STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION

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NH PUBLIC UTILITIES COMMISSION

Re: Aquarion Water Company of New Hampshire

Docket DW 12-085

CLOSING STATEMENT OF
AQUARION WATER COMPANY OF NEW HAMPSHIRE, INC.

I. Introduction

On May 22, 2013, the Commission staff ("Staff"), Office of Consumer Advocate ("OCA"), and Aquarion Water Company of New Hampshire ("Aquarion" or "Company") submitted a partial settlement that resolved all issues in this case other than return on equity ("ROE"). For the reasons set forth below, the Commission should approve the partial settlement as consistent with the public interest and should determine the Company's revenue requirement by applying an authorized ROE of 10.25% to the framework established by the settlement.

II. The Partial Settlement Should Be Approved.

The testimony of Staff and the OCA in this case raised only a few issues other than ROE that related to the Company's proposed revenue requirement, and no revenue requirement issues other than ROE were raised by the municipal intervenors. All of the Staff's recommended adjustments to the schedules supporting the Company's revenue requirement other than ROE were included in the settlement, with one slight modification; namely, that the settlement updates both the debt and equity portions of the Company's capital structure to 2012 year-end balances.[1] Of the two revenue requirement issues raised by the OCA, one (relating to the provision of affiliate services) was withdrawn prior to the settlement because the Company demonstrated that it had filed the relevant affiliate agreement with the Commission. The other issue, which related to approximately $44,000 in compensation increases, was withdrawn by the OCA as part of the settlement.[2] The Company also made a number of concessions sought by the OCA with regard to the structure of its Water Infrastructure and Conservation Adjustment ("WICA") program and modified certain tariff proposals consistent with the testimony submitted by the OCA. Thus, the settlement reflects the Company's agreement to adopt almost every single one of the substantive changes recommended by Staff and the OCA in their testimony.

The Company believes that the relatively small number of issues raised by Staff, the OCA, and the municipal intervenors in this case speaks volumes regarding the quality of service delivered by the Company to its customers and the efficiency and economy with which Aquarion's management delivers that service. The effectiveness of management's efforts can also be judged by the testimony of the Town Manager and the Chairman of the Board of Selectmen of the largest of the three municipalities served by Aquarion. Without prompting from the Company, the Town of Hampton's two witnesses volunteered that:

- The service Aquarion provides is very good;

[1] Staff had originally proposed only updating the Company's debt level. It is worth noting for purposes of the discussion below regarding the fact that the Company's capital structure has a higher debt ratio than other water utilities in the ROE experts' proxy group that this modification to Staff's original proposal had the effect of slightly *decreasing* the debt ratio for purposes of the settlement agreement from what it would have been had the change originally proposed by Staff been implemented. That is, under the proposal as set forth in Staff's testimony, the Company would have appeared to be even more leveraged than the capital structure recognized in the settlement.

[2] It should be noted that the prefiled rebuttal testimony of Company witness Troy Dixon provided a detailed rebuttal to the OCA's position.

- The Town has constant interface with the Company;
- Aquarion provides an excellent quality of water;
- Aquarion's maintenance people are excellent;
- The Company is very prompt in addressing leaks and is "on top of leaks all the time";
- The Company works with the Town to coordinate the replacement of water lines with the Town's Road Maintenance and Sewer Replacement programs and is very aggressive in completing such work;
- The Company itself is excellent;
- Aquarion is an outstanding company that does a great job.

Day 1 Transcript at p. 138 l. 24 – p. 139 l. 21. Similarly, when asked on cross examination whether Aquarion is well managed, the Director of the Commission's Gas and Water Division unhesitatingly shared his opinion that it is.

Given the Company's record of providing excellent service to its customers, the fact that the partial settlement adopts all of the expense and capital adjustments recommended by Staff, and the modifications to the Company's WICA program and tariff proposals sought by the OCA, the Commission should find that the partial settlement is consistent with the public interest and approve it as presented.

III. The Commission Should Establish a Revenue Requirement Based on an Authorized Rate of Return of 10.25% to Appropriately Reflect the Business and Financial Risks Faced by the Company

Despite the excellent service delivered by Aquarion and its management, circumstances have conspired to send a decidedly negative message to the Company's investors in recent years:

1. The Company has been unable to achieve its last allowed return on equity of 9.75%. Its actual earned return since its last rate case has been 6.4% in 2009, 5.6% in 2010, and 3.9% in 2011. Notably, the Commission authorized the 9.75% ROE in September 2009, meaning that with temporary rates in effect the Company's rates should have been sufficient in that entire year to earn the authorized return. This shortfall in earnings has been largely attributable to an increased tax burden (including a particularly steep increase in taxes assessed by the Town of Hampton) and declining consumption consistent with trends observed throughout the water utility industry.

