DW 05-094

PENNICHUCK WATER WORKS, INC.

Petition for Authority to Issue Long Term Debt

Order Approving Financing Request

O R D E R N O. 24,510

September 2, 2005

I. PROCEDURAL HISTORY

On May 12, 2005, Pennichuck Water Works, Inc. (PWW) filed a petition with the New Hampshire Public Utilities Commission (Commission), pursuant to RSA 369, requesting authority to issue long-term debt. The financing involves issuance of up to $50 million in tax exempt debt instruments through the New Hampshire Business Finance Authority (BFA). PWW intends to use the proceeds to refinance existing debt, perform upgrades to its water treatment plant to meet more stringent federal water quality standards, and finance other capital additions.[1]

On May 13, 2005, the Office of the Consumer Advocate filed notice of its intent

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[1] The projects relating to the water treatment plant include: two 350 HP raw water pumps at the Merrimack River intake; passive and active raw water management facilities to Bowers and Harris Ponds; new raw water intake facilities to eliminate daily temperature fluctuations in raw water temperature and eliminate surface floatables from entering the plant; add a second raw water intake line with duplicate raw water inlet control valve; install raw water permanganate and chlorine feeds; add sodium hydroxide and carbon dioxide feed facilities to the headworks; add duplicate raw water automatic cleaning screens to the raw water inlet; add flow meters to the 36 inch water lines feeding the pulsators and new sluice gates to regulate flow to the pulsators; replace existing transite pulsator collector launders with PVC launders; remove pulsator egg crate tube settlers and replace with plate settlers; change filter media from 36 inches of mixed carbon and sand to 60 inches of monomedia carbon; add enhanced backwash facilities; add filter to waste facilities; add combination 6.5 million gallon finished water storage and chlorine contact tank; add 480V genset large enough to run the plant and operate the finished water pumps; construct finished water pumping station with 480V electric motor driven pumps to meet range of water demands; replace chemical feed and storage facilities where appropriate; add training room and elevator to WTP building; and upgrade facilities to OSHA and ADA standards. Exh. 1 at 32 – 33

The other capital improvement projects include: improvements relating to EPA vulnerability assessment; watershed improvements; install arsenic treatment system in the Woodlands water system; implement radio meter reader program; water main replacement and rehabilitation program; Bon Terrain tank maintenance and Fifield Tank replacement; Armory pumping station operational improvements; expand Shakespeare High Pressure service area; replace some vehicles; install some water meters; GIS implementation; and update customer account and billing software. Exh. 1 at 34 – 36.

to participate in this docket on behalf of residential utility consumers pursuant to RSA 363:28, II.

On May 25, 2005, the Commission issued an Order of Notice setting a Prehearing Conference and technical session for June 15, 2005. On June 15, 2005, Staff, on behalf of itself and the Parties, filed a proposed procedural schedule, which the Commission approved by secretarial letter dated June 20, 2005. In accordance with the procedural schedule, Staff and Parties conducted discovery and met in technical sessions. Staff and the Parties filed a Settlement Agreement (Agreement) on July 28, 2005 and presented the Agreement to the Commission at a hearing held on August 2, 2005.

II. DESCRIPTION OF FINANCING

According to the Agreement, upon approval of the Governor and Executive Council, the BFA will issue up to $50 million in tax-exempt bonds (BFA Bonds) to investors identified by PWW. PWW will then enter into a master loan and trust agreement (MLTA) with the BFA under which PWW will be obligated to repay proceeds of the BFA Bonds. The BFA's obligation to repay the investors who purchase the BFA Bonds would be non-recourse in nature and would be limited to payments received under the MLTA and an escrow agreement. Upon receipt from the investors, the proceeds of the BFA Bonds will be deposited with a bond trustee who will act as a disbursing and escrow agent to ensure that the proceeds are used only to fund qualified expenditures.

PWW proposes initially to draw down between $15 and $20 million of the proceeds of the BFA Bonds for certain capital expenditures and issuance costs. PWW refers to this first draw down as Series A Debt. Subsequent draw downs will be referred to as Series B Debt and Series C Debt. The proceeds not initially drawn down by PWW will be held in escrow by the bond trustee until they are requested by PWW. PWW indicates that it expects to draw down the escrowed proceeds in two stages: the first approximately one year after the BFA Bonds are issued; and the second approximately two years after the BFA Bonds are issued.

