BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

IN THE MATTER OF

FORTIS INC. ET AL.

AND

CH ENERGY GROUP, INC.

CASE 12-M-0192

October 2012

Prepared Testimony of:

Staff Policy Panel

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INTRODUCTION

Q. Please state your names and business addresses.

A. Our names are Michael Augstell, Maynard Bowman, Charles Reubens and Aric Rider. We are employed by the New York State Department of Public Service (Department). Our business address is Three Empire State Plaza, Albany, New York 12223.

Q. Mr. Augstell, what is your position at the Department?

A. I am employed as an Associate Utility Financial Analyst in the Office of Accounting and Finance.

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Arts Degree in Economics from the University of Rochester in 1992. Since that time I have worked in commercial loan banking and thereafter as a financial analyst for General Electric Power Systems. For the five years prior to joining the Department I was employed at UHY Advisors NY, Inc. (UHY) in Albany, New York. I worked in the Valuation and Litigation Services department at UHY, conducting business valuations, financial analysis and forensic accounting, and class action claims administration. I joined the Department in December 2006.

Q. Do you hold any designations from professional societies?

A. Yes. I hold the Accredited Member (AM) designation in Business Valuation with the American Society of Appraisers.

Q. Mr. Augstell, please briefly describe your current responsibilities with the Department.

A. I work on assignments that involve analyzing the financial condition, financing mechanisms, risk, cost of debt, cost of equity, diversification and relative business positions of utilities and their holding company parent(s). My assignments involve rate cases, financing proposals and special projects.

Q. Have you previously testified in any regulatory proceeding before the New York State Public Service Commission?

A. Yes. I provided testimony to the Commission regarding the appropriate capital structure and cost of capital for the subject utilities in Case 07-E-0523 (Consolidated Edison Company of

New York, Inc. – Electric Rates), Case 07-E-0949 (Orange and Rockland Utilities, Inc. – Electric Rates), Case 07-S-1315 (Consolidated Edison Company of New York, Inc. – Steam), Case 08-G-1398 (Orange and Rockland Utilities, Inc. – Gas Rates), Case 09-W-0731 (United Water New York, Inc. – Water Rates), Case 09-W-0824 (United Water New Rochelle, Inc. – Water Rates), and Case 10-E-0362 (Orange and Rockland Utilities, Inc. – Electric Rates) and Case 11-G-0280 (Corning Natural Gas Corporation – Gas Rates).

Q. Mr. Bowman, by whom are you employed and in what capacity?

A. I am employed by the Department as Supervisor of Regulatory Economics in the Office of Regulatory Economics.

Q. Please describe your educational and professional background.

A. I have a B.S. in Mathematics from the University of North Carolina at Chapel Hill and I completed all the requirements for a Ph.D. in Economics with the exception of completing a dissertation at the University of Virginia at Charlottesville. While at the University of

Virginia, I was a research assistant in the areas of macroeconomic modeling and regulatory economics. Prior to joining the Department, I was Director of Forecasting at the New York State Energy Office. I have previously testified before the Commission in Niagara Mohawk Power Corporation's Case 95-G-1095 as a member of the Performance-based Regulation Panel, in Rochester Gas and Electric Corporation's Case 96-E-0898 as a member of the Settlement Panel, in Long Island Lighting and KeySpan Case 97-M-0567 as a member of the Staff Panel, and in Case 07-M-0906 (Iberdrola acquisition of Energy East).

Q. Mr. Reubens, by whom are you employed and in what capacity?

A. I am employed by the New York State Department of Public Service as a Supervisor, Office of Accounting & Finance.

Q. Please state your educational background and professional experience.

A. I graduated from the Rochester Institute of Technology with a Bachelor of Science degree in Accounting in August 1975. I have been employed by the Department of Public Service since June 1977 in the Office of Accounting and Finance. I have participated in numerous rate proceedings, finance cases and various other matters, as well as generic policy proceedings instituted by the Commission related to electric, gas, water and telephone companies. I have testified in numerous Commission proceedings and am a Certified Public Accountant in the State of New York.

Q. Mr. Rider, what is your current position?

A. I am a Utility Supervisor, currently assigned to the Major Utility Rates Section of the Office of Electric, Gas and Water.

Q. Mr. Rider, please provide a summary of your educational background and professional experience.

A. I hold a Bachelor of Science Degree in Civil Engineering Technology, which I received in 2001 from the State University of New York Institute of Technology at Utica/Rome. Within the Office of Electric, Gas and Water, I am currently assigned to the Major Utility Rates Section. I previously have been assigned to the Gas Rates, Gas Safety, Gas Policy and Electric Rates Sections. My duties involve the engineering analysis of utility operations as they relate to the ratemaking process, as well as participating in various reviews of local distribution companies’ activities.

Q. Mr. Rider, have you previously testified before the Commission?

A. Yes, I have testified in several proceedings before the Commission regarding cost of service, capital expenditures, depreciation, sales forecasts, revenue allocation, rate design, merchant function charges, revenue decoupling mechanisms, gas safety performance mechanisms and tariff issues.

SCOPE OF TESTIMONY

Q. What is the purpose of this testimony?

A. This testimony explains why Staff, after a comprehensive analysis of the transaction as proposed by the parties initiating this proceeding (we will refer to as the “Merger”) has reached the conclusion that the acquisition of CH Energy Group Inc. (CH Energy) by Fortis Inc. (Fortis) (collectively along with Central

Hudson Electric & Gas Corporation (Central Hudson or Company) we will refer to as the "Petitioners") does not meet the criteria required for the Commission to approve such a transaction absent the substantial modifications to the terms and conditions we recommend to those proposed by the Petitioners.

Q. How is Staff's testimony organized?

A. Staff's testimony consists of five panels and three individuals. The five Panels are the Accounting and Finance (A&F) Rates Panel, the Staff Infrastructure Panel, the Gas Safety Panel, the Natural Gas Capacity Panel and the Retail Access Panel. The three individuals are Laurie Cornelius of the Consumer Advocacy Section of the Office of Consumer Policy; Mary Ferrer of the Distribution Systems Section of the Office of Electric, Gas and Water (OGE&W); and Hieu Cam of the Major Utility Rates Section of OGE&W.

Q. How is the Policy Panel testimony organized?

A. We begin by summarizing the petition initiating this proceeding (Petition), Staff's examination of the Petition, the Commission's standards for approving such petitions, and Staff's recommendations on how the Commission should decide the proceeding. We then provide a more detailed discussion of the transaction proposed by the Petitioners as well as our findings and recommendations on an issue-by-issue basis.

Q. Does your testimony refer to the other Staff testimony in this proceeding?

A. Yes. Many of our recommendations are additionally supported by the other Staff testimony described below.

A&F Rates Panel – This Panel consists of four members of A&F and details the results of Staff's examination of the revenue requirement information for the 12 months ended June 30, 2014. This is the rate year that the Petitioners propose that the rates of Central Hudson, which is the major subsidiary of CH Energy, be frozen as a condition of the Merger. As elaborated upon later, the Petitioner's initial filing did not attempt to quantify the impact of the proposed rate freeze and Central Hudson did not provide the revenue requirement information until June 21, 2012. This testimony includes the Staff adjusted revenue requirement for that period and Staff's estimate of the value of the proposed rate freeze. The value of the proposed rate freeze was calculated in the context of this proceeding following the Company's related proposal to extend various provisions in its current rate plan (Rate Plan) approved by the Commission in Cases 09-E-0588 and 09-G-0589, Central Hudson - Rates, Order Establishing Rate Plan issued on June 18, 2010.

Staff Infrastructure Panel - This Panel consists of four members of OGE&W and addresses the construction forecast Central Hudson used in its revenue requirement projections for the twelve months ended June 30, 2014. The Panel also discusses its findings concerning the Company's forecast of enhanced transmission maintenance, right of way maintenance, production maintenance, and stray voltage expenses. Moreover, the Panel recommends continuing the net plant targets and the transmission right-of-way (ROW), distribution ROW and stray voltage reconciliation mechanisms for the proposed stay-out period.

<u>Gas Safety Panel</u> – This Panel consists of three members of OGE&W and addresses safety performance measures in the areas of infrastructure enhancement, leak management, damage prevention, emergency response and violations of safety regulations. The performance measures focus on the Company's attention to areas widely accepted as of high importance, and that help ensure service reliability.

<u>Natural Gas Capacity Panel</u> - This Panel consists of two members of OEG&W and addresses the Company's gas reliability forecast methodology, capacity asset management and gas service request data collection.

<u>Hieu Cam</u> – The testimony of Mr. Cam, a member of OEG&W, addresses the fixed lost and unaccounted for gas factor. He recommends standardizing the calculation of the gas lost and unaccounted for factor and eliminating an inequity between full service and transportation customer charges.

<u>Laurie Cornelius</u> – The testimony of Ms. Cornelius, a member of the Office of Consumer Policy, addresses the Company's Service Quality

Performance Mechanisms in the context of the Merger. Ms. Cornelius recommends the continuation and expansion of customer service performance incentives, enhancements to programs to address low income customer needs, and the institution of certain winter protections for its customers receiving regular or emergency HEAP payments, as well as customers whose accounts are identified as elderly, blind, disabled or Life Support Apparatus.

Mary Ferrer – The testimony of Ms. Ferrer, a member of OEG&W, addresses electric reliability performance measures in context of the Merger. She recommends continuing the performance measures as safeguards to ensure that reliability of service does not suffer as a result of the Merger.

Retail Access Panel - This Panel consists of a member of the Office of Economic Research and a member of the Office of Consumer Protection and addresses concerns about the competitiveness of the residential market for energy and recommends that Central Hudson provide basic information to Energy Services Company customers concerning the amount that the customer would have been billed if he/she had purchased commodity from the utility.

Q. Panel, did you prepare exhibits supporting this testimony?

A. Yes, we prepared 13 Exhibits:

Exhibit__(PP-1) – Interrogatories (IRs) referred to in testimony
Exhibit__(PP-2) – Staff Recommendations
Exhibit__(PP-3) – Gaz Métro/CVPS Synergies
Exhibit__(PP-4) – Goodwill Ratios
Exhibit__(PP-5) – Proposed Standards Code of Conduct
Exhibit__(PP-6) – Rate Freeze Analysis
Exhibit__(PP-7) – Fortis Common Equity Ratios
Exhibit__(PP-8) – Pro Forma Capitalization
Exhibit__(PP-9) – S&P April 22, 2012 Report
Exhibit__(PP-10) – DBRS July 26, 2012 Report
Exhibit__(PP-11) – Analysis of Claimed Benefits
Exhibit__(PP-12) – Fortis vs. Iberdrola
Exhibit__(PP-13) – Accretion Analysis

Q. Does your testimony refer to, or otherwise rely upon, any information produced during the discovery phase of this proceedings?

A.   Yes. We relied upon a number of the responses to Staff IRs. All of the responses we refer to are contained in the Policy Panel Exhibit__(PP-1). The IRs are referred to using the numbering used by Staff followed by the numbering used by the Petitioners in parenthesis.

PROCEEDING OVERVIEW TO DATE

A. Summary of the Petition

Q.   Would you please describe the petition filed in this proceeding?

A.   The April 20, 2012 Petition requests that the Commission authorize and approve the merger of Central Hudson into the utility holding company system of Fortis. The Petition states this will be accomplished by the merger of Cascade Acquisition Sub Inc., a wholly-owned subsidiary of FortisUS Inc. (FortisUS) that is wholly-owned by Fortis, into CH Energy, with CH Energy as the surviving corporation wholly-owned by Fortis. As previously stated these entities, along with Central Hudson, will collectively be referred to as "Petitioners" where appropriate.

Q.   Does the Petition claim to provide a basis for the Commission to approve the Merger?

A. The Petition maintains the transactions contemplated by the Merger are in the "public interest," as required by Section 70 of the Public Service Law (PSL) because:

1. Fortis is highly qualified to become the successor owner of Central Hudson.
2. The Merger produces benefits for constituencies that include customers, employees, and communities in Central Hudson's service territory.
3. The Merger will produce positive public benefits that will arise in three major areas:
    a. Fortis's commitment and intention to preserve and build on the existing strengths of Central Hudson.
    b. Identifying and affirmatively mitigating any reasonable concerns about potential negative aspects of the Merger paying particular attention to concerns that arose in prior merger proceedings and resolving them in a way consistent with the Commission's dispositions of those cases, as well

as being tailored to the individual circumstances of the Merger.

c. Identifying monetary benefits in the form of specific cost savings as a result of the Merger, as well as commitments to provide additional tangible public benefits to customers at the cost to Fortis shareholders' to attempt to alleviate any conceivable doubt about the Merger's positive benefits including:

i. $2 million in annual operating cost savings and a guarantee they will continue for five years from closing, with more savings expected to be identified over the long-term;

ii. Deferral of the foregoing cost savings for recognition in Central Hudson's next general rate cases;

iii. Commitment to freeze rates set by Central Hudson’s current three-year Rate Plan for an additional year resulting in the deferral of the changes in base electric and gas rates until at least July 1, 2014;

iv. Enhanced Central Hudson access to capital due to Fortis's significantly larger size as compared to Central Hudson; and

v. Commitment of $10 million in shareholder-funded Public Benefit Adjustments (PBAs), to be utilized for the benefit of customers and residents of Central Hudson's service territory.

Q. Did the Petition include testimony and Exhibits?

A. Yes, it included the prefiled direct testimony of Barry V. Perry, James P. Laurito and Michael L. Mosher (Panel Testimony), as well as 21 Exhibits.

B. Staff’s Examination

Q. Would you please summarize Staff’s examination of the filing?

A. Staff asked and examined the responses to several hundred IRs to better understand Fortis, how it operates, its past performance, the proposed Merger conditions and how Central Hudson would be affected if it became part of Fortis. We also examined the responses to IRs asked by the other parties in the proceeding – International Brotherhood of Electrical Workers, Local Union 320, Public Utility Law Project of New York, Inc., the County of Dutchess, and Multiple Intervenors (MI). Additionally, we examined various documents filed with and issued by independent entities including various Canadian and United States government agencies and credit rating agencies. For example, we examined the Definitive proxy statement the Petitioners filed with the Securities and Exchange Commission on May 9, 2012 (the SEC Proxy Statement) and the June 15, 2012 Order issued by the State Of Vermont Public Service Board regarding Gaz Métro Limited Partnership’s (Gaz Métro) acquisition of Central Vermont Public Service Corporation (CVPS) (Gaz Métro/CVPS Merger Order), the Vermont utility that at one point Fortis was attempting to acquire.

