PENNICHUCK

25 Manchester Street
PO Box 1947
Merrimack, NH 03054-1947
(603) 882-5191
Fax (603) 913-2305

www.pennichuck.com

STATE OF NEW HAMPSHIRE

BEFORE THE

NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

RE: PENNICHUCK EAST UTILITY, INC.

DW 05-072

PREFILED DIRECT TESTIMONY

OF

WILLIAM D. PATTERSON

MAY 2005

Q. Please state your name and business address.

A. My name is William D. Patterson. My business address is 25 Manchester Street, Merrimack, New Hampshire.

Q. What is your position with the Company?

A. I am the Vice-President, Treasurer and Chief Financial Officer of Pennichuck East Utility, Inc. ("Company") and of its parent company, Pennichuck Corporation (the "Parent"). I joined the Company in January of this year.

Q. Have you previously testified before this or any other regulatory commission or governmental authority?

A. Yes. I have given live testimony and/or submitted written testimony in Pennichuck Water Works, Inc.'s recent rate case, DW 04-056, in a recent financing docket regarding Pennichuck East Utility, Inc., DW 05-061, and in a docket currently pending before the Commission, DW 05-094. I have also submitted written testimony or given live testimony previously in other forums in numerous matters.

Q. Please summarize your educational background.

A. I hold a Bachelor of Science in Engineering degree, summa cum laude, in Civil Engineering from Princeton University. I was nominated to the Phi Beta Kappa honor society. I also hold a Master of Business Administration degree with high honors in Finance and Accounting from the University of Chicago Graduate School of Business. I was nominated to the Beta Gamma Sigma honor society.

Q. Please summarize your professional background.

A. I spent the first eighteen years of my professional career as an investment banker specializing in the utility industries. From 1990 to 1996, I was a Managing Director in the Investment Banking Division of Smith Barney Inc. where I directed all aspects of the firm's utility corporate finance activities including account coverage, transaction management, and new business development. I served as the primary relationship manager for many of the firm's major utility clients. I have extensive experience in equity and debt financing for utilities in both the public and private markets as well as in advising utilities on a variety of strategic issues including capital structure, dividend policy, acquisitions, divestitures and restructurings. Prior to joining Smith Barney, I was employed in similar capacities at E.F. Hutton from 1978 to 1987 and then at Shearson Lehman following that company's acquisition of E.F. Hutton, from 1988 to 1990. In April 1996, I joined Craig Drill Capital, a private investment firm, as a Managing Director with responsibility for investment research activities. At the same time, I established an independent consulting firm of which I was the principal consultant. In January 1999, I elected to concentrate exclusively on independent consulting practice and formed EnSTAR Management Corporation, for which I served as President. From January 2000 to June 2001, I was employed as Chief Financial Officer of Enermetrix, an early state energy software development company. Thereafter, I returned to my independent consulting practice.

Q. What is the purpose of your testimony?

A. I will address the Company's determination of its proposed overall rate of return, 7.86%, consisting of long-term debt and common equity. I will also address the critical importance to the Company of receiving a reasonable return on common equity in order to restore its financial integrity and to ensure it an opportunity to raise debt and capital at reasonable costs and terms.

Q. Please comment on the Company's financial integrity.

A. The Company's request for prompt rate relief is predicated on the recent serious erosion in its financial integrity. This is best exemplified through a comparison of its recent actual versus allowed return on invested capital (ROI). ROI is defined as net operating income divided by average rate base. As shown in Schedule 4, Attachment A to the Company's filing, the Company's actual ROI has declined rapidly in the last 12-24 months. For the year ended December 31, 2004, the Company's actual ROI was 4.12%, compared to its currently authorized ROI of 8.30%. At December 31, 2004 the difference between the Company's actual ROI and its currently authorized ROI translated into a revenue deficiency of approximately $763,131.

Q. Please explain the principal reasons for this decline in actual ROI.

A. The Company's decline in actual ROI is simply due to increases in operating expenses and capital costs in excess of increases in revenue over a seven year period marked by no increases in rates. Since 1998, the Company's operating expenses have increased by $1,229,583 while its annual revenues have increased by only $1,205,536.

Q. Please explain the Company's proposed capital structure.

A. As shown in Schedule 4, the Company's total capitalization as of December 31, 2004, as adjusted, was $10.56 million. This was comprised of long-term debt of $6.01 million and common equity of $4.55 million. One adjustment was made to actual year-end capitalization. Specifically, in January 2005, the Company issued $1.17 million of tax-exempt bonds through the NH Business Finance Authority (BFA). The proceeds were effectively applied to repay a like amount of inter-company advances related to certain capital projects. The Company's 57/43 debt/equity ratio reflects a much higher level of financial leverage than typical water utility industry levels. As shown on Schedule 4, Attachment B, at December 31, 2004 the median water utility industry debt/equity ratio was 48/52. This relatively high degree of financial risk, combined with substantial business risk (as discussed later in my testimony) makes it especially critical that the Company be afforded prompt rate relief in amounts necessary to provide an opportunity to earn a reasonable return on capital and to access debt and equity capital at reasonable costs and terms.

