

**STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION**

DW 06-073

PENNICHUCK WATER WORKS, INC.

Petition for Temporary and Permanent Rates

Order Approving Permanent Rates

ORDER NO. 24,751

May 25, 2007

APPEARANCES: McLane, Graf, Raulerson & Middleton, P.A., by Sarah B. Knowlton, Esq. for Pennichuck Water Works, Inc.; Upton & Hatfield, L.L.P. by Justin C. Richardson, Esq. for the City of Nashua; Office of the Consumer Advocate by Rorie E.P. Hollenberg, Esq. on behalf of residential ratepayers; and Suzanne Amidon, Esq. for the Staff of the New Hampshire Public Utilities Commission.

I. PROCEDURAL HISTORY

On May 12, 2006, Pennichuck Water Works, Inc. (PWW) filed a Notice of Intent to File Rate Schedules and, on June 16, 2006, PWW filed said schedules along with supporting documentation and testimony. The requested rates were designed to increase PWW's revenues by \$6,091,633, or 36.49 percent, on an annual basis over its current authorized level of rates. PWW proposed that the total increase be broken into two parts: an initial increase of 15.91 percent, based on its 2005 test year, followed by a step increase of 20.58 percent for recovery of costs related to its water treatment plant project. PWW proposed that the initial rate increase take effect on a bills-rendered basis as of August 1, 2006. PWW also filed, pursuant to RSA 378:27, a petition for temporary rates to increase PWW's revenues by \$2,529,083, or 15.15 percent, over current rates.

On July 13, 2006, by Order No. 24,646, the Commission suspended the proposed revisions to PWW's permanent rate tariffs pursuant to RSA 378:6, pending investigation,

scheduled a prehearing conference and technical session for August 1, 2006; and ordered that PWW publish notice of the hearing. The OCA entered an appearance on behalf of residential ratepayers. The City of Nashua (Nashua), Anheuser-Busch, Inc., and customers Barbara Pressly, Fred Teeboom, and Claire McHugh all moved to intervene. The Commission granted the interventions at the prehearing conference, which took place as scheduled.

Following the prehearing conference and ensuing technical session, Commission Staff and the parties filed a proposed procedural schedule. This schedule governed discovery on temporary and permanent rates and set a hearing on the merits for April 3, 2007. The schedule was approved by secretarial letter and Staff and the parties conducted discovery pursuant to that schedule.

On June 19, 2006, PWW filed a depreciation study conducted by Earl M. Robinson of AUS Consultants (AUS). The study recommended adjustments to PWW's annual depreciation rates. AUS stated that PWW's present rates for total depreciable plant in service as of December 31, 2005 resulted in an annual depreciation expense of \$2,907,058; applying AUS's proposed depreciation rates to PWW's total depreciable plant in service at December 31, 2005 resulted in an annual depreciation expense of \$3,009,428. This represented an increase of \$102,370. AUS stated that PWW's present composite depreciation rate was 2.80 percent; while under the proposed rates it would be 2.90 percent.

On September 6, 2006, the Commission held a hearing at which PWW, Staff, OCA and Anheuser-Busch presented a settlement agreement on temporary rates. Staff and the settling parties proposed granting temporary rates at a level 14.41 percent over PWW's test year revenues. The Commission approved temporary rates on September 22, 2006 in Order No. 24,668, retroactive to July 18, 2006 on a service rendered basis. The Commission also approved

the rate design proposed by the settling parties in which fire protection customers would not see an increase for temporary rates, consistent with PWW's 2001 cost of service study.

As discovery ensued, PWW requested confidential treatment of information Staff sought relating to employee names and salaries. The Commission granted PWW's request by Order No. 24,701 (November 22, 2006). On October 11, 2006, the City of Nashua filed a motion to compel PWW to provide community water system-specific cost data and associated reports or analysis for the period subsequent to March 25, 1998. PWW objected to the motion to compel on October 20, 2006. On January 12, 2007, in Order No. 24,725, the Commission granted Nashua's motion and ordered PWW to produce the information within ten calendar days. On January 18, 2007, Nashua filed a letter indicating it had reached an agreement with PWW and withdrew the discovery motion.

On December 1, 2006, Staff filed an assented-to motion to change the procedural schedule to allow the parties additional time to conduct discovery and prepare testimony. The change affected discovery deadlines but preserved the deadlines for filing rebuttal testimony, submitting a settlement agreement, and holding hearings. The Commission approved the change in a secretarial letter.