2. Despite the Commission's recognition through the adoption of the WICA program that infrastructure replacement is a critical priority in the Company's service territory, as it is for other water utilities throughout the United States, it has been suggested that the Company's authorized return should be *lowered* because of WICA. Such an approach not only runs directly contrary to the ratemaking proposals set forth in NARUC's resolution on best practices adopted in 2005, it is also unsupported by either ROE expert in this case and runs contrary to the fundamental purpose of using a proxy group in conducting a cost of equity analysis given the presence of WICA-type mechanisms and other adjustment mechanisms among most if not all of the companies included in the proxy group used by the two ROE experts in this case.

3. To conserve equity capital and have sufficient cash to support the capital required for the WICA program, the Company has not paid shareholders a dividend for nearly three years. As the Town of Hampton's return on equity expert testified, one of the major factors that attracts investors to utility stocks is the dependability of their dividend streams—yet Aquarion investors have foregone dividends for almost three years to fund the Company's capital requirements and maintain safe, adequate, reliable service to customers. While the Commission has a right to expect such behavior from investors, it must also recognize the risk associated with shareholders' taking on such an obligation and the fact that such an approach is not sustainable.

4. The Company's increased capital spending and rising tax burden as well as more limited increases in other operating expenses have resulted in the Company's debt to equity ratio increasing to nearly 60% debt / 40% equity, well above the level for the proxy group used for the DCF analysis performed by the two ROE experts in this case. This higher leverage brings with it an increase in the risk faced by the Company's equity investors, who are paid only after all of the Company's other obligations have been met. Ironically, unless the Commission recognizes the increased risk with an adjustment to the Company's ROE, the increasing leverage will have the effect of further lowering the Company's earnings below what would have been achieved had the Company been able to sustain a more typical 55%/45% or even 50%/50% capital structure. The approach suggested by Mr. Parcell and the Town of Hampton is not sustainable and does not adequately reflect the risk actually faced by the Company's shareholder.

These factors are all significant and should be recognized by the Commission in determining an appropriate ROE.

Setting an ROE that is sufficient to maintain the Company's financial integrity and attract the necessary capital investment to enable the Company to continue to deliver excellent service to its customers is more than a mere theoretical exercise. As the Commission has often noted, determining an appropriate ROE requires considerable judgment and exercise of the Commission's discretion. There is no single correct answer to the question of what ROE to authorize for a utility, and it is not only appropriate but to be expected that the Commission will take the particular circumstances of each case into account in an individualized manner, rather than applying a one size fits all approach as Mr. Parcell's testimony appears to suggest.

The Commission has repeatedly made clear that it will be guided primarily by the discounted cash flow ("DCF") method in determining return on equity, and in this case Mr. Parcell's capital asset pricing model ("CAPM") result is plainly an outlier and should be given no weight of any kind. Mr. Parcell himself admitted that the result of his CAPM analysis, 6.1%, would be insufficient to ensure the financial integrity of Aquarion or to attract capital, and is so low that he did not believe it would be reasonable as an allowed rate of return on equity. If his CAPM result is not a reasonable outcome, there can be no legitimate basis for giving it any weight, let alone equal weight, with his DCF and comparable earnings outcomes to determine an authorized return for Aquarion, and the Commission should not adopt his recommendation that it do so.

Mr. Parcell's consistent focus on the upper end of his DCF range is perhaps the most compelling evidence that even he is well aware that his CAPM result and his 8.3% overall ROE recommendation are far too low. Similarly, an examination of Mr. Parcell's range of results in this case with those in the last two Pennichuck Water Works rate cases in which he testified, and the more recent New Jersey American Water and United Pennsylvania Water cases in which he provided testimony, demonstrate that Mr. Parcell has consistently recommended a return on equity in the high end of the 9-10% range in recent years and that he has reached that result by giving no meaningful weight to his CAPM analysis. Not surprisingly, if one discards Mr. Parcell's CAPM result in this case and focuses on the high end of the range produced by his DCF and comparable earnings results as Mr. Parcell has done in most cases in the past, one arrives at a return that is relatively close, albeit modestly below, the average authorized ROEs for water utilities in other jurisdictions across the country, as demonstrated in Attachment TMD-1 to the prefiled testimony of Mr. Dixon and the rebuttal testimony of Ms. Ahern at page 13, lines 22 - 25.