Also, relevant to our examination was the "Comprehensive Management Audit of Central Hudson Gas & Electric Corporation – Final Audit Report" issued by NorthStar Consulting Group (NorthStar), dated February 28, 2011 (Management Audit Report). This Management Audit was initiated by the Commission in November 2009 in Case 09-M-0764 and on May 19, 2011 the Commission issued an Order directing Central Hudson to develop and file with the Commission an Audit Implementation Plan that should include consulting with Staff and providing written updates on Central Hudson's progress implementing the Plan. Finally, Staff interviewed staff of the regulators of certain Fortis subsidiaries – the Newfoundland and Labrador Board of Commissioners of Public Utilities (PUB) which regulates Fortis subsidiary Newfoundland Power, Inc. (Newfoundland Power) and the British Columbia Utilities Commission which regulates FortisBC.

Q. Please summarize what you learned from the interviews with the Canadian regulators.

A. Both the Canadian regulator groups indicated they had little or no interaction with Fortis, the holding company, in regulating the Fortis subsidiaries under their jurisdiction. This appears to confirm Petitioners' statement that they follow a stand-alone utility subsidiary strategy.

We also learned that the regulation those Fortis subsidiaries are subject to appears to be much less rigid than what Central Hudson is subject to by the Commission. For example, Fortis was originally formed in 1987 when the shareholders of Newfoundland Power approved an arrangement to form a parent company. However, unlike in New York, where jurisdictional companies must get Commission permission to form holding companies, PUB permission was not required for Newfoundland Power to form Fortis. Thus, Fortis has not been subject to the holding company protections that are commonly part of the conditions accompanying Commission approval of a request by a jurisdictional utility to form a holding company.

Also, it appears that rate requests by Canadian utilities are also not subject to the regulatory scrutiny major utility rate filings in New York face. In its July 21, 2011 Credit Opinion for FortisBC Energy Inc. (FEI), Moody’s Investors Service stated, "We consider Canada to have more supportive regulatory and regulatory business environments than other jurisdictions globally. Furthermore, the regulatory environment in the Province of British Columbia (BC) is considered one of the most supportive in Canada reflecting the fact that regulatory proceedings in BC tend to be less adversarial than those in other jurisdictions . . . FEI benefits from the existence of a number of BCUC (British Columbia Utilities Commission)-approved deferral or true-up, mechanisms. These mechanisms limit FEIs exposure to forecast error with respect to commodity price change and volume, pension funding costs, insurance costs, and short-term interest rates. In addition FEI is required to obtain a certificate of public convenience and necessity (CPCN) from the BCUC prior to undertaking any capital project in excess of $5 million. In our view, this process reduces the risk that FEI would be denied the opportunity to recover the cost of its capital investments. We believe these qualitative factors balance FEIs weak financial profile."

Q. What is the significance of Canadian utility regulation to this proceeding?

A. First, it highlights that Fortis is entering a very different regulatory environment than it has been operating under to date. Second, and perhaps more important, a credit rating agency places significant weighting on the regulatory environment when it determines a credit rating for a utility company and, as will be elaborated below, financing issues are of great importance to the Commission in merger proceedings.

C. Standard for §70 Approvals

Q. When did the Commission last comprehensively address its policy for determining if a proposed merger of a major electric or gas utility met the public interest standard in PSL §70?

A In 2008, in Case 07-M-0906, Joint Petition of Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation

<u>and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A</u>.

Q. Did the Commission summarize its merger or acquisition policy in that proceeding?

A. Yes, on page 2 of the Abbreviated Order Authorizing Acquisition Subject to Conditions (issued September 9, 2008), the Commission stated, “Under the PSL §70 ‘public interest’ criterion applicable to this proposed transaction, petitioners must show that the transaction would provide ratepayers a positive net benefit. Here, we have weighed the expected benefits from the transaction against related risks and detriments remaining after applying reasonable mitigation measures. We conclude that, with the provision of PBAs and the conditions ordered here, Iberdrola’s acquisition of the Energy East companies will provide ratepayers sufficient positive net benefits to warrant its approval under PSL §70.” The Commission subsequently issued its final Order Authorizing Acquisition Subject To Conditions on January 6, 2009 (Iberdrola Merger Order), which followed and confirmed the “positive net benefits” reasoning.

D. <u>Summary of Merger Findings and Recommendations</u>

Q. Would you please summarize your findings and recommendations resulting from this examination?

A. We find the Petitioners have made a reasonable attempt to provide the customer protections and PBAs contained in the most recent Commission approvals of acquisitions of major New York State combination electric and gas utilities by foreign entities. However, based on our examination, given the unique conditions and circumstances of Fortis and Central Hudson, the Merger conditions and public benefits offered by the Petitioners do not provide an adequate basis for the Commission to approve the proposed transaction under PSL §70.

Q. What are the most recent Commission approvals of acquisitions of major New York State combination electric and gas utilities by foreign entities to which you refer?

A. There are three:

1. The Opinion and Order Authorizing Merger

and Adopting Rate Plan, Opinion No. 01-6 (issued on December 3, 2001) in Case 01-M-0075, Joint Petition of Niagara Mohawk Holdings, Inc., Niagara Mohawk Power Corporation, National Grid Group plc and National Grid USA for Approval of Merger and Stock Acquisition;

2. The Order Authorizing Acquisition Subject to Conditions and Making Some Revenue Requirement Determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued on September 17, 2007) in Case 06-M-0878, Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and other Regulatory Authorizations (National Grid/KeySpan Order); and

3. The Iberdrola Merger Order referred to earlier.

Q. Do you believe the Merger conditions and PBAs offered by the Petitioners can be modified in a manner to provide the Commission a basis for approving the proposed Merger?

A. Yes, we would be able to recommend the Commission approve the Merger if the Petitioners would agree to various modifications to the terms and conditions they initially propose. Our proposed recommendations are listed in Exhibit__(PP-2) and will be described later in detail. Exhibit__(PP-2) notes where the specific recommendations are discussed in this testimony. Our proposed modifications include increasing the PBA amount to $30 million, requiring Central Hudson to fully comply with the provisions of the Sarbanes-Oxley Act as if it were still legally obligated to do so under U.S. law, requiring Central Hudson to follow our proposed updated Standards of Conduct provided Exhibit__(PP-5), and requiring Central Hudson to provide an estimate of payroll and related costs of Central Hudson employees for Merger related work. Additionally, we propose service quality be maintained, that the Petitioners continue to support the objectives of maintaining an “A” credit rating for Central Hudson, that Central Hudson’s headquarters remain in its service territory, and that Fortis commit to maintaining its stand-alone philosophy as it monitors Central Hudson’s operations in the manner stated in IR DPS-M138 (DPS-338).

MERGER BACKGROUND

A. Description of Fortis

Q. Can you generally describe Fortis?

A. Fortis is described in detail on pages 8-12 of the petition and pages 6-7 of the initial Panel Testimony. Also, as summarized in the SEC Proxy Statement, it is the largest investor-owned distribution utility in Canada with assets totaling approximately $14.2 billion (Canadian) and revenue totaling approximately $3.7 billion for the fiscal year ended December 31, 2011. Fortis serves more than two million gas and electricity customers. Its regulated holdings include electric utilities in five Canadian provinces and two Caribbean countries and a natural gas utility in British Columbia, Canada. Fortis owns non-regulated generation assets, primarily hydroelectric, primarily in Canada and in Belize and to a minimal extent in upstate New York. Additionally, Fortis owns hotels and commercial office and retail space properties in Canada.

Q. Would you please further describe the generation assets in upstate New York?

A. There are four upstate New York hydroelectric generating stations located in Moose River, Philadelphia, Dolgeville and Diana. The four upstate New York plants have a combined capacity of approximately 23 megawatt (MW), about 5% of the total for Fortis Generations facilities of about 474 MW. According to page 121 of Fortis’s 2011 Annual Report to Shareholders, Fortis Generations assets accounted for less than 3% of Fortis’s total assets.

Q. What is Fortis's long-term business strategy?

A. Fortis’s long-term business strategy is discussed on page 9 of the Panel Testimony. Fortis states its long-term business objective is to grow its regulated gas and electric utility business, principally based on organic growth within its regulated utility operations, which it invests approximately $1 billion annually. Fortis also pursues acquisitions of regulated gas and electric utilities in the United States and Canada that fit the Fortis stand-alone operating model.

Q. Does Fortis currently own any major regulated electric and/or gas utilities in the United States?

A. No, Central Hudson would be the first.

Q. What is Fortis's philosophy for managing regulated electric and gas utilities, including Central Hudson?

A. Both the Petition and Panel Testimony emphasize that Fortis uses a stand-alone philosophy to manage its electric and gas subsidiaries that will apply to Central Hudson through the Merger. Specifically, page 16 of the Petition states, "Fortis intends to cause CHEG to appoint a board of directors for Central Hudson that will be comprised of a majority of independent directors resident in the State of New York, with an emphasis on selecting candidates who reside, conduct business or work within the Central Hudson service territory. In addition, the Audit Committee of the Central Hudson Board will be comprised of a majority of independent directors."

B. <u>Description of the Transaction</u>

1) <u>Merger Agreement</u>

Q. Have the Petitioners entered into an agreement regarding the proposed transaction?

A. As described on pages 14-16 of the Petition and pages 20-22 of the Panel Testimony, on February 20, 2012 an Agreement and Plan of Merger (Merger Agreement) was entered into by FortisUS, Cascade, Fortis and CH Energy. The Merger Agreement is provided as Exhibit 13 of the Petition. Pages 21-22 of the Panel Testimony describe the provisions of the Merger Agreement that relate to the service provided by Central Hudson to its customers post Merger which are consistent with Fortis's stand-alone utility management philosophy. The Petitioners maintain that following the Merger Central Hudson will be governed, managed, operated and financed in a manner consistent with this philosophy.

Q. How much does the Merger Agreement call for Fortis to pay to acquire CH Energy?

A. Fortis would pay the holders of CH Energy common stock $65.00 per share in cash, for an aggregate purchase price of approximately $1.5 billion, including the assumption of approximately $500 million of debt. Further, on June 19, 2012, CH Energy shareholders voted to approve acquisition at this price, as well as approving CH Energy's officers and executive management compensation post-Merger.

Q. How does this purchase price compare to the amount of net assets recorded on the books of CH Energy?

A. In response to IR DPS-M73 (DPS-273), Fortis estimates that the amount it will pay CH Energy shareholders is $444 million greater than the amount of consolidated net assets recorded on CH Energy's books at March 31, 2012. In accounting terms, this is referred to as "Goodwill."

Q. Is the Goodwill resulting from the transaction addressed in the Petition?

A. Yes, which we will elaborate on later, along with our concerns with the level of Goodwill that will be on Fortis's books after the Merger.

C. Reasons for Fortis to Acquire CH Energy

Q. Has Fortis stated why it wants to acquire CH Energy?

A. Yes, IR DPS-M58 (DPS-258) asked Fortis to identify the business reasons it believes justify the acquisition of Central Hudson and to discuss the benefits Fortis expects to derive from owning Central Hudson. Fortis responded as follows:

> “. . . Fortis's business is primarily the ownership of regulated electric and gas utilities.
>
> Central Hudson is a well-run electric and gas distribution utility that is regulated on a cost of service basis that reasonably permits Central Hudson recovery of prudently incurred costs and has also allowed Central Hudson to implement rate mechanisms such as gas and electric revenue decoupling that provide a reasonable degree of revenue certainty. Central Hudson's regulated utility operations are quite similar to Fortis's Canadian regulated utility operations.
>
> The acquisition of Central Hudson brings long-term growth opportunities to Fortis by way of organic utility investment. It also increases the diversification of Fortis's overall utility operations in terms of both geography and regulatory jurisdiction. Fundamentally,

the acquisition of Central Hudson is attractive to Fortis because it provides a means for Fortis to pursue its long-term business objective of growing its investment in regulated electric and gas utilities.

The acquisition of Central Hudson is attractive to Fortis for the following reasons:

(i) It enables Fortis to enter into the U.S. regulated electric and gas distribution business with a reasonably sized utility;

(ii) The Acquisition is expected to be immediately accretive to earnings per common share, excluding one-time transaction expenses;

(iii) CH Energy has a strong balance sheet and Central Hudson has strong investment-grade credit ratings;

(iv) Central Hudson, a single-state utility, operates a well-maintained electric and gas distribution system, serving a diversified, primarily residential and commercial customer base;

(v) Central Hudson operates principally under cost-of-service regulation. The utility has earned stable returns and is allowed timely recovery of costs related to purchased electricity and natural gas supply, transmission and capital programs. Other positive mechanisms include full recovery and deferral provisions for pension and other post-retirement benefit expense, manufactured gas plant site remediation and revenue decoupling mechanisms. For the three years beginning on July 1, 2010, Central Hudson’s rates have been established using a 10% return on equity and a capital structure containing 48% common equity;

(vi) Central Hudson’s continued investment in its electric and gas businesses is expected to result in attractive rate base growth; and

(vii) It increases diversification of regulated assets and earnings by geographic location and regulatory jurisdiction."

Q. Has Staff's examination uncovered any information that would question Fortis's stated reasons for wanting to acquire CH Energy Group?

A. No.

Q. Would you please describe what is meant by the statement, "The Acquisition is expected to be immediately accretive to earnings per common share, excluding one-time transaction expenses?"

A. The earnings per share of Fortis's common stock will increase immediately as a result of the Merger being executed even if the companies continue to operate in the exact same manner that they did before the Merger, except for the additional financing Fortis will have to do to purchase CH Energy's outstanding common stock.

Q. Why will this happen?

A. It will happen because the capital structure used by the Commission to set Central Hudson's rates includes a much greater percentage of higher cost equity (versus debt) than Fortis's total assets will be financed after the Merger.

Q. What, if any, are Staff's concerns?

A. As we will elaborate later, as a result of this situation Fortis's shareholders stand to unfairly gain relatively much more from the Merger than Central Hudson's customers, based on the Merger benefits proposed by the Petitioners.

D. Reasons Central Hudson Agreed to the Merger

Q. Why did Central Hudson agree to be acquired by Fortis?

A. The presentation given at the Special Meeting of CH Energy Shareholders held on June 19, 2012 to approve the Merger Agreement listed the following benefits from the transaction:

1. Fortis is a large, high-quality company with demonstrated history of growing successfully through acquisitions.
2. Fortis is committed to charitable contributions to local nonprofit organizations.
3. Fortis is committed to retaining all employees and honoring obligations to current retirees.
4. The Merger allows CH Energy to operate as

an independent entity, with little change in its day-to-day services and operations.

5. The Merger provides improved access to capital and the sharing of best practices.

6. The Merger benefits CH Energy shareholders as the $65 price per share of common that Fortis would pay provided a 9.5% premium to the all-time high CH Energy’s stock ever sold at prior to the announcement of the merger.

