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Please respond to the Portsmouth office

February 10, 2006

Debra A. Howland, Executive Director
N.H. Public Utilities Commission
21 South Fruit Street, Suite 10
Concord, NH 03301-2429

RE: City of Nashua: *Petition for Valuation Pursuant to RSA 38:9*
Docket No. DW04-048

Dear Ms. Howland:

In Order No. 24,555 the Commission directed Nashua and Pennichuck Water Works, Inc., to identify portions of Nashua's testimony to be stricken in response to the Commission's order. Enclosed please find an original and eight copies of Nashua's compliance filing in that regard.

Nashua sought the concurrence of parties pursuant to Puc 203.04. Staff and the Merrimack Valley Regional Water District concur with Nashua's filing. The Town of Merrimack concurred with the filing but took no position on the scope of testimony. The Town of Milford took no position. As set forth in the enclosed filing, Pennichuck Water Works disagreed with the scope of Nashua's filing, but does not intend to object. The remaining parties did not respond.

A complete copy is being sent this day to all persons on the Commission's official service list in this proceeding by first class and electronic mail. If you have any questions, please contact me.

Very truly yours,

Justin C. Richardson
jrichardson@upton-hatfield.com

JCR
Enclosures
cc: Official Service List DW04-048

**STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION**

City of Nashua: Petition for Valuation Pursuant to RSA 38:9
Docket No. DW 04-048

COMPLIANCE FILING PURSUANT TO ORDER No. 24,555

NOW COMES the City of Nashua (“Nashua”) and submits revised testimony pursuant to the Commission’s Order No. 24,555 in this proceeding, and in support of hereof, states as follows:

I. BACKGROUND

1. In Order No. 24,555 issued on December 2, 2005 in this proceeding, the Commission stated that:

Nashua has affirmed it will not operate the water system if acquired and is willing to strike the testimony regarding its experience operating municipal systems. We therefore instruct Nashua and PWW to identify the portion(s) of Nashua’s testimony to be stricken, for submission to the Commission no later than December 23, 2005.

2. Nashua did not identify with PWW the portions of the testimony to be stricken by December 23, 2005. However, on January 30, 2006, in response to a comment from staff, Nashua proposed portions of its November 22, 2004 testimony to be stricken pursuant to Order No. 24,555. Nashua’s identified portions to be stricken in a red-lined revision to the testimony of Mr. Philip L. Munck and Brian S. McCarthy.
3. On February 1, 2006, counsel for Pennichuck Water Works et al., reviewed Nashua’s proposal and further identified:

- a. A paragraph in the November 22, 2004 Testimony of Steven Adams to be stricken; and
 - b. One additional sentence in the November 22, 2004 of Brian S. McCarthy to be stricken related to the City's ability to implement a water conservation measures.
4. Nashua and Pennichuck had further discussions regarding the portions of Nashua's testimony to be stricken but failed to reach an agreement thereon. By letter dated February 7, 2006, Pennichuck informed Nashua that it disagreed with Nashua's proposal, as revised, but does not intend to object thereto. See Attachment A.
 5. In the absence of an agreement, Nashua submits this compliance filing in accordance with Order No. 24,555.

II. NASHUA'S PROPOSAL

6. Nashua's proposal to revise its November 22, 2004 testimony in accordance with Order No. 24,555 is shown on attached "red-lined" revisions to the testimony of Brian S. McCarthy (Attachment B), Philip L. Munck (Attachment C), and Steven Adams (Attachment D). As the attached revisions demonstrate, Nashua proposes to delete the references to its operation of wastewater treatment plant, and its other city departments.
7. Nashua did not strike the portion of Steven Adams testimony concerning Nashua's billing and collections functions. See Attachment D at Page 5. Although Pennichuck requested that this information be stricken, in Order No. 24,488 the Commission ruled that Nashua's billing and collection experience is

relevant to this proceeding and subject to data requests.¹ As a result, Nashua proposes to strike only the references to the “very successful” wastewater treatment plant Nashua “operates”, but not the references to its billing and collection practices.

8. Finally, Nashua did not strike the sentence on page 10 of Brian S. McCarthy’s testimony (Attachment B) that “[t]he City is also in a better position than an investor owned utility to implement a water conservation program.” Although Pennichuck requested that this sentence be stricken, Nashua does not believe that it relates to Nashua’s operation of other city departments or falls within the scope of Order No. 24,555.

III. CONCLUSION

9. Nashua believes that the attached revisions to its November 22, 2004 Testimony of Brian S. McCarthy, Philip L. Munck and Steven Adams meet the requirements of the Commission’s directive in Order No. 24,555.
10. To the extent that neither Nashua nor PWW timely identified portions of Nashua’s testimony to be stricken by December 23, 2005, Nashua requests that the Commission accept this filing on the grounds that good cause exists in light of the importance and extensive nature of the January 12, 2006 testimony submitted by the parties, and that no prejudice is likely to result as trial in this proceeding is scheduled for January 2007.

¹ See Order No. 24,488, Page 7 (“we concur that the three questions addressing billing, collection and uncollectibles for the wastewater treatment and solid waste operations may be relevant, given Nashua’s testimony regarding which services it intends to put to contract if it acquires the water system.”).

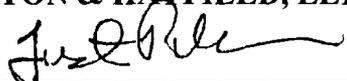
WHEREFORE, Nashua respectfully requests that the Commission:

- A. Accept for the purpose of filing pursuant to Order No. 24,555 Nashua's November 22, 2004 Testimony, as revised herein; and
- B. Grant such other relief as justice may require.

Respectfully submitted,

CITY OF NASHUA
By Its Attorneys
UPTON & HATFIELD, LLP

Date: February 10, 2006

By: 
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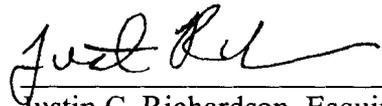
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CERTIFICATION

I hereby certify that a copy of the foregoing was this day forwarded to all persons on the Commission's official service list in the above proceedings.

