STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

AQUARION WATER COMPANY OF NEW HAMPSHIRE, INC.
DOCKET NO. DW 12-085

REBUTTAL TESTIMONY
OF
TROY M. DIXON AND CARL MCMORRAN

March 6, 2013

I. INTRODUCTION

a. Mr. Dixon

Q. Please state your name and business address.

A. My name is Troy M. Dixon. My business address is 600 Lindley Street, Bridgeport, Connecticut.

Q. Have you previously filed testimony in this case?

A. Yes. I filed testimony in support of Aquarion Water Company of New Hampshire, Inc.'s ("Aquarion" or "the Company") petitions for temporary and permanent rates in this case on May 14, 2012. My educational background and qualifications are set forth in my testimony supporting the Company's petition for temporary rates.

b. Mr. McMorran

Q. Please state your name and business address.

A. My name is Carl McMorran. My business address is 7 Scott Road, Hampton, New Hampshire.

Q. Have you previously filed testimony in this case?

A. Yes. I filed testimony in support of Aquarion's petition for permanent rates in this case on May 14, 2012. My educational background and qualifications are set forth in my testimony supporting the Company's petition for permanent rates.

Q. What is the purpose of this testimony?

A. The purpose of our testimony is to respond to direct testimonies provided by Mark Naylor, Director of the Gas and Water Division of the of the Public Utilities Commission Staff ("Staff"), Jayson Laflamme, Staff Utility Analyst, Scott Rubin, consultant to the Office of Consumer Advocate ("OCA"), and Donna McFarland, Finance Director of the OCA.

II. RATE OF RETURN

a. Capital Structure

Q. Does the Company agree with Staff's recommendation that the Company's long-term debt balance be increased by $1 Million to $13.9 Million for purposes of determining the Company's capitalization ratios?

A. No. The Company's capital structure as of the end of the 2011 test year included $12.9 million in long-term debt. Included in that $12.9 million was a $4 million unsecured promissory note. More than six months after the close of the test year, on July 5, 2012, the Company issued $5 million of general mortgage bonds, $4 million of which refinanced the aforementioned note with the remainder providing for financing of an additional $1 million in future capital spending. The Company reflected the reduced weighted average cost of debt resulting from refinancing of the $4 million note in its rate case filing. This change directly benefits customers. The Company did not include the unused portion of the debt issuance in its capital structure because there was no rate base investment associated with the additional capital included in the Company's rate case filing.

Q. Why is it important that the test year capital structure be utilized for purposes of setting rates in this case?

A. The capital structure used for ratemaking purposes should correspond with the rate base that is used to set rates. Obviously, the Company could not artificially increase its equity ratio by adding equity that is not actually used to finance rate base additions, and similarly debt capital that has been added after the test year and is not reflective of the rate base being used to set rates should not be taken into account. Even the Town of Hampton's expert witness, David Parcell, makes clear in his testimony that rate base and the capitalization used to determine the cost of capital should be consistent with one another. Parcell Testimony at 3-4, 11-12. Artificially increasing the Company's debt beyond what it was in the test year throws the capital structure, and thus the cost of capital, out of alignment with the rate base upon which the Company's revenue requirement will be determined.

Moreover, the Company's debt ratio is already substantially higher than the investor-owned utilities used by Mr. Parcell in his cost of equity analysis, Parcell Testimony at 12, yet this significant additional leverage and the risk it puts on equity investors has not been reflected by either Staff or Mr. Parcell in their recommended cost of equity. Staff's imputation of this additional amount of debt artificially pushes the Company's leverage well beyond what is generally seen in the industry. The lower cost of debt that results from the Company having reflected the cost rate for the refinanced $4 million in debt provided an appropriate benefit to customers. An artificial benefit should not be created by also imputing into the capital structure additional debt that hasn't financed rate base.

Q. What is the correct capital structure that should be used by the Commission to set rates?

A. The Commission should use the Company's test year capital structure as set forth in Schedules 4 and 4A to Mr. Dixon's Direct Testimony: 58.73% long term debt, 0.01% preferred stock, and 41.26% common equity. It should not adjust those ratios for post test year changes in the level of debt financing that is not reflected in the rate base used to determine the revenue requirement.

b. Rate Base

Q. Please briefly explain how Aquarion computed its pro forma rate base in its initial permanent rate filing.

A. The Company used test year end values for plant in service and accumulated depreciation, rather than a thirteen month average, as shown on Schedule 3 to Mr. Dixon's Direct Testimony in support of permanent rates.

