OCA Exhibit 1

BEFORE THE STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

In the matter of:

City of Nashua Acquisition of
Pennichuck Corporation
DW 11-026

Direct Prefiled Testimony

Of

Scott J. Rubin
On behalf of the Office of the Consumer Advocate

Dated: **August 30, 2011**

Introduction

Q. Please state your name and business address.

A. My name is Scott J. Rubin. My business address is 333 Oak Lane, Bloomsburg, PA.

Q. By whom are you employed and in what capacity?

A. I am an independent consultant and an attorney. My practice is limited to matters affecting the public utility industry.

Q. What is the purpose of your testimony in this case?

A. I have been asked by the New Hampshire Office of the Consumer Advocate ("OCA") to help the OCA evaluate the proposed acquisition of Pennichuck Corporation ("Pennichuck") by the City of Nashua ("Nashua" or "City"), including the City's proposed post-acquisition ratemaking procedures.

Q. What are your qualifications to provide this testimony in this case?

A. I have testified as an expert witness before utility commissions or courts in the District of Columbia and in the states of Arizona, California, Connecticut, Delaware, Kentucky, Illinois, Maine, Maryland, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, and West Virginia. I also have testified as an expert witness before two committees of the U.S. House of Representatives and one committee of the Pennsylvania House of Representatives. I also have served as a consultant to the staffs of the Connecticut Department of Public Utility Control and the Delaware Public Service Commission, as well as to several national utility trade associations, and state and local governments throughout the country. Prior to establishing my own consulting and law practice, I was employed by the Pennsylvania Office of Consumer Advocate from 1983 through January

1994 in increasingly responsible positions. From 1990 until I left state government, I was one of two senior attorneys in that Office. Among my other responsibilities in that position, I had a major role in setting its policy positions on water and electric matters. In addition, I was responsible for supervising the technical staff of that Office. I also testified as an expert witness for that Office on rate design and cost of service issues.

Throughout my career, I developed substantial expertise in matters relating to the economic regulation of public utilities. I have published articles, contributed to books, written speeches, and delivered numerous presentations, on both the national and state level, relating to regulatory issues. I have attended numerous continuing education courses involving the utility industry. I also periodically participate as a faculty member in utility-related educational programs for the Institute for Public Utilities at Michigan State University, the American Water Works Association, and the Pennsylvania Bar Institute. Attachment SJR-1 to this testimony is my curriculum vitae.

Q. Do you have any experience that is particularly relevant to the issues in this case?

A. Yes, I do. I am very familiar with the ratemaking methods and procedures used by water utilities that are owned by municipalities. I have worked on several cases involving municipal utility ratemaking, including cases before regulatory commissions and courts. For example, cases numbered 14, 75, 106, and 112 in Attachment SJR-1 involved municipal utility ratemaking. I also have helped to prepare rate studies for municipalities and reviewed other municipal water utility rate studies that did not result in my preparing testimony or expert reports. I also have served as an arbitrator in a wholesale water rate dispute between two municipalities.

Moreover, I served on the editorial committee for the preparation of the major ratemaking manual for the water utility industry, the American Water Works Association's Manual M1: *Principles of Water Rates, Fees, and Charges,* published in 2000. One of my responsibilities as a member of the editorial committee was to be primarily responsible for the preparation of Section I of the manual. This section deals with the calculation of water utilities' revenue requirements and encompasses Chapters 1 through 6 of the manual. That portion of the manual, as well as later sections, discusses in some detail how water utilities owned by a municipality (or other government entity) should determine their revenue requirements, allocate costs between customers who reside in the municipality and those who reside outside the municipality, and related issues.

In addition, I have substantial experience in cases involving the proposed acquisition of a public utility. During my career, I have performed legal or consulting services for public advocates, consumer groups, or labor unions in approximately 20 cases involving proposed utility mergers, acquisitions, or spin-offs, including the following:

- Allegheny Energy proposed acquisition of Duquesne Light Company
- Alltel spinoff to create Windstream
- Centerior – GPU merger to create FirstEnergy
- CenturyLink acquisition of Qwest
- CenturyTel merger with Embarq to create CenturyLink
- Dominion Resources sale of Peoples Natural Gas Co. to Steel River

- Duke Energy acquisition of Cinergy
- Exelon proposed acquisition of PSE&G
- FairPoint acquisition of Verizon New England
- FirstEnergy proposed acquisition of Allegheny Energy
- Frontier acquisition of Verizon operations in 14 states
- Long Island Lighting Co. break-up (sale of gas operations to Brooklyn Union Gas; sale of electric operations to Long Island Power Authority)
- Macquarie acquisition of Duquesne Light
- PSC Corp. acquisition of Consumers Water
- RWE acquisition of American Water Works Co.
- RWE divestiture of American Water Works Co.
- SBC acquisition of AT&T
- Sprint spinoff to create Embarq
- United Water proposed acquisition of Pennsylvania Gas & Water Co.
- Verizon acquisition of MCI

Q. Are any of these cases similar to Nashua's proposed acquisition of Pennichuck?

A. Yes. The case that is most similar to the proposed Nashua – Pennichuck transaction involved the sale of Long Island Lighting Company's electric operations to a publicly owned authority, the Long Island Power Authority. In that case, I acted as attorney and policy advisor to a large consumer group, the Citizens Advisory Panel, which was active in energy issues on Long Island. That is one of the very few cases involving the acquisition of a major investor-owned utility by a public entity.

Summary

Q. Please summarize your recommendations and conclusions.

A. I summarize my conclusions and recommendations as follows:

- In my opinion, the proposed acquisition of Pennichuck by Nashua is likely to lead to net benefits to the public, but only if the changes that I recommend in my testimony are made.

