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STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DW 10-091

In the Matter of:
Pennichuck Water Works, Inc.
Petition for Permanent Rates and Step Increase

Direct Testimony

of

Jayson P. Laflamme
Staff Utility Analyst, Gas and Water Division

March 31, 2011

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New Hampshire Public Utilities Commission

Pennichuck Water Works, Inc.

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Petition for Permanent Rates and Step Increase

Direct Testimony of Jayson P. Laflamme

I. INTRODUCTION

Q. Please state your full name.

A. My name is Jayson P. Laflamme.

Q. By whom are you employed and what is your business address?

A. I am employed by the New Hampshire Public Utilities Commission (NHPUC) and my business address is 21 South Fruit Street, Suite 10, Concord, New Hampshire.

Q. What is your position at the NHPUC?

A. I am a Utility Analyst in the Gas and Water Division.

Q. Please describe your duties at the NHPUC.

A. I am responsible for the evaluation of rate and financing filings, including the recommendation of changes in revenue levels that conform to regulatory methodologies. I represent Staff in meetings with company officials, outside attorneys and accountants relative to rate case and financing matters as well as the Commission's rules, policies and procedures.

Q. Would you please describe your educational background?

A. I received a Bachelor of Science Degree in Accounting from Lyndon State College in 1989. In 1998, I attended the NARUC Annual Regulatory Studies Program at Michigan

State University. In 2002, I attended the 22nd Annual Western Utility Rate School in San Diego, California.

Q. Would you please describe your work experience?

A. In 1989, I was hired as a Staff Accountant by Driscoll & Company, a CPA firm located in Littleton, New Hampshire. I performed audits, reviews and compilations as well as prepared tax returns for a variety of entities. I was eventually promoted to the position of Manager. In 1997, I was hired as a Utility Examiner in the Audit Division of the NHPUC. In that position, I participated in field audits of the books and records of regulated utilities in the electric, telecommunications, water, sewer and gas industries. I examined reports and filings submitted to the Commission by regulated utilities and performed rate of return analyses. In 2001, I was promoted to my current position as a Utility Analyst in the Commission's Gas and Water Division.

Q. What is the purpose of your testimony?

A. My testimony will provide Staff's recommendation with regard to a permanent rate revenue requirement for Pennichuck Water Works, Inc. (PWW or the Company).

Q. Will your testimony address PWW's request for a step increase in this case?

A. No. As indicated in the direct testimony of Mark A. Naylor, Director of the NHPUC Gas and Water Division, Staff does not support PWW's request for a step increase in this case, therefore my testimony will not address that issue.

Q. Before discussing the specifics of Staff's recommended revenue requirement, are there any general comments that you would like to make?

A. Yes. I would like to thank the Commission's Audit Staff for their excellent work in this case. The Audit Staff was quite thorough in its examination of the Company's test year and identified several issues which were included in its Final Audit Report dated November 24, 2010 (Final Audit Report) which have been incorporated into Staff's recommended revenue requirement.

II. STAFF RECOMMENDATION FOR PERMANENT RATES

Q. Please provide a brief summary of PWW's request for permanent rates in this proceeding.

A. On May 7, 2010, PWW filed a petition, including testimony and supporting schedules, requesting approval of a permanent rate increase in order to generate additional revenues of $3,915,175, representing a 16.23% increase in its adjusted annual water revenues and resulting in a revenue requirement of $28,031,601. The Company utilized 2009 as its test year in making its determinations.

Q. Did the Company subsequently modify the revenue increase that it is seeking in this rate proceeding?

A. Yes. In its discovery response to OCA Data Request 3-1, PWW provided revised schedules showing the impact of several adjustments based on responses to Staff and OCA discovery as well as the Final Audit Report. The increase in water revenues from permanent rates now being sought by PWW is $4,095,672, or 16.98%, resulting in a revenue requirement of $28,212,098. A copy of PWW's response to OCA 3-1 is attached to my testimony as Attachment JPL-1.