During the period that the proceeds of the Series B and Series C Debt are held in escrow, the BFA Bonds associated with those proceeds will be secured by U.S. Treasury securities. The Treasury securities will have maturity dates coinciding with PWW's planned withdrawal of the escrowed proceeds. The interest rate on the Treasury securities is expected to equal or exceed the interest rate of the Series B and Series C Debt. In the event the interest rate on the Treasury securities securing the Series B and Series C Debt is insufficient to cover the interest expense on that debt, PWW states it will contribute additional funds to the escrow account to cover the difference. PWW states this event is unlikely because both the Series B and Series C Debt will be tax exempt and both are anticipated to be AAA rated.

PWW expects the BFA Bonds to have a final maturity date 30 to 35 years after the date of issuance. The bonds will be multi-modal, which means PWW may elect to specify the interest rate period. At the end of such periods, the bonds may be remarketed with a new interest rate for a new interest rate period. Given the current low interest rates in the tax exempt bond market, PWW plans to have a fixed interest rate for the Series A Debt for an interest rate period that extends to the bonds' maturity date. The interest rate period for the Series B and Series C Debt will initially be set so that it approximately coincides with the PWW's anticipated timing for withdrawing the proceeds of that debt from escrow.

PWW intends to withdraw the escrowed proceeds when it requires those funds for the capital expenditures. As the proceeds of the Series B and Series C Debt are withdrawn from escrow, the BFA Bonds associated with those proceeds will be remarketed for an interest rate period, selected by PWW, by an investment banking firm acting as the remarketing agent. The remarketing agent will offer debt at the lowest interest rate obtainable in order to sell that debt at par for the given interest rate period. If the interest rate period selected by PWW expires prior to maturity of the BFA Bonds, the remarketing agent will again offer the debt for an interest rate period to be selected by PWW. This process will continue until the maturity date of the BFA Bonds is reached, at which point PWW will either seek approval of a new financing to refund the existing debt or will otherwise obtain funds to pay off the BFA Bonds in full.

III. TERMS OF SETTLEMENT AGREEMENT

The Staff and Parties agree and recommend that the Commission adopt the following provisions as part of its order in this proceeding:

A. The capital expenditures for which PWW proposes to use the proceeds of the BFA financing are reasonable and necessary to provide service to the public, the terms and conditions of the proposed financing as presented by PWW are reasonable and, therefore, the proposed use of the proceeds and the financing are prudent and consistent with the public good pursuant to RSA 369.

B. The Staff and Parties recommend the Commission:

1. Authorize PWW to execute and deliver to the BFA up to $50 million in promissory notes and other debt instruments with a maturity of up to 35 years, for the purpose of financing certain capital expenditures.

2. Authorize PWW to determine the maturity dates, interest rate periods and interest rates borne by such debt instruments, subject the conditions described herein.

3. Authorize PWW to enter into an escrow or other similar agreement with the BFA and the bond trustee to escrow up to $38 million of the proceeds of the BFA Bonds until such time as PWW requires the escrowed proceeds, or any portion thereof, for capital expenditures.[2]

4. Authorize PWW to enter into debt instruments payable to the BFA with regard to the Series A Debt at a fixed interest rate to maturity equal to the lowest rate

[2] The Settlement Agreement originally requested authority to escrow $35 million. At hearing, PWW modified this amount and testified that PWW recently learned $3 million was available through the State Revolving Loan Fund (SRF). PWW explained that SRF funds have a lower interest cost than the BFA funds and thus PWW would use the SRF funds first. PWW expects to seek Commission approval of the SRF funds posthaste. 8/2/05 Tr. at 39, 40, and 41 lines 1-8.

obtainable by the underwriters of the BFA Bonds in order to sell the BFA Bonds associated with the Series A Debt at the lowest all-in cost to PWW.

5. Authorize PWW to nominate its debt obligations with regard to the escrowed proceeds into a Series B and Series C, or such other nominations as PWW shall reasonably determine to be appropriate, including subseries thereof, to reflect differing interest periods elected by PWW or to enable PWW to withdraw the proceeds of such debt from escrow in varying increments in order to better match the timing of PWW's need for such funds.