Q. Has Staff’s examination revealed any other reasons why Central Hudson would agree to be acquired by Fortis?

A. No.

RISKS AND REQUIRED CUSTOMER PROTECTIONS

A. Management and Governance

Q. Does the Panel address how Central Hudson would be governed after the Merger, if it is approved?

A. Yes, pages 22, line 15 through page 23, line 2, the Panel Testimony states:

“Central Hudson would be governed in a manner consistent with the governance of Fortis's larger regulated utilities. Central Hudson's local management would report to Central Hudson's board of directors. The majority of the board of directors will be independent of Fortis. The board of directors of Central Hudson will be responsible for management oversight generally, including the approval of annual capital and operating budgets; establishment of dividend policy; and determination of debt and equity requirements. The Central Hudson board of directors will have an audit committee, the majority of whom will also be independent and a key responsibility of this committee will be ensuring the ongoing financial integrity of Central Hudson.”

Q. How does Fortis intend to monitor Central Hudson’s activities?

A. In IR DPS-M138 (DPS-338),, Fortis responded as follows:

“While the majority of members of Central Hudson’s Board of Directors will be independent of Fortis, there will be Fortis representatives on the Board. At Central Hudson’s regular Board meetings, management will be expected to report on corporate performance. Currently, within the Fortis utility group, routine reporting typically includes matters such as service reliability, customer satisfaction, public and worker safety, regulatory activities, financial performance and capital expenditures. Explanations are expected to be provided on a timely basis for material variances from business plans.

As part of its capital markets disclosure obligations, Fortis is required to prepare annual and quarterly consolidated financial statements. Like the other Fortis operating utilities, Central Hudson will be required to prepare and submit annual and quarterly financial statements, including notes and other necessary financial information that will be required to facilitate Fortis' fulfillment of its financial reporting obligations.

Please refer to the response to DPS-M83 (DPS-M283), which deals with the mandate of the Board of Directors of Fortis for strategic planning and risk management. Fortis will expect Central Hudson to develop its strategic and business plans by the same stand-alone approach used by Fortis' current utility operating companies. Fortis will monitor progress against those plans on an ongoing basis.

Finally, Fortis' Internal Auditor and Audit Committee will monitor the stand-alone internal audit activities of Central Hudson. This will include performance of an Enterprise Risk Management system. This process is more fully described in the response to DPS-M323."

Q. Do you find the manner Fortis proposes to manage and governing Central Hudson satisfactory?

A. We believe there are both positives and negatives to the "stand-alone" governance and management approach Fortis intends to apply to Central Hudson.

Q. What are the positives of Fortis's "stand-alone" governance and management approach?

A. We agree that Central Hudson currently has many strengths and is generally a well-run, lean company, which may be a reason why there has been no firm offers to acquire Central Hudson in the past. Further, if the parent and/or subsidiaries of a consolidated entity have substantial intercompany transactions, improprieties and other regulatory concerns can result. For example, in Case 10-E-0050, a Niagara Mohawk Power Corporation d/b/a National Grid (Niagara Mohawk) electric rate case, Staff presented testimony detailing alleged internal control deficiencies, misallocation of costs and questionable transactions included in National Grid Service Company charges to Niagara Mohawk. As a result, the Commission made $50 million of Niagara Mohawk's electric rates temporary subject to the results of the pending audit of National Grid service company expenses in Case 10-E-0050 and 08-E-0827, Order Establishing Rates for Electric Service (issued January 24, 2011, pp. 8-11). Under a stand-alone utility corporate structure there should be few, if any, opportunities for questionable inter-corporate transactions.

Q. What are the negatives of Fortis’s “stand-alone” governance and management approach?

A. Fortis’s “stand-alone” philosophy severely limits the potential synergy savings that can result because of a merger. Indeed, that was one of the major reasons why Fortis’s bid to acquire Central Vermont Public Service Corporation was ultimately rejected in favor of a bid by Gaz Métro that offered substantial more synergy savings passed on to customers because of shared services.

Q. Would you please elaborate on the estimated customer savings indicated in the Gaz Métro/CVPS Order?

A. The Order states Gaz Métro/CVPS projected that proposed merger would result in customer savings of as much as $500 million over the first twenty years and guaranteed a minimum of $144 million in customer operations and maintenance (O&M) cost savings alone over the first ten years (Gaz Métro/CVPS Merger Order, pp. 14-15) versus CVPS’s preliminary estimate of savings available to customers from the Fortis transaction in the range of $2.5 to $3.0 million per year and $25 to $30 million over ten years (Gaz Métro/CVPS Merger Order, p. 56).

Exhibit__(PP-3) lists several of the actions that Gaz Métro/CVPS indicated would generate the substantial synergy as a result of that merger that Central Hudson customers will never realize if the Merger is approved because of Fortis's stand-alone philosophy. That being said, we are unaware that there have been any other serious suitors to acquire Central Hudson. Thus, the potential for Central Hudson to realize synergy savings indicated by the Gaz Métro/CVPS Merger is questionable.

Q. Do you question if Fortis will consistently apply this "stand-alone" philosophy to Central Hudson's operations in the future?

A. Fortis has apparently maintained this "stand-alone" philosophy with its Canadian subsidiaries, as well as the subsidiaries in the two Caribbean countries. However, as noted earlier, Central Hudson would be Fortis's first major United States regulated electric and gas utility and we are concerned that as Fortis acquires other United States regulated electric and gas utilities it could use Central Hudson resources to strengthen Fortis on a consolidated basis at the expense of Central Hudson’s New York utility customers.

Q. What is the basis of your concern and has your analysis revealed any current plans where Fortis plans to utilize Central Hudson resources to benefit Fortis on a consolidated basis?

A. Staff asked several IRs concerning the related income tax ramifications of the proposed Merger. In response to IR DPS-M116 (DPS-316), Fortis revealed for the first time it “expects that the staff of Central Hudson will prepare the consolidated federal income tax returns of FortisUS Inc. and include FortisUS Energy Corporation in Central Hudson’s combined New York State income tax returns once the transaction is completed.” While we agree with Fortis’s remarks in its response to IR DPS-M116 (DPS-M316) that, given Fortis’s current United States holdings this should not significantly expand the work of Central Hudson’s Tax Department and a fair allocation of the related costs can be allocated to the non-Central Hudson subsidiaries, the situation could change dramatically as Fortis carries out its presumed plans to expand in the United States.

Q. Do you have any other concerns with CH Energy being Fortis’s first major United States subsidiary?

A. While Fortis has an apparent proven track record of maintaining its stand-alone philosophy with its Canadian subsidiaries, they may not find that approach as effective with a United States subsidiary as far away from its corporate headquarters as Central Hudson. Conversely, Central Hudson’s distance from Fortis’s headquarters could result in Central Hudson being neglected compared to the closer located Canadian Fortis subsidiaries.

Q. Should the Commission require a condition, if it approves the Merger, to address these concerns?

A. Yes, Fortis should commit in writing that it will both maintain its stand-alone philosophy and do the monitoring it says it will do in its response to IR DPS-M138 (DPS-338) indefinitely unless it obtains Commission permission to do otherwise. Specifically, 1) there will only be one Fortis representative on Central Hudson’s Board of Directors; 2) at Central Hudson’s regular Board meetings, management will continue to be expected to report on corporate performance; 3) Central Hudson will only have to do the routine reporting currently done within the Fortis utility group relating to matters like service reliability, customer satisfaction, public and worker safety, regulatory activities, financial performance and capital expenditures; 4) Central Hudson will only have to provide, on a timely basis, explanations for material variances from business plans; and 5) like the other Fortis operating utilities, Central Hudson only will be required to prepare and submit annual and quarterly financial statements, including notes and other necessary financial information that will be required to facilitate Fortis’s fulfillment of its financial reporting obligations.

Q. Have the Petitioners attempted to address concerns expressed by the Commission in prior merger proceedings regarding corporate governance?

A.   Yes, the Petitioners state that (1) Central Hudson’s headquarters will remain in Poughkeepsie (Panel Testimony, p. 22), (2) the Board of Directors will be made up of a majority of independent members from Central Hudson’s service territory (Panel Testimony, p. 26) and (3) Fortis will reappoint up to three members of the Board of Directors (Panel Testimony, p. 21).

Q.   Are the Petitioners’ governance proposals sufficient?

A.   We believe that it is positive that Central Hudson’s headquarters will remain in Poughkeepsie. The location of the utility headquarters is important because it is more likely that the Board of Directors will be responsive to customers and focused on the safety and reliability of the distribution systems. We also believe that independent members on the Board is positive in that it will exceed the recent Management Audits goals, and the reappointment of current Board Members will provide the necessary familiarity with New York regulation during the transition.

Q.   Do you have any concerns with the Petitioners’ proposal?

A. Yes. The Merger Agreement between Fortis and CH Energy does not guarantee that Fortis will not relocate Central Hudson's headquarters. The Commission should require, as a condition of Merger approval, that the headquarters remain in Central Hudson's service territory unless approval is sought and received from the Commission to relocate outside of the Company's service territory. This condition will preserve the benefit of a focused and responsive Board of Directors. In addition, the Company's Standards of Conduct should be updated to address potential Board of Director's conflicts of interest.

Q. Please explain.

A. Central Hudson's current Standards of Conduct established in Case 96-E-0909 does not address conflicts of interest with the Board of Directors. We propose modifications to the Standard of Conduct, including conflicts of interest provisions, later and in Exhibit___(PP-5).

B. Service Quality

Q. How have the Petitioners addressed service quality?

A. Page 26 of the Panel Testimony states that the Rate Plan Central Hudson is operating under includes a comprehensive set of service quality metrics and incentives. On page 27, the Panel Testimony claims that by providing continuity in management and operations, customer service will continue at, or above, current levels.

Q. Did the Commission consider the Merger when it approved Central Hudson’s current customer service metrics and incentives?

A. No.

Q. Do the Petitioners believe that there will be positive impacts to service quality stemming from this transaction?

A. Central Hudson’s response to IR MI-14 claims that the acquisition will produce positive impacts to the quality of service provided to Central Hudson’s customers over time.

Q. Did the Petitioners present any evidence that service quality would be enhanced as a result of the Merger?

A. No, and since Fortis claims that it will not interfere and let Central Hudson's management run the utility, we do not see how service quality would be enhanced. In addition, there are no proposed terms and conditions in the Petition or Panel Testimony that ensure increased or enhanced service quality, safety, or reliability in the future. The stated reliance upon current management underscores the fact that Fortis will not bring any meaningful improvements to the levels of customer service currently present at Central Hudson.

Q. Are there additional risks related to this transaction that should be considered when reviewing the service quality metrics and incentives?

A. Yes. The Merger has financial risks that cause us to have concern about the appropriate incentive levels for the service quality metrics.

Q. How should the risks be mitigated?

A. The testimony of Ms. Ferrer, the Gas Safety Panel and Ms. Cornelius make recommendations that better mitigate the risks associated with the Merger.

Q. Has the Commission addressed increased risk from a merger transaction?

A. Yes. The Commission adopted more stringent incentives in the National Grid/Keyspan Order and Iberdrola Merger Order to protect customers from service quality, reliability and safety degradation. The testimony of Ms. Ferrer, the Gas Safety Panel and Ms. Cornelius follow the Commission's recommendations in those cases to protect Central Hudson's customers.

Q. Why are reliability, safety and customer service provisions so vitally important?

A. Such provisions are required to deter performance degradation and provide incentives for continued electric system, gas system, and customer service improvements.

C. Financial Integrity

1) Goodwill and Acquisition Costs

Q. Did the Panel Testimony address Goodwill and acquisition costs generated by the Merger?

A. Yes, page 28, line 18 through page 29, line 4 of the Panel Testimony states, "Central Hudson and Fortis agree that there will be no recovery in Central Hudson customer rates, or recognition in the determination of rate base or earned returns for New York State regulatory reporting purposes, of: (i) legal and financial advisory fees or other costs associated with Fortis's acquisition of CHEG; or, (ii) any premium above net book value paid by Fortis associated with its acquisition of CHEG.”

i. Acquisition Costs

Q. Did Staff request the Petitioners to provide an estimate of the one-time incremental costs to achieve the Merger?

A. Yes, in their response to IR DPS-M2 (DPS-202), the Petitioners estimated that the one-time incremental costs to achieve the merger were approximately $15.5 million for Fortis and $14.8 million for Central Hudson, for a total of approximately $30.3 million.

Q. Would you summarize what these costs consist of?

A. Fortis’s costs primarily consist of an investment banking fee, legal and advisory fees, filing fees as well as miscellaneous assessments. Central Hudson’s costs are said to primarily consist of legal and advisory fees, equity compensation, an investment banking fee and the costs to redeem its outstanding Preferred Stock.

Q. Did Central Hudson explain what it meant by “equity compensation”?

A. Yes, the response stated, “the only one-time incremental labor costs for Central Hudson employees are those associated with the Long-term Incentive Program (LTIP). As a result of the announcement of the merger, Central Hudson’s stock price increased, resulting in a higher expense for the three grant periods outstanding for the LTIP. The one-time incremental portion of the expense was calculated using the amount by which Central Hudson’s stock price on March 31, 2012 exceeded the price on December 31, 2011. Additionally, the Merger Agreement provides for an accelerated payout of the LTIP grants for the 2011-2013 and 2012-2014 periods, contingent on closing the merger. These costs have been, and will continue to be, recorded at the holding company without any allocation to Central Hudson.”

Q. Are there other costs that should be considered?

A. Yes, payroll and payroll related costs of

Central Hudson and Fortis employee costs for those who worked on the Merger. Thus, Staff asked for the information for both companies in IR DPS-M281 (DPS-481). Fortis responded that employees working on the Central Hudson acquisition are not tracked separately, and the information is therefore not available as requested. However, Fortis noted that payroll and payroll overhead costs charged to FortisUS by employees of Fortis' regulated subsidiaries who have worked on due diligence and other matters related to the Merger prior to the filing of the Petition and which have been charged to FortisUS in accordance with each utility's regulator-approved guidelines related to affiliate transactions total $152,619. Central Hudson responded that it does not have the requested information, as payroll is not tracked at this level of detail. Central Hudson went on to "clarify" that the intention of the proposal was limited to just incremental costs of outside services related to completing the transaction, and not to activities of Central Hudson employees.

Q. Does Central Hudson’s response concern you?

A. Yes, the Rate Plan that Central Hudson is operating under and proposes to extend with modifications includes an earnings-sharing provision. As Central Hudson is not keeping track of the payroll and payroll related costs of Central Hudson employees working on the Merger it cannot make the necessary adjustment to eliminate those costs from the earnings calculation it is required to make and file with the Commission pursuant to the rate plan’s earnings-sharing provision. As a result, Central Hudson’s customers may indirectly be forced to pay for the costs of a Merger that may not even be approved or executed.