- The special ratemaking and accounting provisions requested by Nashua are not consistent with the public good and would cause substantial harm to customers who do not live in the City.

- If the Commission approves the acquisition, it should do so without the special ratemaking and accounting provisions requested by the City. Otherwise, the Commission cannot conclude that the transaction would be in the public interest.

- If the transaction is approved, the Commission should adopt the ratemaking procedures I recommend to recognize the difference between owner-customers (customers who are located in the City) and non-owner-customers (customers who are not located in Nashua).

The Proposed Acquisition

Q. What is your understanding of the proposed transaction?

A. Nashua is proposing to purchase all of the outstanding common stock of Pennichuck for $29 per share, which equates to the sum of approximately $138 million. Patenaude Direct, p. 4. At least for the present time, Nashua intends to keep Pennichuck as a separate, for-profit corporation, all of whose stock would be owned by Nashua.

Following Nashua's acquisition, Pennichuck would continue to be the sole stockholder of three regulated utilities Pennichuck Water Works, Inc. ("PWW"), Pittsfield Aqueduct Company, Inc. ("PAC") and Pennichuck East Utility, Inc. ("PEU") (collectively, "Pennichuck Utilities") as well as two unregulated subsidiaries, The

Southwood Corporation and Pennichuck Water Services Corporation. Nashua's ownership interest in the Pennichuck Utilities would be indirect, and the Pennichuck Utilities would continue to be regulated by the Commission.

Nashua intends to borrow 100% of the purchase price by issuing taxable municipal bonds. In addition to the purchase price, Nashua also intends to increase the amount of the bond issue to reimburse Nashua for the following expenses: approximately $5 million in expenses Nashua incurred in litigating an eminent domain (takeover) action against PWW, a wholly owned subsidiary of Pennichuck;[1] approximately $7 million in acquisition expenses (such as legal and consulting fees and bond issuance costs);[2] approximately $2 million that Pennichuck will need to pay to its officers and other employees who will not be retained after the acquisition for severance benefits; and approximately $5 million that Nashua will borrow to establish a "Revenue Stabilization Fund" at each utility.[3] In total, Nashua intends to borrow approximately $157 million to consummate the acquisition.[4] Patenaude Direct, pp. 12-13.

Nashua seeks approval of its purchase of Pennichuck's stock and the transfer of the Pennichuck Utilities' franchises as well as approval of certain special accounting and ratemaking mechanisms for the 30-year, bond repayment period. The City is not seeking Commission approval, however, of the amount or terms of the acquisition bond. OCA

[1] This amount does not include the approximately $5 million in expenses that Pennichuck incurred in litigating the eminent domain action.
[2] The City has not provided any specific information about these costs.
[3] This fund has been variously referred to as a Rate Stabilization Fund and a Revenue Stabilization Fund. For consistency, I will refer to it as a Revenue Stabilization Fund because the fund's purpose is to stabilize the revenue stream to the City, not the rates paid by customers of the utilities. *See* OCA 1-36 (Attachment SJR-2) and OCA Tech 1-1 (Attachment SJR-3).
[4] The City may decide to borrow additional amounts to refinance existing Pennichuck debt, if it is cost-effective to do so. Patenaude Direct Testimony, p. 12. *See also* OCA 1-56 (Attachment SJR-4) (amount of bond could change).

1-43 (Attachment SJR-5).[5] Although it predicts some savings to arise from its ownership of Pennichuck, Nashua does not seek any changes in rates at this time. *See* OCA 1-45 and OCA 1-57 (b) and (d) (Attachments SJR-7 and SJR-8, respectively).

Q. What is your understanding of the ultimate question before the Commission in this proceeding?

A. I am advised by counsel that the Joint Petitioners seek approval of the proposed transaction pursuant to Chapter 1, Section 118 of the 2010 Special Session (this law, as amended, is referred to herein as the "Special Legislation"), RSA Chapter 38, and RSA 374:30. The Special Legislation authorizes Nashua to purchase the stock of Pennichuck and requires the Commission to "make a public interest determination prior to any such purchase." The Special Legislation mandates that "the provisions of RSA 38 shall apply to the acquisition of stock by the city." RSA 38 authorizes the acquisition of utility property and plant if it is "in the public interest." RSA 374:30 authorizes the transfer of a utility franchise only if the Commission finds "that it will be for the public good."

I am advised that the Commission has not made it clear whether the "public interest" or "for the public good" standard requires only "no net harm" to the public, or the application of a more stringent standard that the transaction should produce a "net benefit" to the public. For example, in *Merrimack County Telephone Co.*, 87 N.H. P.U.C. 278 (2002), the Commission stated: "In verifying the assertion made by the Parties at the hearing that there are no adverse effects, or no net harm associated with the

[5] The City has represented that it is only possible for the proposed transaction to result in the same or lower rates than those that currently exist for the Pennichuck Utilities if the interest rate on the acquisition debt is at or below 6.5%. *See, e.g.*, Gottlieb, p. 5, lines 18-20; and Staff 1-68 (Attachment SJR-6).

transaction, we also inquired as to whether the acquisition provides net benefits to consumers." *See also National Grid plc*, 92 N.H. P.U.C. 279 (2007) (Noting that a variety of statutes applied and complex issues were being resolved, the Commission "consider[ed] all the interests involved and all the circumstances in determining what is reasonable."), and *Verizon New England Inc.*, 93 N.H. P.U.C. 24 (2008) (similar).

Q. Have you formed an opinion as to whether the proposed transaction would be for the public good?

A. Yes, I have.

Q. What are you relying on to reach that opinion?

A. As detailed throughout my testimony, I am relying primarily on statements and analyses provided by the City and its consultants, as presented in testimony and responses to numerous data requests.

