STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

Re: City of Nashua Acquisition of Pennichuck Corporation

Docket DW 11-026

DIRECT TESTIMONY OF

ARTHUR GOTTLIEB

February 18, 2011

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Introduction and Purpose for Testimony

Q. Please state your full name and business address.

A. My name is Arthur Gottlieb. My business address is 60 State Street, Boston, Massachusetts 02109. That is the address of C.W. Downer & Co.

Q. Please state your occupation, your educational background and your professional qualifications.

A. I am a Managing Director of C.W. Downer & Co., an investment banking firm operating through offices in the US, Europe, Asia and Australia. I joined C.W. Downer & Co. in 1998, with more than 20 years experience in management, consulting and corporate development. I hold a B.S. in Computer Science with honors from the Massachusetts Institute of Technology (1976) and an MBA from the Harvard Business School (1988). Additional information concerning C.W. Downer & Co. and additional biographical information is attached to my testimony as Exhibit AG-1.

Q. What role have you played in the effort of the City to acquire Pennichuck Corporation?

A. I have provided investment banking and consulting services to the City. C.W. Downer & Co. was retained by the City in November 2008, and I have been working with the City since that date. In that capacity, I have assisted the City in assessing the value of Pennichuck Corporation and its subsidiaries, negotiating the Merger Agreement between the parties, and developing a long-term financial model to evaluate the financial impacts of the proposed transaction. I have also attended numerous meetings of the City's Board of Aldermen and its committees to provide information on various matters involving the Pennichuck Corporation acquisition.

Q. Have you testified before the New Hampshire Public Utilities Commission or any other utilities regulatory authority on any previous occasions?

A. No.

Q. What are the purposes of your testimony?

A. The purposes of my testimony are: (1) to summarize the proposed financial structure to be employed following the City's acquisition of Pennichuck Corporation; (2) to explain why I am confident that, under City ownership, the Pennichuck utilities will be able to generate sufficient cash to meet all of their operating and capital obligations necessary to continue to provide water service to their respective customers and to provide the cash necessary to pay debt service on the City's Acquisition Debt, at a level of rates and revenue requirements that will be lower than under current ownership; and (3) to explain why the merger consideration to be paid by the City under the Merger Agreement for the shares of Pennichuck Corporation is fair and reasonable from a financial point of view.

<u>Description of the Transaction and Operational Structure of the Companies</u>

Q. Please summarize your understanding of the transaction and the financial structure of Pennichuck Corporation and its subsidiaries following consummation of the merger.

A. Under the Merger Agreement, the City will purchase all outstanding shares of Pennichuck Corporation for $29 per share. Based on current estimates, as explained in Mr. Patenaude's testimony, this price will result in a total purchase consideration of about $138 million. Upon consummation of the merger, the City will become the sole shareholder of Pennichuck Corporation. Pennichuck Corporation, in turn, will remain the sole owner of its five subsidiaries, Pennichuck Water Works, Inc. ("PWW"); Pennichuck

East Utility, Inc. ("PEU"); Pittsfield Aqueduct Company, Inc. ("PAC"); Pennichuck Water Service Company; and The Southwood Corporation. PWW, PAC and PEU will continue to be public utilities regulated by this Commission.

Q. How will the City access the cash flow of the regulated utility subsidiaries so that the City may pay the debt service on the bonds it issues to finance the merger?

A. Under the proposed operational structure, the three regulated utilities, and the other current unregulated operations of the other Pennichuck subsidiaries, will continue to operate as they do today, collecting revenues at rates approved by this Commission (in the case of the regulated companies), and paying operating costs, including debt service on indebtedness that is currently outstanding and also on new indebtedness that will be incurred to finance needed capital improvements. After paying these current operational cash obligations, the subsidiaries will have positive cash flow that they can distribute as intercompany dividends to the parent company, Pennichuck Corporation. Pennichuck Corporation will then use that available cash to pay its obligations to the City in its capacity as sole shareholder.

Comparison of Revenue Requirements under City and Current Ownership

Q. Mr. Gottlieb, do you have an opinion on how future revenue requirements under City ownership compare to revenue requirements under current Pennichuck ownership?

A. Yes. As demonstrated in Ms. Hartley's testimony, initial revenue requirements and rates under City ownership are expected to be slightly lower than the revenue requirements under current ownership. Given that starting point, it is reasonable to conclude that revenue requirements under City ownership will continue to be lower than revenue requirements under current ownership as long as the following two conditions are met: (1) inflation remains positive, and (2) capital expenditures are greater than depreciation. Over any reasonable time period at reasonable assumptions, both of those conditions are almost certain to be satisfied.

