

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

**Re: City of Nashua Acquisition of Pennichuck Corporation**

**Docket DW 11-026**

**DIRECT TESTIMONY OF**

**ARTHUR GOTTLIEB**

**February 18, 2011**

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1 **Introduction and Purpose for Testimony**

2 **Q. Please state your full name and business address.**

3 A. My name is Arthur Gottlieb. My business address is 60 State Street, Boston,  
4 Massachusetts 02109. That is the address of C.W. Downer & Co.

5 **Q. Please state your occupation, your educational background and your professional  
6 qualifications.**

7 A. I am a Managing Director of C.W. Downer & Co., an investment banking firm operating  
8 through offices in the US, Europe, Asia and Australia. I joined C.W. Downer & Co. in  
9 1998, with more than 20 years experience in management, consulting and corporate  
10 development. I hold a B.S. in Computer Science with honors from the Massachusetts  
11 Institute of Technology (1976) and an MBA from the Harvard Business School (1988).  
12 Additional information concerning C.W. Downer & Co. and additional biographical  
13 information is attached to my testimony as Exhibit AG-1.

14 **Q. What role have you played in the effort of the City to acquire Pennichuck  
15 Corporation?**

16 A. I have provided investment banking and consulting services to the City. C.W. Downer &  
17 Co. was retained by the City in November 2008, and I have been working with the City  
18 since that date. In that capacity, I have assisted the City in assessing the value of  
19 Pennichuck Corporation and its subsidiaries, negotiating the Merger Agreement between  
20 the parties, and developing a long-term financial model to evaluate the financial impacts  
21 of the proposed transaction. I have also attended numerous meetings of the City's Board  
22 of Aldermen and its committees to provide information on various matters involving the  
23 Pennichuck Corporation acquisition.

1 **Q. Have you testified before the New Hampshire Public Utilities Commission or any**  
2 **other utilities regulatory authority on any previous occasions?**

3 A. No.

4 **Q. What are the purposes of your testimony?**

5 A. The purposes of my testimony are: (1) to summarize the proposed financial structure to  
6 be employed following the City's acquisition of Pennichuck Corporation; (2) to explain  
7 why I am confident that, under City ownership, the Pennichuck utilities will be able to  
8 generate sufficient cash to meet all of their operating and capital obligations necessary to  
9 continue to provide water service to their respective customers and to provide the cash  
10 necessary to pay debt service on the City's Acquisition Debt, at a level of rates and  
11 revenue requirements that will be lower than under current ownership; and (3) to explain  
12 why the merger consideration to be paid by the City under the Merger Agreement for the  
13 shares of Pennichuck Corporation is fair and reasonable from a financial point of view.

14 **Description of the Transaction and Operational Structure of the Companies**

15 **Q. Please summarize your understanding of the transaction and the financial structure**  
16 **of Pennichuck Corporation and its subsidiaries following consummation of the**  
17 **merger.**

18 A. Under the Merger Agreement, the City will purchase all outstanding shares of  
19 Pennichuck Corporation for \$29 per share. Based on current estimates, as explained in  
20 Mr. Patenaude's testimony, this price will result in a total purchase consideration of about  
21 \$138 million. Upon consummation of the merger, the City will become the sole  
22 shareholder of Pennichuck Corporation. Pennichuck Corporation, in turn, will remain the  
23 sole owner of its five subsidiaries, Pennichuck Water Works, Inc. ("PWW"); Pennichuck

1 East Utility, Inc. (“PEU”); Pittsfield Aqueduct Company, Inc. (“PAC”); Pennichuck  
2 Water Service Company; and The Southwood Corporation. PWW, PAC and PEU will  
3 continue to be public utilities regulated by this Commission.

4 **Q. How will the City access the cash flow of the regulated utility subsidiaries so that the  
5 City may pay the debt service on the bonds it issues to finance the merger?**

6 A. Under the proposed operational structure, the three regulated utilities, and the other  
7 current unregulated operations of the other Pennichuck subsidiaries, will continue to  
8 operate as they do today, collecting revenues at rates approved by this Commission (in  
9 the case of the regulated companies), and paying operating costs, including debt service  
10 on indebtedness that is currently outstanding and also on new indebtedness that will be  
11 incurred to finance needed capital improvements. After paying these current operational  
12 cash obligations, the subsidiaries will have positive cash flow that they can distribute as  
13 intercompany dividends to the parent company, Pennichuck Corporation. Pennichuck  
14 Corporation will then use that available cash to pay its obligations to the City in its  
15 capacity as sole shareholder.

16 **Comparison of Revenue Requirements under City and Current Ownership**

17 **Q. Mr. Gottlieb, do you have an opinion on how future revenue requirements under  
18 City ownership compare to revenue requirements under current Pennichuck  
19 ownership?**

20 A. Yes. As demonstrated in Ms. Hartley’s testimony, initial revenue requirements and rates  
21 under City ownership are expected to be slightly lower than the revenue requirements  
22 under current ownership. Given that starting point, it is reasonable to conclude that  
23 revenue requirements under City ownership will continue to be lower than revenue

1 requirements under current ownership as long as the following two conditions are met:

2 (1) inflation remains positive, and (2) capital expenditures are greater than depreciation.

3 Over any reasonable time period at reasonable assumptions, both of those conditions are  
4 almost certain to be satisfied.

