STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

Re: City of Nashua Acquisition of Pennichuck Corporation

Docket DW 11-026

SUPPLEMENTAL TESTIMONY OF

JOHN L. PATENAUDE

July 1, 2011

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I. Introduction and Purpose of Supplemental Testimony

Q. Please state your full name and business address.

A. My name is John L. Patenaude. My business address is 1 Timber Lane, Hudson, New Hampshire.

Q. Have you provided written testimony in this proceeding?

A. Yes, I provided written testimony in this proceeding dated February 18, 2011.

Q. What is the purpose for this supplemental testimony?

A. The purpose for this supplemental testimony is to explain certain accounting treatments resulting from the proposed acquisition of Pennichuck Corporation by the City of Nashua, and the request of the Joint Petitioners for approval of these accounting treatments.

Q. How does this supplemental testimony impact your original pre-filed testimony?

A. This testimony supplements my original pre-filed testimony and does not replace it.

II. Reasons for Providing Supplemental Testimony

Q. Why are the Joint Petitioners providing this supplemental testimony seeking approval of the accounting treatments you refer to?

A. In the original testimony provided by the Joint Petitioners, the Joint Petitioners requested approval of the "City Bond Fixed Revenue Requirement" (or "CBFRR") ratemaking structure set forth in Ms. Hartley's testimony and the exhibits attached to her testimony.

The Joint Petitioners did not, however, request approval of any accounting treatments related to the adoption of the CBFRR approach. During the technical session held on May 11, 2011, we were asked several questions regarding the application of certain accounting restrictions to the Pennichuck utilities following the closing. As a result of the Joint Petitioners' work to respond to these questions, it became clear that we needed to provide supplemental testimony to provide this information directly to the Commission and seek authorization for the approach being proposed. (The technical session questions and the responses I am referring to, OCA Tech 1-2, 1-3 and 1-4, are attached to this testimony as Exhibit JLP (Supp.)-1, 2 and 3) My supplemental testimony will discuss these accounting impacts and treatments in more detail.

III. <u>Discussion of Accounting Restrictions</u>

Q. Please identify the restrictions that you are referring to.

A. The restrictions arise from two sources. First, under the current debt arrangements in place at PWW and PEU, PWW and PEU are subject to several financial covenants, which impose contractual restrictions on certain future actions of these utilities. These restrictions include, for example, a covenant that the utilities will not issue new debt if the ratio of debt to total capital would exceed 65 percent. These financial covenants are identified in detail in the response provided to OCA Tech 1-2. Second, in addition to these contractual constraints set forth in PWW and PEU debt instruments, the utilities are subject to a statutory limitation on the payment of dividends set forth in RSA 374:12. This statutory limitation authorizes utilities to pay amounts that are classified as dividends only from their current or accumulated retained earnings. As is explained in the responses to the OCA requests, both of these issues can be readily addressed.

Q. Could these accounting restrictions apply to constrain actions by the Pennichuck utilities following the City's acquisition, such as borrowing to fund additional capital expenditures or payment of cash to the City to cover obligations under the City Acquisition Debt?

A. Determining whether and to what extent these restrictions may apply requires projections regarding future financial performance of the utilities and assumptions regarding how the acquisition transaction and subsequent payments required to fund the repayment of the City Acquisition Debt would be treated for financial and regulatory accounting purposes. While these identified accounting restrictions would, by their terms, apply to the Pennichuck utilities following the City's acquisition, they would not constrain actions by the utilities for several years, depending upon the financial performance and accounting treatment of the acquisition transaction and subsequent payment required to fund repayment of the City Acquisition Debt. Prior to the time at which such constraints might arise, the City would have several options available to avoid the application of these constraints to the utilities. These options would include renegotiation or refinancing of the existing debt arrangements, restructuring of the corporate ownership structure, and several methods for effecting the transfer of available cash flow to the City to support payment of the City Acquisition Debt.