Q. Does Staff agree with the adjustments reflected in the Company's response to OCA 3-1?

A. For the most part. However, Staff is proposing modifications to a few adjustments proposed by PWW in its response to OCA 3-1. Also, additional pro-forma adjustments to rate base as well as operating revenues and expenses are being proposed by Staff in order to derive its recommendation for a permanent rate revenue requirement in this case. All of Staff's proposed adjustments will be discussed in detail later in my testimony.

Q. Are temporary rates currently in effect in this docket?

A. Yes. On October 8, 2010, the Commission issued Order No. 25,153 which authorized an increase in PWW's revenue requirement, on a temporary basis, of $2,604,524, or 10.81%, to an amount of $26,720,711. The effective date of this increase is for service rendered on or after June 16, 2010.

Q. Please summarize Staff's recommendation regarding a permanent rate revenue requirement for PWW in this case.

A. As indicated on Schedule 1 of Attachment JPL-2, Staff is recommending a revenue requirement totaling $26,649,274. This represents an increase of $2,532,848, or 10.50%, over the Company's pro-formed test year water revenues of $24,116,426. Staff's recommended revenue requirement is calculated utilizing a total rate base of $92,219,994 which is computed on Schedule 2 of Attachment JPL-2 and provides for an overall rate of return of 7.76%. The revenue deficiency before tax effect is $1,529,587. The combined federal and state income tax effect of $1,003,261, when added to this revenue deficiency, results in an overall increase in the Company's revenue requirement of $2,532,848.

Q. Please explain the basis for the 7.76% rate of return utilized by Staff in its recommendation.

A. Schedule 1A of Attachment JPL-2 shows Staff's calculation of an adjusted rate of return of 7.76%. As stated previously, Staff is not in support of PWW's request for a step increase in this case. However, the Company's original filing computed a rate of return of 7.86%, which included $4,080,100 of debt related to proposed step increase projects as well as $121,370 of associated annual debt expense. Subsequently, in its response to OCA Data Request 3-1 (Attachment JPL-1), PWW proposed the elimination of $2,301,100 of this debt along with $85,785 of debt expense in a revised calculation resulting in an amended proposed rate of return of 7.95%. The details of this revised calculation are shown on Schedule 4 and Schedule 4, Attachment A (Page's 7 of 8 and 8 of 8, respectively) of the Company's response to OCA 3-1. On Schedule 1A of Attachment JPL-2, Staff has eliminated the remaining $1,779,000 of debt related to proposed step increase projects as well as the remaining $35,585 of associated debt expense, resulting in Staff's computed rate of return of 7.76%. Further discussion relative to Staff's position concerning PWW's weighted average cost of debt is contained in the direct testimony of Mark A. Naylor.

Q. What was used for a Federal and State tax rate?

A. As indicated on Schedule 1B of Attachment JPL-2, an overall effective tax rate of 39.61% is computed. This is the same effective tax rate proposed by the Company in its filing.

III. <u>RATE BASE</u>

Q. Please discuss the rate base amount calculated by Staff on Schedule 2 of Attachment JPL-2.

A. Columns (1) through (3) summarize the Company's derivation of its pro-forma thirteen-month average rate base of $97,733,490 as proposed in its initial filing. Columns (4) and (5) show the subsequent adjustments made by the Company which are contained in its response to OCA 3-1 (Attachment JPL-1) and result in a modified rate base amount of $97,299,491. Columns (6) through (8) show the impact of Staff's adjustments to rate base which result in its recommendation of $92,219,994. Staff's rate base adjustments are further detailed on Schedule 2A of Attachment JPL-2 and discussed below.