Q. What is your recommendation regarding the acquisition costs of this Merger?

A. The costs to consummate the Merger should not be borne by Central Hudson’s customers and to insure this doesn’t happen, the Petitioners should start tracking the costs immediately and also be required, as a condition of receiving Commission approval of the Merger, to submit a schedule detailing the final acquisition costs within 60 days after the issuance of a Commission order in this proceeding. For those costs related to CH Energy, the schedule should specify on which company's books the costs are recorded and for Central Hudson, in which accounts the costs are recorded. Additionally, Central Hudson should be required, regardless of results of this proceeding, to provide an estimate of the payroll and payroll related costs of Central Hudson employees that have worked on the Merger so the necessary adjustment can be made to the earnings calculation required by the earnings-sharing provision of the Rate Plan.

ii. Goodwill

Q. You described Goodwill and the amount of Goodwill that is expected to result from the Merger earlier. Are there any other accounting issues related to Goodwill you wish to address?

A. Yes, under United States Generally Accepted Accounting Principles (US GAAP), which Fortis adopted January 1, 2012, Goodwill must be tested annually for impairment (Accounting Standards Codification (ASC) Topic 350, Intangibles –

Goodwill and Other). As a result, Fortis may have to write-off some or all of the substantial Goodwill it expects to record on its books as a result of the Merger.

Q. If Fortis has to impair the Goodwill recorded on its books at some point in the future, could that affect Central Hudson negatively?

A. In IR DPS-M130 (DPS-330), Fortis responded that Goodwill impairment is fundamentally a risk only to Fortis shareholders. However, we believe that a significant amount of impairment at the Fortis level could affect its bond rating negatively, which in turn could affect Central Hudson's ability to access capital.

Q. Do you propose anything to help alleviate such impairment potential?

A. Yes, should Fortis's bond ratings drop, causing Central Hudson's debt costs to increase, the Commission may wish to impute a debt cost for Central Hudson in the following rate case equivalent to that of an "A" rating.

A. How much Goodwill will result from the proposed acquisition of Central Hudson by Fortis?

Q. Fortis's response to IR DPS-M73 (DPS-273) estimates the proposed transaction will create $444 million of incremental Goodwill on Fortis's balance sheet when the merger is executed.

Q. How much Goodwill does Fortis currently have on its balance sheet?

A. According to its 2011 Annual Report to Shareholders, at December 31, 2011 Fortis had $1.565 billion (Canadian) of Goodwill on its balance sheet, which represents approximately 40.9% of its common equity.

Q. What is the pro forma percentage of Goodwill to common equity for Fortis if the merger is approved?

A. In response to IR DPS-M130 (DPS-330), Fortis estimated that its Goodwill to common equity percentage would be approximately 46.7% after the Merger with CH Energy.

Q. How does this level of Goodwill compare with other utilities in New York State?

A. It is greater than most. Consolidated Edison Inc., the parent for Consolidated Edison of New York, Inc. and Orange and Rockland Utilities, Inc. had a goodwill/common equity ratio of 3.8% at December 31, 2011. National Fuel Gas

Company, the parent for National Fuel Gas Distribution Company had a goodwill/common equity ratio of .30% at September 30, 2011. Iberdrola, S.A. and Subsidiaries, the parent of New York State Electric and Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E) had a goodwill/common equity ratio of 25.2% at December 31, 2011. National Grid, the parent of Niagara Mohawk, KeySpan Energy New York and KeySpan Energy Long Island, had a goodwill/common equity ratio of 51.7% at March 31, 2012. The calculation for these ratios is provided in Exhibit__(PP-4).

Q. Do the rating agencies discuss Goodwill in relation to ratings or risk in recent rating reports?

A. No, we did not see the level of Goodwill discussed in any recent rating agency reports for either Fortis or Central Hudson. However, Central Hudson’s current parent has a goodwill/common equity ratio of 7.5%, so if the Merger is executed Central Hudson will have a parent company with significantly more Goodwill on its consolidated balance sheet.

Q. Did the Iberdrola Merger Order discuss the level of Goodwill resulting from the merger as Iberdrola acquired NYSEG and RG&E?

A. Yes, Goodwill is discussed on pages 26-28 of the January 6, 2009 Iberdrola Merger Order. Specifically, in the Order it was estimated that Iberdrola would have a total of $14.9 billion of goodwill (34% of its equity) on its books after the proposed merger. In the Order it is stated, “Goodwill is of particular concern for regulated utilities because the regulatory process limits their revenue allowance by applying a pre-tax return allowance to an original cost rate base, and thus limits their ability to generate cash flow. To support goodwill, utilities must therefore consistently earn above-normal profits on their tangible earning assets. If an annual goodwill impairment test shows earnings and cash flows from tangible assets do not support goodwill, it must be written off. Iberdrola’s sizeable goodwill balance puts financial pressure on it to produce supporting cash flows or face significant write-offs that could have a serious impact on the company.”

Q. Would you please elaborate on the serious impact a significant impairment and subsequent write-off of Goodwill by Fortis could have on Central Hudson and its customers?

A. If Fortis had a significant impairment of Goodwill, this could potentially affect Central Hudson’s ability to receive equity infusions from Fortis. In addition, impairment of goodwill at Fortis’s level could cause its credit rating to drop, which more than likely would cause Central Hudson’s rating to drop and this could deter Central Hudson’s access to the debt markets at reasonable terms.

Q. How much goodwill does Iberdrola currently have on its balance sheet?

A. At December 31, 2011 Iberdrola had 8.3 billion Euros of goodwill, which is approximately $10.8 billion. This represents 25.2% of its equity as shown on Exhibit__(PP-4).

Q. Do regulatory agencies allow a return on Goodwill?

A. No. This is another reason why large amount of Goodwill adds additional risk.

Q. If Central Hudson is acquired by Fortis, what about the risk of the parent company in terms of Goodwill?

A. Central Hudson's parent, CH Energy Group, has approximately 7.5% of goodwill/equity on its balance sheet. If Central Hudson is acquired by Fortis, there will be approximately 46.7% goodwill/equity on Fortis's balance sheet. Central Hudson would then become part of a holding company with significantly more Goodwill risk.

Q. What about the future acquisitions by Fortis and Goodwill?

A. On Page 9, lines 8-10 of the Panel Testimony it is stated, "To complement this growth and diversify risk, Fortis pursues acquisitions of regulated utilities in the United States and Canada that fit the Fortis operating model." If Fortis does in fact acquire companies in the future at a premium over book value, there will be additional Goodwill on the balance sheet for Fortis and depending on the equity ratio at the time, it could possibly increase Fortis's goodwill/equity ratio.

Q. Does this concern with the high level of

Goodwill resulting from the Merger impact any of your recommendations?

A. Yes, as elaborated later, because of the added risk that will result because of high level of Goodwill the Petitioners indicate will result from the Merger, the Petitioners need to provide Central Hudson's customers more PBAs in order for the Commission to conclude the Merger is in the public interest.

2) Credit Quality and Dividend Restrictions

Q. What commitments do the Petitioners make regarding credit quality and dividend restrictions?

A. These commitments are described on page 29, line 6 through page 30, line 2 of the Panel Testimony and are also listed later. The last three refer to the Restructuring Settlement Agreement (RSA) approved by the Commission in Case 96-E-0909, Order Adopting Terms of Settlement Subject to Modifications and Conditions (issued February 19, 1998), which was the proceeding that deregulated Central Hudson's electric generation operations.

a) Central Hudson will maintain, on a basis consistent with Commission orders and accounting practices, a common equity ratio reasonably consistent with that determined by the Commission from time to time to be reasonable for ratemaking purposes.

b) The Petitioners will continue to support the objective of maintaining an "A" rating for Central Hudson, unless and until the Commission modifies its financial integrity policies.

c) Central Hudson will continue to comply with the RSA with respect to any restrictions on the payment of common dividends related to credit ratings.

d) Consistent with RSA, Central Hudson will maintain separate debt instruments and will maintain its own corporate and debt credit ratings with at least two nationally recognized credit rating agencies. Neither Fortis nor Central Hudson will enter into any credit or debt instrument containing cross default provisions that would affect Central Hudson.

e) Consistent with the RSA, Central Hudson will not lend to, guarantee or financially support Fortis or its affiliates, or any subsidiary or other joint venture of Central Hudson. Furthermore, Central Hudson will not engage in, provide financial support to or guarantee any non-regulated businesses, except as may have been authorized in the RSA or by Commission Order subsequent to the closing of the acquisition.

Q. What is your recommendation regarding these proposed commitments?

A. We find these commitments are necessary customer protections and should be conditions if the Commission is to approve the Merger. In addition, there should be a condition that if the bond rating for Fortis is reduced by one or more rating agency, which in turn increases Central Hudson's cost of debt, the Commission may impute an "A" rated cost of debt in the Company's next rate case.

Q. Why do you believe this additional condition is necessary?

A. Central Hudson has a Standard and Poor's (S&P)

rating of “A-” and a Moody’s rating of “A3.” As elaborated earlier, we are concerned that Fortis has a significant amount of Goodwill on its balance sheet. If Fortis has to make a material write-off of the Goodwill recorded on its books because it becomes impaired under US GAAP, Fortis’s bond ratings may drop, which could affect Central Hudson’s ability to access debt at reasonable terms.

3) Money Pooling

Q. Would you please describe the Petitioners proposed commitment regarding money pooling?

A. The Panel Testimony (at page 30) states that if the Commission would approve the Merger, Fortis would commit to Central Hudson maintaining banking, committed credit facilities and cash management arrangements that are separate from other affiliates. Central Hudson could participate in money pooling arrangements only if all other participants are U.S. regulated utilities, in which case Central Hudson could participate as either a borrower or a lender. Central Hudson could not participate in a money pooling arrangement in which any participant directly or indirectly loans or transfers funds to FortisUS or Fortis Inc.

Q. What is your recommendation regarding money pooling?

A. This commitment is similar to one adopted by the Commission in the Iberdrola Order and should be a condition adopted by the Commission if it approves the Merger proposed in this proceeding.

4) Special Class of Preferred Stock

Q. Do the Petitioners propose to make a commitment related to a potential bankruptcy?

A. Yes, to align Central Hudson's post-acquisition operations with customers' interests in avoiding potential risks and to preserve credit quality, Central Hudson, with Fortis's support, promises to use its best efforts to take the necessary steps to establish a special class of preferred stock consisting of a single share with a voting right or alternative means to prevent a bankruptcy, liquidation, receivership or similar proceeding (bankruptcy) of Central Hudson being caused by a bankruptcy of Fortis or its affiliates.

If Central Hudson and Fortis are unable to meet this commitment despite good faith efforts to do so, they would petition the Commission for relief from this commitment. The petition would explain why the commitment cannot be met and what Central Hudson and Fortis propose to do to mitigate any risk that a bankruptcy involving Fortis or any of its affiliates will cause Central Hudson to voluntarily enter bankruptcy.

Finally, Central Hudson will maintain its capital structure on a stand-alone basis that is consistent with the capital structure used in establishing rates. Central Hudson will maintain separate (stand-alone) credit ratings on its long-term debt issues with at least two independent nationally recognized credit rating agencies.

Q. What is your recommendation for this proposed commitment?

A. This proposed commitment mirrors a condition adopted by the Commission in the January 6, 2009 Iberdrola Merger Order (pp. 43-44) that describe the single share of preferred stock that would be established as a “golden share” that would prevent a bankruptcy of the parent or any of its affiliates from triggering a voluntary bankruptcy of the regulated utility. Thus, a like condition should be adopted here.

5) Financial Transparency and Reporting

Q. Would you please describe the commitments the Petitioners say they will make regarding financial transparency and reporting?

A. These commitments are described on pages 31-32 of the Panel testimony and summarized below.

a) The Petitioners will continue to use US GAAP for financial reporting purposes.

b) The Petitioners will (i) maintain separate books and records; and (ii) agree to prohibitions against loans or pledges of utility assets to Fortis.

c) Central Hudson will comply with the provisions of the Sarbanes-Oxley Act (SOX) as if it were still legally obliged to do so. Central Hudson's periodic statutory financial reports must continue to include certifications provided by its officers concerning compliance with SOX requirements as if still bound directly by the provisions of SOX. An independent audit opinion on internal controls will not be required; however, Central Hudson would remain subject to annual financial statement audits by an independent auditor.

d) Subject to the confidentiality and privilege provisions of the RSA, Staff will be given access to the books and records, including, but not limited to, tax returns, of Fortis and its affiliates to the extent necessary to determine whether Central Hudson’s rates are just and reasonable.

e) Fortis will annually file its consolidated financial statements, including balance sheets, income statements, cash flow statements and the related notes, with the Commission.

Q. What is your recommendation regarding these proposed commitments?

A. Except for part of the commitments related to SOX, we find these commitments as necessary conditions for the Commission to approve the Merger. For the most part, they mirror similar conditions included in Appendix 1 of the January 6, 2009 Iberdrola Order.

Q. What is SOX?

A. SOX is the U.S. federal law enacted July 29, 2002 that set new or enhanced standards for all public company boards, management and public accounting firms in a reaction to a number of major corporate and accounting scandals, the most memorable one being related to Enron. As Central Hudson will be a subsidiary of Canadian-based Fortis, it arguably will no longer be subject to SOX’s requirements.

Q. What part of the Petitioners proposed commitment related to SOX do you disagree with?

A. We disagree with the proposal to ignore the requirement for an annual independent audit of Central Hudson’s internal controls because it is an integral part of SOX and it provides a strong deterrent for managers tempted to commit financial fraud.

Q. Did you ask an IR related to this proposed commitment?

A. Yes. IR DPS-M136 (DPS-336) asked Fortis to fully explain why it believes an independent audit opinion on internal controls should not be required consistent with Congress’s intent when passing SOX. The response concludes by saying:

> “The Fortis approach to monitoring management control generally and certifying internal controls over financial reporting and disclosure specifically provides Fortis (as the investor) with a high degree of assurance with respect to financial reporting by its utility operating subsidiaries. This approach avoids additional external audit fees to the Fortis subsidiaries aimed at assuring investor confidence and passes those savings on to the customers of its regulated utilities. These same cost savings will be available to the customers of Central Hudson Gas and Electric following closing.”

Q. Do you agree with this response?

A. No, the internal procedures described by Fortis do not provide the necessary assurance that the type of fraud SOX is meant to prevent does not happen because assertions of Fortis employees can never provide the required assurance provided by an independent audit.

Q. Do the revenue requirement forecasts for the year of the proposed rate freeze provided by Central Hudson reflect the costs savings from not having to do the independent audit of internal controls required by SOX?

A. No, Central Hudson’s response indicated that it couldn’t provide that information because it was billed for “an integrated audit that combines both the audit of the financial statements and internal controls.”