On February 23, 2007, Staff filed testimony of Jayson P. Laflamme, James J. Cunningham, James L. Lenihan, and David C. Parcell. Mr. Laflamme recommended a revenue requirement of \$17,972,743, an increase of \$1,339,157, or 8.05 percent, over PWW's pro-forma test year operating water revenues of \$16,633,586. To calculate the increase, Staff used a rate base of \$48,428,642 and an overall rate of return of 7.87 percent to derive a net operating income requirement of \$3,811,334. Mr. Laflamme also made a number of adjustments for, among other things, contributions in aid of construction, accumulated depreciation, depreciation and

amortization expense, and unfunded FAS 106 costs, which were detailed more fully in his testimony.¹ Mr. Cunningham stated that he had reviewed PWW's depreciation study and recommended a depreciation and amortization expense of \$2,032,387, which was \$761,368 less than that contained in PWW's study. Mr. Cunningham attributed the difference to, among other things, his use of average test year plant balances as compared to PWW's use of test year-end plant balance. Mr. Cunningham testified that his approach represented the traditional method used in rate-base and rate-of-return ratemaking, mirrored PWW's bookkeeping practice, and was more accurate since Staff stated PWW's accounting for cost of removal had not been in accord with the Water Chart of Accounts. In addition, Mr. Cunningham testified that he included an adjustment to reduce PWW's depreciation reserves. Mr. Lenihan recommended that any permanent increase apply to all rates, including fire protection. Mr. Lenihan stated that PWW's last cost of service study, in 2001, was based on 2000 data and that it is not clear whether the study's conclusions would be the same today. Mr. Parcell recommended a cost of equity capital range for PWW of 9.00 percent to 10.50 percent and an overall rate of return range of 7.49 percent to 8.26 percent, with 7.87 percent being the mid-point. This was based on a long-term debt to equity ratio of 49:51. Mr. Parcell stated that the only difference between PWW's request and his recommendation was the cost of equity capital.

On March 21, 2007, PWW filed rebuttal testimony of William D. Patterson, Earl M. Robinson, and Harold Walker, III. Mr. Patterson testified that PWW was at a critical time in its 2005-2009 capital improvement program. PWW's water treatment plant upgrades will cost \$41 million, capital spending to maintain the system is \$6 – 7 million per year, and it is spending another \$2 – 3 million to install radio meter reading equipment. The capital improvement project

¹ The Financial Accounting Standard (FAS) 106, issued by the Financial Accounting Standards Board (FASB), requires companies to recognize post-retirement benefit plans maintained by the employer as a liability on its balance sheets.

has doubled PWW's rate base. Mr. Patterson contended that not allowing construction work in progress into rate base until the plant is used and useful puts a financial strain on PWW and forces PWW to raise outside funds. The failure to recognize the project costs from January to May will send a chilling message to the capital markets and PWW's Baa3 rating could slip, according to Mr. Patterson. He suggested that PWW could face higher costs of capital which will be passed along to customers. Mr. Robinson's testimony rebutted positions taken by Mr. Cunningham. Mr. Robinson testified that his calculation of PWW's theoretical surplus in the depreciation reserve account was \$1,915,042 as compared to Mr. Cunningham's calculation of \$3,858,323. According to Mr. Robinson, depreciation reserve variance should be amortized over the average remaining life of each property group and not eight years as Mr. Cunningham suggests. Mr. Robinson also disputed the \$761,000 in adjustments made by Mr. Cunningham to depreciation expense. Mr. Walker testified that Mr. Cunningham's recommendation would result in a 17 percent reduction in PWW's depreciation expense. Depreciation expense is one of the single largest generators of cash flow for a utility and without it a utility cannot access capital markets, according to Mr. Walker. He suggested that investors will view PWW as a much more risky investment and its Baa3 rating could dip to a Ba or junk bond rating if Staff's recommendations on depreciation expense were adopted. Mr. Walker testified that a reduction in capital expenditures would also impair PWW's ability to meet Safe Drinking Water Act requirements.

On March 30, 2007, Staff filed a stipulation agreement executed by Staff, OCA, and PWW. The Commission held a duly noticed hearing on April 3, 2007 at which Staff, OCA, and PWW presented evidence and testimony in support of the Agreement. Mark A. Naylor, director of the Commission's gas and water division, testified on behalf of Staff. Bonalyn J. Hartley, vice

president of administration for PWW and PWW's parent, Pennichuck Corporation, and Donald L. Ware, president of PWW, testified on behalf of PWW. As a result of a request at hearing, on April 3, 2007, PWW filed an exhibit list and a revised Exhibit 19 detailing the proposed rate impacts on residential customer bills.

On April 11, 2007, PWW submitted its rate case expense total along with supporting documentation for review. On May 1, 2007, Staff filed a letter detailing its recommendation on rate case expenses. Staff's letter indicated that PWW had submitted proposed rate case expenses in the amount of \$245,710.65. Staff recommended that PWW be authorized to recover \$198,770.71, which would mean disallowance of \$46,939.94 in expenses. Specifically, Staff recommended the Commission reject \$42,685.51 relating to temporary service fees for an employee who subsequently became a full time employee, and whose salary costs were accounted for in the underlying settlement. Staff also recommended the Commission disallow \$2,150 relating to the use of a public relations firm, \$1,726.43 relating to costs associated with Staff's audit, and \$378 in other charges which Staff indicated that PWW had agreed should be removed from rate case expenses. Staff indicated that OCA concurred with Staff's recommendation regarding rate case expenses.