Both experts agree that the return on equity authorized by the Commission must be sufficient to reflect the risk associated with investing in the Company's business and be high enough to attract new equity capital. As Mr. Parcell forthrightly stated in his prefiled testimony (Parcell direct testimony at p. 4, lines 10-14), and then reluctantly agreed on cross examination, an efficient, well managed utility should be able to achieve its allowed return. Yet, as the testimony demonstrated, the Company's actual earned return has declined steadily since its last case, and at no time has the Company been able to earn the return authorized by the Commission in that case. Aquarion's inability to do so is plainly a sign of the *increased* risk that investors in the Company face, contrary to the Town of Hampton's argument that the risk to equity investors has declined since the Company's last rate case and that the Company's authorized return should be reduced.

Mr. Parcell's DCF analysis resulted in a recommended range of 9.0% – 9.6%, which was generally consistent with the narrower range of 9.32% – 9.54% that resulted from Ms. Ahern's corrected analysis. However, the evidence demonstrated that Mr. Parcell's analysis failed to account for the substantially increased risk posed to equity investors in Aquarion's New Hampshire operations because of its relatively high leverage compared to the proxy group and its small size. Notably, Aquarion's debt to equity ratio is substantially higher than that of the industry proxy group used by Mr. Parcell. The testimony also demonstrated how Aquarion's small size and the fact that it operates in only three towns can have and has had a significant impact on the risk faced by investors.

As Ms. Ahern explained, the DCF results must be adjusted if the target company's capital structure differs substantially from that of the proxy group. Mr. Parcell, on the other hand, notwithstanding his apparent acceptance of the theoretical basis for such an adjustment, resisted making one for Aquarion based on his repeated, unsupported, and incorrect statements that the Company's debt consists of borrowings from affiliated entities. (See, *e.g.*, Parcell direct testimony at p. 13.) In fact, as Mr. Dixon testified, all of the Company's debt is owed to unaffiliated third party lenders, not to corporate affiliates. Mr. Parcell's position appeared to be based on the Company's statement that it borrows from an affiliate when it requires short term borrowings, but failed to note that the Company's filing and Mr. Dixon's testimony plainly indicated that the Company has no short term debt and that all of its long term debt is owed to unaffiliated entities.

Mr. Parcell also suggested that the Commission should not take account of the Company's true capital structure because he appeared to believe that the Company was somehow able to artificially control its level of equity, when in fact the testimony demonstrated that despite withholding payment of any dividends for almost three years, the Company's equity ratio had still declined. Mr. Parcell failed to offer any reasonable argument as to how the Company could have increased its equity ratio without a substantial infusion of new money from its shareholder, something that seems far fetched given the Company's inability to pay a dividend or earn anywhere near its allowed return for an extended time.

Thus, contrary to Mr. Parcell's unsupported belief, the Company did not "choose to finance itself with less equity." Rather, its capital structure is a direct reflection of the significant earnings impairment experienced by the Company because of the confluence of circumstances it faces and the considerable risk that those circumstances continue to pose. It is clear that there are New Hampshire-specific risks that must be considered in setting the authorized return for the Company, and there is no legitimate basis to consider anything other than the level of risk associated with investing in Aquarion Water Company of New Hampshire. Contrary to Mr. Parcell's suggestion that the Company has "chosen" a capital structure with higher leverage relative to the proxy group, one must ask why would an investor voluntarily put *more* equity at risk under the current circumstances and what is the potential for the situation to improve without appropriate regulatory support?

The Company believes that the confluence of all of the factors at work in this case—increased capital requirements, rapidly increasing tax burden and decreasing consumption levels, excellent service, efficient and economic management, and a sustained inability to earn the previously authorized return—differentiate it to some extent from other water utilities in New Hampshire at this time and do not require the Commission to break significant new ground or set a precedent that will have broad application beyond this case. Ms. Ahern calculated an adjustment of 86 basis points to reflect the increase in risk resulting from the Company's higher leverage relative to the proxy group, and Exhibit 32 similarly demonstrates that the Company's ROE would need to be adjusted upwards by at least 64 basis points to allow it the same overall pretax rate of return it would otherwise be allowed with a more typical 55% debt / 45% equity capital structure. The effect of making an adjustment of this type to Mr. Parcell's and Ms. Ahern's DCF results is shown on Appendix A.