Q. Please explain why the Company did this.

A. The Company used a year-end rate base because it has consistently been unable to earn its authorized rate of return, the large majority of the Company's rate base additions during test year were non-revenue producing in nature, and the Company has faced a pattern of declining sales, all of which indicates that a failure to update the rate base as much as possible will result in the Company not having a reasonable opportunity to earn the return that is authorized in this case. The plant at issue was fully in service as of the end of the test year, and a failure to consider it in the ratemaking process will result in the Company being unable to earn its authorized return from the outset.

Q. Why is it important that a test year-end value be used for all non-revenue producing plant in service rather than a thirteen month average?

A. Approximately 90 percent of the Company's rate base additions in the test year comprise non-revenue producing assets. Many of these assets were put into service within six months of the end of the test year, making their respective values when averaged over thirteen months significantly less than their true cost to the Company. As discussed in Mr. Dixon's Direct Testimony, Aquarion is experiencing a steady decline in consumption by its customers while its capital needs increase due to, among other factors, the high cost of replacing existing infrastructure. If these non-revenue producing additions to utility plant are not fully reflected in rate base, the rates set in this case have no hope of giving the Company a reasonable opportunity to earn its authorized return.

Q. Mr. Laflamme of the Staff has proposed that certain criteria be applied when determining the assets to be included in rate base at a test year-end value (Laflamme Testimony at p. 7). What is the Company's position on this?

A. The Company is not aware of the Commission ever having articulated the standard that Mr. Laflamme seeks to apply as a requirement for including non-revenue producing capital additions in rate base on a test year end or even post-test year end basis. While Mr. Dixon is not an attorney, he has reviewed the Commission orders cited by Staff in Mr. Laflamme's testimony, and they are not applicable to this case. Those orders only address the appropriateness of a step increase for certain *post*-test year plant additions, which the Company is not seeking in this case. Even in that context, however, the cases don't support Staff's position. Specifically, the factors mentioned by Staff as justifications for the Commission's action in the cases cited are specific to those particular cases. There is nothing to indicate that the Commission intended them to be requirements in all cases where a utility seeks to update rate base from the test year average level. The Company's understanding is that, to the contrary, there are numerous cases where the Commission has provided for recovery of non-revenue producing rate base outside the context of a thirteen month test year average without the factors cited by Staff being present, and that it is commonplace for the Commission to do so in situations where there is evidence that the utility will not otherwise have a reasonable opportunity to earn its allowed return. Ultimately, that is what the ratemaking process should do to avoid more frequent rate cases and, potentially, confiscatory rates.

The Company also disagrees with Staff's position that the costs of individual non-revenue producing assets must be "in and of themselves substantive in nature" to be included in rate base at test year-end value. While certain assets may have lower costs relative to other assets, in the aggregate the capital additions in this case represent significant levels of non-growth investment in the test year that should be reflected in rate base at a full test year-end value so the Company has a reasonable opportunity to earn its allowed return.

Q. Staff has recommended that all assets that do not meet the criteria described above be reflected in rate base at a thirteen month average, rather than the year-end value (LaFlamme testimony at pp. 8-9). What is the Company's response?

A. Many of the plant additions excluded from what the Staff refers to as "Non-revenue Producing Asset Treatment" are in fact non-revenue producing assets in service as of the end of the test year that should be should be reflected in rate base at their year-end value for the reasons stated above. These assets are identified as Group 4 in the Company's response to data request Staff 2-1, which is attached as Attachment JPL-4 to the Testimony of Mr. Laflamme. However, the Company recognizes that certain assets identified by Staff as not meeting the criteria described in Mr. Laflamme's testimony are new meters and services associated with new accounts and therefore can be classified as revenue producing. *See* Group 3 in Attachment JPL-4. The Company agrees that the latter group of assets should be reflected in rate base at a thirteen-month average value, resulting in a reduction to plant in service of $36,993. *See* Attachment TMD-CM-1. All remaining non-revenue assets should be reflected in rate base at their test year-end value as proposed in the Company's filing.