On April 30, 2007, PWW filed a request for a step adjustment in accordance with the settlement, including with the request pre-filed testimony of Bonalyn J. Hartley and accompanying schedules.

II. POSITIONS OF THE PARTIES AND STAFF

A. PWW, OCA and Staff

The positions of PWW, OCA and Staff are set forth in the settlement, which is summarized below.

B. City of Nashua

Nashua did not enter into the settlement and stated at hearing that it took no position on the agreement. When asked by the Commission at hearing, Nashua also stated it did not oppose the settlement.

C. Anheuser-Busch, Inc.

Anheuser-Busch, Inc. did not enter into the settlement. Anheuser-Busch, Inc. authorized Staff to represent to the Commission that it took no position on the agreement.

D. Fred Teeboom, Barbara Pressly, and Claire McHugh

These intervenors did not enter into the settlement and did not participate in the April 3, 2007 hearing.

III. STIPULATION AGREEMENT**A. Revenue Requirement****i. Summary**

The settling parties and Staff agreed that PWW should be granted an 11.07 percent increase in revenues, to achieve a revenue requirement of \$18,311,559, based on its 2005 test year. The signatories agreed that the resulting rates would be just and reasonable.

ii. Adjustment for Decreased Water Sales

The settling parties and Staff agreed that 2005 test year revenues should be adjusted downward for one-half of the observed decrease in metered sales over the past year, i.e. \$147,000. The result of this adjustment is that the revenue deficiency would be increased to the benefit of PWW. The settlement signatories intend this to be a one-time adjustment to recognize and mitigate the adverse impact declining sales has had on PWW's cash flow. At hearing, PWW explained it had experienced a reduction in metered sales and that this decline has come at an

inopportune time since PWW is in the middle of a major capital improvement program and is incurring major expenses. Mr. Ware testified that PWW lost a number of large manufacturing customers. 4/3/07 Tr. at 39 lines 12-13. PWW has experienced a 5 percent decline over the past 4 months and a 7 percent decline when comparing March 2006 with March 2007. 4/3/07 Tr. at 40 lines 22-24. Mr. Naylor testified that this adjustment would not be permanent since, once PWW files another rate case, which he expected relatively soon, the test year would be based on more current operating and sales data. 4/3/07 Tr. at 23 lines 12-16.

iii. Other Expense Adjustments

The settling parties and Staff agreed on a number of adjustments to expenses: eliminating \$64,301 in credits to rent expense, adding \$29,994 for an additional customer service representative (plus benefits in the amount of \$14,997 and payroll taxes of \$2,295), adding back \$27,018 in meeting and convention expenses, adding back \$4,864 in membership and fee expenses, adjusting expenses by \$33,958 to reflect allocation to affiliates, adding back \$23,203 for a North Country operations manager, adjusting Staff's recommended depreciation and amortization expense by a net amount of \$200,000, after reflecting a reduction to depreciation expense of \$69,701 to account for cost of removal booked to plant accounts, and reducing income tax expense by \$188,884 for the pro forma adjustments. At hearing, Mr. Naylor explained that the adjustments are essentially modifications to the testimony of Mr. Laflamme and yield the proposed revenue requirement. 4/3/07 Tr. at 22 lines 16-22.

iv. Step Adjustment for Water Treatment Plant

The settling parties and Staff agreed that PWW has expanded its rate base significantly with the additions to its water treatment plant that were placed into service January 5, 2007. The signatories agreed that PWW should be permitted to recover its investment in the water treatment

plant upgrades by means of a step adjustment to its rates effective with the Commission's final order in this docket. The recommended step adjustment amounts to a 20.36 percent increase in revenues over the test year. The settling parties and Staff also agreed that PWW should be permitted to recover from customers the revenues earned from an in-service date of January 5, 2007 to the date of the Commission's final order by way of a surcharge. Those revenues would be combined with a temporary rate refund and rate case expenses and surcharges to customers as provided elsewhere in the settlement. At hearing, Mr. Naylor explained that subsequent to the Commission's approval of PWW's \$50 million financing request for these upgrades in Docket No. DW 05-094, Staff audited PWW's records and determined that upgrades to the waste treatment plant were used and useful as of January 5, 2007. 4/3/07 Tr. at 25 lines 8-20.

v. Depreciation and Amortization

PWW's proposed depreciation and amortization expense was \$2,793,755. Staff witness Cunningham recommended that depreciation and amortization expense be \$2,032,387. The settlement adopted depreciation and amortization expenses of \$2,302,088, an increase of \$269,701. The signatories further agreed to net this figure down to an increase of \$200,000 and to use \$69,701 of the \$269,701 to reflect an adjustment for cost of removal. This results in a settlement amount of \$2,232,387 for depreciation and amortization expense. At hearing, Mr. Naylor testified that this \$200,000 provision represents a compromise and resolution of the differences between Staff and PWW on this issue. 4/3/07 Tr. at 29 lines 10-24. He explained that PWW had included cost of removal in the value of the new assets, which artificially inflated plant balances and thus depreciation expense. The \$69,701 reduction in depreciation expense for cost of removal is meant to correct for the artificially inflated plant balances, but Mr. Naylor stressed that Staff and the parties will continue to discuss this issue to determine the amount of

any future adjustments to PWW's plant balances that may be necessary to resolve questions around the prior inclusion of cost of removal in plant balances.

