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N.H.P.U.C. Case No. DW 10-091

Exhibit No. #8

Witness Panel 2

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STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DW 10-091

In the Matter of:
Pennichuck Water Works, Inc.
Petition for Permanent Rates and Step Increase

Direct Testimony

of

Mark A. Naylor
Director, Gas and Water Division

March 31, 2011

New Hampshire Public Utilities Commission

Pennichuck Water Works, Inc.

DW 10-091

Petition for Permanent Rates

Direct Testimony of Mark A. Naylor

Q. Please state your name, occupation, and business address.

A. My name is Mark A. Naylor. I am Director of the Gas & Water Division at the New Hampshire Public Utilities Commission. My business address is 21 South Fruit Street, Suite 10, Concord, New Hampshire. My experience and qualifications are attached to this testimony as Attachment MAN-1.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide the recommendations of Commission Staff (Staff) with respect to three requests of Pennichuck Water Works, Inc. (PWW): 1) for a Water Infrastructure and Conservation Adjustment (WICA) mechanism; 2) for a step adjustment to its rates for post-test year capital projects, and 3) for use of an "embedded actual cost methodology" for its weighted average cost of debt. I will also provide Staff's recommendation for treatment of the proceeds from the sale of cell tower leases as directed by the Commission in PWW's previous rate case, DW 08-073. Finally, I will also offer comments on the recently filed joint petition of the City of Nashua (Nashua) and Pennichuck Corporation (Pennichuck) in Docket No. DW 11-026 as to its potential impact on PWW and PWW rates.

Q. Please describe what a WICA mechanism is.

A. A WICA mechanism allows a water utility to seek recovery of certain non-revenue producing, pre-approved capital improvements between general rate cases. It is intended as a way of incenting more rapid replacement of aging infrastructure, and is not a replacement for general rate proceedings. The infrastructure to be replaced under a WICA is generally restricted to mains, valves, services, hydrants and meters. A budget for these capital investments is approved by the regulator prior to any construction. Each year the utility makes a filing seeking a WICA surcharge to be added to customer bills to begin recovery of the projects completed that year. The total WICA surcharge added to customer bills at any one time is generally limited to a certain percentage of the utility's total revenues before the utility must seek a new general rate case. At the conclusion of the rate case, the surcharge revenues are incorporated into the total revenue requirement, new tariff rates are established, and the surcharge is re-set to zero. The Commission approved a WICA mechanism for Aquarion Water Company of New Hampshire, Inc. (Aquarion) in that company's last general rate case, DW 08-098. Order No. 25,019, September 25, 2009.

Q. Please describe PWW's proposed WICA.

A. Through his prefiled testimony and response to Staff discovery requests, Donald Ware, President of PWW, states that PWW is seeking approval for a WICA program very similar to that approved by the Commission for Aquarion. PWW's requested WICA program would concentrate on water main replacement within the Nashua core system. This request is based on planned annual replacement or rehabilitation of 12,000 to 15,000 linear feet of existing distribution main over a 20 to 25 year time frame. At this time the company is seeking only to include projects within the Nashua core system in the WICA as Mr. Ware has indicated that the age and type of water mains and services in PWW's community water systems will not require consideration for replacement for some time into the future. Within Nashua, PWW will also incorporate replacement of services, meters, gate valves, and hydrants into its proposed WICA. The company indicates that it will prioritize its water main replacement efforts based on coordination with any scheduled City sewer work as well as break history, soil types, fire protection flows, etc. PWW seeks a WICA where the maximum annual increase in revenues would be 2%, up to a total maximum amount of 7.5% between rate cases.

Q. What are the asserted benefits of a WICA?

A. The benefit to the company is that a WICA mechanism permits a water utility to begin to recover by a surcharge the costs of capital improvements intended to address issues of aging infrastructure. By commencing recovery of these replacements between general rate cases, the utility's cash flows are enhanced and the WICA may therefore help to speed up replacement of such aging plant. And because a surcharge is placed on customer bills between rate cases, the benefit to customers is that it may lengthen the time between full rate cases, thus saving rate case expense which customers pay. WICA programs also may help in reducing rate shock by virtue of a more gradual increase in customer bills as infrastructure is replaced. And if a WICA program does incent a utility to speed the rate of infrastructure replacement, then it stands to reason the distribution system will ultimately be more reliable.