Q. How do those two conditions lead to lower revenue requirements under City ownership?

A. The revenue requirement under current ownership must cover operating expenses, return on capital, and depreciation. As demonstrated in Mr. Patenaude's testimony, operating expenses will be approximately $1.7 million lower under City ownership than they are under current ownership. Since inflation applies to all operating expenses, that differential will widen over time, meaning the absolute operating expense savings under City ownership will be greater in the future than they are today.

The City also plans to make capital expenditures necessary to maintain viable and high quality water service. These capital expenditures under City ownership will be the same as under current ownership. Under current ownership, capital investment at the utility level is funded by a mix of debt and equity, and the allowed rate of return for each utility reflects that mix. Under City ownership, the City expects that capital investment for each utility will be funded entirely by debt issued by the utilities. Since equity has a substantially higher allowed rate of return than debt, that component of the revenue requirement will also grow more quickly under current ownership than under City ownership. This effect can be demonstrated by an example attached as Exhibit AG-2. The example compares the revenue requirements arising from an assumed capital investment of $8,000,000. As shown in the example, the revenue requirement under City ownership would be approximately $404,202 lower under City ownership than under current ownership because the City's overall rate of return will be lower than the rate of return under current ownership. This beneficial savings is compounded over the years as more capital is spent.

Finally, depreciation, which is a function of the current asset base and future capital investment, will be the same regardless of owner. Since two of the three revenue requirement components will grow more slowly under City ownership, and the third will remain the same, future revenue requirements for each utility will be lower under City ownership than they would be under current ownership. This means that the City projects that customers of each utility will pay lower rates over time than under current ownership.

Q. What would be the impact on revenue requirements if the City is able to issue the City Acquisition Debt at an interest rate lower than the base case assumption of 6.5%?

A. Under the Fixed Annual Revenue Requirement methodology described in Ms. Hartley's testimony, if the City is able to issue the City Acquisition Debt at lower interest rates, the annual debt service requirement for the City Acquisition Debt will be lower. Accordingly, at interest rates lower than 6.5%, the revenue requirements under City ownership would start lower and grow even more slowly than they would under current ownership.

<u>Reasonableness of Merger Price for the Stock of Pennichuck Corporation</u>

Q. Do you believe that the consideration to be paid by the City under the Merger Agreement for the shares of Pennichuck Corporation is fair and reasonable?

A. Yes. As a preliminary matter, I note that valuation of companies is not an exact science. The value of a company is usually set through market competition. For example, the share prices of public companies are determined by buyers and sellers in the stock market. In this case, the City and Pennichuck Corporation agreed to a negotiated price of $29.00 per share. This negotiated result did not involve any auction or market process that could be used to establish a market value. The negotiated approach was necessary because Pennichuck Corporation was selling in the context of an eminent domain proceeding, which by its nature prevented other bidders from entering the process.

Q. How have you reached your conclusion that the merger consideration is fair and reasonable?

A. In the absence of an auction process, one can evaluate the value of Pennichuck Corporation with reference to how companies similar to Pennichuck are valued in public markets. In this case, C.W. Downer & Co. prepared an analysis that compared Pennichuck Corporation to nine other publicly traded water utilities that both Pennichuck Corporation and financial analysts generally consider to be peers of Pennichuck Corporation. A copy of this analysis is attached as Exhibit AG-3.

This analysis uses three different market valuation methodologies. The first is based on comparing multiples of earnings before interest, income taxes, depreciation and amortization ("EBITDA"). EBITDA is a proxy for the cash flow potential of a business. The second is based on comparing multiples of book value. Book value is a measure of the equity invested in a business. The third is based on comparing multiples of rate base. Rate base is a measure of the total capital invested to provide water services to utility customers.

It is important to note that the premium calculation was based on share prices for the 30-day period through October 31 and on Pennichuck operating results for the 12 months ending September 30, 2010.

Q. What are the results of your analysis?

A. Premiums for utility transactions typically run between 20% and 40%. According to Mergerstat, a leading database of detailed information on mergers and acquisitions, the average control premium for utility transactions that were announced between January 2008 and October 2010 was 40%. The median control premium for that period was 26%. Using data available as of November 1, 2010, $29 per share represented a premium between 27% and 39% over Pennichuck's peer group, depending on the valuation metric that was used. That is a reasonable premium range in the context of a negotiated transaction with a public company.

Q. Have you updated your analysis to use more current data?

A. Yes. We have prepared an analysis using share prices through February 9, 2011 and, where available, updated operating results for Pennichuck Corporation and its peers. With that data, the $29 share price represented a premium between 26% and 40%, again depending on the valuation metric used. The new premium range is still reasonable for a negotiated acquisition of a public company.

Q. Do you have any further testimony at this time?

A. No.