Q. Would you please summarize your recommendation regarding SOX if the Commission were to approve the Merger?

A. The Commission should only approve the Merger with a condition that Central Hudson will fully comply with SOX as it does now as a U.S. corporation.

6) <u>Affiliate Transactions, Cost Allocations and Code of Conduct</u>

Q. Does Central Hudson currently have Cost Allocation Guidelines and a Standard of Conduct?

A. Yes. DPS-M46 (DPS-246) indicates that Central

Hudson currently follows the Cost Allocation Guidelines and Standard of Conduct provisions established in Case 96-E-0909, the proceeding that restructured Central Hudson to provide customers competitive choice for the commodity portion of their bills. These Cost Allocation Guidelines and Standard of Conduct provision were provided in Attachment H and Attachment I, respectively, of the Settlement Agreement adopted by the Commission in Case 96-E-0909, Order Adopting Terms of Settlement Subject to Modifications (issued February 19, 1998).

Q. Does Central Hudson propose any modifications to these Cost Allocation Guidelines and Standard of Conduct due to the proposed merger?

A. In the above mentioned response, Central Hudson indicates that it proposes the Cost Allocation Guidelines and Standard of Conduct currently in effect continue to apply post-Merger.

Q. Does Fortis have Cost Allocation Guidelines?

A. IR response DPS-M47 (DPS-247) indicates that Fortis does not have Cost Allocation Guidelines.

Q. Have Central Hudson’s Cost Allocation Guidelines been addressed recently?

A. Yes, Chapter III, Corporate Mission, Objectives Goals and Planning of the Management Audit Report discussed earlier addressed Central Hudson’s Cost Allocation Guidelines and made certain recommendations that are being implemented.

Q. Does this mean that Central Hudson’s Cost Allocation Guidelines are adequate for its operations post-Merger, if the Commission were to ultimately approve the Merger?

A. Not necessarily, when the consultants that performed the Management Audit did their examination of Central Hudson’s Cost Allocation Guidelines, the Company had recently indicated that it was curtailing its nonregulated activities (See CH Energy 2010 Annual Report to Shareholders, p. 2) and there was no indication that a merger with a non-U.S. holding company like the one proposed here was even a remote possibility.

Q. What is your recommendation regarding Central Hudson’s Cost Allocation Guidelines?

A. To the extent the level of intercompany transactions stay at or near the level they have been in recent years, we find Central Hudson’s Cost Allocation Guidelines adequate. However, they may not fully consider conditions that could result if the level of intercompany transactions grows materially as a result of the Merger. Information that the Company provided Staff in past rate cases and as part of Staff’s review of Central Hudson’s progress implementing the Management Audit’s recommendations indicates the total amount of intercompany transactions has always been less than $1 million dollars. If Central Hudson forecasts at any point in time that the level of intercompany transactions will be greater than $1 million in any given calendar year, we recommend the Company, as a condition of receiving approval of the Merger, be required to the notify the Secretary of the Commission that it expects intercompany transactions to total over $1 million in a calendar year. The Secretary of the Commission should then issue a Notice to interested parties that a collaborative is being instituted to assess if Central Hudson’s Cost Allocation Guidelines continue to be adequate.

Q. Does Fortis have a Standard of Conduct governing relationships among its subsidiaries?

A. IR response DPS-M48 (DPS-248) indicates that four of Fortis's regulated companies have codes of conduct and/or transfer pricing policies.

Q. Do you believe that Central Hudson's Standard of Conduct should be updated?

A. Yes and we have attached our proposed Standard of Conduct as Exhibit___(PP-5).

Q. Please explain.

A. The current Standard of Conduct document is somewhat dated and was established for a domestic holding company. Further, since 1996, the Standards of Conduct applicable to other jurisdictional companies have been updated in merger proceedings including the KeySpan/National Grid and Iberdrola merger proceedings.

Q. Can you provide a few examples of areas of the Standards of Conduct you recommend be updated?

A. The areas we propose be updated include: (1) the organizational structure, (2) governance and separation of utility business, (3) affiliate transactions, (4) conflicts of interest, (5) certification and training on the standards, (6) cost allocations, (7) resource sharing, (8) audits, and (9) reporting.

7) <u>Follow-on Merger Savings</u>

Q. Would you please describe the Petitioners proposed commitment for follow-on merger savings?

A. The Petitioners state that if Fortis completes any additional mergers or acquisitions in the U.S. before the Commission adopts an order approving new rates for Central Hudson and the additional merger or acquisition creates savings which would be reasonably applicable for the benefit of Central Hudson or its customers, then Fortis will share such follow-on merger savings, to the extent such savings are material (i.e., 5 percent or more of Central Hudson net income on an after-tax basis), between shareholders and customers.

Q. Do you agree with this proposed commitment?

A. Yes, it is consistent with a like condition adopted in the January 6, 2009 Iberdrola Merger Order (p. 51) and should be a condition of any Commission Order approving the Merger proposed here.

D. PROPOSED RATE PROVISIONS

1) Background

Q. Would you please summarize the Petitioners position regarding Central Hudson's rates in this proceeding?

A. The Petitioners propose a rate freeze for the year after the Rate Plan Central Hudson is currently operating under expires, the twelve months ended June 30, 2014, based on the same terms as the third year of the Rate Plan. However, they would modify the Earnings Sharing Mechanism provided for in Section VI.D of the Rate Plan in a manner they claim will limit any overearnings. Specifically, the Petitioners would lower the thresholds for earnings sharing by 50 basis points and eliminate the initial dead band. The Petitioners contend these provisions eliminate the potential risk that rates could become excessive post-merger. Finally, the Petitioners commit to filing a general rate application to become effective no earlier than July 1, 2014. (Panel Testimony, pages 27, 33-34)

Q   Did the Petitioners provide any information regarding the value of their proposed rate freeze?

A.   No. Thus, Staff asked numerous rate related electric and gas IRs. Subsequently, Staff and the Petitioners reached an agreement whereby Central Hudson would respond to the IRs plus provide the revenue requirement information it would provide in major rate case for the year it proposed to freeze rates, the 12 months ended June 30, 2014. Central Hudson provided most of this information to Staff on June 21, 2012.

2) <u>Revenue Requirement Information</u>

Q.   Would you summarize the revenue requirement information Central Hudson provided Staff on June 21, 2012?

A.   The information was in effect rate case workpapers that Central Hudson would have provided supporting the Exhibits that would have detailed and supported the proposed electric and gas revenue requirements for the twelve months ended June 30, 2014.

Q.   How much were the proposed revenue requirements?

A.   For electric, $39.2 million or 14.2% of delivery revenues before the proposed rate increase and for gas, $3.8 million or 5.0% of delivery revenues before the proposed rate increase.

Q. Does the total of these two amounts, $43 million, represent the value to Central Hudson’s customers of the proposed rate freeze for the twelve months ended June 30, 2014?

A. No, Central Hudson’s revenue requirement estimates reflected its best estimate of the base rate increases Central Hudson would have requested for the 12 months ended June 30, 2014 if the Merger Agreement with Fortis had not been reached. As a result, it assumed the provisions for the third rate year of the current Rate Plan would not be in effect for the twelve months ended June 30, 2014 as the Petitioners propose as part of the rate freeze. Thus, the proposed rate increases include: 1) amounts that would be deferred pursuant to the rate plan; 2) the establishment of a storm damage reserve and the amortization of storm costs Central Hudson is requesting deferral accounting treatment for in petitions that it would have reflected in a general rate filing for the 12 months ended June

30, 2014 if not for the Merger; and 3) resetting amounts in base rates for items that are part of mechanisms, such as the Revenue Adjustment Mechanisms it currently employs pursuant to prior Commission Orders, that result in it fully recovering amounts related to the item regardless of whether or not it files a rate case.

Q. Did the Staff Infrastructure Panel review the Legacy Replacement Program?

A. Yes.

Q. What was that Panel's conclusion?

A. The Staff Infrastructure Panel does not recommend including the Legacy Replacement Program expenditures in the net plant target because the Central Hudson's executive management and Board of Directs have not yet approved a plan.

Q. What are the estimated costs to replace the legacy system?

A. Central Hudson estimates the total cost of the legacy system replacement to be between $49 million and $63 million over a five year period.

Q. Are you concerned with the proposed level of spending?

A. Yes, because of the potential rate impacts on customers.

Q. How do you recommend Central Hudson proceed?

A. Central Hudson should continue to explore its alternatives, get approval from its Board of Directors and have Commission approval before it moves forward with a plan to replace its legacy system.

Q. Would you please explain Exhibit__(PP-6)?

A. Exhibit__(PP-6) consists of two schedules. Schedule A analyzes the electric revenue requirement information Central Hudson provided on June 21, 2012 and Schedule B provides a like analysis for the gas revenue requirement information. Page 1 of both Schedules consists of four columns. Column 1 on that page describes the major cost components of Central Hudson’s estimated revenue requirements for the 12 months ended June 30, 2014. Column 2 on page 1 of Schedules A and B provides a revenue requirement reconciliation between the estimates provided by Central Hudson on June 21, 2012 and the revenue requirement forecasts agreed to for the third rate year of the Rate Plan.

Column 3 on page 1 of both Schedules in Exhibit__(PP-6), labeled “Stayout Adjustments,” reflects the items referred to earlier that Central Hudson will continue to collect from customers at some point because of the extension of the deferral provisions of the Rate Plan, operation of other Commission-approved mechanisms that result in the actual amount of the item being trued-up with the amount allowed in base rates and the impact other items Central Hudson estimates that it would have included in a general rate filing for the 12 months ended June 30, 2014 if the Merger Agreement had not been signed. These adjustments are explained on page 2 of Schedules A and B of Exhibit__(PP-6).

Column 4 on page 1 of Schedules A and B of Exhibit__(PP-6) is the extension of columns 2 and 3.

Q. Would you please describe what you mean by “revenue requirement reconciliation”?

A. A revenue requirement reconciliation is a tool used by Staff that breaks down the utility’s proposed revenue change by its primary causes.

As a result, it helps explain why the utility believes it needs to change rates.

Q. Would you please summarize what Exhibit__(PP-6) shows?

A. Although the revenue requirement information provided by Central Hudson on June 21, 2012 computed an electric rate increase of $39.2 million and gas rate increase of $3.8 million, once the full impact of Central Hudson's rate freeze proposal plus the other rate mechanisms available to it are considered the value of the rate freeze based on the estimates is only $6.0 million for electric and $3.0 million for gas.

Q. Is the value of the proposed rate freeze then $9.0 million?

A. No, as elaborated in the next section, Staff's examination of the Revenue Requirement Information filed by Company on June 21, 2012, revealed that the proposed rate freeze is of no value to customers for purposes of determining if the Merger is in the public interest.

3) Staff Examination

Q. Would you please summarize Staff's examination of the revenue requirement information provided by Central Hudson on June 21, 2012?

A. Staff examined that information in the same manner that it would examine a major rate filing. Staff's findings and recommendations as a result of that examination, except for the recommended capital structure and rate of return that is provided later, are detailed in the testimony of the A&F Rates Panel, the Staff Infrastructure Panel and the Gas Safety Panel.

4) <u>Rate of Return</u>

a) <u>Fair Rate of Return</u>

Q. Generally speaking, what is a fair rate of return for a regulated utility?

A. A fair rate of return for a regulated utility is one that enables it to provide safe and adequate service to its customers, while assuring it continuing support in the capital markets for both its debt and equity securities, at terms that are reasonable given the company's level of risk.

Q. Please explain why there is a difference between the cost of debt and the cost of equity?

A. Investors in debt securities enter into contractual obligations with the utility in exchange for receive relatively fixed income streams. Common equity investment, on the other hand, is non-contractual. Common equity investors may share in, but are not guaranteed, a portion of the utility’s residual earnings. The fair rate of return, therefore, allows the utility to recover its prudently incurred cost of debt, while providing its common equity investors with the opportunity to earn a return commensurate with the risk of their investment.

Q. How is a fair rate of return calculated?

A. Generally, in New York State, the fair rate of return for a utility company is calculated through a weighted average of the individual cost components of its expected capitalization during the rate year. Thus, determining the proper capital structure for setting rates involves forecasting and reconciling a company’s sources of capital together with its capital requirements.

Turning to the cost rates of the individual components, the cost of the long-term debt component is usually a relatively simple computation. This is because in return for lending money to the company, debt holders receive returns in the form of contractual payments of interest and principal. Debt financing is obtained from public sources or private sources like banks and non-bank lenders. Additionally, the Commission prescribes the cost of customer deposits. The common equity component is neither contractual nor prescribed by the Commission. Its calculation is further complicated by the fact that it cannot be directly observed. It is important to remember that while both debt and equity holders supply the utility with the funds it needs to build and operate its system, the equity investors only earn a return after the payment of all other expenses, including debt costs. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by equity investors is usually higher than that of the utility’s debt holders.

The expected return requirements of a utility’s common equity investors can only be gleaned through a cost of equity analysis. Generally, methodologies such as the Discounted

Cash Flow (DCF) and the Capital Asset Pricing Model (CAPM) are employed to estimate the return required by equity investors.

b) Capital Structure

Q. What capital structure did Central Hudson use in its revenue requirement forecasts for the 12 months ended (TME) June 30, 2014?

A. Central Hudson used the following capital structure. The amounts shown are in millions of dollars.

	Amount	Ratio
Long-Term Debt	$514	51.3%
Customer Deposits	7	.7%
Common Equity	480	48.0%
Total	$1,001	100.0%

Q. How did Central Hudson determine this capital structure?

A. Central Hudson basically updated the Capital Structure used to set rates for the third year of the Rate Plan. The 48% common equity ratio is the same equity ratio that was used to set rates for the third rate year of the Rate Plan.

Q. Did the capital structure that was used to set rates for the third rate year of the Rate Plan include any other component not included in the capital structure used by Central Hudson for TME June 30, 2014?

A   Yes, 2% of that capital structure was for preferred stock that Central Hudson has or plans to reacquire in anticipation of the Merger. See Case 12-M-0172, Central Hudson-Financing, Order Authorizing Issuance of Securities (issued September 14, 2012) pp. 7-8 (referred to as the "New Securities Order").

Q. Did you ask any IRs regarding what equity ratio Central Hudson would be requesting in future rate cases as a Fortis subsidiary?

A. In IR DPS-M65 (DPS-265), Fortis was asked, "When Central Hudson files a rate case, will the company request an equity ratio in line with the parent and most of the subsidiaries of 40%? If not, please explain." The Company responded in part, "Central Hudson assumes both that: (i) current Commission policy will continue and (ii) a 48% equity ratio is consistent with rating agency expectations for maintenance of its A-level credit ratings. Central Hudson plans to maintain an equity ratio of no less than 48% in the future and expects to include a minimum of 48% equity ratio in its next rate filing."