An adjustment to reflect the heightened risk faced by a particular company is not without precedent in New Hampshire, and a number of mechanisms have been recognized as appropriate means to combat a utility's chronic inability to achieve its authorized return. One mechanism recognized by the New Hampshire Supreme Court as a way of addressing the erosion in earning power of a utility is the inclusion of an attrition allowance. *See New England Tel. & Tel. Co. v. State of N.H.*, 113 N.H. 92, 97 (1973). The evidence in this case has demonstrated that, despite the use of a year-end rate base for much of the Company's capital investment and the implementation of the WICA program, declining consumption has made it impossible to achieve the Company's authorized return. Moreover, the Company's response to the Commission's second record request (Exhibit 24) demonstrates that the Company anticipates a continuation of declining returns after this rate case, projecting a return of 8.38% in 2013, 7.68% in 2014,and 7.31% in 2015. Thus, if the Commission determines that circumstances are such that it is unlikely that the Company will be able to achieve the return on which the revenue requirement in this case is calculated, it can properly authorize a higher ROE than it would otherwise normally allow[3] to ensure that the Company's earned return is sufficient to meet the constitutional requirements for cost of capital. Aquarion believes that the evidence in this case unambiguously supports such a finding and further justifies the 10.25% requested in the Company's filing.

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[3] The Commission has consistently and repeatedly authorized an equity return of 9.75% for other water utilities in the state in recent years, doing so as recently as the Lakes Region Water case decided last year in DW 10-041 (Order No. 25,391). As Mr. Naylor noted, that Company has faced significant management issues in recent times. To award Aquarion a lower return now would send its investors the wrong message.

IV. The Commission Should Not Penalize the Company for Implementing a WICA Program By Adjusting Its Allowed ROE Downwards.

With regard to the Staff's suggestion that the Commission should adjust the Company's ROE downward because of the WICA program, the Company respectfully and emphatically disagrees with Mr. Naylor. Although he demurred from offering his own opinion on the Company's cost of equity and forthrightly conceded that he is not a cost of equity expert and had performed no quantitative analysis of the Company's cost of equity or the impact of WICA on that cost, Mr. Naylor nevertheless testified that he believed that the Company's authorized ROE should be reduced from what the Commission would otherwise approve in the absence of the WICA. While Mr. Naylor's position may at first have some intuitive allure, there simply is no quantitative basis for it. In fact, such an adjustment would run contrary to the way in which ROE is normally determined. Notably, neither Mr. Parcell nor Ms. Ahern proposed such an adjustment. It is apparent that they did not do so because the proxy group they utilized includes companies that have a myriad of adjustment mechanisms. In particular, a majority of the companies in the proxy group have subsidiaries who themselves have WICA-type mechanisms in place. In other words, even if Mr. Naylor were correct that WICA reduces risk relative to not having a WICA, and even if that risk could be quantified (something which no witness in this case has attempted to do), an adjustment is unnecessary because the change in risk profile is already incorporated into the ROE analysis performed by Mr. Parcell and Ms. Ahern.

Aside from the lack of any theoretical or quantitative basis for making a downward adjustment to ROE because of WICA, the Commission should also consider the fact that the very purpose of WICA is to *incentivize* the utility to *increase* its capital investment in critical infrastructure replacement. Reducing the Company's ROE would instead penalize it for doing so.

Finally, and perhaps most tellingly, the Commission has repeatedly approved other capital adjustment mechanisms for gas and electric utilities as well as WICA mechanisms for two other water utilities and has never imposed a reduction on authorized return nor even suggested that a reduction was required to reflect the impact of these mechanisms. Given the record in this case, now is not the time to change that practice.

V. Conclusion

For the reasons set forth above, the Commission should approve the partial settlement agreement among Staff, the OCA, and the Company and establish a revenue requirement for the Company based on an authorized return on equity of 10.25%.

Respectfully submitted,

Aquarion Water Company of New Hampshire

By Its Attorneys

MCLANE, GRAF, RAULERSON & MIDDLETON, P.A.

Dated: June 7, 2013 By: ______________________________

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Certificate of Service

I hereby certify that a copy of this Closing Statement has been electronically served on the service list in this case.

Date: June 7, 2013 ____________________

Steven V. Camerino

Appendix A

Return on Equity Calculations

	Ahern Mid-Point	Ahern High End	Parcell Mid-Point	Parcell High End
DCF result	9.43	9.54	9.30	9.60
Financial Risk	0.86	0.86	0.86	0.86
Risk-Adjusted ROE	10.29	10.40	10.16	10.46

	Ahern Mid-Point	Ahern High End	Parcell Mid-Point	Parcell High End
Risk-Adjusted ROE	10.29	10.40	10.16	10.46
Business Risk	0.40	0.40	0.40	0.40
Fully Risk-Adjusted ROE	10.69	10.80	10.56	10.86