Date: February 10, 2006


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Exhibit A

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February 7, 2006

Justin C. Richardson, Esq.
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**Re: City of Nashua: Taking of Pennichuck Water Works, Inc.
DW 04-048**

Dear Justin:

This is in follow up to our conversation regarding the City's testimony and its proposal to strike portions of it as no longer relevant to this proceeding. We believe that the City's proposal is overly narrow and should strike portions of Mr. Adams' testimony as well as further provisions in Mr. McCarthy's testimony. However, because we deem none of the City's public interest testimony relevant to this proceeding, we will not object to your proposed submission to the Commission. We reserve the right to object to the City's reliance on any of this testimony in support of its petition in this docket.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Sarah B. Knowlton".

Sarah B. Knowlton

cc: Donald L. Correll
Steven V. Camerino
Thomas J. Donovan
Marcia Thunberg

STATE OF NEW HAMPSHIRE
BEFORE THE
NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

CITY OF NASHUA'S PETITION FOR VALUATION PURSUANT TO RSA 38:9

Docket No. DW04-048

DIRECT TESTIMONY OF BRIAN S. McCARTHY

Q: PLEASE STATE YOUR NAME AND POSITION WITH THE CITY OF NASHUA?

A: My name is Brian S. McCarthy and I am an Alderman-At-Large and President of the Board of Alderman for the City of Nashua having served in that capacity since January, 2004. Prior to that I was Alderman from Ward 5 from 1994 through 2003. I have been Chairman of the Aldermanic Pennichuck Special Water Committee since it was formed on November 13, 2002.

Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A: I am testifying in support of the City's Petition for Valuation under RSA 38:9. I hope to provide the commission with background concerning the City's desire to acquire the assets of Pennichuck Water Works, Inc., (PWW), Pennichuck East Utility, Inc., (PEU), and Pittsfield Aqueduct, Inc., (PAC). It is also my intent to establish how important the ownership and control of these assets is to the City and region. Finally, although it is my understanding that the City's acquisition of these assets is already presumed to be in the public interest because a majority of the City's voters voted in favor of acquiring them, the purpose of my testimony is to provide further support for the presumption of public interest.

Q: WHEN DID THE CITY FIRST BECOME INTERESTED IN THE OPERATIONS OF THE PENNICHUCK COMPANIES, WHICH ULTIMATELY LED TO THE CITY'S PETITION?

A: Pennichuck has operated in Nashua in one form or another since the 1800's. In recent years there has been concern about its growing real estate operations and what some believe is its failure to protect the watershed through those real estate operations. On June 14, 2002 Pennichuck Corporation, the parent of PWW, PEU and PAC, announced that it had petitioned the Commission to approve the indirect acquisition of the subsidiaries by Philadelphia Suburban Corporation (PSC) to be accomplished through the merger of Pennichuck into a wholly owned subsidiary of PSC. Initially Nashua was not opposed to the merger, although there was considerable public concern about an out-of-state company owning and operating the City's water system. That concern was exacerbated by the fact that one of PSC's largest shareholders was a foreign company. Following its intervention in the docket established by the PUC regarding the merger, the City engaged consultants to advise it concerning the merger and to conduct a comprehensive review of the Pennichuck system. Simultaneously, the City participated in discussions with its citizens and representatives of other municipalities relating to the formation of a regional water district.

Q: WHAT WERE THE CONCLUSIONS OF YOUR CONSULTANTS?

A: The consultants presented a number of options to the City including the following:

- a. Recommend the merger not be approved.

- b. Recommend that the merger be approved with conditions.
- c. Take PWW.
- d. Create a regional water district and take the assets of PWW and PEU.

The consultants further concluded that public ownership in general is financially beneficial to customers due to the fact that public entities do not pay taxes or dividends and can raise capital at much lower rates than investor owned utilities.

In addition, public ownership has the opportunity to build equity in the utility over time as the debt is paid down.

Q: WHAT DID THE BOARD OF ALDERMAN DO UPON RECEIPT OF THE CONSULTANTS RECOMMENDATIONS?

A: The recommendations were made on November 1, 2002. As I said earlier, an Aldermanic Pennichuck Special Water Committee was formed on November 13, 2002. Thereafter, on November 26, 2002 by a vote of 14 – 1, the Board of Alderman pursuant to RSA 38:3 determined that it was expedient for the City to establish a water works system and to acquire all or a portion of the water works system currently serving the inhabitants of the City and others. Because it was the intent of the Board to acquire the assets, not only of PWW but also PEU and PAC, the board authorized the mayor to support, along with other municipalities proposed legislation to establish regional water districts and in particular to support the formation of a regional water district including the City.

Q: WAS THAT RESOLUTION OF THE BOARD OF ALDERMAN CONFIRMED BY THE VOTERS OF THE CITY?

A: Yes. At the November 26, 2002 meeting the Board authorized a special meeting of the voters of the City to be held as a special election for the purpose of confirming the vote of the Board of Alderman, that it was expedient for the City to establish water works system. Thereafter, a very public campaign was conducted by the City to make sure the voters understood what it proposed to do. Pennichuck made clear its opposition. A number of public hearings were held to discuss the acquisition. The public discussion was well covered by the Nashua Telegraph and copies of the articles that appeared in the newspaper are attached as Exhibits A to G. The City was clear throughout this period that it intended to acquire assets located outside Nashua and that it intended to participate in a regional water district. On January 14, 2003, with a turnout of approximately 20% of the registered voters of the City, the resolution of the Alderman was confirmed by a margin of 6,525 to 1,867, or a 78% majority.

Q: FOLLOWING THE CONFIRMATORY VOTE, WHAT DID THE CITY DO?

