

**BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION**

IN THE MATTER OF THE APPLICATION OF TECO )  
ENERGY, INC., NEW MEXICO GAS COMPANY, INC. )  
AND CONTINENTAL ENERGY SYSTEMS LLC, )  
FOR APPROVAL OF TECO ENERGY, INC.'S )  
ACQUISITION OF NEW MEXICO GAS INTERMEDIATE,)  
INC. AND FOR ALL OTHER APPROVALS AND )  
AUTHORIZATIONS REQUIRED TO CONSUMMATE )  
AND IMPLEMENT THE ACQUISITION, ) Utility Case No. 13-00231-UT  
)  
TECO ENERGY, INC., NEW MEXICO GAS )  
COMPANY, INC. AND CONTINENTAL ENERGY )  
SYSTEMS LLC, )  
)  
JOINT APPLICANTS. )  
\_\_\_\_\_ )

**REBUTTAL TESTIMONY**  
**OF**  
**WILLIAM P. ZARAKAS**  
**ON BEHALF OF THE JOINT APPLICANTS**

**March 10, 2014**

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 **Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.**

2 **A.** My name is William Zarakas. I am a Principal with The Brattle Group, a  
3 consulting firm which specializes in utility economic, regulatory and financial  
4 analyses among other matters. My business address is 44 Brattle Street,  
5 Cambridge, MA 02138.

6

7 **Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR PROFESSIONAL**  
8 **QUALIFICATIONS.**

9 **A.** I have worked as an economist on matters concerning utility and  
10 telecommunications infrastructure and investments, cost structures, business  
11 cases, rates and performance metrics for roughly 30 years. My most recent work  
12 has involved the economic and financial feasibilities associated with utility  
13 investments in resiliency and reliability, and the evolving factors that are affecting  
14 utility business models. I have also analyzed the cost and financial impacts on  
15 utilities involved in mergers and acquisitions. Additionally, I have analyzed  
16 investments and assets in other infrastructure industries, notably concerning  
17 wireless spectrum that is used in telecommunications and media.

18

19 I have provided testimony and expert reports used in courts of law, arbitration  
20 panels and in regulatory proceedings, and have authored reports submitted to the  
21 U.S. Securities and Exchange Commission. I have led special investigations on  
22 behalf of corporate boards of directors and have led audits of management

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 practices and operational and financial performance on behalf of regulatory  
2 commissions.

3  
4 I have been a Principal with The Brattle Group since 2002. Prior to that, I was a  
5 Senior Vice President with PHB Hagler Bailly and successor companies, and a  
6 Managing Director with a predecessor company, Theodore Barry and Associates  
7 (TB&A), from 1987 until I joined The Brattle Group. PHB Hagler Bailly and  
8 TB&A were management and economic consulting firms which also focused  
9 primarily on the economics, finance, regulation and management of energy and  
10 telecommunications companies.

11  
12 I hold an M.A. in Economics from New York University and a B.A. in Economics from  
13 the State University of New York. My curriculum vitae is provided as JA Exhibit WPZ-1  
14 Rebuttal.

15

16 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

17 A. I have been asked by Counsel for TECO to respond to the statements made in  
18 testimony filed by Staff and Intervenors in this case which suggest that that the  
19 acquisition price paid by TECO for New Mexico Gas Company Inc. (“NMGC”)  
20 is too high and that such a high acquisition premium may, in turn, lead to  
21 excessive cost reductions and/or deterioration in the quality of utility service. In  
22 response to this testimony from Staff and Intervenors, I place the TECO-NMGC  
23 acquisition premium in context by comparing it to the premiums on utility

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 equities (i.e., above book values) that investors routinely pay, and the additional  
2 premiums that acquirers pay on top of that for control of a utility. I also provide  
3 an overview as to why investors and acquirers are willing to pay such premiums.