Q. In your opinion, is the proposed transaction likely to lead to net benefits to the public?

A. Generally yes, but only if the changes I recommend are adopted by the Commission. In my opinion, the proposed acquisition of Pennichuck by Nashua is likely to lead to net benefits to the public in the broadest sense. Those net benefits would take the form of greater control by residents of Nashua over the operations of Pennichuck's subsidiaries that take place within the City limits, including a portion of the operations of PWW. Those net benefits also would include the likelihood that Pennichuck's overhead expenses would be lower once it is no longer a publicly traded company. In particular, ownership by Nashua would reduce Pennichuck's expenses for various officers, stockholder relations, accounting, and related matters (*e.g.*, S.E.C. filings and Sarbanes-Oxley compliance). It also is possible, but not certain, that the costs of capital to Pennichuck's utility operating subsidiaries, PWW, PAC, and PEU, would be lower over time under Nashua's ownership than they would be as part of an investor-owned utility holding company.

Q. Does your opinion mean that you support the Joint Petition for Approval that was filed by Nashua and Pennichuck on February 4, 2011?

A. No. The Joint Petition goes well beyond asking the Commission to approve the acquisition. The Joint Petition includes requests for special ratemaking and other regulatory provisions that are unprecedented and not in the public interest. Further, in its supplemental testimony, Nashua has requested additional accounting and ratemaking provisions that are not in the public interest and would lead to significant harm to customers outside of Nashua.

The opinion I just stated is true for the acquisition itself and is based upon the assumption that none of the costs of the acquisition (including the costs of the eminent domain proceeding, the transaction costs, the payment of any acquisition premium above net book value, and the guarantee of a revenue stream sufficient to repay bondholders) would be paid by customers of the Pennichuck Utilities who do not reside or do business in Nashua. If that assumption is not correct – that is, if customers of the Pennichuck Utilities who do not have a nexus to the City are required to pay a portion of the acquisition costs and otherwise guarantee the financial integrity of the City – then the proposed transaction would cause a net harm to the public and would not be for the public good.

In other words, if the Commission were being asked to approve the proposed acquisition without the proposed special ratemaking provisions, without requiring outside-City customers to pay acquisition or transaction costs, and without any type of direct or indirect push-down accounting, then I would find the acquisition to be for the public good.

Q. Why is it unreasonable to ask customers outside of Nashua to pay transaction costs, eminent domain costs, and a portion of the acquisition premium?

A. Those costs are the types of costs that should be borne by the new owner of a utility. When a utility (or any business, for that matter) is acquired, the customers of the business should not be required to pay the costs of the acquisition. As I mentioned earlier, I have been involved in about 20 utility merger or acquisition cases, and I cannot recall one case where customers were asked to pay any costs associated with the transaction.

As I explain below, a clear distinction should be made between owners of the utility and customers of the utility. Nashua will be the owner of the utility and, therefore, it is reasonable for residents and businesses in the City to bear the costs (and receive the benefits) of ownership. It is not reasonable, however, for customers who reside outside of Nashua to bear any of the costs associated with owning the utility.

Customers who are outside of Nashua's city limits do not have the ability to vote for the City's decision-makers (including those who decided to pursue this transaction), and they would not receive the benefits of a hypothetical future sale of (or other distribution of income or assets from) the utility business. Those are prerogatives of the owners – as proposed, the residents of Nashua. Moreover, the customers outside of Nashua had no ability to participate in the vote that ratified the Nashua Board of Alderman's initial decision to pursue the taking of PWW by eminent domain; that choice, which resulted in millions of dollars in litigation costs, rested solely with the citizens of Nashua, the proposed owners of Pennichuck.[6]

In my opinion, if customers outside of Nashua are required to bear any of the costs of the transaction, as the City proposes, the transaction would not be consistent with the public good. Rather, it would be highly inequitable to require such non-owner-customers to assume any of the responsibilities of the owners of the business.

Q. Are there other aspects of Nashua's ratemaking proposals that lead you to conclude that those proposals are not consistent with the public good?

A. Yes, and I discuss those later in my testimony.

What it Means to have City Ownership of a Water Utility

Q. Will the City and its taxpayers benefit from ownership of Pennichuck's stock?

A. Yes.

Q. What kinds of benefits would City residents enjoy through the City's ownership of Pennichuck's stock?

[6] The same would be true for any eminent domain costs incurred by the Commission that Pennichuck is required to pay to the Commission. Any such payments should be the responsibility of Nashua, not of outside-city customers.

A. There are two primary benefits of owning stock in a utility (or in any company, for that matter). The first is control. The City, acting on behalf of its residents and other property owners, would exercise control over the operations of Pennichuck and its subsidiaries. Various Nashua officials have publicly stated that one of the reasons they want to own Pennichuck is to gain control over land owned by one or more Pennichuck subsidiaries in and around the City. For example, Mayor Lozeau states: "this transaction allows the City to gain control of its water supply and watershed land so that the City can preserve and protect this public resource now and long into the future. As I stated earlier, this was the fundamental driving force behind the City's longstanding effort to acquire these important public resource assets." Lozeau Direct, p. 10.

The City will exercise control over Pennichuck by appointing members of Pennichuck's Board. In fact, the Mayor herself will serve on the Board for the first two years. Patenaude Direct, p. 20.

Q. What is the second type of benefit that citizens of Nashua could expect as a result of the City's ownership of Pennichuck stock?

A. The second major benefit of owning stock is financial gain (or at least the opportunity to obtain such a gain). Investors generally purchase stock in a company with the expectation that there will be some financial gain from owning the stock. The gain might be through the receipt of dividends, returns of capital, or capital appreciation (that are converted to cash when the stock is sold). Through one or more of these mechanisms, investors expect that they will receive more money over time than they have invested in the stock. If this transaction is approved, any financial gains from owning the stock of

Pennichuck would accrue to the City and provide a benefit to the taxpayers of the City – through enhanced services, reduced taxes, investments in new infrastructure or enterprises, or some combination of these.