The settling parties and Staff also agreed to PWW's proposed increases in negative net salvage, and use of year-end plant balances for calculation of depreciation expense. The signatories further endorsed a 10-year amortization period for the depreciation reserve surplus, amortization of leasehold improvements over a 10-year period and application of a 30-year life for wells and springs, a 70-year life for paving following main replacements, a 45-year life for paving following repair or replacement of service lines to customer premises, and a 49-year life for developer-installed hydrants.

vi. Cost of Capital

The settling parties and Staff agreed upon Staff's recommended cost of capital, with one adjustment: increasing PWW's total equity by \$808,000 based on FAS 158² to produce an overall cost of capital of 7.89 percent. This adjustment raises PWW's overall cost of capital by 0.02 percent.

B. Rate Design

i. Study

The signatories agreed that PWW's 2001 cost-of-service study should be updated and that PWW will conduct a new study prior to its next general rate case.

² According to FAS 158, an employer must recognize the overfunded or underfunded status of a defined benefit post-retirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. As to PWW, FAS 158 allows PWW to avoid write-downs of equity for unfunded pension liabilities.

ii. Application of Permanent Rate and Step Adjustment

The settling parties and Staff agreed to the application of the 11.07% permanent rate increase to metered customers but not to fire protection customers, consistent with the revenue allocation for temporary rates. Mr. Naylor testified at hearing that it was necessary to keep the same rate design for temporary and permanent rates since customers were owed a refund. 4/3/07 Tr. at 28 lines 3-7. The settling parties and Staff also recommended applying the step adjustment increase to all customer classes, including fire protection customers, effective January 5, 2007.

C. Effective Date for New Permanent Rates

The signatories to the settlement agreed that the permanent rate increase of 11.07 percent, should be applied to all metered customers and not to fire protection customers as of the date of the Commission's final order in this docket, to be reconciled with the temporary rates previously approved.

D. Recoupment

The settling parties and Staff agreed to reconcile the new permanent rates to the temporary rates currently in effect through a refund mechanism that would require PWW to net the temporary rate refund against the 20.36 percent step increase surcharge for the water treatment plant and PWW's rate case expense surcharge. For fire protection customers, a separate surcharge consisting of the step increase surcharge and the rate case expenses would be calculated. The signatories to the settlement propose this as a means of simplifying the refunds and surcharges. The signatories agreed that it would be reasonable to apply both surcharges to customer bills over a 9-month period.

We note that according to Exhibit 2 presented at the temporary rate hearing, the 14.41 percent overall rate increase was effectively a 16.96 percent increase to metered customers since fire protection customers were excluded from temporary rates. According to Attachment B to the settlement, the 11.07 percent overall permanent rate increase is a 13.05 percent effective rate increase for metered customers and the 20.36 percent step increase associated with the water treatment plant is a 20.50 percent effective increase. This is because the step increase applies to the Milford and Hudson special contract volumetric charges but not to the overall contract charges. Exh. 18 at 25. Thus, the Settling Parties' request can be construed as seeking approval to net the refund produced by the reconciliation of 16.96 percent and 13.05 percent against the step increase of 20.50 percent and the future rate case expense surcharge.

E. Rate Case Expenses

The settling parties and Staff agreed that rate case expenses should be combined with the refund for the temporary-permanent rate reconciliation for metered customers and the step increase that is applied to all customers. As stated earlier, the objective is to simplify the surcharges for customers. PWW agreed to file its summary of rate case expenses with the Commission, which it did on April 11, 2007. The settlement provides for Staff to review and file a recommendation, which it did on May 1, 2007. As stated earlier, Staff indicated OCA concurred with its recommendations.

F. Mechanism for Future Step Adjustment

The signatories to the settlement agreed to a step adjustment mechanism for PWW to seek recovery of its costs associated with Sarbanes-Oxley compliance.³ The settling parties and Staff also recommended that the step adjustment include, subject to audit requirements: (1) a

³ This refers to the federal Sarbanes-Oxley Act of 2002, which in relevant part requires a system of internal controls for all publicly traded companies to be documented and compliance with acceptable standards to be certified. *See Pittsfield Aqueduct Co.*, 88 NH PUC 679, 683-84 (2003) (discussing recoverability of such costs).

reduction in PWW expenses related to the return on common plant that will be allocated to affiliated companies, (2) recovery of additional expenses in the amount of \$142,381 for four new positions as set forth in Attachment C to the settlement, (3) recovery of PWW's incremental operating expenses related to electric service and chemicals for the water treatment plant, which are described in Attachment D to the settlement.