Q. Would you please discuss the overall rate of return that the Company is requesting in this rate proceeding?

A. Yes. Schedule 4 summarizes the Company's capital structure as well as the proposed component costs for long-term debt and common equity. The

Company is requesting that the Commission authorize the Company to earn an overall rate of return on investment (ROI) of 7.86%. The 7.86% is comprised of: (i) 5.89% for long-term debt, and (ii) 10.45% for the cost of common equity.

Q. Please describe your methodology in determining the Company's embedded cost of long-term debt.

A. I have used the embedded actual cost methodology which has been widely used and adopted by this Commission. Under this approach, the actual annual interest expense for each debt issue is computed and added to the annual amortization of related issuance costs. The totals for all long-term debt issues are added. The sum total amount is divided by the total principal balance outstanding at the end of the test year, as adjusted. This produces a weighted average cost of long-term debt. The Company has three separate long-term debt issues: $4.50 million taxable loan with Bank of America, $1.17 million tax-exempt bonds issued through the BFA, and $0.35 million low cost loan with the NH State Revolving Fund (SRF). The "as adjusted" reference above relates to the $1.17 million BFA Bonds. The offering was in process at year-end 2004 but did not actually close until January 2005. The proceeds were effectively applied to repay a like amount of inter-company advances. The Company is reflecting this transaction and application of proceeds in its filing. Referring to Schedule 4, the weighted average cost of long-term debt for the three debt issues is 5.89% based on total annual interest and amortization costs of $354,525 and on a total principal balance outstanding of $6.01 million.

Q. Has the Company retained an outside expert witness for return on (cost of) common equity?

A. No. Recognizing its small size, limited financial resources, concerted efforts to control costs, and extreme under-earning position prompting this request for substantial rate relief on a timely basis, the Company has not contracted for an outside expert witness for cost of equity. Retaining a witness on cost of equity would significantly impact rate case expense, particularly since the cost of such a witness would not vary based on the size of the Company. The Company is concerned that hiring such a witness would have a disproportionate impact on rate case expense. In order to avoid such a significant expense, the Company is providing the facts sufficient to support its proposed return on equity. If the Company cannot reach agreement with the Commission staff ("Staff") on a recommended cost of equity, it would expect to submit supplemental testimony from an expert witness, either in response to or prior to testimony from the Staff, based on further discussions with the Staff.

Q. What is the return on common equity that the Company is proposing in this rate proceeding?

A. The Company is seeking a return on common equity of 10.45% on its December 31, 2004 common equity balance of $4.55 million as shown in Schedule 4. The Company notes its current authorized rate of return on common equity is 11.00%. While there is ample support for maintaining the current authorized rate, the Company is also very cognizant of the magnitude of its overall rate increase request. Thus, the Company is seeking a somewhat lower return on common equity to mitigate, in part, the effect of the increase on customers.

Q. Please discuss the Company's principal business and financial risk factors.

A. The Company believes a 10.45% return on common equity is warranted due to its high business and financial risk profiles. The Company's primary business risk factors are its very small size (as measured by revenues, assets, customers, etc.) and its relatively large capital additions program. Small size magnifies the effects of high levels of fixed expenses (which are common among water utilities) and of unexpected increases in operating expenses or decreases in revenues (due to loss of customers, adverse weather conditions, supply interruptions, etc.). Furthermore, the Company's 2005 to 2008 capital additions program will increase its current rate base by more than 40% and will make it that much more imperative for the Company to be able to access the equity markets.

Q. Please address the Company's financial risk profile.

A. The Company would be considered a high financial risk for investors. This is based on a number of factors, including the fact that the Company is currently under-earning and faces the need to make significant capital additions in the next three years. This financial risk is further demonstrated by an analysis of the Company's ability to issue debt. The Company's existing BFA long-term loan agreement contains a debt issuance covenant that ties the Company's ability to issue debt directly to earnings. Specifically, the Company can issue long-term debt only if the Company's earnings available for interest are at least 1 ½ times its prospective annual interest expense. The Company was required to meet this test in its recent $4.5 million loan extension transaction (approved by the Commission on April 7, 2005 in Order No. 24,250). The Company's calculated coverage ratio was only 1.86, barely sufficient to meet its debt incurrence test. The Company was also required to meet this test in its recent $0.75 million SRF loan for its Pelham tank storage project (approved by the Commission on September 30, 2004 in Order No. 24,375 and closed on May 9, 2005). The Company's calculated coverage ratio for the SRF loan was only 1.58, again barely above the required threshold. (Debt incurrence tests are "bare minimums" below which borrowers are not legally permitted to issue debt. Businesses should not operate at or near "bare minimum" levels for more than temporary periods.