Q. What is Staff's recommendation regarding a WICA for PWW?

A. Staff has recently expressed its support for a WICA program in the current Pittsfield Aqueduct Company, Inc. (PAC) rate case, and Staff also supports the establishment of a WICA program for PWW. Staff would support structuring a WICA for PWW that is very similar to the pilot program in place for Aquarion. The Aquarion WICA is to be re-evaluated at the time the company files its next rate case, and this is a good model to follow for PWW as well. PWW has expressed an interest in beginning a WICA program later in 2011, beginning with a filing for a three-year capital budget no later than November 1, 2011. Staff intends to discuss this issue further with PWW and the other parties to this docket with the intent of establishing a WICA pilot program that benefits both the company and its customers.

Q. Are there any other recommendations with respect to WICA that Staff would like to make?

A. Yes. Staff recommends that because Commission review of WICA filings are by necessity more brief than review of full rate cases, PWW be responsible for providing notice to its customers and to the City of Nashua at least 30 days in advance of its WICA filings[1]. In addition, the company's WICA filings should be accompanied by the following: 1) all the documentation necessary for Staff and the parties to verify the costs of the completed projects; 2) proposed tariff page(s); and 3) testimony that summarizes the WICA budgets and the calculation of the surcharge requested.

Q. In your testimony in the referenced Aquarion docket, DW 08-098, you testified that you believe a WICA mechanism shifts risk away from the utility and onto its customers. Do you still take this position?

A. Yes. As I stated in my Aquarion testimony, a WICA mechanism reduces regulatory lag, speeds up cash flows, and mitigates litigation risk for the utility. In this way a WICA mechanism is very similar to step adjustments, which are typically granted for large post-test year capital projects which, if not recognized in rates immediately following a rate case, will have a detrimental impact on the utility's rate of return. This Commission has adopted the use of step adjustments for a number of years now, particularly for water utilities. One way to address the issue of the shifting of risk that results from the implementation of a WICA mechanism is to eliminate the granting of step adjustments, or restrict them only to very large capital projects directly impacting the quality of service to customers.

Q. PWW has requested a step adjustment in this docket for ten post-test year capital projects. What is the position of Staff with respect to this request for a step adjustment?

[1] If PWW were to propose WICA projects in any towns outside Nashua, Staff would recommend those communities also be provided notice in order to give them an opportunity to participate.

A. Staff does not support this request as it is clearly outside the parameters this Commission has established for step adjustments. Step adjustments have been typically granted for large post-test year capital projects which would cause immediate underearning by the utility if not recognized in rates. Step adjustments have not, however, been granted for all or nearly all a utility's capital spending in the year immediately following a test year, and this is the case with PWW's request in this docket. PWW has proposed recovery of ten separate capital projects to be undertaken in 2010 totaling over $5,000,000[2]. This proposal in Staff's view inappropriately alters the balancing of interests between the utility and ratepayers. Going forward, Staff is supporting the implementation of a WICA for PWW, which can be a means by which some of the issues raised by capital spending can be addressed. I therefore believe a step adjustment is not appropriate in this case.

Q. In PWW's previous rate case, DW 08-073, Staff supported the recovery in a step adjustment of over $12 million in post-test year capital spending. Why is Staff now opposing a step adjustment for considerably less?

A. The capital additions included in the step adjustment that Staff supported in DW 08-073 were made up almost entirely of two very large projects. PWW's water treatment plant upgrade was still ongoing in 2008, the year following the 2007 test year for the rate case, and capital expenditures in that project that year exceeded $9.4 million. The second large capital project included in the step adjustment was the Fifield Tank costing about $2.3 million. The significance of these projects relative to PWW's total rate base, and the timing of their completion immediately after a test year, were factors the Commission found justified authorizing a step adjustment and which were consistent with past Commission decisions. The step adjustment request in the instant case is much different as it is comprised of many smaller projects.

[2] Through the discovery process PWW has modified its step adjustment request and is now seeking recovery of about $4.5 million in 2010 plant additions net of associated retirements.