A: On January 28, 2003, pursuant to RSA 38:6, the Board of Alderman determined that all of the property of PWW, PEU and PAC was necessary for its municipal water service (Exhibit H) and on February 5, 2003 gave notice to PWW, PEU and PAC of the vote and made inquiry whether they would sell the property it had identified. Copies of the notices are attached to Nashua's Petition as Exhibits B, C and D. On March 25, 2003, PWW, PEU and PAC responded to the City's notice, pursuant to RSA 38:7, in the negative. After the Pennichuck companies responded in the negative to the City's inquiry, under RSA 38:6, the City decided it would be in all parties interest to continue to pursue a possible agreement on the

basis of President and CEO, Maurice Arel's, earlier press statement of November 28, 2002 (copy attached as Exhibit I), which indicated that Pennichuck would only accept a superior offer from the City compared to PFC's offer worth \$106 million. He listed items totaling approximately \$13 million. On April 2, 2003, Mr. Arel stepped down and the interim CEO, John Kreick, told city representatives on April 10, 2003 that Pennichuck would entertain an offer for the entire company including the two non-regulated subsidiaries, Southwood Development Corporation and Pennichuck Services Company. Mr. Kreick also advised that negotiations would need to await appointment of a new permanent President and CEO.

Q: FOLLOWING THESE DISCUSSIONS WITH REPRESENTATIVES OF THE PENNICHUCK COMPANIES, WHAT DID THE CITY DO?

A: The City had already obtained a comprehensive report on the Pennichuck companies; the history of its operations; the status of its supply, treatment and distribution system; and the issues of public versus private ownership and control. The City also obtained a preliminary appraisal of the value of the five Pennichuck companies as of December 31, 2002 prepared by George E. Sansoucy, PE, LLC. For purposes of negotiation with Pennichuck, the City hired the law firm of Devine, Millimet & Branch, PA, it also had as its advisors, its long time bond counsel, Palmer & Dodge of Boston, Massachusetts and its long time financial advisors, First Southwest Company, a major investment banking firm in public finance which has in-house expertise on municipal acquisition and operation of water companies. During July 2003, counsel for the City and Pennichuck met and

discussed, inter alia, taxation issues, a possible management contract and financing alternatives. Because the City had been advised by members of its legal staff that it did not have the power to purchase the stock of private companies or the assets of non-utility private businesses (Southwood Corporation and Pennichuck Services Company), the City sought and found a third party willing to buy those companies at a certain price if the City could reach agreement on a overall price with Pennichuck. For the purpose of avoiding prolonged time, expense and litigation, the City ultimately decided to offer a sum for the assets of all five Pennichuck companies that would include a reasonable premium over the appraised value the City had in hand, designed to offset the estimated tax impact of the sale on the Corporation. The offer was for \$121 million dollars and was made on November 20, 2003.

Q: DID PENNICHUCK ACCEPT THE OFFER?

A: No. The offer was rejected on December 15, 2003. The parties met again on January 7, 2004 in an attempt to bridge their differences. On January 27, 2004 Pennichuck indicated that it declined to negotiate further and on February 4, 2004 filed its first lawsuit.

Q: DO YOU BELIEVE PENNICHUCK EVER INTENDED TO SELL ITS ASSETS TO THE CITY?

A: No. I now believe that Pennichuck negotiated with the City throughout this period to allow time for its public relations campaign to turn public opinion against the City's acquisition and the regional effort and in hopes that the November 2003 election results would change the City's policy on the

acquisition. Meetings were difficult to arrange and then typically scheduled weeks in the future.

Q: FOLLOWING PENNICHUCK'S TERMINATION OF NEGOTIATIONS AND THE FILING OF ITS FIRST LAWSUIT, WHAT DID THE CITY DO?

A: The City moved as quickly as possible in February and March 2004 to appropriate funds for consultants and legal counsel to plan for and pursue eminent domain under RSA 38.

Q: WHY DIDN'T THE CITY FILE A PETITION UNDER RSA 38 EARLIER?

A: The City and its advisors believed that voluntary negotiations were more likely to be successful in the absence of such a petition.

Q: WHAT HAPPENED TO THE EFFORT TO FORM A REGIONAL WATER DISTRICT?

A: During the summer and fall of 2003 a regional water district committee drafted a proposed regional district charter and submitted it to the governing bodies of the various municipalities. It has since been approved by the City of Nashua and seven towns, which now comprise the Merrimack Valley Regional Water District.

Q: WHY DO YOU BELIEVE IT IS IN THE PUBLIC INTEREST FOR NASHUA TO ACQUIRE THE ASSETS OF PWW, PEU AND PAC?

A: Water is a crucial community resource, which should be locally owned and controlled. Pennichuck Corporation has been clear that it (including PWW, PEU and PAC) is for sale and the most likely acquirers are foreign. The City will not accept control of water decisions which are made by a company so removed as to

be unaware and unconcerned with long term effects on the community, nor decisions on long term supply of water or protection of a water source which are based on short term revenue interests rather than sound planning for the future. Moreover, the Board of Alderman has found that the maintenance of an adequate supply of clean, affordable drinking water is essential to the viability of any community; that the maintenance of an adequate supply of water for the protection of life and property is essential to the viability of any community and that the maintenance of an adequate supply of clean, affordable water to be used for commercial purposes within the City is essential to the economic viability and orderly growth of the community. It further found that the maintenance of a water system, which performs these purposes, was best served by the formation of a regional water district representing the several towns and cities impacted by it. Nashua seeks to acquire all of the assets of the three Pennichuck regulated utilities because the City believes it would promote the interest of all customers/rate payers, the general public, the employees of Pennichuck and the owners of Pennichuck. Specifically, Nashua asserts that acquiring the assets of PWW, PEU and PAC, including those outside of Nashua, is in the public interest because it will eliminate any claim for severance losses by any of the Pennichuck companies; it will prevent likely rate increases for that portion of the system which is not acquired by Nashua due to the need to generate additional revenue to offset proportionally higher operating expenses; it will protect the level of service to be received by PEU and PAC customers; and it will mitigate harm to Pennichuck and Pennichuck shareholders by eliminating the need to operate a

small or less efficient and less profitable portion of the system. The will of Nashua voters would be implemented; the goals of the Merrimack Regional Water District, organized under Laws 2003, Chapter 281 would be promoted; rates would be lower over time; service would remain adequate; water supplies would come under long range public control; continued employment of Pennichuck operation and maintenance personnel would be reasonably accommodated; and Pennichuck owners would receive fair value for their assets without the disadvantages of retaining ownership of smaller systems only.