4  
5 Specifically, in this testimony, I provide the Commission with an overview of the  
6 relationships between the prices that acquirers and investors pay for local gas  
7 distribution companies (“LDCs”) - that is, acquisition prices and share prices -  
8 and various measures of LDC financial value, such as book value, enterprise  
9 value and Earnings Before Income Taxes, Depreciation and Amortization  
10 (“EBITDA”).

11  
12 **Q. WHY ARE THESE MEASURES OF INTEREST TO THE COMMISSION**  
13 **IN THIS PROCEEDING?**

14 A. This proceeding involves TECO’s application to acquire NMGC. It is my  
15 understanding that the Commission is examining the reasonableness of the  
16 acquisition price being paid by TECO, among other matters. My Rebuttal  
17 Testimony responds to concerns raised by Staff and Intervenors that the  
18 acquisition premium being paid by TECO is too high to be reasonable. It is  
19 common for acquisition prices to be put in perspective by placing them in a ratio  
20 such as: 1) acquisition price / enterprise value and 2) acquisition price / EBITDA.  
21 In examining the acquisitions of regulated utility assets such as local distribution  
22 companies (“LDCs”), observers may also examine acquisition price / utility rate  
23 base. These ratios are typically greater than 1.0, indicating that the acquirer has

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1           paid more for the utility than the book enterprise value (which I shall refer to as  
2           the book value). In this testimony, I provide these ratios for the proposed  
3           transaction in comparison to utilities in general and for recent transactions  
4           involving the acquisition of LDCs.

5

6   **Q.   WHAT IS THE DIFFERENCE BETWEEN A COMPANY'S BOOK**  
7   **VALUE AND ITS ENTERPRISE VALUE?**

8   A.   A company's book value of long-term financing can be derived from its balance  
9   sheet. It includes the dollar value of stockholders equity (as provided on the  
10   company's balance sheet) plus its long-term debt, the current portion of long-term  
11   debt and the value of any capitalized leases.<sup>1</sup> Stockholders equity is defined as a  
12   company's total assets less their liabilities; it is also sometimes referred to as a  
13   company's net assets. A company's enterprise value includes the same  
14   categories, except that the equity component is reflected at the market value of the  
15   company's stock (i.e., shares multiplied by the current price traded in the stock  
16   market). Thus, the difference between a company's book value and its enterprise

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<sup>1</sup> There are other definitions for book value that are used by financial analysts. The definition used herein (i.e., stockholders equity + long-term debt + the current portion of long-term + the value of any capitalized leases) is commonly used. I apply this definition consistently throughout my analysis to ensure that calculations are sufficiently comparable across company performances and transactions. In other contexts, book value is also used to refer to the net value of assets. I am using it here as a measure of the value of long term financing, as I define above.

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 value is the premium that the stock market has placed upon its equities above that  
2 recorded on the company's balance sheet.<sup>2</sup>

3

4 **Q. WHY IS THE RATIO OF ENTERPRISE-TO-BOOK VALUE A USEFUL**  
5 **METRIC FOR UNDERSTANDING ACQUISITION PRICES?**

6 A. Essentially all publicly traded companies have enterprise values that differ from  
7 their book values. This is because, for the most part, book values simply reflect  
8 the depreciated value of the assets relative to their original construction cost,  
9 while enterprise values reflect the discounted present value of the assets in future  
10 use under projected market conditions.

11

12 **Q. DO THE ENTERPRISE VALUES FOR UTILITIES EXCEED THEIR**  
13 **BOOK VALUES?**

14 A. Yes, typically they do. The case for utilities is particularly interesting because it  
15 is well understood that regulated utilities in the U.S. earn their actual profits by  
16 way of a rate of return that has been approved by their regulators, and allowed on  
17 their rate base. The rate base, in turn, is derived from the book value of the net  
18 property, plant and equipment that is in service. This means that investors in  
19 utility stocks are generally willing to pay a premium to own utility stocks, above

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<sup>2</sup> There is also the impact from any differences between the book value and the market value of debt. However, the difference between the book and market values of debt is typically relatively minor in comparison to the difference between the book and market values of equity. I treat debt in terms of its book value consistently in this analysis.