Q. What is the embedded actual cost methodology that PWW is requesting for the calculation of its cost of debt?

A. The testimony of Thomas Leonard, Chief Financial Officer of PWW, indicates that he calculates PWW's weighted average cost of debt (WACD) using an embedded actual cost methodology. This approach takes into consideration the amount of outstanding debt issuance costs when calculating the WACD. Essentially this method calculates a WACD that includes a return *on* the level of unamortized debt issuance costs in addition to a return *of* those costs. This approach differs from that requested by PWW in its past rate cases. In the past, PWW's calculation of its WACD would include only the actual interest obligation for each debt issue, as well as recovery of the associated debt issuance costs. In the instant request, PWW seeks to add a return on the unamortized balance of the issuance costs.

Q. Has PWW previously requested consideration of this methodology?

A. Not formally. While PWW did not request this treatment when it filed its last rate case, DW 08-073, the company raised the issue during discovery and asked the parties to the case to consider it. Since Staff and the parties had not had adequate time to review the issue in discovery, Staff and PWW subsequently entered into a settlement agreement which utilized the WACD that PWW had originally filed, but agreed that PWW could pursue consideration of the embedded actual cost methodology in a future proceeding.

Q. What is Staff's position with respect to use of the embedded actual cost methodology for calculating WACD?

A. Staff is now willing to support it, primarily because it is consistent with the regulatory principle that a utility is compensated for all reasonably incurred costs. In this case, debt issuance costs represent reasonable, prudent costs that the utility recovers over time through the "effective interest rate", a rate which provides both interest to the bond or note holder as well as straight-line recovery of debt issuance costs. To this point, however, that recovery has been without a return on the unamortized balance. This method as proposed provides that return on the unrecovered balance of costs.

Q. Please describe the issue with cell tower leases you referenced earlier.

A. As referenced in Ms. Hartley's testimony beginning at page 13, in 2007 the company sold seven cell tower leases that, in the past, had provided additional revenues to the company based on cell towers located on company property. In previous settlements of rate cases approved by the Commission, those revenues were shared on a 50/50 basis with ratepayers. Since the leases had been sold, the settlement reached between Staff and PWW in DW 08-073 did not provide for any revenues to be credited to customers. The Commission in its final order imputed revenues in the total amount of $52,189 as a credit to customer rates, and indicated that in PWW's next rate proceeding it would "consider the propriety of the sale of the cell tower leases and the appropriate allocation of benefits between ratepayers and shareholders." Order No. 25,006, August 13, 2009.

Q. What is PWW's position regarding this issue?

A. PWW takes the position that no portion of the sale proceeds should be allocated to ratepayers. Because the company property on which the cell towers were located is owned by the company's shareholders, the company asserts that any gain on the sale of the cell tower leases belongs to shareholders.

Q. What is the Staff's position with respect to this issue?

A. Staff believes that a continuation of the sharing of benefits from the cell tower leases is appropriate. These benefits stem from the use of utility property that is included in rate base.

Therefore, for the same reason that Staff supported the sharing of annual lease revenues, it is appropriate that there be a sharing of the sale proceeds now that the leases have been sold.

Q. PWW has indicated in Ms. Hartley's testimony at page 14 that the value of the land in rate base on which the cell towers were located was negligible. Does this fact impact Staff's position with respect to this issue?

A. No it doesn't. Regardless of the original cost of the properties, the principle remains the same. The utility property in rate base is included in customer rates, and therefore Staff takes the position that a continued sharing of the benefits is appropriate.

Q. What is the Staff's recommendation with regard to how those benefits are calculated?

A. The testimony of Staff witness Jayson Laflamme provides these details. The cell tower leases were sold in 2007, but the Commission continued the sharing arrangement in DW 08-073. Staff therefore believes that the revenues shared with customers since the effective date of temporary rates in that docket should be applied to reduce the balance of the lease sale proceeds going forward. Mr. Laflamme's testimony provides an explanation.

Q. Earlier you referenced the joint petition of Nashua and Pennichuck in Docket No. DW 11-026. What are your comments regarding this joint petition as it may affect PWW and PWW rates?

A. Nashua and Pennichuck have filed a petition with the Commission for approval of the acquisition by the City of all of the outstanding stock of Pennichuck. A prehearing conference was held February 24, 2011 and the petition is expected to be ruled upon before the end of 2011. As there are certain costs that are passed down to PWW from Pennichuck, those costs should be expected to change under new, municipal ownership. Staff's positions on PWW's revenue requirement, rate design, and all other recommendations as advanced in the testimony of the Staff witnesses filed today are based solely on the current ownership and cost structure as they exist today.

Q. Does this conclude your testimony?

A. Yes it does.