III. OPERATING EXPENSES

Q. The Staff has opposed the Company's proposal to treat the first fifteen months of a new right-of-way (ROW) tax imposed by the Town of Hampton during the test year as a deferred asset (Laflamme Testimony at pp. 10-11). Why is the ratemaking treatment sought by Aquarion appropriate in this case?

A. The assessment of the ROW tax in 2011 represents an extraordinary expense involving a substantial new tax not included in Aquarion's existing rates.

Q. Staff has taken the position that the deferred asset treatment sought by the Company is retroactive ratemaking. Why does the Company believe the Staff is wrong about this?

A. Deferred accounting treatment is the appropriate way to address extraordinary expenses that are substantial in amount. In this case, the new ROW tax assessed by the Town of Hampton burdened the Company with a substantial new tax expense. In fact, the Company did not pay the new tax until October 2012. There is nothing retroactive about recovery of this expense. Authorizing deferral accounting treatment of the expense is necessary because the Company could not reasonably have obtained rate relief quickly enough to adjust its rates for this item when it became obligated to pay the tax.

Q. Is the Company aware of any Commission precedent requiring that the creation of a deferred asset be contingent upon a future benefit to the utility and its customers (Laflamme Testimony at p. 11)?

A. The Company is not aware of such a requirement. Nevertheless, Aquarion's financial health is a benefit to its customers, and funds recovered in connection with the deferral will be available as capital for investment in the system, which also provides a benefit to customers.

IV. Employee Wages

Q. The OCA argues that the Company acted unreasonably in increasing wages by 3% to 3.5% annually. What is the Company's response?

A. The OCA points to a recent wage freeze affecting state employees in New Hampshire, as well as recent annual cost of living increases of 1.5% for retirees in New Hampshire's retirement system, as bases for its position that the 3% - 3.5% annual increase in overall compensation experienced by the Company is unreasonable. The OCA fails to provide any basis for comparing private and public sector workers, and fails to provide any evidence that a 3% - 3.5% annual increase in wages is not reasonable in light of inflation and in comparison to other annual increases in the private sector. Moreover, the OCA does not account for the fact that a portion of the increase in compensation since the Company's last rate case is attributable to the fact that several employees received promotions to higher-paying positions in the normal course of their employment, not because of a general increase in wages.

Q. What support does the Company have for the reasonableness of the increase in compensation?

A. With respect to union employees, Aquarion is obligated to provide an annual increase in wages consistent with the terms of its contract with the union. That said, for union and non-exempt, non-union employees alike, 3% - 3.5% is a modest increase in wages to enable employees to keep pace with cost of living increases while recognizing the employee's performance and value to the Company. The Consumer Price Index for New

Hampshire increased approximately 6.5% from January 2009 to January 2012, or approximately 2.2% per year. *See* Attachment TMD-CM-3.

Q. What market comparisons has the Company done to determine whether its wage increases are reasonable?

A. The Company utilizes the Executive Resource Group ("ERG") on an annual basis to complete salary studies for all levels of employees to ensure that Aquarion's compensation is properly aligned with the market. ERG uses a group of comparator companies, including regulated and unregulated businesses across the nation, and obtains its data from the Hay Group, a well-established management consulting firm that is widely recognized and referenced as an authority on compensation information. Of critical importance is the fact that information provided by ERG reflects the application of market indices which adjust for inflation rates, cost of living increases and geographical considerations. All of this data allows the Company to evaluate each employee position in relation to the relevant market. In addition to ERG, the Company also uses survey data from the Saje Consulting Group, Inc. ("Saje") as an additional benchmark for its higher level manager and director positions. The Saje survey is an industry-specific compensation and benefits survey of investor-owned water utilities that has been conducted for over twenty years. The survey derives data from water utilities of various sizes and includes in-depth compensation information for a spectrum of positions that is highly useful to the Company. The combination of these resources ensures that the Company's wage levels are appropriate for its employees. These studies are included as Attachment TMD-CM-2. The bottom line is that the Company undertakes a careful review of its compensation levels as compared to analogous companies in the marketplace. The OCA, on the other hand, has offered no meaningful comparison or basis for its position regarding an appropriate level of compensation.