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 and beyond the present value of the income-making abilities of the assets  
2 currently included in rate base.

3

4 **Q. WHY DO INVESTORS TEND TO VALUE UTILITY STOCKS ABOVE**  
5 **THEIR BOOK VALUES?**

6 A. The premium that investors place upon utility stocks above book value can reflect  
7 several factors. First, companies have market value due to both their cash flow  
8 from existing assets and operations as well as from the expected value of future  
9 growth options. Investors tend to view utilities that are located in high growth  
10 market areas, or in areas which would benefit from considerable infrastructure  
11 upgrades, as holding yet-unrealized future value, and so they will pay a premium  
12 for that prospect. Second, net income retained from existing assets and sales may  
13 be enhanced if utilities are able to reduce costs through deployment of better  
14 technologies and/or efficiency-enhancing business processes.

15

16 Also, there can be times when utility stocks are appealing compared to other  
17 securities available in the financial markets. Historically, utilities have been  
18 steady payers of dividends, which recently have been a relatively attractive  
19 alternative to the low interest rates paid on fixed income securities, such as  
20 government and high quality corporate bonds, over the last several years. At the  
21 same time, utility stocks have continued to be perceived as relatively safe  
22 investments, probably leading investors to place a premium upon utility equity.  
23 Finally, many utility assets (e.g., pipes, wires, power plants, etc.) are quite capital-

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 intensive, which may present tax depreciation benefits that can improve its cash  
2 flow.

3  
4 Regardless of how many of these circumstances apply to a specific utility, it is  
5 generally true that utility stocks trade at prices above their book values. The  
6 persistence of these market-to-book ratios being greater than 1.0 indicates that  
7 utility investors are comfortable with these disparities between the book  
8 accounting values used in ratemaking and the market prices they have to pay to  
9 own shares of utility stocks.

10

11 **Q. HOW DOES THIS RELATE TO UNDERSTANDING THE PREMIUM**  
12 **PAID ABOVE BOOK VALUE BY TECO FOR NMGC?**

13 A. It suggests that even without an acquisition offer by TECO, the market value of  
14 NMGC's stock was probably greater than its book value. As I indicated above,  
15 this would be a normal outcome for stocks of publicly traded utilities. Since  
16 NMGC is a privately held company the ratio of its enterprise value to book value  
17 could not be directly observed. However, it would be very unusual for NMGC's  
18 market value to not exceed its book value. An investor comparing stock in  
19 NMGC to ownership of other utility stocks would most likely expect to pay more  
20 than NMGC's book value. On top of that, any company aspiring to acquire a  
21 utility in its entirety would expect to pay a premium above and beyond the  
22 implicit market value of NMGC in order to gain control.

23



**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 **Q. WHAT ARE THE RECENT RATIOS OF ENTERPRISE VALUES TO**  
2 **BOOK VALUES FOR TRADED LDCS?**

3 **A.** The enterprise values (EV), book values (BV) and ratio of EV to BV for 11 LDCs  
4 that are publicly traded in the U.S are provided in JA Exhibit WPZ-2 Rebuttal.<sup>3</sup>  
5 There are many more than 11 LDCs in the U.S., but many LDCs are not publicly  
6 traded or are parts of combined electric and gas utilities and/or holding  
7 companies. As I described above, being able to directly observe stock prices is  
8 important to calculating an LDC's enterprise value. Hence, the panel of LDCs in  
9 JA Exhibit WPZ-2 Rebuttal is less than the universe of such utilities.

10

11 As is shown in the JA Exhibit WPZ-2 Rebuttal, the ratios of EV to BV for the  
12 panel of publicly traded LDCs range from roughly 1.04 (in the case of UGI) to a  
13 high of 1.78 in the case of New Jersey Resources. The average for the panel is  
14 1.36.