As the transaction is proposed, Nashua wants to ensure that all of its costs – including the eminent domain proceeding costs and all other acquisition costs – are fully recovered from Pennichuck's operations. The City does not want to use any City funds (such as general tax revenues) to pay these costs, even though it is the City's taxpayers who would ultimately own the stock of Pennichuck and would be able to reap any benefits that come from that stock ownership. Because Nashua and its taxpayers will enjoy the benefits of Pennichuck ownership, however, Nashua and its taxpayers should fully shoulder the responsibilities of ownership.

Q. What are the responsibilities of ownership?

A. The primary responsibility of ownership of a public utility is stewardship. A water utility provides an essential public service that is directly tied to public health, economic development, and community vitality. Water utilities are capital-intensive businesses that require constant investments of new capital to maintain safe and reliable service, as well as to expand service to customers who demand it. The owners of the utility – in this case the City and its taxpayers, if the transaction is approved – have the responsibility to raise capital and ensure that such capital is available when the utility needs it.

Q. How does this notion of ownership apply to a water utility owned by a municipality?

A. The same benefits and burdens of ownership apply whether the owners of the utility are private stockholders or a public entity, such as a city or public authority. In fact, municipal ownership of water utilities is quite common. Approximately 80% of water utilities in the United States are owned by a city, town, or other arm of state or local government. Thus, in the field of water utility ratemaking, there is a well-developed procedure for establishing rates for publicly owned water utilities. That process includes a distinction between owner-customers and non-owner-customers.

Q. What do you mean by an owner-customer?

A. An owner-customer is a customer of the utility that resides within (or has a business located within) the jurisdictional boundaries of the owner. In the case of a city, like Nashua, owner-customers are those who are customers of the utility and who reside in the City. These owner-customers have a special responsibility and also have the opportunity to receive benefits from their ownership.

Q. What is the role of owner-customers and how does it differ from the role of non-owner-customers of a publicly owned water utility?

A. Owner-customers have the dual roles of being both owners (investors) in the utility and customers of the utility. As such, their rates usually are set differently than the rates of non-owner-customers.

Specifically, owner-customers have the responsibility of investors: they must ensure that the utility has access to capital and that sufficient cash is raised to pay third-party investors (such as banks or bondholders). In addition, owner-customers also are customers of the utility and are responsible for paying their fair share of the costs of operating the utility.

Non-owner-customers generally are treated in the same manner as customers of an investor-owned utility (where the customers also are not owners of the utility). They pay rates based on the owners' investment in plant (the rate base), pay a reasonable return on that investment, and compensate the owners for the diminution in value of that plant during the current period (depreciation expense).

In short, owner-customers have certain responsibilities, chief among them being assurance of access to capital. Over time, owner-customers help build up equity in the business for which they are compensated by non-owner-customers. And, if the business is sold, the proceeds stay within the City, providing a benefit to the owner-customers. Non-owner-customers have no such claim on the proceeds of a sale of the business; they are simply customers, they have not contributed capital to the business, assumed responsibility for raising capital, nor have any expectation of benefit if the business is sold.

Q. How does the water industry recognize the difference between owner-customers and non-owner-customers in the ratemaking process?

A. In the water industry, there are two generally recognized methods for developing a utility's revenue requirement: the cash-needs approach and the utility-basis approach. Both the utility-basis approach and the cash-needs approach use the same information for the utility's annual out-of-pocket operating expenses (payroll, supplies, and so on). They differ in how to treat the revenues needed to support the utility's investment in property, plant, and equipment (PP&E).

The cash-needs approach calculates the annual debt service requirement to pay principal and interest on outstanding bonds or other loans, and then provides additional revenues to pay for new capital investment, to recognize that some PP&E is supported by equity (such as retained earnings), and to provide a cushion to deal with unexpected occurrences. That additional revenue above expenses and debt service can be calculated as a level of "coverage" above the debt service. For example, a utility might use a coverage level of 30% in excess of the amount of debt service, which would be referred to as a debt-service coverage of 1.30 times. Instead of using debt-service coverage, some utilities calculate an "operating ratio" which is a multiple of operating and maintenance costs. For example, if a utility has operating and maintenance costs of $1.0 million, an operating ratio of 1.5 times would provide an additional $500,000 in revenues as a cushion to deal with unexpected occurrences. In addition, under the cash-needs approach, some utilities supplement the coverage or operating ratio calculation with reserve funds that are used for future capital improvements.

In contrast to the cash-needs approach, the utility-basis method sets rates using a process that is commonly employed by regulatory commissions throughout the United States, including this Commission. The utility-basis method calculates a utility's rate base, determines an appropriate rate of return on that rate base, and provides an allowance for annual depreciation expense on depreciable PP&E.

The revenue requirement calculated under the cash-needs approach and the revenue requirement calculated under the utility-basis approach usually will not be the same. While operating expenses and the interest portion of debt service usually will be the same in the two approaches (unless a hypothetical capital structure is used in the utility-basis method), the recovery of principal through debt service may be more or less than the amount of depreciation that is calculated based on the useful life of the assets. Moreover, the coverage (or operating ratio) and reserve funds calculated under the cash-needs approach may be more or less than the return on equity calculated under the utility-basis method.

Most government-owned water utilities determine their revenue requirements for inside-city customers (that is, owner-customers) based on the cash-needs approach. They need to ensure that they have sufficient funds to pay bondholders and provide some reserve for capital expenditures or unforeseen expenses. Thus, the rates for owner-customers typically include the recovery of expenses, provide sufficient cash flow to meet the requirements of third-party investors, and require some level of investment in the business to pay for capital additions and to provide working capital.