Q. What capital structure do you propose be used for valuing the rate freeze the Petitioners propose for the TME June 30, 2014?

A. Staff proposes the capital structure used by Central Hudson in its revenue requirement forecasts for the TME June 30, 2014 be used to value the rate freeze.

Q. Did you consider any other capital structure for valuing the proposed rate freeze?

A. Yes, we considered recommending the consolidated capital structure of Fortis to value the rate freeze versus the stand-alone capital structure used by Central Hudson. We will discuss later in this testimony.

c) Cost Rates

Q. What cost rates do you recommend be used in the Capital Structure used to value the rate freeze for the TME June 30, 2014?

A. We recommend 5.11% for the cost of debt, 2.45% for customer deposits and 8.90% for the return on common equity (ROE) as shown on Exhibit__(PP-8).

Q. Explain where these cost rates came from.

A. The debt and the customer deposit cost rates are from the Capital Structure for the 12 months ended June 30, 2014 included in the revenue requirement information that Central Hudson provided Staff on June 21, 2012. The ROE of 8.9% is the current unadjusted result using the Commission's standard methodology of applying a 1/3 discounted cash flow and 2/3 Capital Asset Pricing Model weightings to a group of companies of similar risk (referred to as the "proxy group"). It is also the ROE that is being recommended by Staff in the current Niagara Mohawk electric and gas rate cases, 12-E-0201 and 12-G-0202.

Q. Why is the ROE recommended by Staff in the Niagara Mohawk rate cases appropriate for valuing the rate freeze proposed in this proceeding for the TME June 30, 2014?

A. Central Hudson used an ROE of 10.0%, which is from the Rate Plan approved over two years ago, and the Petitioners did not attempt to justify why that ROE is still appropriate. Given the changed circumstances since the Commission approved the Rate Plan, primarily lower interest rates, using a 10.0% ROE is inappropriate. The 8.9% ROE Staff is recommending for Niagara Mohawk is the current unadjusted ROE using the Commission's standard methodology for determining the ROE in rate cases and provides a reasonable estimate of the ROE the Commission would allow Central Hudson at this time as the companies are similar of risk.

Q. Earlier in your testimony it was mentioned that you considered using the consolidated capital structure of Fortis in valuing the rate freeze. Please explain.

A. Fortis's consolidated capital structure at December 31, 2011, from its 2011 Annual Report to Shareholders, is as follows:

(Amounts are in millions of Canadian dollars)

	Amount	Ratio
Long-Term Debt	$5,685	54.6%
Preference Shares	912	8.7%
Common Equity	3,823	36.7%
Total	$10,420	100.0%

The primary difference between Central Hudson's and Fortis's capital structure is the common equity ratio of 36.7% for Fortis versus 48.0% for Central Hudson. If the cost rates applied to the components of the two capital structures are assumed to be the same, using the Fortis consolidated capital structure versus Central Hudson’s stand-alone capital structure would indicate that a substantially lower revenue requirement is required for Central Hudson.

Q.   How are Fortis’s regulated utility subsidiaries financed?

A.   Each of Fortis’s regulated utilities is financed on a stand-alone basis as indicated on page 14 of the Panel Testimony.

Q.   How will Central Hudson be situated within Fortis if the Merger is approved?

A.   If the Merger is approved, Central Hudson’s common stock will no longer trade publicly as Central Hudson would become part of a holding company structure as shown on the Petitioner’s Exhibit 14, Page 1. As noted earlier, Central Hudson will be a subsidiary of CH Energy Group Inc., which will be owned by FortisUS Inc., a subsidiary of FortisUS Holdings Nova Scotia Limited that in turn will be a subsidiary of the ultimate parent, Fortis. Central Hudson will obtain equity capital indirectly from Fortis and debt will be raised by Central Hudson, as it does now (See Response to IR DPS-M121 (DPS-321).

Q. You state that debt will continue to be raised by Central Hudson. Will the markets that Central Hudson currently accesses remain the same?

A. Probably not. Central Hudson raises public debt primarily through registration with the United States SEC. If the Merger is approved Central Hudson may not stay registered with the SEC because it is costly and time consuming when raising public debt. As noted in the New Securities Order, Central Hudson asked for authority to issue debt and rely more on the private market for raising debt capital under SEC Rule 144A in that proceeding. Rule 144A is a safe harbor exemption from the registration requirements of the Securities Act of 1933 that allows companies to sell securities in the private market to qualified institutional buyers in a more timely fashion with less disclosures and filing requirements. While the New

Securities Order did not approve issuing debt through private markets in relation to the Merger, it did allow for use of 144A if the transaction results in reasonable savings.

Q. Please describe holding company structures in general and Fortis’s structure specifically?

A. A utility holding company reports its overall capital structure as part of its consolidated financial statements in the annual and quarterly reports it must file with the applicable federal regulator, the Securities and Exchange Commission in the U.S. and the Canadian Securities Administrators (CSA) in Canada. The consolidated balance sheet reflects the financial position of all of the holding company's operations. A holding company like Fortis has many utility subsidiaries, and thus contains many individual financial statements for its major subsidiaries, of which CH Energy would be but one part. Importantly, if the Merger is approved Central Hudson will no longer issue equity, as it will only receive equity indirectly from Fortis. Page 38, lines 12-20 of the Panel Testimony indicates that Central

Hudson will benefit from ready access to equity capital without the transactional costs associated with a public issue. Fortis's access to equity capital and equity infusions to its subsidiaries is one of the primary financial benefits of the proposed Merger discussed in the Panel Testimony as it supplies all the equity capital for its Canadian subsidiaries. On page 11 of the Panel Testimony it states that Fortis provided approximately $180 million of common equity to its regulated utility subsidiaries in 2011.

Q. What are the allowed common equity ratios for Fortis regulated utilities?

A. The majority of its subsidiaries have an allowed equity ratio of approximately 40% as shown in Exhibit__(PP-7).

Q. Do you think it is appropriate to use the capital structures of intermediate corporations that hold utilities, if they are only subsidiaries of a larger holding company?

A. While there may be instances in which such an approach might be warranted, a careful analysis of the holding company's financing practices is necessary to determine the appropriateness of such an approach. The capital structures for utility subsidiaries of holding companies may not reflect either rational capitalization policies or actual common equity employed, and therefore may not be suitable for establishing a utility’s rate of return. Ultimately, equity infusions come from the parent corporation, regardless of how many intermediate subsidiaries there are.

Q. Explain why the use of a subsidiary’s stand-alone capital structure may not be reasonable.

A. The subsidiary common equity balance reported by an intermediate subsidiary of a holding company may not, in fact, be financed by common equity at the holding company level. Rather, some of the utility’s common equity balance may instead be proceeds from debt issued at the holding company level and classified on the utility subsidiary's books as common equity at the time the proceeds were invested in the utility subsidiary. This is referred to as double leverage.

Q. Why did you conclude not to use Fortis’s equity ratio in the capitalization for Central Hudson in valuing the rate freeze?

A. Fortis’s capitalization at December 31, 2011 has an equity ratio of 36.7%. It is not appropriate to just use the equity ratio for Fortis, a Canadian company, and apply it to the capitalization for Central Hudson, a U.S. company, without considering the amount of leverage in the capitalization. By reducing the equity ratio, the debt ratio rises, which increases the leverage for Central Hudson. This added leverage could lead to more volatile earnings and a higher beta, which is a measure of volatility used in the CAPM ROE calculation.

Q. What exactly is meant by the term “beta”?

A. Beta is a measure of how closely correlated the return for a particular stock is to the return on the market as a whole. A beta of 1.0 indicates that the stock’s return mirrors the return of the market as a whole. Betas of less than one, which are typical for utility stocks, indicate that the stocks are less volatile than the market as a whole.

Q. What are the beta and equity ratio for the proxy group of U.S. electric and gas utility companies used to determine the recommended ROE of 8.9% in valuing the rate freeze?

A. The proxy group of U.S. utility companies had an average beta of .70 and an average equity ratio of 49.6%.

Q. What adjustment would you propose to the 8.9% ROE if you were recommending using Fortis’s consolidated equity ratio of 36.7% to value the rate freeze?

A. The change required to reflect the higher risk associated with Fortis’s equity ratio of 36.7% versus the 49.6% equity ratio of the proxy group used to determine the 8.9% ROE can be made by making what is referred to as the Hamada adjustment. This adjustment is computed by taking the beta used in the proxy group of .70 and recalculating the beta with no leverage. The beta with no leverage is then applied to the lower equity ratio (36.7%) and a new levered beta is calculated. The difference between the unlevered beta of the proxy group and the new levered beta is then used to arrive at a cost of equity that more appropriately reflects the lower equity ratio of 36.7%.

Q. What is the resulting Hamada adjustment to the ROE of 8.9% if you were to use Fortis's equity ratio of 36.7%, in the capitalization for Central Hudson?

A. The adjustment results in an additional 120 basis points to the ROE of 8.9%. This is shown on Exhibit__(PP-8).

Q. So, if Fortis's equity ratio of 36.7% is used to value the rate freeze for Central Hudson, the ROE should be increased from 8.9% to 10.1%?

A. Yes, as shown in Exhibit__(PP-8), using an equity ratio of a 36.7% in the capitalization for Central Hudson requires an ROE of 10.1%. This results in an overall cost of capital that is close to that of the capitalization using Central Hudson's equity ratio of 48.0% and the updated ROE of 8.90%.

Q. How does the ROE of 10.1% compare with the allowed returns for Fortis's regulated subsidiaries?

A. As discussed above, most of the allowed ROEs for Fortis's regulated subsidiaries are well below 10.1% despite the fact they have an equity ratio of approximately 40%.

Q. Don’t most New York State utilities have an equity ratio of 48% in their respective rate plans and isn’t part of the reason for this to allow them to access the credit markets at favorable terms and preserve their credit ratings?

A. Yes, but the subsidiaries of Fortis have had no difficulty accessing the credit markets and have maintained credit quality ratings in the “A” range. Page 16 of Fortis’s 2011 Annual Report states, “Long-term capital required to carry out the utility capital expenditure programs is mostly obtained at the regulated utility level. The regulated utilities issue debt at terms ranging from between 10 and 50 years....To help ensure uninterrupted access to capital and sufficient liquidity to fund capital programs and working capital requirements, the Corporation and its subsidiaries have approximately $2.2 billion in credit facilities, of which approximately $1.9 billion was unused at December 31, 2011. With strong credit ratings and conservative capital structures, the

Corporation and its regulated utilities expect to continue to have reasonable access to long-term capital in 2012." As stated previously, Fortis targets a capital structure with 40% and most of the subsidiaries also have an equity ratio of 40%.

So, while we do not recommend using the consolidated equity ratio of Fortis for Central Hudson in valuing the rate freeze, it does not appear to have prevented any of the subsidiaries of Fortis from accessing capital or affected their credit ratings. As we discussed earlier, this appears to be primarily due to the favorable opinion of credit rating agencies regarding the regulatory environment in Canada.

Q. What does Fortis target as an equity ratio?

A. Fortis's 2011 Annual Report states, "To help ensure access to capital, the Corporation targets a consolidated long-term capital structure containing approximately 40% equity, including preference shares, and 60% debt, as well as investment-grade credit ratings."

Q. Should the issue of using Central Hudson's stand-alone capital structure versus Fortis's consolidated capital structure to set Central Hudson’s rates be explored further?

A. Yes, although we are recommending the use of the stand-alone capital structure for valuing the rate freeze, it should not be inferred that will be Staff’s position in future Central Hudson rate cases.

Q. Why might Staff change its position on using Central Hudson’s stand-alone capital structure to set Central Hudson’s rate?

A. As we have explained, this is a very complex, technical matter. Additionally, this is Staff and the Commission’s first notable experience with Canadian utility and financial regulations and laws. Finally, neither the original filing in this proceeding, nor the revenue requirement information filed by Central Hudson, provided information related to Fortis’s Capital Structure. Thus, we were forced to do our analysis by asking IRs and performing our own independent research. As a result, we could not perform the detailed analysis needed to make a precise estimate of Fortis’s Capital Structure.

Q. What is your recommendation regarding this matter?

A. As a condition of the Commission the Merger, the Petitioners should commit, in Central Hudson's first rate case as a Fortis subsidiary, to provide a complete analysis of the Fortis consolidated capital structure and discuss how Fortis's Canadian regulated utilities can maintain investment grade ratings at or close to Central Hudson's ratings when customer rates are based on a 40% equity ratio (versus 48% for Central Hudson) in combination with allowed ROEs in the range of those being allowed by the Commission for New York utilities.

d) <u>Rating Agencies</u>

Q. Will the credit ratings for Central Hudson drop if it is acquired by Fortis?

A. Fortis has a Dominion Bond Rating Service (DBRS) rating of "A (low)" and a Standard and Poor's (S&P) rating of "A-" as shown in its response to MI-8. Central Hudson has an S&P rating of "A" and a Moody's rating of "A3." We cannot predict what the rating agencies will do regarding their current ratings if the Merger is approved, however, S&P did mention in an August 22, 2012

RatingsDirect report that, “Given that Central Hudson is being acquired by a lower rated company with a weaker financial risk profile, and based on the current structure of the Merger we would expect to lower our ratings on Central Hudson when the transaction closes.” This S&P report is provided in Exhibit__(PP-9).

Q. What do you think would happen to the credit ratings for Central Hudson if the Company had an equity ratio for its electric and gas rate plans that matched Fortis’s consolidated equity ratio of 36.7% you discussed previously?

A. Again, we cannot predict what rating agencies like S&P and Moody’s would do, as they have many qualitative and quantitative criteria that factor into establishing a credit rating for a company, however, several of Fortis subsidiaries have maintained “A” ratings with DBRS, S&P and Moody’s with a 40% allowed common equity ratio from their respective regulatory authority. The equity ratios for the Fortis’s subsidiaries are shown on Exhibit__(PP-9).

That being said, it is highly doubtful to believe that Central Hudson’s credit rating would strengthen post-Merger. It would appear that post-Merger there is a greater chance that the credit rating would remain the same, at best, or be lowered.

Q. You mentioned earlier the concept of double leverage, does it appear that Fortis has double leveraged its subsidiaries common equity?

A. Yes, and this will be discussed when we address the level of PBAs the Petitioners should be required to provide Central Hudson’s customers for the Commission to approve the Merger.

Q. Have any of the rating agencies mentioned double leverage in their credit reports of Fortis?

A. Yes. In a July 26, 2012 DBRS Rating Report it stated, “Fortis is currently rated the same as some of its subsidiaries (FortisBC Inc. and FortisAlberta Inc.), despite the structural subordination and double leverage at the parent.” The full report is shown in the Petitioners Exhibit__(PP-10).