Q: DOES THE CITY INTEND TO CONVEY ANY ASSETS IT ACQUIRES TO THE MERRIMACK VALLEY REGIONAL WATER DISTRICT?

A: If the City is successful in its acquisition of the assets of PWW, PEU and PAC it is the intent of the City to convey those assets to the regional water district. The City's support for and participation in the regional water district is based upon the City's determination that regional control over the water supply and distribution is in the best interest of Nashua as well as the surrounding areas. The City is not, however, a "stalking horse" for the regional water district as has been suggested by the Pennichuck companies. Rather, the City takes the position that its acquisition of the Pennichuck assets outside of Nashua is in the public interest whether or not the regional water district ultimately owns and controls them.

Q: DOES THE CITY HAVE THE TECHNICAL CAPABILITY OF OWNING AND OPERATING A WATER UTILITY?

A: Yes. Nashua is the second largest City in NH and interestingly the only City in the State which does not own its water system. ▽

Deleted: It provides all the municipal services of a large, urban municipality, including but not limited to wastewater collection and treatment, storm water collection, streets and highways, solid waste disposal and police and fire departments. Moreover, Nashua owns and manages a large and complex physical plant, including but not limited to, a city hall, schools, a public works building, a police station, fire stations and a wastewater treatment plant. This physical plant has a value of approximately \$300 million (as compared to the \$85 million of value of the Pennichuck assets the City seeks to acquire). Nashua provides all of these services and performs all of these functions through a capable and professional staff.

_____ The City is also in a better position than an investor owned utility to implement a water conservation program. Water conservation is an important priority for the City. Finally, as I will discuss in greater detail below, the City intends to contract out the day- to- day operation of the system and management oversight to skilled operating companies.

Q: DOES THE CITY HAVE THE MANAGERIAL CAPACITY OF OWNING AND OPERATING A WATER UTILITY?

A: Yes. A water utility is a good example of a function in which skilled operating companies are available to physically operate the system while the City retains ownership and the financial benefits that come from municipal ownership. It is Nashua's intent in the management of the water system to employ contractors to perform the day-to-day operation and maintenance of the system and to exercise certain management oversight. The City has sought expressions of interest in these contract operations and has received eleven (11) positive responses, including one from Pennichuck Service Company, Inc. The City is reviewing drafts of solicitations for proposals in this regard. The first is for direct operation and maintenance of the assets and the second is for the management oversight function. The City intends to have contracts in place when ownership transfers. The City will also provide the legal framework for the operation of the water system by adopting a Water Ordinance, a draft of which is presently being reviewed. It is intended, and probably required in order to comply with covenants

that are likely to be incorporated into bonds that will finance the acquisition, that the City Finance Director and her staff will perform all treasury functions. v

Q: DOES THE CITY HAVE THE FINANCIAL CAPABILITY TO OWN AND OPERATE A WATER UTILITY?

A: Yes. RSA 33-B permits the City to issue bonds for the acquisition of revenue producing facilities such as a water works system. These bonds are referred to as revenue bonds and are secured by the revenues from the water works system as opposed to government obligation bonds which are secured by a pledge of the faith and credit of the municipality, or in other words, by the ability of the municipality to raise taxes. Because Nashua will be able to roll its expenses of acquisition into the revenue bonds used to pay for the acquisition, Nashua taxpayers will not ultimately bear any cost of the acquisition or purchase. Nashua can also borrow through the issuance of revenue bonds, funds necessary for extraordinary capital improvements. Nashua intends such borrowing simultaneous with its acquisition borrowing for capital improvements to the water treatment plant. The operations and maintenance of the water works system, including repayment of the revenue bonds, will be funded by rates. Because of the City's lower cost of money and operation, it believes ratepayers in the short-term will experience rates no worse than those charged by the Pennichuck Companies. Over time, the City expects to charge rates lower than what ratepayers could expect if the Pennichuck Companies returned ownership. Because the City will make a payment in lieu of taxes (PILOT) for any property it

Deleted: In addition to the operating and oversight contractors, the City has its own Public Works Department which presently operates its wastewater collection and treatment facilities in close conjunction with the operations of PWW.

acquires, its ownership will not impose any burden of the taxpayers of any municipality in which the property is located.

Q: WOULD THE TECHNICAL MANAGERIAL AND FINANCIAL CAPABILITIES YOU HAVE DESCRIBED BE IMPACTED IF THE COMMISSION PRECLUDED NASHUA'S ACQUISITION OF ANYTHING OTHER THAN THE CORE SYSTEM OF PWW?

A: No. Such a ruling by the PUC would reduce the size of the system Nashua could acquire but only minimally. Our consultants have advised the City that the so-called core system represents most of the value of PWW and includes the water treatment plant and all the reservoirs as well as the distribution system hydraulically connected to the treatment plant. Nashua does not believe PEU or PAC would be entitled to severance damages if the acquisition was limited to the core system or that PWW would be entitled to any premiums because of any claimed benefit its assets provided to PEU or PAC. If severance damages were, however, ordered by the Commission the impact is believed to be marginal on subsequent rates. Nashua has always expressed the preference to purchase assets rather than pay severance in an effort to avoid any impact on rates. If Nashua was limited to the core system, its technical, managerial and financial capabilities would not be impacted except perhaps improved to the extent it was required to pay less for the assets and had lower costs of operation. Nashua's capabilities would not otherwise be affected.