5 **Q. How do those two conditions lead to lower revenue requirements under City  
6 ownership?**

7 A. The revenue requirement under current ownership must cover operating expenses, return  
8 on capital, and depreciation. As demonstrated in Mr. Patenaude's testimony, operating  
9 expenses will be approximately \$1.7 million lower under City ownership than they are  
10 under current ownership. Since inflation applies to all operating expenses, that  
11 differential will widen over time, meaning the absolute operating expense savings under  
12 City ownership will be greater in the future than they are today.

13 The City also plans to make capital expenditures necessary to maintain viable and high  
14 quality water service. These capital expenditures under City ownership will be the same  
15 as under current ownership. Under current ownership, capital investment at the utility  
16 level is funded by a mix of debt and equity, and the allowed rate of return for each utility  
17 reflects that mix. Under City ownership, the City expects that capital investment for each  
18 utility will be funded entirely by debt issued by the utilities. Since equity has a

19 substantially higher allowed rate of return than debt, that component of the revenue  
20 requirement will also grow more quickly under current ownership than under City  
21 ownership. This effect can be demonstrated by an example attached as Exhibit AG-2.

22 The example compares the revenue requirements arising from an assumed capital

23 investment of \$8,000,000. As shown in the example, the revenue requirement under City

1 ownership would be approximately \$404,202 lower under City ownership than under  
2 current ownership because the City's overall rate of return will be lower than the rate of  
3 return under current ownership. This beneficial savings is compounded over the years as  
4 more capital is spent.

5 Finally, depreciation, which is a function of the current asset base and future capital  
6 investment, will be the same regardless of owner. Since two of the three revenue  
7 requirement components will grow more slowly under City ownership, and the third will  
8 remain the same, future revenue requirements for each utility will be lower under City  
9 ownership than they would be under current ownership. This means that the City  
10 projects that customers of each utility will pay lower rates over time than under current  
11 ownership.

12 **Q. What would be the impact on revenue requirements if the City is able to issue the**  
13 **City Acquisition Debt at an interest rate lower than the base case assumption of**  
14 **6.5%?**

15 A. Under the Fixed Annual Revenue Requirement methodology described in Ms. Hartley's  
16 testimony, if the City is able to issue the City Acquisition Debt at lower interest rates, the  
17 annual debt service requirement for the City Acquisition Debt will be lower.

18 Accordingly, at interest rates lower than 6.5%, the revenue requirements under City  
19 ownership would start lower and grow even more slowly than they would under current  
20 ownership.

21 **Reasonableness of Merger Price for the Stock of Pennichuck Corporation**

22 **Q. Do you believe that the consideration to be paid by the City under the Merger**  
23 **Agreement for the shares of Pennichuck Corporation is fair and reasonable?**

1 A. Yes. As a preliminary matter, I note that valuation of companies is not an exact science.  
2 The value of a company is usually set through market competition. For example, the  
3 share prices of public companies are determined by buyers and sellers in the stock  
4 market. In this case, the City and Pennichuck Corporation agreed to a negotiated price of  
5 \$29.00 per share. This negotiated result did not involve any auction or market process  
6 that could be used to establish a market value. The negotiated approach was necessary  
7 because Pennichuck Corporation was selling in the context of an eminent domain  
8 proceeding, which by its nature prevented other bidders from entering the process.

9 **Q. How have you reached your conclusion that the merger consideration is fair and**  
10 **reasonable?**

11 A. In the absence of an auction process, one can evaluate the value of Pennichuck  
12 Corporation with reference to how companies similar to Pennichuck are valued in public  
13 markets. In this case, C.W. Downer & Co. prepared an analysis that compared  
14 Pennichuck Corporation to nine other publicly traded water utilities that both Pennichuck  
15 Corporation and financial analysts generally consider to be peers of Pennichuck  
16 Corporation. A copy of this analysis is attached as Exhibit AG-3.  
17 This analysis uses three different market valuation methodologies. The first is based on  
18 comparing multiples of earnings before interest, income taxes, depreciation and  
19 amortization (“EBITDA”). EBITDA is a proxy for the cash flow potential of a business.  
20 The second is based on comparing multiples of book value. Book value is a measure of  
21 the equity invested in a business. The third is based on comparing multiples of rate base.  
22 Rate base is a measure of the total capital invested to provide water services to utility  
23 customers.

1 It is important to note that the premium calculation was based on share prices for the 30-  
2 day period through October 31 and on Pennichuck operating results for the 12 months  
3 ending September 30, 2010.

4 **Q. What are the results of your analysis?**

5 A. Premiums for utility transactions typically run between 20% and 40%. According to  
6 Mergerstat, a leading database of detailed information on mergers and acquisitions, the  
7 average control premium for utility transactions that were announced between January  
8 2008 and October 2010 was 40%. The median control premium for that period was 26%.  
9 Using data available as of November 1, 2010, \$29 per share represented a premium  
10 between 27% and 39% over Pennichuck's peer group, depending on the valuation metric  
11 that was used. That is a reasonable premium range in the context of a negotiated  
12 transaction with a public company.

13 **Q. Have you updated your analysis to use more current data?**

14 A. Yes. We have prepared an analysis using share prices through February 9, 2011 and,  
15 where available, updated operating results for Pennichuck Corporation and its peers.  
16 With that data, the \$29 share price represented a premium between 26% and 40%, again  
17 depending on the valuation metric used. The new premium range is still reasonable for a  
18 negotiated acquisition of a public company.

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

20 A. No.