Q. Please discuss Staff Adjustment # 1 which increases Accumulated Depreciation by an amount of $44,079.

A. The purpose of this entry is to eliminate the Company's pro-forma adjustment contained in its original filing to reduce accumulated depreciation for the one-half year of depreciation expense recorded on certain assets retired during the test year (see Tab 13, Schedule 3, Attachment C, Adjustment I B of PWW's filing). Staff disagrees with this pro-forma adjustment because it is assumed that at the time these assets were originally retired by the Company, an accounting entry was made to reduce the appropriate plant accounts as well as reduce accumulated depreciation respectively for the full cost of the retired plant. This entry would have been made in accordance with that prescribed for utility plant retirements in Section 610.01(e)(10)B.2 of Part Puc 610, the Uniform System of Accounts for Water Utilities (USOA). Therefore, Staff believes that the accumulated depreciation account has already been reduced relative to the retirement of the plant in question thus making the Company's proposed pro-forma adjustment unnecessary.

Q. Please explain Staff Adjustment # 2 to reduce Cash Working Capital by an amount of $1,394.

A. This adjustment relates to Staff's proposed adjustment to decrease Operating and Maintenance (O&M) Expenses by $11,309 (Staff Adjustment # 9) as shown on Schedule 3, Column 6 of Attachment JPL-2 and discussed later in my testimony. This proposed decrease in O&M Expenses, when multiplied by the 12.33% working capital rate, results in a $1,394 decrease in the cash working capital component of rate base.

Q. Please discuss Staff Adjustment # 3 which reduces Unamortized Deferred Debits by the amount of $49,310.

A. This entry pertains to a pro-forma adjustment made by PWW in its original filing to increase deferred debits by $49,310 (see Tab 13, Schedule 3, Attachment B, Adjustment II B of the Company's filing). This adjustment was made in conjunction with a similar entry to reduce amortization expense for certain deferred debit items for which a reduced amortization expense would have been recognized during 2010. Staff disagrees with PWW's adjustment to further increase unamortized deferred debits because the unamortized cost of these items is already appropriately included in PWW's rate base.

Q. Please explain Staff Adjustment # 4 which reduces Unamortized Deferred Debits by an amount of $4,824,907.

A. In its original filing, PWW included a pro-forma adjustment to add the net unamortized cost of its defense against the City of Nashua's recent eminent domain action in DW 04-048. PWW's entry consists of a total of $5,361,008 in proposed eminent domain defense costs reduced by one year of amortization expense ($536,101) for a net amount of $4,824,907. However, on March 17, 2011, the Office of Consumer Advocate (OCA) filed with the Commission an Assented to Motion to Stay Consideration of Recovery of PWW's Eminent Domain Defense Costs which was assented to by Staff, Anheuser-

Busch (A-B) as well as PWW. As such, Staff believes that it would be prudent to remove these costs from the Company's rate base for purposes of determining permanent rates at this time.

Q. Please discuss Staff Adjustment # 5 to reduce Unamortized Deferred Debits by an amount of $2,123.

A. In its response to OCA Data Request 3-1 (Attachment JPL-1), PWW included an entry to reduce amortization expense related to 2006-2007 union contract negotiation costs by $2,123 (see OCA 3-1, Page 4 of 8, Adjustment 11). Related to this, is a similar entry to increase unamortized deferred debits by the same amount (see OCA 3-1, Page 6 of 8, Adjustment 6). Staff believes that PWW's entry to increase unamortized deferred debits is unnecessary because the remaining cost of the 2006-2007 union negotiations is already appropriately included in the Company's test year rate base.

Q. Please explain Staff Adjustment # 6 which reduces Unamortized Deferred Debits by an amount of $427.

A. Included in its response to OCA 3-1 (Attachment JPL-1), the Company made an entry to increase unamortized deferred debits by $427 (see OCA 3-1, Page 6 of 8, Adjustment 7) relative to its 2009-2010 union negotiation costs. This entry was made in conjunction with a similar adjustment to increase amortization expense by the same amount (see OCA 3-1, Page 4 of 8, Adjustment 12). Per the Company's response to Staff Data Request 1-25, the 2009-2010 union negotiation costs were not incurred until 2010. Therefore, it is Staff's position that the Company's entry to increase rate base should be eliminated because it would be inappropriate to include post-test year assets in rate base for ratemaking purposes.