Q: DOES THIS CONCLUDE YOUR TESTIMONY?

A: Yes.

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STATE OF NEW HAMPSHIRE
BEFORE THE
NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION
CITY OF NASHUA'S PETITION FOR VALUATION PURSUANT TO RSA 38:9
Docket No. DW04-048

DIRECT TESTIMONY OF PHILIP L. MUNCK

Q. What is your name and what is your association with the City of Nashua?

A. My name is Philip L. Munck. I am an associate of George E. Sansoucy, P.E., LLC, a consulting firm that has been engaged by the City of Nashua to assist it in this proceeding.

Q. Please describe your educational background.

A. I have a bachelor's degree from the University of Michigan and a Master of Business Administration degree from Plymouth State College.

Q. Please describe your professional background.

A. I have been an associate of George E. Sansoucy, P.E., LLC, since 1994 providing professional assistance in cases involving the valuation of special purpose properties and other engineering projects. Most notably, I was intimately involved in the process through which the Town of Hudson petitioned the PUC to take assets of Consumers New Hampshire Water Company and ultimately purchased the company. I was likewise involved in the acquisition of a water utility by the County of Ashtabula, Ohio. I have also been involved in several other water related cases of the firm.

Prior to joining George E. Sansoucy, P.E., LLC, I was employed for a total of 15 years by four communities in Michigan and New Hampshire as City Administrator, City Manager and Town Administrator. In the cities of Mt. Morris, Michigan, and Franklin and Somersworth, NH, the water departments reported directly to me. In Epping, NH, I provided significant administrative and managerial support to the Selectmen and the Water Commissioners for the daily operation of the Water Department.

In addition to the positions above I served for 10 years on active duty in the U.S. Navy and worked as a newspaper reporter and a manager of engineering administration for a defense contractor.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to describe the managerial and technical competency of the City of Nashua to own and operate a water utility and to discuss the financial advantages of public ownership of the water utility.

Q. Does the City of Nashua have the managerial capability to own and operate a water utility?

A. Yes, it does.

Ownership and operation of a water utility is a common municipal function. Local governments as large as New York City and Los Angeles and as small as Epping, New Hampshire, successfully own and operate water utilities. Nashua is the only city in New Hampshire that presently does not own its water utility.

As with all other municipal functions, there are levels of management responsibility. It falls to the elected leadership of the City to establish broad policy and to exert financial control by adopting budgets and setting rates. It exerts detailed control by engaging competent professional management to run the system according to City policy.

Nashua has determined that it will contract out the operation and maintenance and management oversight of the water system it acquires to skilled operating and management companies.

Q. Is the City's proposal to contract for operation of the water utility a reasonable approach?

A. The model in which a municipality owns a water (or other) utility and contracts for its operation has been successfully employed in a number of locations. The Pennichuck Water Service Company, another subsidiary of the Pennichuck

Corporation, operates the water utility of the Town of Hudson under just such an arrangement.

The City of Indianapolis has one of the largest public-private relationships in the United States with a firm that has expressed an interest providing contract services to a Nashua or regional water utility.

Deleted: This public-private relationship is not the only way to operate a public water utility. Most of the municipal water systems in the United States are staffed and operated by dedicated public employees. Nashua's sewer collection and treatment utility is such an operation and Nashua, if it desired, could readily combine the sewer and water systems and operate them as one.¶

Q. What are some of the advantages of the public-private relationship?

A. Typically a municipality gains the services of an organization that is focused on the single narrow task of operating and maintaining a specialized plant. If an operator from a large organization is selected, the resources of that organization are available to deal with technical issues.

Because the municipality retains ownership, it also is able to direct the future of the utility in areas, such as conservation, in which a privately owned utility has no inherent interest.

Q. What are some of the disadvantages of the public-private relationship?

A. Because the relationship between public owner and private operator are defined by a contract, there is somewhat less flexibility in the ability of the owner to change directions quickly. There is also a reduced ability to share in some of the common capabilities of an integrated public works department.

The advantages and disadvantages balance fairly closely and either public operation or private operation can be successful making the choice a policy decision of the community.

Q. What steps has Nashua taken to develop a public-private relationship?

A. The City of Nashua has made a policy decision to contract for all aspects of the operation and maintenance of the water utility except for the treasury and cash management functions. Earlier this year, the City sought expressions of interest and qualifications from a number of potential contract operators and received positive expressions of interest from eleven companies including the Pennichuck Water Service Company.

The City is in the process of developing two requests for proposals. One is for the operation and maintenance of the system and a second is for management oversight of the operations and maintenance contractor. The two contract approach is being taken to minimize the additional in-house staff required by the City. Moreover, such an approach would, in the event there is an assumption of the operation of the system by the Merrimack Valley Regional Water District, permit that transfer of ownership to take place with the least disruption to ratepayers and the two entities.

Q. What should happen to the revenues required of ratepayers under public ownership as compared to private ownership?

A. All other things being equal, the cost to ratepayers for utility services has to be less under public ownership than under private ownership.

By other things being equal, I mean that the same amount of capital investment is made and that the same costs of operation such as staffing, power, chemicals and the like are made by each owner.

Those things being equal, there are costs that are lower for a municipality and costs that are avoided altogether.

The cost of capital, that is, the cost of the money needed to make investments in infrastructure, are about 5% for a municipality at the present time, which is the price of revenue bonds. Between the need to earn returns for investors and the higher rates of private debt, Pennichuck's cost of capital is over 8% at the present time. Exhibit PLM-1 is an analysis of the cost of capital reported by investor-owned water utility companies that indicates the industry cost of capital for larger water utility holding companies is 7.5% and for smaller holding companies is 8.2%.

Water utilities are capital-intensive enterprises. The net book value of the three Pennichuck Corporation utilities was about \$78 million at the end of 2003. The annual cost of that capital for the City would be \$3.95 million and over \$6 million for a private utility.