Q. Please explain how the statutory constraint on dividend payments might arise.

A. As I noted above and in my direct testimony, the Joint Petitioners' proposal in this case is based on a ratemaking methodology that provides for establishment of a fixed revenue requirement for each of the utilities that is designed to provide revenues required to support payment of their share of the City Acquisition Debt. These cash payments are expected to be made from the utilities to the parent holding company through several mechanisms, including payment of dividends, other distributions from equity, payments of amounts that reflect each utility's respective responsibility for income tax liability; and intercompany loans. Under RSA 374:12, a public utility's authority to pay dividends is limited to the amount of "net corporate income [and] any undistributed balance of such net corporate income previously accumulated." In other words, any dividend payments must come from retained earnings. As indicated in the financial model attached to the response to OCA Tech 1-3, under certain scenarios, there could come a point where this restriction would limit the utilities' ability to pay dividends to support the CBFRR. This problem is really a technical one that relates to how payments are classified from an accounting standpoint and how the source of the cash used to make such payments is accounted for. In other words, under the Joint Petitioners' proposal, there would be no shortage of cash to make the CBFRR payments, but there could be an issue as to whether the funds are available from the proper accounts.

As I will explain below, by making certain accounting adjustments that reflect the true nature of the CBFRR ratemaking treatment being requested by the Joint Petitioners, neither the constraint on paying dividends under RSA 374:12 nor the issue relating to the financial covenants in the existing debt arrangements would arise. In order to avoid any questions regarding these issues at a later date, the City prefers to address them transparently and in the context of this proceeding as a means of ensuring that a resolution of these technical restrictions is provided at the same time as the Commission considers the transaction itself. In addition, the requested accounting treatments more accurately reflect the true economic reality of the transaction and its financing.

IV. Description of the Municipal Acquisition Regulatory Asset and Basis for Finding It Is In the Public Interest

Q. Please summarize the accounting treatments that the Joint Petitioners are now requesting.

A. The Joint Petitioners request that the Commission authorize the three utilities to recognize a regulatory asset as the result of the City's acquisition of Pennichuck Corporation, which we refer to as the "Municipal Acquisition Regulatory Asset", and confirm that they may make certain related accounting adjustments. These requested accounting adjustments do not alter the CBFRR ratemaking structure as proposed in the direct testimony filed on February 18, 2011 and indeed are consistent with the true nature of the CBFRR ratemaking treatment being proposed. Specifically, the Joint Petitioners are requesting the Commission to authorize the utilities to record a regulatory asset that represents the incremental asset value being recovered through the CBFRR portion of utility rates.

Q. Please describe the regulatory asset that you indicated the Joint Petitioners are requesting be recognized by the Commission.

A. The City is requesting the Commission to approve a Municipal Acquisition Regulatory Asset ("MARA") for each of the three utilities. The aggregate amount of the MARA will be equal to the excess of the purchase price over the book value of the assets of Pennichuck Corporation. The purchase price is equal to the price paid for the shares including all transaction and debt financing cost plus all of the existing liabilities assumed. This aggregate MARA amount will be allocated among the Pennichuck Corporation subsidiaries, including the utilities. As I noted above, the basis for allocating the aggregate MARA amount will be the same basis used to allocate responsibility for the City Acquisition Debt among the subsidiaries.

Q. Please explain why the Joint Petitioners believe that recognition of the MARA would be in the public interest.

A. Recognition of the MARA as a regulatory asset is in the public interest because: (1) it is consistent with the ratemaking treatment already proposed by the Joint Petitioners in support of the overall acquisition transaction; (2) the Joint Petitioners have shown that the acquisition of Pennichuck Corporation, including its utilities and the proposed CBFRR ratemaking structure are reasonably projected to result in rates that will be lower over time than the rates that would be charged by the utilities if they continued under the current non-municipal ownership; (3) the rate differential between private and municipal ownership of the utilities is quantifiable; and (4) the projected savings and ratepayer benefits cannot be obtained without acquisition of the utilities by the City. As explained in the Joint Petitioners' initial filing in this case, these lower rates result principally from two factors: (1) under the CBFRR ratemaking structure proposed by the City, the City's overall cost of capital will be less than that of Pennichuck's under private ownership and (2) the City will be able to obtain immediate, quantifiable savings from operating efficiencies that result from the change in ownership. These benefits are described in more detail in my original testimony (at p. 24, lines 1-5), Ms. Hartley's original testimony (at p. 4, lines 13-16), and Mr. Gottlieb's testimony (at p. 4, lines 7-23 and p. 5, lines 1-11).