PWW agreed to file its step adjustment proposal with the Commission no later than April 30, 2007, with copies to the service list. We noted earlier that this filing had been made. The settling parties and Staff agreed that the step adjustment should be applied to all customers and be effective June 1, 2007 on a service-rendered basis. Staff agreed to audit the request and to provide PWW the opportunity to respond to the audit prior to the implementation of the step adjustment. Following the audit Staff agreed to file a recommendation with the Commission, with OCA having the option of either joining Staff's recommendation or filing comments separately.

G. Lost Water Reporting

PWW agreed to provide an annual accounting of lost water by individual system, tabulated monthly, beginning with the company's 2006 annual report, consistent with the Commission's adoption of such a requirement in *Investigation into Water Conservation*, 88 NH PUC 603 (2003). At hearing, Mr. Ware testified that PWW has been supplying monthly lost water data with its annual report since 2004. 4/3/07 Tr. at 42 line 24 and at 43 line 1 and 20.

IV. COMMISSION ANALYSIS

Pursuant to RSA 541-A:31,V(a), informal disposition may be made of any contested case at any time prior to the entry of a final decision or order, by stipulation, agreed settlement, consent order or default. The Commission encourages parties to attempt to reach a settlement of

issues through negotiation and compromise “as it is an opportunity for creative problem-solving, allows the parties to reach a result more in line with their expectations, and is often a more expedient alternative to litigation.” *Concord Electric Co.*, 87 NH PUC 595, 605 (2002) (quoting *Granite State Electric Co.*, 87 NH PUC 302, 306 (2002)). Notwithstanding a settlement among the parties, we must still independently determine whether the settlement results comport with applicable standards. *Id.*

N.H. Code Admin. Rules Puc 203.22 (b) requires us to determine, prior to approving disposition of a contested case by settlement, that the settlement results are just and reasonable and serve the public interest. RSA 378:7 authorizes us to fix rates after a hearing upon determining that the rates, fares, and charges are just and reasonable. In determining whether rates are just and reasonable, we must balance the customers’ interest in paying no higher rates than are required with the investors’ interest in obtaining a reasonable return on their investment. *Eastman Sewer Company, Inc.*, 138 N.H. 221, 225 (1994). Additionally, in circumstances where a utility seeks to increase rates, the utility bears the burden of proving the necessity of the increase pursuant to RSA 378:8.

A. Revenue Requirement

The settlement contemplates a revenue requirement of \$18,311,559 for permanent rates, which represents an overall increase of 11.07 percent, based on PWW’s 2005 test year. The signatories to the settlement adopted this revenue requirement after agreeing upon resolution of the following issues: decreased water sales after the test year, adjustments to various expenses, step adjustment treatment for PWW’s water treatment plant, adjustments to PWW’s depreciation and amortization expense, adjustment to PWW’s depreciation expense for cost of removal, and cost of capital. We address each issue in turn.

i. Decreased Water Sales

The Commission uses a historical test year method of determining a utility's revenue requirement. A test year is a snapshot in time of a specific historical period to which we compare the utility's approved revenue requirement. If there is a deficiency, it signals that a rate increase may be appropriate. We have approved pro forma adjustments to a test year, if necessary, to better reflect the utility's future revenue needs. In this case, the settling parties and Staff propose an adjustment based on recently declined sales. PWW has provided documentation of the decreased sales with data as recent as March 2007. Mr. Naylor testified that, in light of the decrease, the signatories to the settlement agreed to recognition for ratemaking purposes of half of the decreased sales, given that in PWW's next rate case the new test year will fully capture the more current sales figures. Predicting future sales revenue is difficult but enough data exists to prove a declining trend in PWW's sales. In light of the evidence and testimony, we find it is just and reasonable to allow the test year revenues to be adjusted downward to account for half of the sales decline.

ii. Other Expense Adjustments

With respect to the eleven expense adjustments that appear in section III (A) (iii) of the settlement, we understand that they represent a compromise between those listed in PWW's testimony and the testimony submitted by Staff. We heard testimony at hearing that discovery subsequent to this testimony aided in the parties' understanding and helped bring the issues to resolution. 4/3/07 Tr. at 24 lines 15-24. The discovery provided as Exhibits 4 through 8 and 14 at hearing evidence that these adjustments were actively debated by the parties. Given the pre-filed testimony, rebuttal testimony, and discovery, we conclude that the expense adjustments are reasonable.

iii. Step Adjustment for Water Treatment Plant

The settlement recommends a step adjustment to revenues for improvements to PWW's water treatment plant, which would result in an additional overall revenue increase of 20.36 percent over the 2005 test year. PWW initially requested an increase of 20.58 percent for these improvements. The proposal in the settlement is slightly less than that. As stated earlier, we approved PWW's request to finance the water treatment plant upgrades in Docket No. DW 05-094. *See Pennichuck Water Works, Inc.*, 90 NH PUC 371 (2005). In that docket, we found that the capital improvements were reasonably necessary and that they were consistent with the public good. *Id.* at 375. RSA 378:28 requires us to make a finding that plant, equipment, or capital improvements are prudent, used, and useful before including such items in permanent rates. In light of our decision in Docket No. DW 05-094, nothing here suggests a reason to deem any of the relevant expenditures to be imprudent. At hearing, we learned that Staff had audited PWW's records and had determined that upgrades to the water treatment plant were used and useful as of January 5, 2007. Accordingly, we find that the water treatment plant improvements are prudent, used, and useful and we will allow recovery of the costs.