6. Authorize PWW to withdraw the escrowed proceeds or any portion thereof from escrow for use for the capital expenditures, or as may otherwise be authorized by the Commission, and to retain a remarketing agent to remarket all or any portion of the Series B and Series C Debt for new interest rate periods and at such interest rates as PWW reasonably determines are likely to result in the lowest cost of capital over the long term.

7. Authorize PWW to remarket the remarketed debt on a long or short term basis without further approval of the Commission, provided that the final maturity date of the remarketed debt is no later than the maturity date of the BFA Bonds upon their initial issuance and further provided that all of the remarketed debt instruments shall bear interest at rates that are determined by the remarketing agent to be the lowest rates obtainable in order to remarket such debt at par.

8. Require PWW to notify the Commission and Office of the Consumer Advocate at least 30 days in advance of any remarketing of Series B or Series C Debt that PWW intends to remarket such debt and further require PWW to provide the following information: (i) the new interest rate period(s) of the Remarketed Debt; (ii) the anticipated new interest rate(s); and (iii) PWW’s basis for determining the particular interest rate period(s) selected. PWW's notice to the Commission shall either confirm that it has reached such determination based on the methodology outlined in the Decision Process for Determining Maturity Date of Bonds, attached to the Agreement or, if PWW has varied from such methodology, it shall set forth the reasons for such variation.

9. Authorize PWW to enter into one or more loan and trust agreements with the BFA and the Trustee and others to obtain such credit enhancement, including bond insurance, as it determines to be reasonable to minimize the overall cost of such financing.

C. PWW should be authorized to accrue allowance for funds used during construction (AFUDC) at a rate of 8% on the capital expenditures to be financed with the proceeds of the BFA loan until such time as those expenditures are included in rate base for recovery through rates.

IV. COMMISSION ANALYSIS

Commission review of additions, extensions, or capital improvements to a utility's fixed property can commence under various circumstances. Pursuant to N.H. Code Admin. Rules, Puc 609.12, a utility must file a Form E-22 when it makes any addition, extension, or capital improvement to the utility's fixed property. The requirement to file an E-22 emanates from RSA 374:5, which requires utilities to inform the Commission of additions to rate base, prior to making any addition, extension, or capital improvement to the utility's fixed property. When these changes to fixed property require financing, public utilities must obtain Commission approval before issuing evidence of indebtedness payable more than 12 months after the date thereof, pursuant to RSA 369:1. The Commission must find the proposed issue and sale of securities is "consistent with the public good" in accordance with RSA 369:4. The New Hampshire Supreme Court has further provided that the public good consideration involves looking beyond actual terms of the proposed financing to the use of the proceeds of those funds and the effect on rates to insure the public good is protected. *See, Appeal of Easton,* 125 N.H. 205, 211 (1984). It is against this regulatory framework that we review PWW's proposed additions, extensions, and other capital improvements to its fixed property.

We will consider the financing structure first. PWW has requested authorization to issue, through the BFA, up to $50 million in long term debt over 35 years at an interest rate that is yet to be determined. PWW avers that the financing structure and lack of exact interest rate is necessary to take advantage of the BFA's ability to issue PWW up to $50 million in tax-exempt bonds in calendar year 2005. Exh. 1 at 12, lines 11-20. PWW testified at hearing that the proposed financing structure is not unique and is used by borrowers who want to take advantage of the annual allocation for bond issuance (known as “volume cap”) when it is available but do not need to use the funds until later. Hearing Transcript of August 2, 2005 (8/2/05 Tr.) at 15 lines 9-15. On July 29, 2005, PWW’s Board of Directors authorized PWW to seek the financing. Exh. 4. The financing is a general unsecured obligation.

Because the bonds have yet to be issued, PWW is only able to state that the present interest rate for a 30-year, AAA-rated, New Hampshire-based issuer, subject to the alternative minimum tax, is approximately 4.65%. Comparable 1-year and 2-year rates are 3.00 and 3.04%, respectively. Exh. 2 at 29. Knowing that tax-exempt bonds are traditionally among the lowest cost financing available, it is likely these rates will be the lowest financing available for PWW’s capital improvement projects.