When a city serves customers outside of its jurisdiction (non-owner-customers), however, the rates for those outside-city customers should be determined using the utility-basis approach. That is, rates for non-owner-customers should be determined exactly the same way that this Commission sets rates for the customers of investor-owned utilities. As I discuss below, it is not unusual for a single utility to have two rate zones or districts: one for inside-city customers and one for outside-city customers.

Q. Is there a ratemaking guide for the water industry that discusses these procedures?

A. Yes, the American Water Works Association ("AWWA") publishes a ratemaking manual, Manual M1: *Principles of Water Rates, Fees, and Charges* (5th edition, published in 2000), usually referred to as the M1 Manual. As I mentioned at the outset of this testimony, I was a member of the editorial committee for the current edition of the M1 Manual, and I am very familiar with its contents and the ratemaking concepts embodied in it. I consider the M1 Manual to be an authoritative text in the field of water utility ratemaking.

On pages 6-7 of the M1 Manual (part of the discussion of how to determine a utility's revenue requirement), the following text appears:

> The utility basis of cost allocation is an appropriate method for calculating the costs of service applicable to all classes of customers. <u>It is particularly applicable to those customers located outside the geographical limits of a government-owned utility.</u> When a government-owned utility provides service to customers outside its geographical limits, the situation is similar to the relationship of an investor-owned utility to its customers because the owner (political subdivision) provides services to nonowner customers (customers outside its geographical limits). In this situation, the return from nonowner customers [is] based on the value of its plant required to serve those customers. (Emphasis added)

The specific situation of service to non-owner, outside-city customers is discussed in greater detail in Chapter 8 of the M1 Manual. On pages 65-66, the manual contains the following text under the heading "Service Outside City Limits":

> A government-owned utility, in most cases where not regulated by a state public utility commission, determines its total revenue requirements, or costs of service, on a cash-needs basis. That is, it must develop sufficient revenue to meet cash needs for O&M expense, debt-service requirements, capital expenditures not debt-financed, and possibly other cash requirements as described in chapters 1 through 6 of this manual. Such cash needs must be met by the utility as a whole. <u>However, when that utility serves outside-city, non-owner customers, it is most appropriate to measure the costs of such service on a utility basis; that is, to assign costs to outside-city customers for O&M expense, depreciation expense, and an appropriate return on the value of property devoted to serving them.</u> The inside-city customers are then responsible for all remaining cash

> requirements not derived from outside-city customers. Thus, if total utility revenue requirements are relatively low, perhaps as a result of retiring a major part of the bonded indebtedness and thus having a large amount of paid-up equity, the inside-city customers have relatively low rates. Thus, the inside-city customers benefit from having invested in and owning paid-up equity in the system. The reverse situation could also occur. If the rate of return is properly set, the utility basis of allocating cost of service is fair to both the supplier and the outside-city customer. (Emphasis added)

Nashua's Special Ratemaking and Accounting Proposals

Q. With that background, please describe your understanding of Nashua's ratemaking and accounting proposals.

A. The specifics of Nashua's proposed accounting and ratemaking conditions have been evolving as the case has moved forward and, in July, the City revised its proposal through supplemental testimony. What follows is my best understanding of the current state of Nashua's proposal in a somewhat simplified form.

Generally, Nashua is proposing that the rates for PWW, PAC, and PEU should be set to guarantee that Nashua receives sufficient cash flow to repay its bondholders each year. In order to do this, the City has requested the Commission's approval of two special (indeed I would call them unprecedented) ratemaking procedures, which, if approved, would remain in place for the 30-year life of the bonds.

First, Nashua requires that the rates of PWW, PAC, and PEU should be established to provide Nashua with the required cash flow to repay bondholders. The concepts of rate base, rate of return, depreciation expense, and income tax expense essentially would be eliminated, or at least made irrelevant to the determination of the revenue requirement. They would be replaced with what the City calls the City Bond

Fixed Revenue Requirement ("CBFRR"). The City's explanation of the CBFRR makes it sound as if there still would be a rate base, rate of return, depreciation, and income taxes; but in reality all of those calculations would be irrelevant. If the result of those calculations is less than the CBFRR, the capital-recovery portion of the revenue requirement would be increased to equal the CBFRR. If the result of those calculations is greater than the CBFRR, then they would be reduced to equal the CBFRR. *See* Hartley Direct pp. 7-9, and Hartley Supplemental, p. 4.

Second, Nashua is concerned that Pennichuck's utilities might not collect the entire CBFRR each year. This could occur, for example, if more capital must be invested than planned, if expenses increase, if revenues are lower than anticipated, or for any combination of these factors. The City, therefore, proposes to borrow an extra $5 million as part of the bond issue. Those funds would be divided up among the three utilities (roughly in proportion to their rate base). The funds would be treated as an equity investment in each utility, but placed in a dedicated reserve fund known as a Revenue Stabilization Fund ("RSF"). The RSF would be part of each utility's rate base (and thus would earn a return for the City), but would be drawn upon only to make up any shortfall in net revenues, then passed up to the City (through Pennichuck) – presumably as a return of capital – to ensure that the City has enough funds to repay its bondholders. OCA Tech 1-1 (Attachment SJR-3) and OCA Tech 2-3 (Attachment SJR-9).