Municipal water utilities avoid altogether the payment of dividends to investors, state and federal taxes (other than payroll taxes), most of the compliance filings with the Securities and Exchange Commission and all of the regulatory costs of filings with the N.H. Public Utilities Commission. In 2003, the Pennichuck utilities paid \$1.6 million in income taxes and declared dividends to stockholders of \$1.9 million.

Q. Does this conclude your testimony?

Yes.

EXHIBIT PLM-1 - WATER UTILITY WEIGHTED AVERAGE COST OF CAPITAL

| Company | Shares (000,000) | Book /Share | Equity (000,000) | Equity x ROE | Equity x ROE | Preferred (000,000) | Pref. Int. (000,000) | LT Debt (000,000) | LT Debt Int. (000,000) |
|---|---------------------|-------------|---------------------|-----------------|-----------------|------------------------|-------------------------|----------------------|------------------------------|
| American States Water | 15.21 | \$13.97 | \$212.5 | 5.6% | 11.899 | | | \$277.4 | \$16.5 |
| California Water | 16.93 | \$14.44 | \$244.5 | 7.9% | 19.313 | \$3.5 | \$0.2 | \$272.0 | \$16.0 |
| Aqua America | 92.59 | \$7.12 | \$659.2 | 10.2% | 67.243 | | | \$686.3 | \$45.0 |
| Total | | | \$1,116.2 | | 98.455 | \$3.5 | \$0.2 | \$1,235.7 | \$77.5 |
| As % Capital | | | 47% | | | 0% | | 52% | |
| Weighted Average | | | | 8.8% | | | 4.29% | | 6.27% |
| <u>Weighted Average Cost of Capital</u> | | | | | | | | | |

| | Weight | Rate | | |
|-----------|--------|-------|------|------|
| Equity | 47% | 8.82% | 4.2% | |
| Preferred | 0% | 4.29% | 0.0% | |
| Debt | 52% | 6.27% | 3.3% | |
| | | | | 7.5% |

Source: Value Line Investment Survey, Issue 9, July 30, 2004 for 2003

| Company | Shares | Book /Share | Equity | Equity x ROE | Equity x ROE | Preferred | Pref. Int. | LT Debt | LT Debt Int. |
|---|--------|-------------|---------|-----------------|-----------------|-----------|------------|---------|-----------------|
| Conn. Water Services | 7.97 | \$10.46 | \$83.4 | 10.9% | 9.087 | \$0.8 | \$0.0 | \$65.1 | \$4.6 |
| Middlesex Water Co. | 10.48 | \$7.60 | \$79.6 | 7.9% | 6.292 | \$4.1 | \$0.3 | \$98.3 | \$5.2 |
| SJW Corp. | 9.14 | \$18.21 | \$166.4 | 10.0% | 16.644 | | | \$143.9 | \$8.5 |
| Southwest Water | 14.67 | \$5.40 | \$79.2 | 9.0% | 7.130 | \$0.5 | \$0.1 | \$55.0 | \$4.6 |
| York Water | 6.42 | \$6.08 | \$39.0 | 11.4% | 4.450 | | | \$29.9 | \$2.5 |
| Total | | | \$447.7 | | 43.602 | \$5.4 | \$0.4 | \$392.2 | \$25.4 |
| As % Capital | | | 53% | | | 1% | | 46% | |
| Weighted Average | | | | 9.7% | | | 7.59% | | 6.48% |
| <u>Weighted Average Cost of Capital</u> | | | | | | | | | |

| | Weight | Rate | | |
|-----------|--------|-------|------|------|
| Equity | 53% | 9.74% | 5.2% | |
| Preferred | 1% | 7.59% | 0.0% | |
| Debt | 46% | 6.48% | 3.0% | |
| | | | | 8.2% |

Source: Value Line Investment Survey - Small and Mid-Cap Edition, Issue 9, July 30, 2004 for 2003 except LT Debt Int. from SEC 10-K for 2003

George E. Sansoucy, PE, LLC
32 Nimble Hill Rd
Newington, NH 03801

**Nashua Pre-filed Testimony
Of Steven A. Adams
First Southwest Company**

1. What is your name and by whom are you employed?

My name is Steven Adams. I am a Senior Vice President for First Southwest Company, where I have been employed for over 15 years.

2. What is First Southwest Company and what is its relationship to the City of Nashua?

First Southwest Company is the financial advisor to the City of Nashua and we have served in this capacity for the past 15 years. As financial advisor, our role is to advise the City in all aspects of issuing municipal bonds. We assist in preparing financial plans, preparing offering documents, assist with attaining ratings and bond insurance and we are generally responsible for coordinating all of the people responsible for completing a bond issue. As a broker/dealer, we are regulated by the National Association of Securities Dealers and the Securities and Exchange Commission.

3. What is your experience in the preparation and sale of bonds for local governments?

First Southwest Company is one of the largest financial advisory firms in the nation. From January 1, 1999 through August 30, 2004 we served as financial advisor on 2,835 bond issues totaling \$85.2 billion. Of this amount 609 issues totaling \$8.28 billion were specifically for water and wastewater revenue bonds.

In the past 15 years we have assisted the City of Nashua in the issuance of \$264,505,000 general obligation bonds comprised of 16 bond issues.

Because of our experience, First Southwest Company has a vast knowledge of the credit requirements of municipal bond rating agencies and municipal bond insurance companies. In fact, First Southwest Company is one of the largest worldwide customers of Standard and Poor's Rating Service, despite the fact that all of our business with them is public finance business. Additionally, we work with all of the recognized triple A rated municipal bond insurance companies. Our experience working with the rating agencies and insurance companies allows us to understand first hand and in great detail their requirements for investment grade municipal debt.