Q. Please discuss Staff Adjustment # 7 to include Deferred Revenue from the Sale of Cell Tower Leases of $157,256 in the calculation of rate base.

A. The direct testimony of Mark A. Naylor provides a general explanation relative to Staff's position behind the inclusion of this particular item in PWW's rate base. I will attempt to explain the mechanics behind this particular entry. In its response to Staff Data Request 3-6, PWW indicated that it sold seven cell tower leases in 2007 for a gross amount of $1,108,080 but netted $615,636 after incurring commissions ($88,646) and income taxes ($403,798) on the sale. Based on the Company's previous arrangement whereby it shared 50% of its net cell tower lease income with ratepayers, Staff determined that 50% of the net income recognized on the sale of these leases should likewise be recorded as a deferred credit item in PWW's rate base and shared with ratepayers over time through operating revenues. Staff determined that the portion of the sale proceeds that should be shared with ratepayers is $307,818 ($615,636 x 50%). However, Staff believes that the Company has already recognized $98,373 of this income through rates. According to counsel, in DW 08-073 (PWW's previous rate case) by Order No. 25,006 issued on August 13, 2009, the Commission established an annual imputed amount of $52,189 relative to cell tower lease income to be shared with ratepayers and thus reflected in rates. The effective date for rates approved in that docket was for service rendered on or after July 28, 2008. Therefore, with regard to the period of time over which PWW recognized this imputed income, Staff has determined that it should extend from the effective date of the rates approved in DW 08-073 until the effective date for the permanent rates to be established in the instant docket of June 16, 2010 (per Commission Order No. 25,153). This period of time consists of a total of 688 days, or 1.9 years (688 days ÷ 365 days).

Thus, the income previously recognized by PWW is $98,373 ($52,189 x 1.9 years) which should, in turn, be deducted from the deferred credit to be recorded in rate base. Staff also proposes that the Company should continue to recognize the annual income amount previously established by the Commission of $52,189 as imputed cell tower lease sales income for ratemaking purposes on a going-forward basis until such time as the deferred credit is fully amortized. Therefore, for the test year in the instant docket, Staff has determined that the initial amount of the cell tower lease sales income deferred credit should be $157,256 consisting of the original portion of cell tower lease sales income to be shared customers of $307,818 less the total amount of income previously recognized by PWW in prior rates of $98,373 and less the annual amount of income that will be recognized by PWW in future rates of $52,189.

IV. NET OPERATING INCOME

Q. Please discuss the Operating Income Statement for PWW presented on Schedule 3 of Attachment JPL-2.

A. Columns (1) through (3) present PWW's derivation of its pro-forma test year net operating income as proposed in its original filing in the amount of $5,312,859. Columns (4) and (5) summarize the Company's subsequent adjustments to net operating income as presented in its response to OCA Data Request 3-1 (Attachment JPL-1). PWW decreased its original net operating income proposal by $52,593 to an amount of $5,260,266. Columns (6) through (10) summarize my testimony in support of Staff's proposed revenue requirement of $26,649,274. Specifically, in Columns (6) through (8), a total of four pro-forma adjustments are shown which increase the Company's net operating income by a tax adjusted amount of $362,916 to $5,623,182. These adjustments are further detailed on Schedule 3A of Attachment JPL-2 as well as discussed later in my testimony. Columns (9) and (10) summarize the revenue requirement calculation from Schedule 1 of Attachment JPL-2, showing a proposed increase in PWW's revenue requirement of $2,532,848 to $26,649,274, ultimately resulting in a net operating income requirement of $7,152,768.