As a utility's RSF is drawn down, a special rate surcharge would be imposed on all customers of the utility to restore the fund's balance.[7] It appears that certain customers might be exempt from this funding requirement, but the City has not been clear on this point. In response to OCA Tech 1-1 (dated June 24, 2011) (Attachment SJR-3), the City states: "The RSF surcharge will be calculated by taking the RSF deficit divided by the approved revenue requirement and using the derived percentage as the surcharge amount on each customer's bill (<u>exclusive of fixed contract customers</u>)." (Emphasis added) Neither the City's testimony nor any other responses to data requests on the RSF issue mention an exemption for fixed contract customers. For example, on August 3, 2011, the City stated:

> The RSF surcharge would be expressed as a percentage and applied to the effective portion of the total amount billed to each customer under the utility's approved tariff rate and charges with the exception of miscellaneous charges. The surcharge shall be applied equiproportionally to all classes of customers on a service rendered basis.

City's response to OCA Tech 2-3, paragraph 5(a)(1) (Attachment SJR-9).

Q. Is the potential exemption of fixed contract customers significant?

A. Yes, it is. The largest customer, by far, of the Pennichuck utilities is Anheuser-Busch Corp., which owns a brewery in the Town of Merrimack and is a customer of PWW. In addition, PWW has special contracts with two municipalities, Milford and Hudson. Collectively, these three special contract customers use approximately 15% of PWW's

[7] In addition to a surcharge to replenish the RSF, it also is possible that the utility would file a general rate case. *See*, *e.g.*, Staff 1-56(Attachment SJR-10) (City would file a rate case after transaction "in the event that cash flows from the operating subsidiaries, augmented by any Revenue Stabilization Funds, were not adequate to meet bond service obligations").

water and provide more than 5% of PWW's total revenues.[8] If those customers are exempted from having to fund the RSF, then all other customers would be asked to contribute even more to restore the City's equity in the business.

Q. Is it more consistent with the public good for special contract customers to be required to fund the RSF?

A. No, that would not be consistent with the public good either. As I explained above, the RSF is a forced equity contribution from customers to the City. The special contract customers outside of the City are a perfect example of the problems with such a requirement. Anheuser-Busch, obviously, is a for-profit company engaged in a very competitive business. Its brewery is not located in Nashua and does not pay taxes to Nashua. Yet, the City's ratemaking proposals would require Anheuser-Busch to make substantial equity investments in the City's utility operations – investments on which Anheuser-Busch could never receive a return.

In PWW's recently concluded rate case, Anheuser-Busch was responsible for approximately 3.4% of PWW's total revenue requirement (approximately $921,000 out of PWW's revenue requirement of approximately $27,000,000). Presumably that would mean that Anheuser-Busch also would be responsible for approximately 3.4% of PWW's RSF. According to the City, PWW's RSF would be $4,248,818. Nashua Exh. BJH (Supp)-1, p. 9 (Bates 8). So, if fixed contract customers are not excluded, Anheuser-Busch would be responsible for making an initial equity contribution to the City of

[8] In PWW's recently concluded rate case (DW 10-091), PWW filed a cost-of-service study in May 2011 to reflect the settlement in that case. Schedule 15 of that filing shows total contract revenues of $1,428,598 out of total revenues of $26,997,164, which is 5.29% of revenues. That schedule also shows that special contract customers use 740,013 100 cubic feet (ccf) of water out of total company sales of 4,998,599 ccf, or 14.8% of all water sales.

approximately 3.4% of that amount, or approximately $144,000. Each time the RSF needs to be replenished, Anheuser-Busch would be responsible for making a further equity contribution – again without the prospect of ever receiving a return on that investment. Each $1 million shortfall in the RSF would require Anheuser-Busch to make another $34,000 equity contribution to the City.

The same would be true (but in different amounts) for the other special contract customers, which are two other municipalities (the towns of Milford and Hudson). I would expect that each of these entities – a manufacturer engaged in a highly competitive business and two municipalities struggling with a difficult economy – would have other projects in which they could invest their precious capital, rather than being forced to shore up Nashua's investment in the water business.

This also is true for every customer who resides outside the City, though the dollar amounts would be smaller. Every non-Nashua resident or business would have other demands on their limited financial resources – demands that have the prospect for earning a positive return for (or otherwise improving the well-being of) the customer. But Nashua's proposal would divert those funds to the benefit of the City and its taxpayers.

Q. Is Nashua also proposing any special accounting provisions?

A. Yes, Nashua is proposing to create a regulatory asset known as the Municipal Acquisition Regulatory Asset ("MARA"). Mr. Patenaude describes the MARA as follows:

> 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 costs plus all of the existing liabilities assumed.

Patenaude Supplemental, pp. 5-6.

In other words, Nashua is proposing to require customers to reimburse the City for all acquisition costs and the entire acquisition premium; that is, the amount in excess of net book value that Nashua is paying for Pennichuck.

Q. How much a premium is Nashua paying for Pennichuck's stock?

A. According to Mr. Patenaude, the total MARA would be in excess of $82 million. Exhibit JLP (Supp.)-4 (Bates 47).

Q. In your opinion, is it reasonable for customers who live outside of Nashua to reimburse the City for these acquisition costs?

A. No. Acquisition costs are incurred by the owner to acquire existing assets. They should not be the responsibility of utility customers; they are the responsibility of the utility's owners. In all of the merger and acquisition cases in which I have been involved over the past 25 years or more, I am not aware of any significant utility transaction where acquisition costs, severance costs paid to the acquired company's officers, and the acquisition premium were pushed down to the utility and required to be paid by customers. These costs are not part of the cost of providing utility service to the public. They are costs incurred for the convenience of the new owner (and its investors) and they should be borne by the new owner.

Q. In your opinion, are these special ratemaking and accounting provisions reasonable and consistent with the public good?