As to the increase being applied as a step adjustment to permanent rates effective January 5, 2007, we note that we have previously employed step adjustments to rates as a means of ensuring that a regulated utility retains its ability to earn a reasonable rate of return after implementing large capital projects, after a test year, which increase the utility's rate base. The step adjustment avoids placing a utility in an earnings deficiency immediately after a rate case in which the revenue requirement was based on a historical test year. We understand from the pre-filed testimony of Mr. Patterson that not allowing PWW to recognize the water treatment plant improvements in rates until the conclusion of this rate case may adversely affect PWW's

financial position. Since the improvements have nearly doubled PWW's rate base, we understand the financial strain PWW may experience if it were not allowed to recover its costs in a timely manner. We, therefore, find the recommendation that PWW be allowed to recover, from all customers including those within fire protection classes, its water treatment plant improvements as of the date the improvements became used and useful to be reasonable and consistent with the public good. We will authorize PWW to implement the 20.36 percent step adjustment to permanent rates effective January 5, 2007. We understand that the settling parties and Staff intend that the revenue from this step adjustment from January 5, 2007 to the date of this order be recovered as part of a surcharge as discussed earlier. We agree this is a reasonable method of recovery of these revenues and we approve it.

iv. Depreciation and Amortization

The signatories to the settlement have proposed changes to PWW's depreciation rates and depreciation and amortization expense as compared to those presented in PWW's depreciation study. Evident from the testimony of Messrs. Cunningham and Robinson is that they differed as to whether, among other things, average test year plant balances or test year-end plant balance was an appropriate means of measuring depreciation and amortization expense. In settlement, the Company and Staff resolved their differences and recommend that we approve: use of year-end plant balances for calculation of depreciation expense, PWW's proposed increases in negative net salvage, use of a 10-year amortization period for the depreciation reserve surplus, allowing PWW to amortize leasehold improvements over a ten-year period, allowing PWW to use a 30-year life for wells and springs, a 70-year life for paving related to main work, a 45-year life for paving related to service connections, and a 49-year life for developer-installed hydrants. We consider these adjustments a reasonable compromise between opposing positions. As with

the discovery on other expense adjustments, it is apparent that the parties explored each others' positions fully. We find the various lives attributed to plant in the settlement to be reasonable and we find amortizing leasehold improvements over a ten-year period to also be reasonable. We will adopt these terms in our approval of PWW's rates.

The settling parties and Staff also propose a deduction of \$69,701 from PWW's proposed depreciation expense for cost of removal. We understand from the testimony at hearing that the cost of removal adjustment is being proposed to resolve, for this docket, the issue of overstated plant and that the signatories to the settlement plan to continue discussing how to resolve the overstatement permanently. We find it is reasonable to adjust depreciation and amortization expense and depreciation expense for cost of removal by the proposed adjustments pending the outcome of these additional discussions. We will, however, revisit this issue either upon a presentation by the signatories of a permanent solution or at PWW's next rate case.

v. Cost of Capital

The settling parties and Staff recommend a 7.89 percent overall cost of capital. We note that this is only slightly higher than that recommended by Staff in the testimony of Mr. Parcell. According to his testimony, the only issue that separated PWW and Staff on cost of capital was the cost of equity. At hearing, Mr. Naylor testified that it was implied that the signatories to the settlement, in recommending the 7.89 percent overall cost of capital, had adopted a cost of equity of 9.75% that was the mid-point of Mr. Parcell's recommendation of 9.00 to 10.50 percent. While comparison of the costs of equity among different utility industries is not dispositive, some comparison is useful to gauge the reasonableness of a cost of equity figure. Consequently, we note that PWW's cost of equity generally falls within the range approved for other utilities under stipulated and litigated circumstances. See *Unitil Energy Systems, Inc.*, Order No. 24,677

(October 6, 2006) (approving a stipulated 9.67 percent cost of equity); *Granite State Telephone*, Order No. 24,621 (May 12, 2006) (approving a stipulated 9.30 percent cost of equity); *Public Service Co. of New Hampshire*, 90 NH PUC 542 (2005) (approving a return on equity of 9.62 percent); and *Verizon New Hampshire*, 89 NH PUC 17 (2004) (approving a return on equity of 9.82 percent). In light of the thorough review of the cost of capital in discovery by the settling parties and Staff, the testimony provided, we find the cost of capital proposed by the settlement to be reasonable.