Q. The OCA also contends that the Commission should limit Aquarion's recovery of incentive compensation expenses to 50%. What is the Company's response?

A. The OCA provides no basis for this recommendation, and fails to provide any explanation as to why the amount of incentive compensation included in Aquarion's test year expenses is not reasonable. Aquarion's employee incentive plan is designed to improve the Company's customer service and business performance goals while attracting and retaining a strong and motivated workforce, and compensation under the plan can only be earned upon the achievement of established criteria. By linking incentive compensation to customer satisfaction, product quality, and business performance goals, the plan not only furthers those objectives but also helps attract and retain employees who are focused on customer service and the success of Aquarion's business. A copy of the Company's incentive compensation plan is attached to Ms. McFarland's testimony in Attachment DLM-5.

Q. The OCA additionally recommends a disallowance of costs related to service provided by Aquarion's Massachusetts affiliate on the grounds that there is no approved affiliate service agreement in place (McFarland Testimony at pp. 18 – 20). What is the Company's position on this issue?

A. Aquarion filed an applicable affiliate agreement with the Commission by letter dated May 1, 2002. It is the Company's understanding that the OCA has withdrawn its recommendation on this issue.

V. WATER INFRASRUCTURE AND CONSERVATION ADJUSTMENT

a. Cost of Equity

Q. What is the Company's response to Staff's position that the Company's cost of equity in this case should be reduced relative to other recently approved equity returns if WICA continues (Naylor Testimony at p. 7)?

A. Mr. Naylor takes the position that the Company's ROE should be lowered from what it would otherwise be because, he says, the WICA mechanism mitigates the Company's operating risk by speeding up cash flow. Mr. Naylor's perspective ignores the fact that, even with the WICA, the Company has been consistently unable to earn its allowed rate of return because of steadily declining consumption by customers, the impact of increased capital spending under the WICA program, and escalating expenses, including significantly increased property taxes. The facts simply do not support the argument made by Staff on this point.

The purpose of WICA is to encourage accelerated replacement of the Company's aging infrastructure. Without the WICA mechanism, the Company will either have to scale back investment in its infrastructure to pre-WICA levels in order to have a better opportunity to earn its allowed return or maintain the increased level of spending and file more frequent rate cases. WICA was implemented to avoid such an outcome, so reducing the Company's allowed return would be counterproductive.

Q. Does the return on equity earned by the Company from 2009, when it implemented the WICA mechanism, to 2011 demonstrate that WICA has not mitigated the Company's operating risk?

A. Yes. The Company's earned return on equity for 2009, 2010, and 2011, respectively, was 6.4%, 5.6%, and 3.9%. After factoring in pro forma adjustments to revenues and expenses reflected in this case, the earned return on equity on a pro forma basis would be 3.0%. This compares to a last allowed return on equity of 9.75%.

Q. Is the Company aware of any other water utilities in New Hampshire with a WICA mechanism that have been granted a lower return on equity relative to that granted to other utilities?

A. No. In his testimony at page 7, Mr. Naylor recommends a return on equity that is lower than other recently approved equity returns, and notes that the Commission has recently granted a 9.75% return on equity to water utilities in several dockets. At least two of those water utilities, Pennichuck Water Works, Inc. and Pittsfield Aqueduct, Inc., were granted a 9.75% return on equity with a WICA mechanism in June 2011. *Re Pennichuck Water Works, Inc.*, Order No. 25,230 at 12, 16 (June 9, 2011); *Pittsfield Aqueduct, Inc.*, Order No. 25,229 at 9-10, 15 (June 9, 2011). The Commission's orders do not indicate that the Commission authorized a lower return in those cases because of the WICA.

b. WICA Objectives

Q. What is the Company's response to OCA witness Scott Rubin's assertion that the WICA mechanism has not met its objectives?

A. Mr. Rubin's testimony makes it appear that he misunderstands the objectives of the WICA program. While improving system reliability and water quality to the extent possible are certainly desirable, the more critical objective of WICA is to protect against various problems associated with the Company's aging system, including leaks and main breaks, in addition to deterioration in water quality and service reliability. To that end, the WICA mechanism is intended to incentivize acceleration of necessary infrastructure replacement.