A. No, they are not. The City has proposed what amounts to a rather convoluted way to use the cash-needs approach to determine its "revenue requirement," but tried to make it look like the utility-basis approach. There is no need to recreate the wheel. The cash-needs approach is a valid way to determine a water utility's revenue requirement, as long as it is applied only to owner-customers of the utility.[9]

Nashua's error comes in using the cash-needs approach for all customers, rather than limiting its application to owner-customers (that is, inside-city customers). In my experience, the ratemaking provisions that are part of the cash-needs approach (such as reserve funds and setting rates to ensure that a certain amount of cash is obtained) are unprecedented in their application to non-owner-customers (that is, customers who are outside of the City).

Q. What is wrong with using the cash-needs approach for non-owner-customers?

A. As I explained earlier, the cash-needs approach is based on the underlying assumption that customers have the responsibility to ensure that the utility raises sufficient funds to repay its investors and to invest in new facilities. That is a valid assumption for owner-customers, but it is not correct for non-owner-customers.

Non-owner customers have little or no right to control the utility or benefit financially from investment in the utility and do not have any responsibility to guarantee that payments are made to the utility's bondholders or to provide capital that can be used

[9] While the M1 Manual does not contain any mandatory procedures that water utilities must follow (the manual is designed to provide guidance to water utilities, consumers, and regulators), I strongly recommend that the Commission follow the manual's guidance and use the utility-basis approach to set the revenue requirements for outside-city customers. This method recognizes the critical distinctions in the rights and responsibilities of inside-city customers (owner-customers) and outside-city customers (non-owner-customers).

to make future capital investments. Stated differently, non-owner-customers' obligations are based on capital already invested in the utility. They pay a reasonable return on the net investment in facilities, and they pay depreciation expense to compensate the utility's investors for the reduction in value of the facilities as the facilities age.

In contrast, owner-customers have a different obligation. As owners of the utility, they must ensure that bondholders are paid, and they can be required to provide additional funds to make sure such payments are made. Further, owner-customers have an obligation to ensure that the utility can raise new capital, and they often are asked to contribute to that capital by making contributions to working capital reserves or capital improvement accounts. In exchange for these capital contributions, owner-customers have control over the utility's operations, help the utility build up equity in the business, and are compensated for that equity in future rate cases.

Q. How does this distinction between owner-customers and non-owner-customers translate into rates?

A. In the early years of a utility, investors (owner-customers) may be required to make capital infusions to the utility, so their rates might be higher than those paid by non-owner-customers. Over time, however, bondholders are repaid and equity is built up in the business. Sometimes that equity is substantial. For example, I recently worked on a case for a municipally owned water utility that had been in business for more than 100 years, and had a capital structure that was about 75% equity. Once that occurs, then it is likely that the rates paid by inside-city customers would be less than those paid by outside-city customers.

It is hard to generalize, but the key is that outside-city rates are set using the utility-basis approach (traditional rate base, rate of return, depreciation), which ensures that the rates are cost-based and that those costs are fairly allocated between inside-city and outside-city customers. This method also ensures that non-owner-customers are not being asked to subsidize or invest in the business (or pay an excessive return on the owner's investment for the benefit of owner-customers).

Inside-city customers then have the responsibility to ensure that the business generates enough cash to meet its obligations. There may be times when inside-city rates are higher than outside-city rates, and other times when inside-city rates are lower than outside-city rates. Those are the burdens and benefits of ownership.

Q. Can you illustrate the harm to outside-city customers under Nashua's ratemaking proposals?

A. Yes, I will use PEU as an example. According to Nashua's analyses, PEU is expected to experience negative cash flow in 2012, the first year of City ownership. This negative cash flow occurs even though the City's financial model assumes a revenue increase of $650,000 (10.66%) for PEU in 2012.

Specifically, Nashua Exh. JLP (Supp.)-2, page 16 (Bates 30) shows PEU's revenues increasing from $6,147,528 in 2011 to $6,802,609 in 2012. Page 18 of that exhibit (Bates 32) shows the net cash flow for PEU in 2012 – even after this substantial increase in revenues – would be -$141,026. This exhibit assumes that the City is able to borrow money for the acquisition bonds at a 5.7% interest rate. If the City's interest rate is 6.5%, PEU's cash flow in 2012 would be even worse at -$261,765. Id., p. 27 (Bates 41).

Under the City's proposal, that negative cash flow would require PEU to tap into PEU's RSF, which would be funded at the initial level of $658,420. Nashua Exh. BJH (Supp) -2, p. 2 (Bates 17). Thus, in just the first year, between one-fifth and one-third of PEU's RSF would be drawn down, which according to the City would require PEU customers to be assessed a surcharge to replenish the RSF.[10]

In the second year of City ownership, 2013, the only way that PEU avoids having negative cash flow is to have revenues increase by an additional $700,000 (10.4%). Nashua Exh. JLP (Supp.)-2, p. 16 (Bates 30). Despite having revenues increase by more than $1.3 million in two years, PEU's cash flow in 2013 would be between $259,983 and $380,892, depending on the interest rate. Id., pp. 18 and 27 (Bates 32 and 41). Further, if the rate relief is less than the City expects, or if the timing of the revenue increases differs from the City's assumptions, PEU could be required to draw on the RSF yet again in 2013.

Thus, in just the first two years of City ownership, PEU customers – none of whom reside in the City – can expect base rate increases of $1.3 million, plus an additional surcharge increase of between $140,000 and $260,000.

[10] It is unclear whether the surcharge would be assessed over 12 months or 24 months or whether the surcharge would be a reconciling mechanism. In response to OCA Tech 1-1 (dated June 24, 2011) (Attachment SJR-3), the City stated the RSF would be replenished through a surcharge over 24 months. In response to OCA Tech 2-3 (dated August 3, 2011) (Attachment SJR-9), the City stated the RSF would be replenished annually, with a limit that the surcharge could be no more than a 5% rate increase.