Additionally, we have served as lead managing underwriting on 830 debt issues totaling \$8.57 billion from January 1, 1999 to August 31, 2004. In terms of number of transactions, only 17 firms in the nation underwrote more bond issues than us. Of the total issues underwritten by First Southwest Company, 271 totaling \$1.262 billion were for water and wastewater revenue bonds. In this category only four firms in the nation wrote more debt issuances than First Southwest Company. Without question, First Southwest Company is one of the nation's leaders in both financial advisory work and underwriting of water and wastewater revenue bonds. This experience allows us to understand the investing community. Our sales force works very closely with most every major institutional investor of municipal bonds. This also helps us to determine the best structures and covenants for municipal financings.

First Southwest Company is also a leader in New England. First Southwest Company has approximately 300 clients in New England. During the past 3 years we have served as financial advisor on more than 1,000 bond and note issues totaling more than \$10 billion.

At First Southwest Company, my primary experience is working with clients that issue water and wastewater and electric utility revenue bonds. I currently work with approximately 20 clients on a continuing basis that issue water and wastewater revenue bonds. These clients vary from large water utilities that issue bonds several times a year to small utilities that issue bonds once every few years.

Prior to working for First Southwest Company, I was employed at the Texas Water Development Board (the "TWDB") as a financial analyst. The TWDB purchased bonds for water and wastewater projects from political subdivisions within the State of Texas. I was responsible for reviewing the credit on those applications and making recommendations for loans to the Board of the TWDB. I was employed at the TWDB for approximately three years. Additionally, I helped conceive and create a State revolving fund that utilized State and federal funds as a part of the 1987 Clean Water Act. The TWDB created and sold revenue bonds backed by the loan revenues to establish this program.

Prior to working for the TWDB, I worked for the City of Austin, Texas where I was an analyst in the Debt Management division of the Budget Office. During that time, I worked on the team that was responsible for issuing general obligation, water and wastewater, electric utility and other debt of the City of Austin. I was employed at the City for approximately one year. During that time, the City of Austin sold numerous revenue bond issues totaling hundreds of millions of dollars.

Within First Southwest Company I spend most of my time studying and developing revenue bond structures. It is for that reason that I have been asked to work with Nashua by our firm.

4. What is the purpose of your testimony?

The purpose of my testimony is to state the opinion of First Southwest Company, from a financial perspective, that the bonds proposed by the City of Nashua are marketable at the rates used in the City's financial plan for the acquisition of Pennichuck's regulated water utilities.

5. Have you examined the borrowing portions of the financial plan?

Yes. I have examined the financing plan the appears as Exhibit GES-7 of George Sansoucy's testimony.

6. Please describe them.

The financing plan is a long-term projection of cash flows of a utility system. It projects operating revenues, operating expenses, capital expenditures, required debt issuances and fund balances. It is based upon the audited financial statements and regulatory filings of Pennichuck; proposed ordinances and structures of the City of Nashua; and expert projections of George Sansoucy & Co. We have worked with George Sansoucy's staff in developing a traditional revenue financing plan. We relied on Sansoucy for the following information:

Operating Revenue Projections;

Operating Expense Projections;

Growth assumptions; and

System purchase price.

We incorporated the future capital costs as projected by Pennichuck.

Once the basic operating revenues and expense were projected, we could determine how many future bond issues were needed to fund the capital program.

We then developed the size and cash flow structure of a traditional municipal utility financing structure as described below.

Based upon the assumptions by Sansoucy and the bond issue requirements of the rating agencies and market place; it appears that the City of Nashua could issue investment grade securities and qualify for municipal bond insurance

7. What does the bond market look for in municipal revenue bonds backed by the revenues of a municipally owned utility?

The credit features of a revenue bond can be broken into four main areas:

- Management
- Financial Strength
- Legal Covenants; and
- Demographics.

I believe that the City can satisfy the minimum requirements for an investment grade credit rating in all four of these areas.

Management

Management can be broken down into two main areas: financial management and operating management. As for the financial management, the City of Nashua already has the necessary expertise in place to serve these functions. The City owns a wastewater utility. All of the required areas of financial management that are required for an investment grade credit rating can easily be assimilated into the City's current management structure. For example, the City already bills and collects funds; invests funds; prepares budgets and audits and all other necessary functions with regard to financial management.

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Notwithstanding this current experience, the City has made the policy decision to contract for the financial management and operation and maintenance of the water utility. Accordingly, Nashua is in the process of selecting firms for the financial and operations management of the utility. Several well qualified firms have expressed interest in working with the City to manage the operations and financial management of its utility. It is my opinion that Nashua's management plan will be acceptable to qualify the bonds for investment grade credit ratings and municipal bond insurance.

Financial Strength

While a City owned water utility does not exist at this time, the cash flow projections that have been developed indicate that there is adequate cash flow for the utility to attain an investment grade credit rating and qualify for municipal bond insurance. Since the cash flow model that we have developed is based upon the actual results of Pennichuck, there

is great comfort in the fact that Pennichuck has been in existence for a long time. This is much easier than proving revenues from a completely new venture with no real track record.

Furthermore, the City of Nashua holds a Aa2 general obligation from Moody's Investors Service and a AA+ rating from Standard & Poor's Ratings, Inc. There are very few entities, municipal or corporate, that have ratings this high. While the City's general obligation rating has no direct bearing on the proposed utility rating, the fact that the City is so strong indicates that the City is well managed. It is rare that you will find a City's utility rating higher than its general obligation rating. In some cases, the general obligation rating serves as a ceiling. Nashua's "ceiling" is very high. This will be very helpful for the utility side. Given the history of Pennichuck; the pro-forma cash flow models; and the strong financial position of the City, we believe that the financial strength will be adequate to warrant an investment grade rating and qualify the issue for bond insurance.

Legal Covenants

A traditional revenue bond financing has legal covenants that are defined in the bond resolution. The resolution is a contract between the issuer and the investors and defines the rules by which the utility must operate while any revenue bonds are outstanding. The major provisions of revenue bond resolutions include:

Flow-of-Funds;

Security for the Bonds;

Rate covenant;

Additional Bonds Tests;

Reserve Fund Requirements.