Q. Is the City seeking rate base treatment of the MARA?

A. The City is not proposing to include the MARA in rate base. Rather, under the ratemaking structure proposed by the City, the City will rely entirely on the CBFRR to generate the revenues necessary to allow the City to meet its obligations under the City Acquisition Debt. Accordingly, the City is not proposing that the MARA be the basis for determining rates. Rather, the City's ratemaking proposal remains unchanged from what was contained in its original proposal.

Q. If recognition of the MARA doesn't affect CBFRR ratemaking proposal, how does it and the related accounting treatments you are requesting affect the ratemaking structure proposed by the Joint Petitioners in this proceeding?

A. The MARA would be treated as an "equity-related asset" that would be removed from the traditional ratemaking structure and included as part of the CBFRR calculation. In addition, any amortization of the MARA would be similarly eliminated from the traditional ratemaking structure, as illustrated in the exhibits attached to Ms. Hartley's supplemental testimony. Accordingly, there is no impact on the CBFRR requested under the proposed ratemaking structure.

Q. What amortization schedule does the City propose for the MARA?

A. Because the MARA is directly related to the City Acquisition Debt, the City requests approval by the Commission to amortize the MARA as part of the CBFRR ratemaking structure at the same rate at which principal is paid on the underlying City Acquisition Debt. Accordingly, the MARA would be scheduled to expire at the same time as the City Acquisition Debt.

Q. Will the amortization of the MARA have any impact on utility rates as compared to what was anticipated in the Joint Petitioners' original proposal?

A. No. Under the ratemaking structure proposed by the City, as demonstrated in Ms. Hartley's Supplemental Testimony, the City will rely entirely on the fixed revenue requirement to generate the revenues necessary to generate sufficient cash flow to allow the City to meet its obligations under the City Acquisition Debt. The MARA does not result in a change in the level of the CBFRR, and in fact is merely intended to more accurately reflect the impact of the CBFRR ratemaking treatment that was originally proposed on the financial statements of the utilities.

V. Accounting Treatment of Municipal Acquisition Regulatory Asset and Related Accounts

Q. How will the MARA be reflected on the books of the utilities?

A. The proposed acquisition transaction will be accounted for using the purchase method. Under this method, the purchase price for Pennichuck Corporation, together with transaction costs, will be allocated to each of its subsidiaries. Under the Commission's Chart of Accounts, the MARA amounts will be recorded in Account No. 186. To balance these entries, paid-in-capital accounts on the equity side will increase to the extent of the excess purchase price. As a result of the application of the purchase method of accounting to the transaction, and the allocation of the MARA to the subsidiaries, the current retained earnings of Pennichuck Corporation and its subsidiaries will be converted to additional paid-in-capital. The accounting entries for the transaction are presented in Exhibit JLP (Supp)-4. These entries reflect the current estimate of the amounts that will be finally determined as of the closing.

Q. How will the proposed MARA and related accounting treatments impact the financial integrity of the utilities?

A. The proposed MARA and related accounting treatment will strengthen the financial presentation of the utilities because it will improve the utilities' respective net book values and equity. Recognition of the MARA, and the related adjustment to the paid-in-capital accounts, will better reflect the actual future revenue capacity of the CBFRR ratemaking structure proposed by the City, which includes the fixed revenue requirement at a level structured to provide for payment of the City Acquisition Debt. It will also have the effect of improving the debt-to-capital and other financial ratios of the utilities at the same time, and therefore will improve the ability of the City to access debt markets for future utility borrowings.

Q. Does the proposed MARA and accounting treatment have any impact on the ability of the utilities to pay dividends to the parent holding company?

A. Indirectly, it does. From an accounting perspective, this accounting approach essentially represents the termination of the old entity and the creation of a new one. As noted, this treatment requires the effective restatement of the common equity of the utilities as if they were new companies. As a result, the existing retained earnings balance for the utilities is likely to be eliminated over time. Under purchase accounting, the portion of the purchase price allocated to each company will establish its new common equity balance. Thus, the existing retained earnings that are available to pay dividends before the transaction closes would effectively become part of the new common equity balance recorded in the paid-in-capital accounts, which also includes the equity increase that balances out the excess purchase price. Accordingly, the City is requesting that the Commission confirm that the utility subsidiaries may pay distributions from the restated paid-in-capital accounts, up to the amount of their respective obligations with respect to the City Acquisition Debt.

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

A. No.