Q. What is the most appropriate measure for determining the effectiveness of the WICA program?

A. Because the WICA mechanism is designed to protect against or mitigate leaks, main breaks, and service deterioration, the beneficial impacts of the increased capital spending are inherently difficult to quantify. Much of the benefit from the WICA mechanism's implementation comes in the form of avoided problems. Even if the avoidance of service disruptions and similar problems were easily measured, the WICA has been in place for less than three years and it is simply too soon to expect measurable results for such events. Given that the critical purpose of WICA is to accelerate infrastructure replacement, the best measure of the program's success is the degree to which the Company has increased its spending on replacing the Company's aging system. The record demonstrates that the Company has met expectations for the mechanism in this respect. In the time that the WICA program has been in effect, Aquarion has increased its spending on infrastructure replacement by nearly 20% on an annual basis when compared to the level of spending prior to authorization of the WICA mechanism and almost 80% on an annual basis when compared to the amounts included in the Company's capital budget at the time of the Company's last rate case.

Q. Mr. Rubin claims that Aquarion's levels of non-revenue water and unaccounted-for water have increased during the time that the WICA mechanism has been implemented. Do such increases mean that the WICA program is not effective and is not providing a benefit to the Company and its customers?

A. Quite the contrary. The reality is that the Company's infrastructure is aging faster than it is being replaced, even with the current WICA mechanism. While the Company is taking advantage of the WICA program to replace infrastructure to prevent or minimize leaks and breaks, it can only do so much with the resources available to it. The average age of the Company's mains continues to increase. The increases in non-revenue water and unaccounted-for water actually make a strong case for an even more aggressive WICA program than the one now in place, rather than demonstrate that the program is not effective.

Q. Mr. Rubin states that Aquarion's spending on transmission and distribution operations and maintenance expenses in 2009 and 2010 decreased from 2008 levels and speculates that this could have contributed to water losses (Rubin Testimony at pp. 8-9). What is the reason for the decrease in the referenced spending?

A. These apparent decreases are attributable to changes in accounting practices relative to the charging of certain labor expenses, and do not reflect an actual decrease in spending levels for transmission and distribution projects. In addition, the absence of a leak detection survey in 2010 also resulted in a slightly lower level of expense for that year. There is no correlation between decreased amounts reflected in these accounts and increases in non-revenue water.

Q. Mr. Naylor states that the Company is no longer suggesting that extending the time between rate cases is an objective of WICA. Is he correct about that?

A. Mr. Naylor's testimony on this point is partially correct. If the Company were to continue the level of capital spending it has undertaken under the WICA program without having the WICA mechanism in place, it would need to file more frequent rate cases. WICA enables the Company to continue on its previously announced plan to file rate cases approximately every three years. At the same time as it has implemented the

WICA, the Company has also experienced steady declines in consumption by its customers as well as steady increases in operating expenses, particularly those associated with property taxes and the new, unexpected ROW tax assessed by the Town of Hampton. As declining consumption and rising operating expenses are trends that are likely to continue for the foreseeable future, the Company believes it is likely that it will need to file a rate application at least every three years for the foreseeable future. The WICA mechanism in no way insulates the Company from these events.

c. Projects Included in WICA

Q. Mr. Rubin recommends the removal of what he refers to as "emergency response or other unplanned capital spending" from inclusion in the WICA (Rubin Testimony at pp. 8, 11). Why is it essential that the projects he is referring to be included in the WICA program?

A. As explained earlier in this testimony, a primary objective of WICA is to accelerate capital spending on infrastructure replacement to prevent or mitigate various problems associated with the Company's aging system. Needless to say, some elements of the Company's aging infrastructure are going to break before others, and excluding replacements simply because they address broken mains or equipment rather than infrastructure that is deteriorated or at the end of its useful life and has the potential to break is arbitrary and contrary to the spirit and intent of the WICA program.