Q. How does that compare to what would happen to PEU's rate if Pennichuck remained a privately owned company?

A. If Pennichuck remained a privately owned company, PEU's rate would not change until the next rate case and would, presumably, continue to include approximately $46,000 per year in operating expenses, which amount, according to Ms. Hartley, corresponds to the benefits to PEU of City ownership. *See* City Exh. BJH (Supp) – 2, p. 1 (Bates 16) (reducing the 2009 equivalent revenue requirement from $6,528,978 to $6,482,916). In contrast, under City ownership, the $46,000 of reduced annual expenses would be dwarfed in just the first year by the required $140,000 to $260,000 rate increase to pay for the shortfall in the RSF – an increase between three and six times the alleged annual savings from City ownership.

Q. What do you conclude from your analysis of the City's ratemaking proposals?

A. I conclude that the City's ratemaking proposals would cause significant harm to customers who reside outside the City. Those customers are likely to be required to pay higher rates. Those rates include the making of substantial forced equity investments in the City's water business, even though the outside-city customers would not have any prospect of earning a return on that investment and would not exercise any control over that business.

Recommendation

Q. Can you recommend a way to cure these defects in the City's proposal?

A. Yes. I recommend that, if the Commission authorizes Nashua to purchase the stock of Pennichuck, the following ratemaking procedures should apply:

- PWW should be divided into two ratemaking districts: one district for customers located within the city limits of Nashua, and one district for customers located outside the city limits.

- None of the acquisition-related costs should be assigned to PAC, PEU, or the outside-city district of PWW. By acquisition-related costs I am referring to eminent domain costs, transaction costs, severance costs, and the acquisition premium that Nashua is paying (that is, the purchase price in excess of the net book value of Pennichuck). Simply, there should be no change in the rate base, and no change in rates to pay acquisition costs, at PAC, PEU, or the outside-city district of PWW as a result of this transaction.

- In future rate cases, Pennichuck should be required to file rate cases simultaneously for PWW, PAC, and PEU (which I refer to below as a "consolidated" rate case).

- The revenue requirements for PAC and PEU should be determined as they are determined now, by using the utility-basis method (the traditional rate base, rate of return, depreciation approach to rate-setting).

- A separate revenue requirement should be determined for the outside-city portion of PWW, using the utility-basis method. That revenue requirement calculation likely will include the allocation of various costs and facilities that are incurred on a total-company basis for PWW. I would expect that other costs or facilities could be separately identified as being either inside or outside of Nashua. This allocation process would take the form of a cost-of-service study that assigns or allocates costs between PWW's two rate districts. That study should be based on the utility-basis methodology of determining the revenue requirement.

- The consolidated rate case should include a calculation of Pennichuck's total revenue requirement from utility operations using the cash-needs approach. That is, Pennichuck would calculate the amount of cash that Pennichuck needs to meet expenses and meet the City's debt service obligation (plus any reserve funds), then subtract from that the amount of cash it anticipates from unregulated operations to determine the cash it needs from its utility operations. This calculation would be based on the total debt service requirements, including the portion of the bond proceeds that were used to pay eminent domain costs, transaction costs, severance costs, the acquisition premium, or to fund reserve accounts.

- The revenue requirement for the inside-city district of PWW would be equal to the Pennichuck revenue requirement from utility operations, minus the revenue requirements of PAC, PEU, and the outside-city district of PWW.

- Over time, the Commission may want to evaluate whether it is consistent with the public good to consolidate some or all of the outside-city utility operations (PAC, PEU, and the outside-city district of PWW) into fewer ratemaking areas. Such a consolidation certainly is not required for this process to work effectively, but the Commission may be interested in evaluating rate consolidation for other public policy reasons.

Q. What are the benefits of your recommended approach?

A. Under my approach, residents (and businesses) of Nashua would bear the responsibilities of owner-customers of the utility. Nashua residents would be responsible for ensuring that the business generates sufficient cash to pay bondholders, for funding the eminent domain proceeding, for paying the transaction costs the City incurred, for paying the significant premium over net book value for Pennichuck's stock that the City negotiated, for paying severance to Pennichuck officers or employees that result from the transaction, and for providing on-going equity infusions into the business (such as through an RSF or other reserve fund). In exchange for these obligations – all of which stem from decisions made by elected representatives of the City as well as the Nashua citizens' vote to take PWW by eminent domain – Nashua residents collectively expect to build up equity in the business and receive a return on that equity investment in future rate cases.

My approach also ensures that those who are outside of Nashua – residents and businesses that have no obligation to pay taxes to Nashua, no ability to vote for Nashua's decision-makers, and that have no expectation of receiving any benefit if Nashua decides to sell (or otherwise monetize) its investment in the utilities – will pay rates that are established in the same way they are now. This Commission will continue to protect outside-city customers by establishing a reasonable rate of return, ensuring that costs are fairly allocated between inside- and outside-city customers, reviewing expenditures to ensure that they are prudently incurred, ensuring that facilities are used and useful in serving the public, and otherwise regulating the rates, services, and operations of the utilities.

Conclusion

Q. In your opinion, if the Commission were to adopt your ratemaking approach, would the proposed transaction be consistent with the public good?

A. Yes.

Q. In your opinion, if the Commission did <u>not</u> adopt your ratemaking approach, would the proposed transaction be consistent with the public good?

A. No. As I explained earlier, if Nashua insists on having non-owner-customers pay owner-related costs (eminent domain costs, transaction costs including severance benefits, acquisition premium, and reserve funds), then the transaction would not be consistent with the public good for customers who reside outside of the City.

Q. What do you recommend?

A. I recommend that the Commission approve the proposed transaction if, and only if, the Commission also requires PWW, PAC, and PEU to follow the ratemaking procedures I discussed above.

Q. Does this conclude your direct testimony?

A. Yes.