15

16 The EV to BV ratio for TECO is also shown in JA Exhibit WPZ-2. TECO,  
17 through its ownership of Tampa Electric Company, owns a combined electric and  
18 gas utility, and is included in this table for comparison purposes. The ratio of EV  
19 to BV for TECO is 1.25, which is slightly lower than the panel average. The EV

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<sup>3</sup> The 11 LDCs included in the panel are the companies included in Value Line Investment Survey's Natural Gas Utility category. Several of the companies included are not "pure" LDCs in that the companies also have additional areas of operations, such as pipeline and/or storage operations. In one case, NiSource, Value Line included the company as a natural gas utility, although it also has some electric utility operations.

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 to BV ratio for NMGC cannot be derived directly because the company is  
2 privately held and is not traded in a stock market. Using the price that TECO has  
3 offered to acquire NMGC (\$950 million) as a proxy for NMGC's enterprise value  
4 yields an EV to BV ratio of roughly 1.51.<sup>4</sup> This ratio includes any premium that  
5 TECO paid to acquire NMGC above the premium that investors would have paid  
6 in the stock market for NMGC stock if it were publicly traded. This ratio is  
7 higher than the average for the panel, but it is within the range that has been  
8 observed for these 11 companies.

9

10 **Q. HOW DOES THE TECO-NMGC TRANSACTION LOOK IN**  
11 **COMPARISON TO THE RATIOS OF EV TO BV FOR A BROADER**  
12 **PANEL OF UTILITIES?**

13 **A.** JA Exhibit WPZ-3 Rebuttal provides the enterprise values, book values and ratios  
14 of EV to BV for 43 gas, electric and combined utilities or utility holding  
15 companies in the U.S. As is shown in the table, two of the utilities in the panel  
16 have EVs that are lower than their BVs. All of the rest have EVs that equal or  
17 exceed their BVs, with six utilities included in the panel having ratios of EV to  
18 BV that are greater than 1.5, the estimated EV to BV ratio for NMGC (assuming  
19 that the company's EV was equal to the acquisition price paid by TECO). The  
20 EV to BV ratio for NMGC is thus within this range of observed EV to BV ratios,

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<sup>4</sup> I am aware that other ratios using "book" value are used in this proceeding, notably a ratio of acquisition price to rate base or acquisition price to net property, plant and equipment. The ratio of EV to rate base is higher than the ratio of EV to BV.

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1           albeit on the higher side, even though it also includes an acquisition premium that  
2           the other stocks may not reflect.

3

4   **Q.   DO INVESTMENT ADVISORS CONSIDER OTHER FINANCIAL**  
5   **RATIOS IN ASSESSING A UTILITY'S PERFORMANCE AND/OR**  
6   **PREMIUMS PAID IN ACQUISITIONS?**

7   **A.**   Yes. One measure frequently used is the ratio of a company's enterprise value to  
8           EBITDA. EBITDA is accounting net income with interest, taxes, depreciation,  
9           and amortization added back in. Net income accrues to equity holders, while  
10          these other amounts accrue variously to the rest of the financial stakeholders in a  
11          company (e.g., interest expense is obviously paid to creditors). Thus, EBITDA is  
12          a measure of total accounting returns to total invested capital. Conversely, the  
13          ratio of market value to EBITDA is a measure of how much value a company has  
14          per dollar of cash flow available to all of its investors.

15

16          The ratios of enterprise values to EBITDA for the recent LDC transactions are  
17          shown in JA Exhibit WPZ-4 Rebuttal and the EV to EBITDA ratios of the  
18          broader utility panel referenced earlier are shown in JA Exhibit WPZ-5 Rebuttal.