Mr. Rubin is incorrect when he says that the cost to replace broken or leaking mains and equipment should be omitted from WICA because it is a "routine part of any utility's business." Rubin Testimony at p. 11. Absent recovery of these replacement costs through the WICA mechanism, the Company would in most cases repair, rather than replace, the broken or leaking infrastructure, thereby addressing the short term problem of the failure or leak but leaving the more critical long term problem of an aged and deteriorated part of the Company's system in the ground, to be addressed at a later time. Such an approach would, in the long term, be more costly to the Company and to its customers. It simply makes sense to replace broken infrastructure, even if the replacement is unplanned, because doing so reduces the long term cost of providing water service.

Q. Mr. Rubin also recommends the exclusion of "customer metering expenditures" from inclusion in the WICA (Rubin Testimony at pp. 8, 11). Why are such expenditures appropriately included in the WICA program?

A. The Company's meters have a useful life of ten years, after which their reliability becomes compromised. Aquarion's program of replacing older meters with new radio-read meters is a method of replacing a significant and aging element of the Company's infrastructure and is therefore consistent with the objectives of the WICA program. While the Company has seen a slight reduction in meter-reading expense as a result of the installation of new radio-read meters, expenses as a whole have not decreased; rather, labor hours that were previously devoted to meter reading are now devoted to other service work and system maintenance.

Q. Mr. Rubin recommends that the WICA mechanism for Aquarion be limited to projects on an updated main prioritization list (Rubin Testimony at p. 12). Is this a prudent approach?

A. No. As an initial matter, the Company does not agree that the WICA program should be limited to main replacements. There are other critical elements of the Company's infrastructure that are aging and require replacement on an accelerated basis. But even with respect to proposed main replacement projects included in the Company's annual WICA filing, the Company does not agree with Mr. Rubin's recommendation. While the Company does employ objective scoring criteria to derive a list of potential main replacement projects, it must also consider subjective factors such as planned municipal projects when selecting its proposed WICA projects in a given year. The Company must retain the flexibility to propose the projects that make the greatest amount of practical and economic sense in a given year.

Q. What is the Company's response to Mr. Rubin's proposal to modify the WICA program to more closely resemble the WICA program in Connecticut (Rubin Testimony at p. 13)?

A. The WICA program in Connecticut is a legislative creation designed to apply to multiple water utilities operating water systems that are exponentially larger than Aquarion's system in New Hampshire. Aquarion's New Hampshire program is specifically designed to meet the needs of its aging New Hampshire system, and it is not prudent to simply bootstrap the mechanics of the Connecticut WICA program to the Company's program in this state. At least one requirement cited by Mr. Rubin as being in effect in Connecticut, a "cost/benefit analysis" for proposed WICA projects, is no longer mandated by the Connecticut Public Utility Regulatory Authority (formerly Department of Public Utility Control).

VI. Proposed Tariff Changes

Q. Mr. Rubin has recommended that the "missed appointment fee" proposed by the Company be reciprocal (Rubin Testimony at p. 14). Is this reasonable?

A. No. As the Company understands Mr. Rubin's recommendation, Aquarion would compensate a customer in the $44 fee amount if Aquarion misses or is late for a scheduled service call. Mr. Rubin does not claim that Aquarion personnel have in fact arrived late for appointments or missed them altogether, and the Company is not aware of this being a problem. Beyond that, though, there is no basis for making the proposed "missed appointment fee" reciprocal. The fee reflects the costs associated with scheduling and committing resources to a service appointment that a customer fails to appear for and that are then borne by all other customers. While the Company does not anticipate that it would ever have to pay the reciprocal fee proposed by Mr. Rubin, it does not believe that including it in the tariff is appropriate.

Q. Does the Company have an opinion as to Mr. Rubin's recommendation that the Company's proposed "collect at the door" fee be imposed only upon the second instance of a customer paying at disconnection in a twelve-month period?

A. Yes. As Mr. Rubin acknowledges, the fee as proposed by Aquarion is lawful under Puc 1203.11, and the Company intends to implement the fee without modification to the proposed tariff. Aquarion incurs costs associated with deploying resources to disconnect a customer who then pays at the time of the disconnection, and the fee reflects those costs.

Q. Mr. Dixon and Mr. McMorran, does this conclude your testimony?

A. Yes, it does.