Q. Please explain Staff Adjustment # 8 which increases PWW's Other Operating Revenues by $52,189.

A. As previously explained in my discussion regarding Staff Adjustment # 7, this amount represents the annual income amount proposed by Staff to be recognized by PWW relative to the sale of its cell tower leases in 2007. According to counsel, this amount was first established by the Commission in Order No. 25,006 in DW 08-073; PWW's previous rate case.

Q. Please discuss Staff Adjustment # 9 to reduce Administrative and General Expenses by $11,309.

A. This adjustment stems from Page 26 of the Final Audit Report where it was indicated that $11,309 had been expensed by the Company during the test year for an open house event whereby customers were invited to tour the Company's recently upgraded treatment plant facility. The Audit Staff deemed that the expenses incurred by PWW relative to this event were non-recurring. Therefore, Staff Adjustment # 9 removes this amount from the Company's pro-forma test year.

Q. There were two other expense items identified by the Audit Staff as potentially of a non-recurring nature, yet no adjustment has been made for either item by Staff. Please explain.

A. Also, on Page 26 of the Final Audit Report, the Audit Staff indicated that purchased water costs of $13,808 stemming from a failed well and transmission repair costs of $5,137 to a pickup truck should also be considered to be non-recurring expenses. However, after reviewing the Company's response relative to these two items included in the Final Audit Report, Staff believes that the two expense items in question should be deemed as normative parts of the Company's ongoing operations. Thus, no adjustments have been proposed by Staff to remove these two cost items from PWW's test year.

Q. Please explain Staff Adjustment # 10 which decreases Amortization Expense – Other by $536,101.

A. In my previous discussion regarding Staff Adjustment # 4 relative to the elimination of the Company's proposed accumulated eminent domain defense costs from rate base, this amount was explained as representing the annual amortization expense of these costs proposed by PWW to be included in its test year. As explained previously, since an Assented to Motion to Stay Consideration of PWW's Eminent Domain Defense Costs has been filed with the Commission by the OCA, Staff believes it would be prudent at this time to remove this expense from the Company's test year for purposes of determining permanent rates.

Q. Please discuss Staff Adjustment # 11 which reduces Property Tax Expense by $1,354.

A. In its response to OCA 3-1, the Company adjusted its pro-forma test year property tax expense to an amount of $2,844,093 which coincides with its 2010 assessment for both state and municipal property taxes. However, in Staff's review of the 2010 municipal property tax bills provided in response to Staff Data Request 3-11, it was discovered that a number of the bills issued by the Town of Merrimack and the City of Nashua included an assessment of the state school rate. The state school rate assessed by these communities is essentially the same tax that is assessed by the State of New Hampshire Department of Revenue Administration (NHDRA) on PWW's utility property. It is Staff's position that since PWW is paying a state school tax to the NHDRA, it should not be paying the same tax to these municipalities in which it owns property. Therefore, Staff believes that PWW is overpaying its annual property tax expense. In Attachment JPL-3, Staff has identified that the amount of this overpayment for 2010 is $1,354. Staff is eliminating this amount from PWW's pro-forma test year.

V. <u>TAX EFFECT OF OPERATING REVENUE AND EXPENSE ADJUSTMENTS</u>

Q. Please briefly explain Schedule 3B of Attachment JPL-2.

A. This schedule calculates the income tax effect of the above described revenue and expense adjustments. The combined impact of Staff Adjustments # 8 through # 11 results in a net increase in the Company's pro-forma net operating income of $600,953. This increase in net operating income results in a marginal increase in PWW's New Hampshire Business Profits Tax (NHBPT) of $51,081 calculated at a rate of 8.50% as well as a marginal increase in its Federal Income Tax of $186,956 calculated at a rate of 34.0%. Therefore, the net pro-forma increase in PWW's operating income resulting from

Staff's adjustments after taking into account the effect of marginal state and federal income taxes is $362,916.

Q. Does this conclude your direct testimony?

A. Yes.