The Commission recently approved bond financing arrangements for PWW in Docket No. DW 04-171. In that docket, BFA issued $6.8 million in tax-exempt bonds with a AAA rating. The bonds were divided into Series A, B, C, and D according to maturity date and, as is the case here, PWW was unable to provide an exact interest rate. In that docket, Staff stated the bonds carried a coupon rate 30 to 50 basis points below the prevailing Bond Buyer Revenue Index (BBRI), and thus Staff expected the interest rates to range from 4.55% to 4.75%. *Pennichuck Water Works, Inc.*, Order No. 23,495 (November 5, 2004). Here, the estimated interest rates fall within a similar range and PWW is fairly certain that at the conclusion of the financing, its debt to equity ratio will remain within its existing 65/35 ratio. Exh. 2 at 17. For these reasons, we find the terms and conditions of the proposed financing reasonable.

We next consider the purpose for which the financing is sought. PWW plans to use the proceeds of the financing to upgrade its water treatment plant and make various other capital improvements to its infrastructure. Latest cost estimates for the treatment plant improvements indicate PWW will need $35 million. 8/2/05 Tr. at 40 lines 11-17. Capital improvements to the remainder of PWW's infrastructure are expected to cost $14,759,000. Ex. 1 at 36. These cost estimates total approximately $50 million, the amount PWW seeks approval to finance.

At hearing, PWW explained the panoply of federal regulations over the past ten years which culminated in PWW's proposed capital improvement schedule. 8/2/05 Tr. at 72-75. Specifically, PWW states the upgrades to its water treatment plant and other capital improvements are necessary to insure its compliance with the federal Safe Drinking Water Act. Exh. 2 at 20-21. Staff stated that the combination of aging plants and growing regulations have caused other utilities such as Manchester Water Works, Hampton Water Works, and Exeter Water Works to make significant upgrades to their water treatment plants as well. 8/2/05 Tr. at 83 lines 13-24 and at 84 lines 1-5. Staff testified that it had reviewed engineering reports which identified the need to make the proposed capital improvements and agreed with PWW that the improvements were reasonably necessary. 8/2/05 Tr. at 82 lines 11-24 and at 84 lines 17-18. Based upon our review of the petition and other evidence in the record, we agree that the capital improvements are reasonably necessary and find that the use of the proceeds is consistent with the public good.

We next turn to Staff and the Parties' request to allow PWW to accrue an allowance for funds used during construction at a rate of 8%. AFUDC is allowed by the Uniform System of Accounts adopted by the Commission and is an accounting method which allows utilities to capitalize the cost of a utility's capital associated with a construction project.[3]

[3] AFUDC is recorded part as current income, part as an offset to interest expenses, but no cash payments are made by ratepayers during construction. The payments from ratepayers to recover the carrying charges begin when the

It assists utilities in maintaining its earnings levels while funding construction, and also complies with the mandate of RSA 378:30-a that construction work in progress not be included in rates. AFUDC is particularly appropriate in circumstances where the capital improvements are significant relative to the size of the utility and where cash flow to fund the construction can become an issue. Utilities recognize the revenue from AFUDC in their earnings, even though the associated cash is not collected from ratepayers until the project is completed and in service, and rates are increased to reflect recovery of the new asset. PWW intends to book AFUDC accruals through month-end journal entries by debiting construction work in progress in Account 105 and crediting either AFUDC-Debt or AFUDC-Equity in Account 420. Exh. 2 at 32. Combined with a Commission finding that the capital improvements are consistent with the public interest, AFUDC can make a utility a more attractive investment.

Citing current accounting and auditing standards, PWW's outside auditors require express Commission approval of AFUDC before they will allow PWW to accrue AFUDC. 8/2/05 Tr. at 21 lines 14-21. Because our Uniform System of Accounts allows this accounting treatment, we will focus our analysis to the use of 8% as the accrual rate. PWW testified that 8% was chosen since it reflected PWW's present overall weighted average cost of capital.[4] 8/2/05 Tr. at 63 lines 4-6. According to PWW, the income generated by AFUDC mitigates the interest expense associated with the financing and helps keep PWW from falling below its minimum coverage ratios necessary to issue debt. 8/2/05 Tr. at 22 1-11. PWW avers that the 8% interest rate is appropriate for AFUDC accruals since the project is supported by both debt and equity

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completed plant goes on stream. The entire cost of the plant, including AFUDC, is added to rate base, and it earns a rate of return on investment and is depreciated over the life of that plant. J.C. Bonbright, *Principles of Public Utility Rates,* 246 (1988).