B. Rate Design

The settlement adopts the same revenue allocation for the permanent rate increase as was used for the temporary rate increase; the revenue increase would apply to metered customers and not to fire protection customers. This revenue allocation is consistent with PWW's 2001 cost of service study, but as the signatories to the settlement agree, it is outdated. Since the settlement contemplates a 11.07 percent overall permanent revenue increase, which we understand translates to a 13.05 percent effective rate increase for metered customers, and that it is lower than the temporary rate, customers are owed a refund. In these circumstances, it would be inequitable to deviate from the temporary revenue allocation and calculate a refund using a different and expanded pool of customers. For this reason, we find it reasonable to continue the present revenue allocation for permanent rate purposes.

With respect to the step adjustment for PWW's water treatment plant, we are not so constrained by PWW's 2001 cost of service study. In the testimony of Mr. Lenihan, Staff questioned whether the study's conclusions, which were based on 2000 data, would be valid today. Mr. Lenihan recommended that a permanent rate increase apply to all customer classes. The signatories to the settlement have apparently agreed a departure from the 2001 study is

warranted since they recommend we approve the water treatment plant step adjustment for all customers. We agree that a departure is warranted since PWW's cost of service study is based on data that is seven years old, PWW's major plant additions are not reflected in the study, and all customers benefit from these additions. Accordingly, we approve application of the step adjustment to all metered and fire protection customers.

Lastly, we note that PWW agreed to complete a new cost of service study prior to filing its next general rate case. We find this requirement essential to maintaining just and reasonable rates. At hearing, Mr. Naylor testified that cost of service studies ought to be conducted, on average, every five to seven years. 4/3/07 Tr. at 32 lines 1-4. PWW's 2001 cost of service study is at the outer bounds of the frequency Staff recommends. Accordingly, we will require PWW to complete a cost of service study and to file it with its next general rate case. Filing the study at the beginning of PWW's next rate case will ensure that Staff and any other parties to that docket will be able to explore it thoroughly through discovery.

C. Recoupment and Other Surcharges

The settling parties and Staff have recommended a surcharge to account for the refund of the difference between temporary rates and permanent rates in this proceeding. The difference between temporary and permanent rates is approximately 3.34 percent and this must be credited back to customers. Since only metered customers have been paying temporary rates, only those customers will be credited with the temporary rate reconciliation refund. Since temporary rates did not apply to fire protection customers, they will not be subject to any refund.

As for the surcharge associated with the water treatment plant, both metered and fire protection customers will see a rate increase as a result. That increase will be effective January 5, 2007. Thus, metered and fire protection customers will pay a surcharge for the recovery of the

new investment in the water treatment plant from January 5, 2007 to the date of this order. This surcharge will be netted down by the refund for metered customers but not for fire protection customers. A surcharge to recover rate case expenses will be added to the surcharge and will apply to all customers.

The settling parties and Staff recommend we approve these surcharges to customer bills over a nine-month period. This time period is reasonable because it helps avoid the potential that surcharges will overlap any future rate case. We do not want to create a situation where customers are paying surcharges from one rate case as well as a temporary rate increase for another rate case. PWW has stated that it will seek rate relief as the remainder of its capital improvement project is completed. Staff has also testified that it expects PWW to file for rate relief relatively soon. For the foregoing reasons, we find the proposed surcharges and recovery time period to be reasonable.

D. Rate Impacts

Having approved the revenue requirement and step adjustment, we next consider the impact these rate increases will have on the average residential customer. At hearing, the settling parties and Staff presented Exhibit 19-Revised, which depicted the impact of the temporary-permanent rate reconciliation and the step adjustment. A residential customer using 28.26 hundred cubic feet of water per quarter would see an increase from \$83.46 to \$94.35 as a result of the permanent rate increase, and to \$100.57 as a result of the step adjustment. In total, this represents an increase of 33.55 percent. A residential customer using 9.42 hundred cubic feet of water per month, would see an increase from \$27.82 to \$31.45 as a result of the permanent rate increase, and to \$33.52 as a result of the water treatment plant step adjustment. This also represents an increase of 33.55 percent.

E. Mechanism for Future Step Adjustment

The settling parties and Staff recommend a mechanism through which PWW could seek a future step adjustment to rates for a series of specific issues, including costs related to PWW's compliance with federal Sarbanes-Oxley requirements. We understand PWW will file this step adjustment request no later than April 30, 2007, and that the signatories to the settlement agree the adjustment should also cover a reduction in revenues related to the return on common plant that will be allocated to affiliated companies, recover PWW's additional expense related to four new employees, and recover incremental operating expenses related to electric and chemicals for the water treatment plant. Staff agreed to audit PWW's step adjustment request and allow PWW the opportunity to comment on that audit before making a recommendation to the Commission. The settling parties and Staff intend that this step adjustment be applied to all customer classes and that it be effective June 1, 2007 on a service-rendered basis. As stated earlier, PWW has made its step adjustment filing but we have not yet received a recommendation from Staff. We will approve this provision but we will defer determining whether it is appropriate to grant PWW step adjustment treatment for the listed issues until we have had an opportunity to review the filing, Staff's recommendation, and any other parties' position on the matter.