To place the Company's perilously low coverage level in clear perspective, Standard & Poor's (S&P) publishes and maintains credit rating benchmarks. Based upon the overall water utility industry business risk profile of "3," the range of interest coverage ratio for a "BBB" rating (the lowest investment grade rating category) is 1.8-2.8. Due to the array of its normal and unique business risks (as described above) it would not be unreasonable to impute to the Company a business risk profile of "4" in which case the coverage ratio range for a "BBB" rating would increase to 2.2-3.3. Absent rate relief, the Company's actual coverage ratios would imply "non-investment grade" status for its debt securities.

Another S&P benchmark is funds from operations as a percentage of total debt (FFO-to-Debt). At business risk position "3", the FFO-to-Debt range for a BBB rating is 14-20%; at business risk position "4" the required range increases to 17.5-24.5%. By sharp contrast, the Company's actual FFO-to-Debt ratio is only 9.7%, once again well below the investment grade rating threshold.

Q. Will Nashua's eminent domain action have any effect on the Company?

A. Yes. If the Commission were to approve the taking of the assets of Pennichuck Water Works, Inc. and Pennichuck East Utility were left as a stand alone company, it would be significantly more difficult for the Company to access the capital markets, thus making the Company an even riskier proposition for investors. It is possible that lenders or other parties considering making capital additions to the Company would take this risk into account today.

Q. Please address the Company's current ability to raise equity.

A. Due to limitations on its ability to incur debt and its large capital additions program, the Company may be required to seek additional equity. Here, the current scenario is equally grim. In order to raise new equity the Company must be able to demonstrate its ability to maintain a competitive dividend policy. The water utility industry median dividend payout ratio, expressed as a percentage of book value, for 2000-2004 is about 7.00%. The ability to achieve and to maintain a 7.00% dividend-to-book payout requires the Company have the opportunity to achieve earnings at a reasonable cushion above that level (e.g. the opportunity to earn 10.45% and pay out 7.00%). The Company's actual earnings levels for the past few years have not only been well below its allowed return of 11.00% (and its requested return of 10.45%) but also well below the water utility industry median dividend-to-book payout ratio of 7.00%. In other words, the Company is currently incapable of sustaining a dividend policy at or even near competitive levels. Thus, its ability to attract new equity is severely constrained. In summary, the Company requires prompt and adequate rate relief in order to restore its financial integrity and to earn a return on capital at a level that ensures the opportunity to access debt and equity capital at reasonable costs and terms.

Q. What are investors' current expectations for water utility companies regarding return in equity?

A. In my opinion, the markets view water utilities as a "10%+ ROE" industry. Ample evidence exists in support of this view. Schedule 4, Attachment C provides a list of recent rate case decisions for selected utilities. The list is for all water utilities (outside NH) with annual revenues less than $100 million. The mean ROE for the full universe of 20 companies is 10.62%. Given the Company's extremely small size, I separately calculated the mean for small companies (i.e. companies with annual revenues less than $10 million). The mean ROE for the subset of 9 small companies is 11.00%.

This clearly demonstrates that small companies are generally awarded higher ROE's presumably to compensate for the added business and financial risks associated with small size. I am also aware that in 2004, the Connecticut Commission authorized BIW a 10.% return on equity. Also, in its April 29, 2005 report, Value Line, a highly respected, independent research organization, provides "Composite Statistics for the Water Utility Industry" in which it projects 10%+ earned returns for the water companies it follows. A Commission decision embracing a return on common equity well below the Company's 10.45% request would be viewed quite negatively by the markets. Certainly, the Parent's ability to successfully attract new investors would be impacted should investors elect to reassess the Company's traditionally supportive regulatory environment. Should these actions result in negative pressure on share price, the Company's cost of equity, and ultimately the cost to consumers, would rise.

Q. Would you please summarize your rate of return testimony.

A. The Company is seeking an overall rate of return of 7.86%, comprised of an embedded cost of long-term debt of 5.89% and a 10.45% cost of common equity. The Company has entered a crucial new phase in its seven year operating history under the Parent's ownership. The Company is embarking on a four year capital additions program driven largely by federally mandated projects which will increase its rate base by 40%. Given its modest levels of projected internal cash flow relative to its associated capital expenditure requirement, the Company must rely heavily on its ability to raise debt and equity capital. It is equally critical that the Company achieve access to capital at reasonable costs and terms. Regulatory support, consistent with prior decisions and with investor's current expectations, in the form of reasonable rate relief including a fair ROE, is absolutely necessary. As evidenced by ROE's awarded to peer companies, recognizing its extremely small size (and concomitant high business and financial risk profiles), together with the Company's need to raise debt and equity capital, the Company firmly believes it can readily justify retention of its current allowed return on equity of 11.00%. However, in a concerted effort to contain individual rate increases (i.e. to mitigate potential rate shock), the Company respectfully requests the Commission grant a 10.45% return on equity.

Q. Does this complete your direct testimony?

A. Yes. It does.