[4] PWW derived the 8% by dividing $44,640,000 in rate base by $3,574,734 in Net Operating Income Requirement. Exh. 2 at 4.

capital, and the use of PWW’s weighted average cost of capital is supported by accounting and regulatory practice. 8/2/05 Tr. at 64 lines 10-13. We agree that the weighted average cost of capital is appropriate for the AFUDC accrual rate. Even though PWW is acquiring financing for the projects at a debt rate that is expected to be below 5%, the construction of the treatment plant project is supported by equity from PWW and Pennichuck Corporation. PWW testified that equity capital has been or will be injected into PWW based on a recent public offering by Pennichuck Corporation. 8/2/05 Tr. at 50 lines 1-13. This equity does not come free of costs. Given these factors and the fact that using the weighted average cost of capital for AFUDC accruals is accepted practice in utility accounting, we find that accruing AFUDC is reasonable and we will approve it.

For the reasons given above, we find that the proposed financing is consistent with the public good and we approve the Settlement Agreement as amended at hearing. We also note that, at hearing, Staff indicated that it expected to conduct an audit of the costs incurred with respect to the capital improvements and financing. 8/2/05 Tr. at 47 lines 13-24. Given the level of expected expenses and capital improvements, we will require Staff to conduct an audit of PWW’s books before we determine what construction costs may be recovered from ratepayers in future proceedings.

Based upon the foregoing, it is hereby

ORDERED, that the Settlement Agreement proposed by the Staff and Parties is approved, consistent with the foregoing analysis; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. may execute and deliver to the BFA up to $50 million in promissory notes and other debt instruments with a maturity of up to 35 years, for the purpose of financing capital expenditures described above; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. may determine, in the manner as described above, the maturity dates, interest rate periods, and interest rates borne by such debt instruments; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. may enter into an escrow or other similar agreement with the BFA and a bond trustee to escrow up to $35 million in BFA Bonds proceeds until Pennichuck Water Works, Inc. requires all or some of the proceeds for the above-described capital expenditures; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to enter into debt instruments payable to the BFA with regard to the Series A Debt at a fixed interest rate to maturity equal to the lowest rate obtainable by the underwriters of the BFA Bonds in order to sell the BFA Bonds associated with the Series A Debt at the lowest all-in cost to Pennichuck Water Works, Inc.; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to nominate its debt obligations with regard to the Escrowed Proceeds into a Series B and Series C, or such other nominations as PWW shall reasonably determine to be appropriate, including subseries thereof, to reflect differing interest periods elected by Pennichuck Water Works, Inc. or to enable Pennichuck Water Works, Inc. to withdraw the proceeds of such debt from escrow in varying increments in order to better match the timing of its need for such funds; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to withdraw all or some of the escrowed proceeds for use for said capital expenditures, or to retain a remarketing agent as described above; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to remarket certain debt, described above, on a long- or short-term basis without further approval, provided that the remarketed debt's maturity date does not exceed that of the BFA Bonds and that the remarketed debt's interest shall be the lowest rates obtainable; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. shall notify the Commission and Office of the Consumer Advocate at least 30 days in advance of any remarketing of Series B or Series C Debt and such notice shall include the new interest rate period(s) of the remarketed debt, the anticipated new interest rate(s), and Pennichuck Water Works, Inc.'s basis for determining said interest rate period(s); and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to enter into one or more loan and trust agreements with the BFA and the bond trustee and others for the purpose of obtaining credit enhancements, including bond insurance, which may reasonably minimize financing costs; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to accrue allowance for funds used during construction at a rate of 8% on the capital expenditures to be financed with the proceeds of the BFA loan until such time as those expenditures are included in rate base for recovery through rates; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. shall cause a copy of all executed financing documents to be filed with the Commission no later than 30 days from the date of execution.

By order of the Public Utilities Commission of New Hampshire this second day of September, 2005.

Thomas B. Getz Chairman	Graham J. Morrison Commissioner	Michael D. Harrington Commissioner

Attested by:

Michelle A. Caraway
Assistant Executive Director and Secretary