5) Results of Staff’s Examination and Recommendation

Q. Would you please summarize the results of Staff’s examination of the revenue requirement information provided by Central Hudson on June 21, 2012 and your recommendations as to how the Commission should consider the proposed rate freeze when deciding if the Merger should be approved?

A. A&F Rates Panel Exhibit__(ARP-1) and Exhibit__(ARP-2) shows that based on the information provided by Central Hudson, Staff would recommend revenue requirements of approximately $24.4 million for Central Hudson’s electric operations and $638,000 for the Company’s gas operations. However, when the analysis described above and shown on Exhibit__(PP-6) is performed the value of the proposed rate freeze is an approximately negative $3.2 million for Electric and $893,000 for Gas. Thus, Staff concludes the rate freeze proposed by the Petitioners for the TME June 30, 2014 has no value to Central Hudson’s customers as proposed and should be ignored by the Commission when assessing whether or not the proposed merger is in the public interest.

Q. Do you have any further comments on the Company’s proposed rate freeze?

A. Yes, we have two. First, in order for Central Hudson to be allowed to increase base rates for the TME June 30, 2014 under the Commission's current rules for major rate filings it would have had to file for a rate increase by July 31, 2012. As Central Hudson did not make such a rate filing and has yet to make one, Central Hudson has forgone the opportunity to increase base rates regardless of the Commission's decision in this proceeding for at least three months of the proposed year it proposes to freeze rates. Thus, no value should be given to a rate freeze in this proceeding until Central Hudson actually makes a rate filing that would make the rate freeze a tangible benefit to Central Hudson customers or the Commission issues an Order that would bar Central Hudson from making such a rate filing for a specified period subsequent to an Order in this proceeding.

Q. What is your second comment regarding the proposed rate freeze?

A. As noted, the Petitioners condition their proposed rate freeze on the continuation of the various deferral provisions in the Rate Plan. As indicated by the relevant amounts in the "Stayout Adjustments" column of Exhibit__(PP-6) and A&F Rate Panel Exhibits__(ARP-3) and (ARP-4)__, substantial deferrals or amounts customers owe Central Hudson as a result of Commission-approved mechanisms will build up as a consequence of Central Hudson not making the rate filing it likely would have made if the Merger Agreement causing this proceeding not been entered into. As a result, Central Hudson's customers likely will be facing significantly larger rate increases in those later years than they would have if this proceeding had never been initiated.

Q. Did Staff calculate the value of freezing rates for the TME June 30, 2015 as a potential benefit of the merger?

A. Yes. Based on limited information for that period provided by Central Hudson, we estimate a rate freeze for the Company's electric operations for the TME June 30, 2015 to be worth approximately $8.1 million to customers. Valuing a rate freeze for Central Hudson's gas operations for the TME June 30, 2015 is complicated by the fact that a $4.6 million amortization of regulatory assets ends June 30, 2014 established in Case 08-G-0888, Central Hudson – Rates, Order Adopting Recommended Decision With Modifications, (issued June 22, 2009). If it is assumed the Company would continue to make this amortization on its books the value of a rate freeze for Central Hudson's gas customers is $2.3 million. If it is assumed the amortization stops, the value of the rate freeze is a negative $2.4 million.

Q. What is your recommendation regarding a rate freeze for the TME June 30, 2015 being considered a benefit from the merger?

A. Because of our concern discussed above regarding the growing level of deferrals or amounts customers owe Central Hudson as a result of Commission-approved mechanisms, we cannot recommend the Commission consider a rate freeze for that period at this time under the conditions to the rate freeze for the TME June 30, 2014 proposed by the Petitioners. However, under the right circumstances, a rate freeze beyond June 30, 2014 may be in the public interest. Thus, if settlement discussions are to occur, interested parties should be prepared to address the level of deferrals or amounts customers owe Central Hudson as a result of Commission-approved mechanisms in the context of a rate freeze proposal.

Q. What is your recommendation regarding the Petitioners proposed modification to the Earnings Sharing Mechanism provided for in the Rate Plan?

A. We agree with the proposal to eliminate the initial dead band; however, the ROE used for determining if there are excess earnings should be the 8.9% ROE we recommend above for valuing the proposed rate freeze.

Q. Should the terms of the Company's Rate Plan be continued?

A. Yes. Unless specifically noted in the Rate Plan or in Staff's collective testimony in this proceeding, all of the terms of the Company's current Rate Plan should continue.

E. <u>Market Power Impact</u>

Q. What generating assets do FortisUS and CH Energy own or control in New York?

A. As indicated earlier, FortisUS owns four small run-of-river hydroelectric facilities (Moose River, Philadelphia, Diana and Dolgeville Projects) totaling 23. The four facilities are connected to the National Grid transmission System and their output is under contract to National Grid. CH Energy owns 66 MW of generating capacity, including two peaking units and hydro facilities, and controls 13 MW through contracts for a total capacity of 79 MW. The merged company would own or control at most 102 MW, which represents less than .25% of the capacity in the New York market (NYISO Zones A-K) and less than half of the Upstate market (NYISO Zones A-I), which we consider de minimis shares of these markets.

Q. Does the Merger result in market power for the combined companies in New York?

A. No, the merged companies will own de minimis generating assets in New York and will have no ability to exert market power.

IDENTIFIABLE MONETARY BENEFITS

A. Background

Q. What identifiable monetary benefits does the Petition claim the Merger will provide?

A. The identifiable monetary benefits the Petitioners allege will occur as a result of the Merger are discussed on pages 4-5 of the Petition. They are:

1) Commitments to $2 million in annual operating cost savings and a guarantee the cost savings will continue for five years from closing, with more cost savings expected to be identified over the longer term;

2) Deferral of the foregoing cost savings for recognition in Central Hudson's next general rate cases;

3) Commitment to freeze rate year rates and defer the filing of new electric and gas rate case applications so as to become effective no sooner than July 1, 2014 (addressed above);

4) Enhanced Central Hudson access to capital due to Fortis's significantly larger size as compared to Central Hudson and from the sharing of experience and expertise that

takes place among Fortis’s utility affiliates; and

5) Commitment to $10 million in shareholder-funded PBAs, to be utilized for the benefit of customers and residents of Central Hudson's service territory.

B. <u>Cost Savings</u>

Q. Do the Petitioners address the potential for reduced costs associated with Fortis ownership?

A. Yes, the Panel first concedes that Fortis's stand-alone philosophy limits cost reductions from synergies; however, they go on to maintain the potential for reduced utility costs does exist, and is pursued, among Fortis's regulated utilities. The reduced costs are said to come from two sources 1) avoided, or substantially avoided, costs and 2) economies of scale.

Reduced securities compliance costs because Central Hudson will be a relatively small proportion of the compliance costs incurred by Fortis as a publicly traded entity is provided as an example of a potential avoided cost. Lower insurance costs because Fortis’s insurance program provides the necessary insurance coverage for all its subsidiaries at reduced cost as a result of a combination of group purchasing power and risk diversification is provided an example of potential reduced costs through economies of scale. A $2.0 million per year estimate for these items is provided and guaranteed annually for five years, regardless if these cost savings come to fruition or not. (See Panel Testimony, pages 37-38)

Q. Did the Petitioners perform any studies related to cost savings expected from the merger?

A. No, in response to DPS-M26 (DPS-226) Central Hudson stated, "There were no studies performed by or on behalf of Central Hudson before the merger was announced to quantify the expected savings as a result of the transaction. The $2 million estimate which was compiled subsequent to the merger announcement is simply an estimate of the avoided public company costs and reduced insurance costs that could be realized in future years as a result of the transaction." Additionally, the response indicated there were no studies performed to demonstrate the effect of this merger on earnings or the earned return on equity at Central Hudson and Fortis.

Q. Did Staff’s investigation reveal potential savings not identified in the Petitioners $2 million estimate?

A. Possibly. Page 219, paragraph 56 of the Gaz Métro/CVPS Merger Order noted that CVPS did a preliminary analysis of the savings available to customers from the Fortis transaction and estimated those savings were estimated to be in the range of $2.5 to $3.0 million per year and $25 to $30 million over ten years. As CVPS is much smaller than Central Hudson, its 2011 operating revenues were just a little more than half of Central Hudson’s, Staff asked Fortis about the estimated savings referred to in Vermont. In its response to DPS-M235 (DPS-M435), which is provided in Exhibit__(PP-1), Fortis stated that it was not a party to the proceeding in Vermont but provided certain information related to CVPS’s $2.5 to $3.0 million per year estimated savings. Most notably, the information indicated CVPS’s estimated savings included amounts for the elimination of the Investor Relations and

Shareholder Services functions that were not among the items considered by the Petitioners when developing the $2.0 million estimate of synergy savings referred to the Panel Testimony.

Q. Did Staff ask any IRs regarding potential savings from the elimination of the Investor Relations and Shareholder Services functions?

A. Yes, we did in DPS-M268 (DPS-468) and in its response Central Hudson responded, "Petitioners do not anticipate labor savings to Central Hudson Gas & Electric Corporation from eliminating work related to investor relations or shareholder services functions as a result of the merger. As quantified in the response to Part b of this question, below, approximately $90,000 of labor expense for these activities was embedded in the cost information for the 12 months ending 3/31/12 that was previously provided to Staff. The reasons why these amounts are relatively low follow. The duties and responsibilities performed by the areas identified in the question associated with being a publicly traded company are relatively minor in relation to the entire scope of duties and responsibilities for these areas. In addition, the corporate records area will be experiencing an increase in workload due to the installation of a new enhanced records and content management system that will absorb the time previously dedicated to shareholder related activities."

Q. Have the Petitioners adequately explained why CVPS, a company half the size of Central Hudson, would expect more synergy savings than Central Hudson from being acquired by Fortis?

A. No. While we tried to discovered other synergy savings, it appears the Petitioners will not commit to identify other savings.

Q. Do the Petitioners propose to guarantee any of these potential savings?

A. Yes, the Petitioners propose to defer the revenue requirement effect, net of costs to achieve and with carrying charges, of the estimated $2.0 million per year in operating cost savings for five years following closing of the Merger, as discussed earlier, for a total potential obligation of $10.0 million over the first five years of Fortis ownership. The savings deferred prior to the next general rate cases for Central Hudson would be available for consideration by the Commission at that time. Once rates are reset, savings actually achieved would be reflected in rates as they occur. Customers will realize any benefits of any other cost reductions from the Merger, because any other future cost reductions and savings can be reflected in future rate cases.

Q. Did you ask any IRs regarding the $2 million of costs savings the Petitioners guarantee and propose to defer?

A. Yes, IR DPS-M19 (DPS-219) asked the Petitioners certain questions intended to clarify that proposal. In the response, which is provided in Exhibit__(PP-1), Central Hudson stated that it was assuming the annual savings costs from the Merger in the period following the closing of the Merger until rates are next changed in accordance with the rate proposal will be less than $2 million due to the time necessary to implement these benefits. Thus, Central Hudson felt it was unnecessary to track the actual savings and if the actual savings exceed $2 million on an annualized basis, Central Hudson’s customers may only receive the additional savings to the extent they are part of any benefit resulting from the revised earnings sharing mechanism proposed by the Petitioners.

Q. Do you agree that Central Hudson should not track cost savings resulting from the Merger?

A. No, as elaborated above, we have doubts about the accuracy of the Petitioners $2 million dollar estimate. Additionally, a tracking of the costs and savings of the operational changes resulting from the Merger will provide valuable information to appropriately set Central Hudson's rates in its first rate case as a Fortis subsidiary. Thus, it should be a required condition for the Commission to approve the Merger.

C. Other Claimed Benefits

Q. Do the Petitioners elaborate on the claim that Central Hudson's customers will benefit from the Merger due to reduced costs from ready access to equity capital and from the sharing of experience and expertise that takes place among Fortis's utility affiliates?

A. The Panel Testimony notes that raising equity capital can, at times, be challenging for a smaller utility, like Central Hudson, and Fortis’s strong financial position and ready access to capital will enable Central Hudson to raise equity capital in a more timely and cost effective fashion than it does now. Additionally, it maintains that Fortis can, and will, provide future equity capital to Central Hudson without delay and without the transactional costs associated with a public issue.

Regarding the sharing of experience and expertise among its utility affiliates, the Petitioners argue that Fortis believes the sum of the experience and expertise within its utilities is greater than that resident in any one of them and points to the assessment of metering technology deployment by the Fortis utilities as an example of the value of this diversity.

Q. Do you agree with these claimed benefits?

A. While the Petitioners have identified some additional areas where benefits to Central Hudson’s customers may ultimately be realized, they have not provided adequate detail for us to fully assess them. Further, no attempt has been made to quantify the savings. Thus, we cannot recommend the Commission consider them when deciding if the Merger is in the public interest

D. Public Benefit Adjustments

Q. Has the Commission explained its rationale for requiring PBAs in a merger proceeding?

A. Yes, on pages 131-132 of the Iberdrola Order the Commission stated, ". . . we adopt the Recommended Decision's general rationales for PBAs only insofar as the Recommended Decision found that (a) PBAs are necessary if the transaction's risks and benefits, considered together, fall short of satisfying the PSL §70 positive benefits test; and (b) the validity of a PBA requirement therefore does not depend on whether the PBAs can be funded from available synergy savings. Indeed, as this case illustrates, the very absence of identified synergies can aggravate the lack of net positive benefits, thus strengthening rather than weakening the justification for monetized benefits such as PBAs."

Q. As the Petitioners are offering to provide PBAs in this proceeding, does this mean they feel they are necessary for the Commission to approve the Merger?

A. No, the Petitioners state although the Petitioners are willing to provide them as part of the Merger, PBAs are not necessary for the Commission to approve the Merger because the Petitioners have demonstrated why the circumstances under which the Commission concluded PBAs were necessary in approving prior mergers “are not present here; the risks for which the PBAs are intended to compensate either do not exist or, if they do exist at all, are fully neutralized or mitigated.” (See Panel Testimony, page 41)

Q. What PBAs do the Petitioners propose?

A. The Petitioners propose two public benefit funds that would take effect in the month following closing. Both funds would be furnished at the expense of Shareholders.

Q. Would you please describe the first proposed public benefit fund.

A. The first fund would result from the forgiveness of $5.0 million in deferred amounts that would otherwise be recoverable from customers. This would be accomplished by writing off the stated amount on the Central Hudson books of account. The Petitioners note this would also have the added customer benefit of stopping the accrual of carrying charges otherwise to be paid by customers. In its response to IR DPS-M21 (DPS-221), Central Hudson stated: “The Petitioners have not identified the specific balance sheet accounts, and anticipate the specific regulatory assets accounts would be identified and agreed to among the parties in settlement negotiations.”

