLE
8 LEVERAGE. (HEVERT REBUTTAL AT 24) HAS HE ACCURATELY
9 DESCRIBED YOUR TESTIMONY?

10 A. No. Mr. Hevert misunderstands my testimony. It is, of course, true that Gaz
11 Métro plans to use double leverage financing to accomplish the acquisition of
12 CVPS. This means that debt capital (in this case costing about 4.5%) will be used
13 to finance the Company's equity investment that is expected to earn a pre-tax
14 return of about 16 percent, resulting in substantial additional profit for Gaz Métro
15 of about \$16 million per year. It is also the case that leveraged debt financing can
16 increase overall financial risk. I also explained that this financial risk concern can
17 be largely dealt with in this case by appropriate ring-fencing and that the matter of
18 ratepayer cost and Gaz Metro's additional profit from double leverage financing
19 should be considered in conjunction with evaluating merger benefits and the

1 sharing of these benefits with ratepayers.

2 While double leverage adjustments to limit earned returns to investors' actual cost
3 of capital have often been implemented in rate cases, this is not a rate case, and,
4 accordingly, I have not proposed such an adjustment here. In fact, I have stated
5 that it is apparent that the Petitioners do not anticipate that such a double leverage
6 ratemaking adjustment will be made, and, for the purpose of my benefit sharing
7 analysis, I have assumed that none will be made. But that certainly does not mean
8 that the Board should ignore the substantially enhanced profit that the acquisition
9 financing will enable Gaz Métro to realize – and that ratepayers will (if the
10 Company's expectation and my assumption are correct) pay. This is a very real
11 and a very substantial economic gain which is, no doubt, a very substantial
12 inducement for Gaz Métro to accomplish the merger. As such, it should surely be
13 considered by the Board in evaluating the sharing of merger benefits.

14 **Q. MR. HEVERT ALSO ASSERTS THAT “A JUST AND REASONABLE**
15 **RATE OF RETURN” IS NOT SUFFICIENT IN THIS CASE BECAUSE**
16 **THE MERGER INCREASES RISK “FOR WHICH SHAREHOLDERS**
17 **SHOULD BE COMPENSATED.” HE ASSERTS THAT “MERGER RISKS**
18 **ARE NOT REFLECTED IN THE RISK UNDERLYING THE**
19 **AUTHORIZED UTILITY COST OF EQUITY.” (SEE HEVERT**
20 **REBUTTAL AT 22) DO YOU AGREE WITH THIS ARGUMENT?**

1 A. No. This argument is, to say the least, very novel, and the additional investor
2 compensation advocated by Mr. Hevert is not the usual rule, as described in my
3 direct testimony. Not only is the fundamental premise of Mr. Hevert's argument
4 highly doubtful (indeed, to the contrary, the merger clearly removes the risk of
5 competition between CVPS and GMP, as well as reducing the "concentration risk"
6 noted in Ms. Bugbee's direct testimony at 5), the alleged "cost" should not be
7 considered a ratepayer cost obligation. In fact, this seems to be nothing more than
8 a "creative" argument to ignore Gaz Métro's financial gain as a result of double
9 leverage financing. It should not be given credence by the Board.

10 **Q. MR. HEVERT ALSO CLAIMS THAT YOU HAVE STATED THAT THE**
11 **PETITIONERS SHOULD NOT SHARE IN ANY OF THE MERGER**
12 **SAVINGS. (SEE HEVERT REBUTTAL AT 22) IS THAT TRUE?**

13 A. Certainly not. In fact, I have testified at length that under the "benefits exception"
14 to acquisition premium cost recovery, substantial sharing of merger benefits may
15 be justified in this case. That, of course, is in sharp contrast to my criticism of the
16 merger benefits sharing that the Petitioners have proposed, that weighs too heavily
17 in favor of shareholders.

18 **Q. FINALLY, MR. HEVERT CONTENDS THAT YOU HAVE ASSUMED**
19 **THAT THE COMPANY WOULD RETAIN THE ENTIRE PRE-TAX**

1 **AMOUNT OF ITS \$16 MILLION ANNUAL DOUBLE LEVERAGE GAIN.**

2 **(SEE HEVERT REBUTTAL AT 29) IS HE CORRECT?**

3 **A.** Of course not. While ratepayers will be required to pay the entire pre-tax amount
4 of this gain, incremental income is always subject to income tax. Gaz Métro's \$16
5 million annual double leverage financing gain will be an annual increment to its
6 reported profit before taxes. As in the case of all increments to income, including
7 all of the Company's retained merger benefits that are not passed through to
8 ratepayers, these will be subject to applicable income taxes.

9 **Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?**

10 **A.** Yes; it does.