F. Lost Water Reporting

Consistent with the Commission's conclusions in the water conservation investigation, Docket No. DW 01-253, the settlement provides for lost water reporting by PWW. The Company testified that it has complied with this requirement since its 2004 Annual Report and thus this provision seems redundant. We nonetheless affirm that PWW is required to file lost water reports by individual system, with data tabulated monthly, with its Annual Report each year.

G. Rate Case Expenses

Finally, we will address PWW's recovery of rate case expenses. As stated earlier, PWW initially requested recovery of \$245,710.65. Staff recommended we disallow \$46,939.94 of this request. The largest disallowance Staff recommends concerns temporary service fees for an employee who subsequently became a fulltime employee, and whose salary costs are fully accounted for in the settlement. We agree that recovering these \$42,685.51 of expenses through the revenue requirement proposed in the settlement as well as through a rate case expense surcharge amounts to double recovery of these expenses. We will not permit this.

Staff also recommended disallowing \$2,150 relating to the use of a public relations firm, \$1,726.43 relating to costs associated with Staff's audit, and \$378 in other charges which Staff indicated that PWW agreed should be removed from rate case expenses. Particularly because PWW had hired a public relations firm in connection with Docket No. DW 04-048 (the City of Nashua's effort to municipalize PWW), and because PWW has maintained that costs associated with DW 04-048 are not being borne by customers, we agree that this rate case is not an appropriate vehicle to permit the utility to recover expenses associated with public relations. Concerning the audit expenses, we have historically rejected these expenses as rate case expenses based on the fact that such costs are already reflected in a utility's revenue requirement. To allow them as rate case expenses would allow PWW to recover the expenses twice. For this reason, we will disallow the audit related expenses. With respect to the \$378 in other charges, Staff indicates that PWW concurs with the removal of those expenses from consideration and we therefore need not rule on them. For the foregoing reasons, we authorize PWW to recover \$198,770.71 in rate case expenses. As noted earlier, we have approved the proposal in the settlement to combine the rate case expense surcharge with the temporary-permanent rate

reconciliation and the water treatment plant surcharge. Accordingly, we authorize PWW to recover the surcharge over a nine-month period.

H. Conclusion

Having reviewed the record, including the settlement and evidence presented at hearing, we find the revenue requirement adopted by the signatories to be reasonable and that it will produce just and reasonable rates. We find that the terms of the settlement represent an appropriate balancing of ratepayer interests and the interests of PWW's investors under current economic circumstances. We further find that PWW's investments in rate base used to serve its customers are prudent and used and useful, pursuant to RSA 378:28. We therefore adopt and approve the terms of the agreement as consistent with the public interest. Noting that the settlement leaves unresolved the question of how to permanently adjust plant balances to account for the inadvertent inclusion of cost of removal in the cost of certain plant, we note our expectation that the Settling Parties will propose a resolution to this issue in PWW's next rate filing.

Based upon the foregoing, it is hereby

ORDERED, that the terms of the Stipulation Agreement are hereby adopted and APPROVED as discussed herein; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to collect from customers permanent rates, as discussed herein; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to recover from all customers, effective January 5, 2007, its costs associated with its Water Treatment Plant, as discussed herein; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. is authorized to recover from all customers through a surcharge over 9-months the revenues for recovery of the Water Treatment Plant step increase beginning January 5, 2007 to the date of this order, as discussed therein, and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. shall apply the temporary-permanent rate reconciliation refund to all metered customers; and it is

FURTHER ORDERED, that Pennichuck Water Work, Inc. is authorized to recover rate case expenses totaling \$198,770.71 from all customers through a surcharge over a 9-month period of time; and it is

FURTHER ORDERED, that Pennichuck Water Work, Inc. shall file its calculation of the temporary rate refund and the Water Treatment Plant revenues from January 5, 2007 to the date of this order; and it is

FURTHER ORDERED, that PWW file with the Commission a compliance tariff within fourteen days of the date of this order; and it is

FURTHER ORDERED, that the Settling Parties meet and discuss a resolution of cost of removal and plant balances, as discussed herein, and file a recommendation with the Commission prior to Pennichuck Water Works, Inc. filing its next rate case; and it is

FURTHER ORDERED, that Pennichuck Water Works, Inc. complete an updated cost of service study prior to the filing of its next rate case with the Commission.

By order of the Public Utilities Commission of New Hampshire this twenty-fifth day of
May, 2007.

Thomas B. Getz
Chairman

Graham J. Morrison
Commissioner

Clifton C. Below
Commissioner

Attested by:

Debra A. Howland
Executive Director & Secretary