Q. Would you please describe the second proposed public benefit fund.

A. This fund would be for the benefit of the broader community, including specifically low income, economic development and energy efficiency interests. $5.0 million in shareholder funds in total would be contributed to this fund for these three purposes, or any purpose the Commission deems appropriate. Like the first proposed public benefit fund, a method for the allocation and disposition of this amount would be developed in this proceeding.

D. Analysis

Q. Would you please summarize the identifiable monetary benefits offered by the Petitioners in this proceeding?

A. The Petitioners offer $20 million in identifiable benefits – $10 million resulting from the guaranteed $2 million annual costs savings for five years plus $10 million of shareholder funded public benefit funds. As elaborated on earlier, we find the proposed rate freeze to have no value to Central Hudson's customers and should not be considered by the Commission as an identifiable monetary benefit.

Q. What did the Commission state in the Iberdrola proceeding regarding quantifying the amount of PBAs that the Petitioners in that proceeding should be required to provide as a condition of receiving of the proposed Merger?

A. On page 132 of the January 9, 2009 Iberdrola Order, the Commission agreed with the Recommended Decision issued in that proceeding that, "the determination requires an exercise of informed judgment rather than a purely mathematical calculation, but there are benchmarks we can apply to avoid basing a decision solely on subjective notions of equity.”

Q. Did the Petitioners make a quantified showing that the PBAs they are offering are adequate for the Commission to conclude the Merger is in the public interest?

A. No. However, we attempted to find out if they had nonetheless performed such an analysis in IRs DPS-M265 (DPS-465) and DPS-M290 (DPS-490). The responses to those IRs, which are provided in Exhibit__(PP-1), did not directly answer our questions. Unfortunately, the responses, in effect, only reiterated the Petitioners position that they have taken care of all the concerns raised in recent Commission proceedings that addressed mergers involving major New York energy utilities, but are nevertheless, willing to commit to $10 million of synergy savings over five years and provide PBAs totaling $10 million.

Q. Have you attempted to analyze the value of the

PBAs offered by the Petitioners?

A. Yes, in quantifying the amount of PBAs it would require NYSEG and RG&E provide customers, a key benchmark the Commission considered was the ratio of identified benefits to delivery revenues. Thus, we compared the ratio of identifiable benefits offered by the Petitioners to Central Hudson’s Delivery Revenues to the ratio of PBAs required by the Commission in the Iberdrola proceeding to the sum of NYSEG’s and RG&E’s Delivery Revenues.

Q. What were the results of that analysis?

A. The results of our analysis are provided in Exhibit__(PP-11) and show that the level of identified benefits being offered by the Petitioners as a percentage of delivery revenues is approximately equal to the PBAs required by the Iberdrola Order as a percentage of the sum of NYSEG’s and RG&E’s delivery revenues.

Q. Does this result demonstrate the level of identified benefits proposed by the Petitioners is adequate for the Commission to approve the Merger?

A. No, the Merger proposed in this proceeding warrants a much higher level of identifiable benefits or PBAs to justify that the Merger is in the public interest for three reasons, two of which have been described earlier. The two described earlier are our concern regarding Central Hudson’s future role as Fortis’s first major U.S. electric and gas subsidiary and the substantial amount of Goodwill that would be recorded on Fortis’s books if the Merger is approved as proposed.

Q.   What is your third reason?

A.   Our third reason relates to Fortis’s age and size compared to Iberdrola. Exhibit __(PP-12) compares the age and certain key financial data for Fortis (before and after the Merger) versus Iberdrola and clearly shows that Fortis is much younger, smaller and, therefore, more risky than Iberdrola. For example, an unexpected financial difficulty with the same dollars impact, will impact Fortis and its other subsidiaries (including Central Hudson) much more dramatically than Iberdrola and its subsidiaries. Further while Fortis’s operations are predominantly in Canada, Iberdrola’s operations are much more diversified and thus less risky as demonstrated by page 6 of its 2011 Annual Report to Shareholders that shows Iberdrola had a presence in 37 countries. Given this additional risk, the Petitioners should be required to provide substantially more PBAs to obtain Commission approval of the Merger proposed in this proceeding.

Q. Are there any other factors that should be considered when comparing the PBAs offered by the Petitioners against the PBAs required in the Iberdrola proceeding?

A. Yes, there are two. First, as noted above, Fortis has touted to its shareholders that the acquisition of CH Energy will be immediately accretive to their earnings per share (EPS) of common stock. IR DPS-M85 (DPS-285) and DPS-M156 (DPS-356) requested the Petitioners provide the detailed calculations behind the claim the proposed acquisition would be accretive to Fortis. The Petitioners asserted they were “highly confidential.” The relevance of the accretion concept is described later.

While the Petitioners in the Iberdrola

proceeding also claimed their merger was accretive, based on our examination of the responses to the above IRs, discussions with Staff’s investigation in the Iberdrola merger proceeding as well as NYSEG’s and RG&E’s subsequent rate case (Cases 09-E-0715, 09-G-0716, 09-E-0717, and 09-G-0718) plus relevant documents available in those proceedings it is clear the relevant increase in Fortis’s EPS from accretion as a result of the Merger proposed in this proceeding is much greater than resulted from the Iberdrola merger. Thus, in the long run, Fortis’s shareholders stand to gain much more from acquiring CH Energy and Central Hudson’s customers should be provided more PBAs than NYSEG’s and RG&E’s customers since they will be paying the rates that will generate the accretion. In other words, as a matter of fairness, Central Hudson ratepayers should be entitled to a higher level of PBAs which would further satisfy the Commission’s established public interest standard.

Q. Although the details of the basis for you reaching that conclusion are based on highly confidential information, can you generally describe why Fortis's common equity shareholders benefited more from accretion from the Merger proposed in this proceeding than Iberdrola benefited from the accretion that resulted from its acquisition of NYSEG and RG&E?

A. Yes. As described earlier, the Merger is accretive to Fortis's EPS because Central Hudson's rates are based on a 48.0% common equity ration whereas Fortis's is financed on a consolidated basis based on a 36.7% common equity ratio. Conversely, the difference between the equity ratio NYSEG's and RG&E's rates are based on and Iberdrola's common equity ratio on a consolidated basis is much closer. For example, the NYSEG and RG&E's rates are based on a 48.0% common equity ratio (See Cases 09-E-0715, et al., NYSEG and RG&E – Rates, Order Establishing Rate Plan, (issued September 21, 2010) Appendix C, Schedule J) whereas Iberdrola's common equity ratio on a consolidated basis was 49.6% at December 31, 2009 (See Cases 09-E-0715, et. al., Prefiled Direct Testimony of Staff Finance Panel, filed on January 25, 2010, p. 36).

Q. Have you attempted to quantify the value of the accretion based on publicly available information?

A. Yes, Page 1 of Exhibit__(PP-13) provides a rough estimate, about $4.3 million per year, of the annual amount Fortis's shareholder stand to profit simply by the manner Fortis is financed versus the capital structure used by the Commission to set Central Hudson rates. Page 1 of Exhibit__(PP-13) also shows that the pre-tax or revenue requirement effect of using Fortis's consolidated capital structure with the same ROE is $8.1 million.

Q. Do you wish to comment on the $4.3 million estimate?

A. Yes, as noted, this is a very rough calculation and ignores factors that would both increase and decrease the $4.3 million estimate. For example, as Central Hudson is expected to add substantially more plant than it is retiring in the foreseeable future, the accretion should grow from year to year. Conversely, Fortis paid substantially more for CH Energy's common stock than its book value and the Petitioners have agreed this premium or goodwill will not be recovered from customers. Since Fortis will incur costs to finance the goodwill, the accretion will be somewhat lower. Fortis will likely also incur additional corporate overhead costs as a result of it owning CH Energy, although these should be minimal give Fortis's stand-alone philosophy.

Q. Would you also provide a very rough estimate of the annual increase in the amount of accretion that can result because of the expected growth in Central Hudson's plant additions?

A. Page 2 of Exhibit__(PP-13) provides such an estimate based on information provided by Central Hudson with the financing petition it filed in Case 12-M-0172, which we referred to earlier. Specifically, this very rough estimate shows the accretion increasing about $500,000 in one year based on the forecast data for 2015.

Q. Do you have any other comments about the accretion to earnings Fortis's shareholders are expected to realize because of the Merger?

A. Yes, when discussing this accretion in context of the PBAs that should be required in this proceeding, it must be remembered that while PBAs are a one-time benefit for Central Hudson’s customers, the benefit Fortis’s shareholders will receive from the accretion should go on indefinitely as long as Fortis continues to finance its operations in the manner it currently does and the Commission continues its current policies that result in Central Hudson’s rates being based on a 48.0% common equity ratio.

Q. What is the relevance of this accretion to Fortis’s shareholders to the level of PBAs the Petitioners should be required to provide Central Hudson’s customers in order to obtain Commission approval of the Merger?

A. As in the long run Fortis would benefit relatively more from the accretion resulting from a Merger with CH Energy than Iberdrola did merging with Energy East, it is unreasonable for the PBAs required of the Petitioners in this proceeding to be relatively the same as required in the Iberdrola proceeding. Importantly, the increase in earnings per share Fortis’s shareholders will enjoy from the acquisition of CH Energy is permanent.

Q. What is the second additional factor that you conclude should be considered when comparing the benefits required in the Iberdrola proceeding to those offered by the Petitioners in this proceeding?

A. The conditions on which the Commission approved the proposed transaction in the Iberdrola Order included the petitioners’ commitment to invest $200 million in new wind generation in New York over the next two years or, failing that, allocate up to $25 million of shareholder funds to economic development projects in their New York service territories. Iberdrola Order, p. 2. As the Petitioners in this proceeding have not made an analogous commitment here, all else being equal, the amount of PBAs required must be greater than required in the Iberdrola proceeding.

Q. Do you have any final comments regarding the analysis provided on Exhibit__(PP-11) that should be considered by the Commission when deciding how much in PBAs the Commission should require the Petitioners provide to obtain Commission approval of the Merger?

A. Yes. As elaborated above, the $2 million estimated synergy savings the Petitioners propose to guarantee is not based on a study but a very limited analysis that contradicts an estimate made by CVPS when it was considering being acquired by Fortis.

D. RECOMMENDATION

Q. How much in PBAs should the Petitioners provide to obtain Commission approval of the Merger?

A. As noted earlier, the Commission concluded that quantifying the amount of PBAs that should be required to obtain Commission approval of a merger “requires an exercise of informed judgment rather than a purely mathematical calculation.” We recommend the Petitioners be required to provide Central Hudson’s customers a total of $40 million of identifiable monetary benefits to obtain Commission approval of the proposed transaction. As we are proposing no adjustments to the $10 million of guaranteed synergy savings and the Petitioners have not definitely identified and supported other savings, the Petitioners should be required to provide a total of $30 million in PBAs.

Q. How should the PBAs be provided to customers?

A. If the Commission approves the Merger, we recommend that $25 million of the $30 million of PBAs be used to increase the amount of Central Hudson deferrals the Petitioners propose to forgive from $5 million to $25 million. We make this recommendation because deferred amounts due from Central Hudson's customers has grown substantially as a result of the deferral provisions of the Rate Plan and Central Hudson currently has two petitions pending that propose to defer substantial amounts because of incremental costs incurred to repair damage from two severe storms in Central Hudson's service territory. These petitions are being addressed in Case 11-0651, Petition of Central Hudson Gas & Electric Corporation for Approval of Deferred Incremental Costs Associated with Tropical Storm Irene For Rate Year Ended June 30, 2012, filed on November 29, 2011 and Case 12-M-0204, Petition of Central Hudson Gas & Electric Corporation for Approve the Deferral and

Recovery of Incremental Costs Associated with the October 29, 2011 Snow Storm filed on April 25, 2012. The remaining $5 million would be used as proposed by the Petitioners for the benefit of the broader community, including specifically low income, economic development and energy efficiency interests; all in relationship to Central Hudson's service territory. Additionally, if the interested parties cannot agree on how to best use the $5 million for ratepayer benefit within six months after the issuance of a Commission order, we would recommend that any remaining amount also be used to forgive deferrals for amounts owed by ratepayers.

Q. Regarding the $5 million not used to write-off deferrals, do you recommend any items or areas that should be considered beyond those suggested by the Petitioners?

A. Yes, we recommend considering using a portion of the $5 million to expand Central Hudson’s natural gas conversion program.

Q. Would you please describe Central Hudson’s natural gas conversion program?

A. The Company initiated a natural gas conversion program in April 2012 for customers who want to switch from an alternative fuel source. (Response to IR DPS-G155) Central Hudson has conducted several direct marketing campaigns, held public forums and developed a website that estimates the potential savings for customers as compared to alternative fuels. (Response to IR DPS-M193 (DPS-393)) In addition, the Company worked with Staff and interested parties this summer to provide alternatives to extend gas service to the Town of Beekman.

Q. Where does the Beekman expansion project currently stand?

A. The Company has developed cost estimates for the anchor customer and associated contribution-in-aid-of-construction levels assuming the customer takes service under specific service classes. The project has the potential to attach many residential customers too. Once the anchor customer’s assurances are met, the Company should move ahead with this expansion project.

Q. Do you believe the expansion of gas service in Central Hudson’s territory and neighboring communities is important?

A. Yes. For customers that wish to switch to natural gas service, they may have an opportunity to save on heating costs, and, by reducing energy costs, some customers may provide economic benefits to the local economy. Moreover, economic expansion lowers the delivery cost to all customers. Expanding the customer base economically allows the fixed costs to be spread over more customers, and benefits the shareholders because the utility has a larger investment base.

<u>CONTINUED PARTICIPATION IN STARS</u>

Q What is the State Transmission Assessment and Reliability Study (STARS)?

A. STARS is an initiative by New York's electric transmission owners to develop a thorough assessment of the state's transmission system and create a long-range plan for coordinated infrastructure investment in the state's power grid.

Q. Does the Panel Testimony address STARS?

A. Yes, page 42 of the Panel Testimony notes Central Hudson has been a strong supporter prime mover in the institution of the entire STARS and the Petitioners are committed to Central Hudson's continued participation in STARS, as well as the future "Energy Highway" infrastructure development in New York State.

Q. Should this commitment be a condition of any Commission approving the proposed Merger?

A. Yes.

CONCLUSION

Q. Would you please summarize your testimony?

A. A petition has been filed in this proceeding that would result in Central Hudson being owned by Fortis. Based on our examination of the filing, we recommend the Commission deny the Petition unless the Petitioners agree to all the modifications to the terms and conditions proposed by the Petitioners, as well as other additional Staff proposals. Staff’s modifications and proposals are listed in Exhibit__(PP-2).

Q. Does this conclude your testimony at this time?

A. Yes.