19

20          As shown in JA Exhibit WPZ-4 Rebuttal, the ratio of EV to EBITDA ranges from  
21          under 7.0 to over 15.7 for the panel of the 11 LDCs that are publicly traded in the  
22          U.S. The average EV to EBITDA ratio for the panel is over 9.4. The ratio of EV  
23          to EBITDA for TECO is approximately 7.6, which is slightly lower than the panel

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 average. Using the same assumptions concerning approximating an EV for  
2 NMGC (i.e., using the price that TECO has offered to acquire NMGC as a proxy  
3 for NMGC's EV), yields an EV to EBITDA ratio of roughly 11.1, which includes  
4 an acquisition premium. This is higher than the panel average but in the range of  
5 the larger panel, similar to the ratio for Piedmont Natural Gas, and considerably  
6 lower than the EV to EBITDA ratio for New Jersey Resources. As indicated in  
7 JA Exhibit WPZ-5 Rebuttal, six utilities included in the broader utility panel have  
8 EV to EBITDA ratios that are greater than 10.0.

9

10 **Q. DO PRICES PAID TO ACQUIRE A UTILITY TYPICALLY EXCEED**  
11 **THE UTILITY'S ENTERPRISE VALUE?**

12

13 A. Yes. The acquiring company in a merger or acquisition often pays more than the  
14 enterprise value of the target company that is observed in the market prior to their  
15 bid to acquire. The difference between the acquisition price and a company's  
16 enterprise value is frequently referred to as an acquisition premium; it is the  
17 markup over recent trading prices of the target company's common stock. This  
18 markup is sometimes small (a few percent or perhaps even zero) for mergers  
19 between companies that are of equivalent size and importance (i.e., "mergers of  
20 equals"). However, in other cases the premium paid by an acquirer can be  
21 significant. These acquisition premiums reflect the value that the acquirer places  
22 upon control and strategic opportunities. For instance, the acquirer may expect  
23 that it can: operate the acquired company more efficiently (through operating

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 synergies or employment of new technologies); utilize the acquired company's  
2 assets more effectively; and/or take advantage of growth opportunities.

3  
4 In addition there can be reasons that have nothing to do with expected cost  
5 savings or growth in the target company. In particular, the acquirer can be  
6 motivated by financial or risk reasons, such as attaining a larger, more diversified  
7 scale (with a different overall risk profile than the mix of businesses it has been  
8 relying on in the past) or creating geographic diversity. These can create value (to  
9 justify part or all of the premium) without requiring any "harvesting" of the target  
10 company's costs, growth or quality of service.

11  
12 Most of the recent transactions involving LDCs have involved privately held  
13 companies that were acquired by publicly traded companies. In these cases, the  
14 pre-acquisition EVs were not directly observable, so an acquisition premium  
15 could not be estimated. Two publicly traded LDCs (AGL and Nicor) were  
16 involved in a transaction in 2010-11, when AGL acquired Nicor. AGL paid an  
17 acquisition price that had an implied acquisition EV premium of 17 percent. This  
18 acquisition premium over pre-acquisition market value results in a post-  
19 acquisition ratio of EV to BV of 1.96. This is higher than the post-acquisition  
20 ratio of EV to BV for NMGC of 1.51.

21  
22 In other recent transactions involving LDCs, at least one party was a non-publicly  
23 traded company and, thus, pre-acquisition EVs could not be observed. In the case

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 of Laclede's acquisition of New England Gas and Prime Infrastructure's  
2 acquisition of Equitable Gas, the post-acquisition ratios of EV to BV for the  
3 acquired LDCs were about 1.0. In another case, AltaGas acquired SEMCO  
4 Energy Holdings, a combined LDC, storage, and pipeline part of a larger  
5 company. In that case, the post-acquisition EV to BV ratio for SEMCO was  
6 estimated to be about 1.4.

7  
8 Most recently, UIL Holdings Corp, the parent of United Illuminating, offered to  
9 acquire Philadelphia Gas Works (PGW) for \$1.86 billion. PGW is a municipal  
10 utility, and therefore did not issue stock that was traded in a stock exchange.  
11 However, the post-acquisition ratio of EV to BV for PWG was estimated to be  
12 1.28.