From the standpoint of selling revenue bonds, the ability to negotiate the details of the legal structure with rating agencies and bond insurance companies prior to selling the bonds is a great advantage. Often, existing legal covenants have legal structures that create rating issues for municipal clients. Nashua will not have that issue.

Let me start by defining the flow-of-funds. The flow-of-funds defines how dollars flow through the utility. The bond resolution would require the money is initially deposited into a Revenue Fund. From there, money is used to pay all operating expenses necessary to operate the utility. The Operating Revenues less the Operating Expenses is the Net Revenues. After paying the operating expenses, funds flow to the debt service fund. The debt service fund is used to make payments to the bond holders. Once the debt service fund payments have been made as required, funds flow to the reserve fund to make up for any short falls that may have occurred if those funds had to be used to make debt service payments. Finally, funds flow to "any legal purpose" associated with operating the utility. Generally, these funds are used for capital projects to reduce the need for future debt. Our modeling uses the funds in this manner. This flow-of-funds is consistent with the requirements for investment grade bond ratings and the requirements of bond insurance companies.

The security for the bonds is the legal pledge that the bondholders have to secure the debt. We recommend that the bondholders have a lien on and pledge of the net revenues of the system as defined above. This pledge acknowledges that a system must pay its operating expenses in order to be of any value to the bondholders. This pledge is consistent with municipal revenue bonds sold throughout the nation and is readily accepted in the market. This pledge will allow the bonds to be investment grade rated and qualify for municipal bond insurance.

The rate covenant defines the minimum rate that the issuer legally obligates itself to charge. We recommend that the rate covenant require that rates are high enough to produce net revenues that exceed debt service by 110%. This rate covenant will qualify the bonds for investment grade credit ratings and municipal bond insurance.

The additional bonds test is a mathematical revenue test that an issuer must meet in order to sell subsequent bond issues with a parity pledge to outstanding bonds. It protects the current bondholders from an issuer issuing so much debt that it deteriorates the financial condition of the issuer enough to warrant a ratings downgrade. From the issuer's standpoint, it can issue bonds by meeting the requirements of the bond ordinance without having to attain specific permission to issue debt from the bondholders. The primary calculation associated with this covenant is that the net revenues from the previous year must equal 125% of current and proposed average annual debt service. All of our pro-forma models take this calculation into account. We project that any debt that needs to be issued to meet the capital improvement plan as projected by Pennichuck will fall within the limits of the additional bonds test. This additional bonds test will qualify the bonds for investment grade credit ratings and municipal bond insurance.

Water system revenue bonds typically require a reserve fund held for the benefit of the bond holders. The reserve fund generally is equal to the lesser of (i) ten percent of the bond issue size; (ii) 125% of the average annual debt service requirements, or (iii) maximum annual debt service requirements. This definition is a part of the Federal tax law that defines arbitrage rebate requirements for issuers of tax-exempt bonds; therefore, it is an industry standard that will be in Nashua's revenue bonds covenants. We will also allow for this reserve fund to be provided by a bond insurance company in the form of a reserve fund surety policy. The determination as to whether or not to fund the reserve fund with cash or an insurance policy is made at the time of issuance when we will have a better understanding of expected investment rates and the cost of the insurance policy. Either funding option will qualify the bonds to attain an investment grade rating and to qualify for bond insurance.

Demographics

The southern New Hampshire area has excellent demographics, according to Standard & Poor's Corporation and Moody's Investors Service, Inc. Although both cite a decline in the local economy over the last three years, they both indicate that the economy still exceeds state and national employment averages and believe that the City's location and

tax advantages will support growth in the future. Given the high ratings of the City's general obligation bonds and the comments of the rating agencies, one can conclude that the demographics of the Nashua area support investment grade bond ratings and meet the minimum requirements of bond insurance companies.

8. Can a bond issue incorporating the interest rates and payment schedule of the plan be sold by the City of Nashua?

The United States has a very sophisticated municipal bond market. Through September of 2004, the average daily trading volume of municipal bonds exceeded \$14.6 billion. As of March 31, 2004, a total of \$1.9 *trillion* of municipal bonds were outstanding. Clearly, there is a liquid market for municipal bonds. Today, over 80 percent of Americans receive their water from publicly owned water utilities. Almost all of those utilities are investment grade rated. Water system revenue bonds are a large part of the municipal bond market. Investment grade water system revenue bonds are essentially a commodity. Because the market is so large and liquid, the issue of interest rates depends on market rates, not issuer specific rates.

Since projecting interest rates is difficult, at best, we used higher than market projections in developing the model. For example, the model that we used has a 5.0% interest rate. If we were to sell bonds at November 2004 interest rates, the bonds would likely be sold at rates below 4.6% based upon actual sales. While we know that the Federal Reserve System may continue raising short-term interest rates, they have a stated goal of not impacting long-term interest rates. In fact, since the Federal Reserve has raised short-term rates, long-term tax exempt rates have fallen. Based upon these facts, we believe that the rates and structure in our model are achievable.

9. Is this the only financing plan possible for the City of Nashua?

No. There are many financing options. The model we prepared contemplates using 25 year fixed rate debt with ten year call provisions. This structure is by far the most common and most conservative approach; however many utilities, particularly large utilities have incorporated very sophisticated fixed and variable rate programs that

include the use of derivative products. The plan that we used is the most conservative and simplified approach.

10. Have you taken into account the possibility that the Nashua Regional Water District may take over the system?

Yes, it is our plan to inform the rating agencies, bond insurance companies and investors, that the City reserves the right to transfer the assets and the debt to a regional water district. We will covenant that such a transfer will not change the credit rating, the tax-exempt status and the legal covenants relating to the bonds outstanding. We can accomplish this if the district attains the same customer base and ratemaking powers.

11. Does this conclude your testimony?

Yes.

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