13  
14 Based on the above data, the range of post-acquisition EV to BV ratios for  
15 acquired LDCs is from a low of roughly 1.0 to a high of 1.96. The post-  
16 acquisition EV to BV ratio for NMGC of 1.51 is slightly above the ratios for  
17 PGW and SEMCO, and below the ratio for post-acquisition Nicor.

18

19 **Q. HOW ARE ACQUISITION PREMIUMS RECOVERED?**

20 **A.** It depends upon the specific circumstances involved and the size of the premium  
21 paid. Utilities recover their acquisition premiums through the combination of the  
22 premiums that investors (already) pay for equity, the expected value of future  
23 growth options, and cost efficiencies.

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1

2       As I discussed earlier, a portion of the acquisition premium may already be  
3 covered by investors. When one utility is acquiring another (as is the case here),  
4 any premium reflected in the acquirer's equity prices (i.e., over its own  
5 ratemaking book value basis) is effectively embedded in the currency being used  
6 to finance the acquisition. Thus, that portion of an acquisition premium does not  
7 require any additional recovery in order for the company to be viewed as  
8 financially viable and attractive to investors.

9

10       Any portion of an acquisition premium in excess of the company's ongoing EV to  
11 BV ratio may be recovered through yet-to-be realized value, either through future  
12 growth opportunities or cost savings. The mix of these recovery mechanisms  
13 depends on the specific circumstances and service area characteristics, and a  
14 utility needn't focus on any one area to justify its investment. Future growth  
15 opportunities may come from investments within and/or beyond the acquired  
16 utility's service area, expansions of its lines of business, and/or strategic  
17 positioning for additional business opportunities. Cost savings may come from  
18 efficiencies gained through the effects of economies of scale and/or scope  
19 associated with a larger organization. Harvesting cost efficiencies needs to be  
20 done carefully; it would be exceptionally irrational for a utility to reduce its  
21 service quality in order to recover an acquisition premium. Such a tactic would  
22 diminish its growth prospects and erode its perception in equity markets.

23

**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 **Q. PLEASE SUMMARIZE WHAT THESE RANGES OF MARKET VALUE**  
2 **VS. BOOK VALUE, WITH AND WITHOUT ACQUISITIONS,**  
3 **DEMONSTRATE ABOUT THE ACQUISITION PREMIUM PAID BY**  
4 **TECO FOR NMGC OVER THE BOOK VALUE OF ITS UTILITY**  
5 **ASSETS?**

6 A. Using the acquisition price paid by TECO for NMGC as a proxy for NMGC's  
7 EV, NMGC's ratio of EV to BV (1.51) and its ratio of EV to EBITDA (11.1) are  
8 within the corresponding ranges observed for other LDCs and utilities, albeit  
9 toward the higher end. As I indicated throughout my testimony, it is in general  
10 normal for investors in utilities to pay more to own utility companies than the  
11 book value of their securities. They usually pay even more when an entire  
12 company is acquired, due to expected operating synergies and strategic  
13 opportunities created by combining the two firms. The ratios observed for the  
14 TECO-NMGC transaction are consistent with this general pattern.

15

16 **Q. DOES THE MANNER IN WHICH NMGC WAS OFFERED AND PRICED**  
17 **FURTHER SUPPORT THE REASONABLENESS OF ITS ACQUISITION**  
18 **PRICE?**

19 A. Yes. TECO bid on the acquisition of NMGC as part of an auction process, along  
20 with other potential acquirers. TECO was the high bidder, but was only slightly  
21 higher in its bid than several competing suitors, whose bids were within a few  
22 percentage points of TECO's. This provides confirmation that the other auction



**REBUTTAL TESTIMONY OF WILLIAM P. ZARAKAS  
ON BEHALF OF THE JOINT APPLICANTS  
NMPRC CASE NO. 13-00231-UT**

1 participants similarly valued NMGC's assets and market position, indicating that

2 TECO's valuation falls within utility industry bounds.

3

4 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

5 **A.** Yes, it does.

6