

DW 01-081

PENNICHUCK WATER WORKS, INC.

Petition for Permanent and Temporary Rate Increase

Order Approving Settlement Agreement and Permanent Rate Increase and Granting Recovery of Rate Case Expenses

O R D E R N O. 23,923

March 1, 2002

APPEARANCES: McLane, Graf, Raulerson and Middleton by Steven V. Camerino, Esq. on behalf of Pennichuck Water Works, Inc. and Marcia A. B. Thunberg, Esq., on behalf of Staff of the New Hampshire Public Utilities Commission.

I. PROCEDURAL HISTORY AND BACKGROUND

On April 17, 2001, Pennichuck Water Works, Inc.

(Pennichuck or the Petitioner) filed with the New Hampshire Public Utilities Commission (Commission) a notice of intent to file rate schedules pursuant to the requirements of NH Code of Admin. Rules Puc 1604.05. On June 8, 2001, Pennichuck filed a petition for a 20.09% increase in revenue in the amount of \$2,506,131, to be effective on July 8, 2001. Pennichuck also filed a request for a step adjustment, to be effective July 1, 2002 to recover the cost of certain post-test year plant additions. The Company estimated that this step adjustment would provide for an additional 7.29% in revenue. Pennichuck serves the southern New Hampshire area, operating a core system that serves Nashua, Amherst, Merrimack, and portions of Milford, Hollis and Bedford, as well as a number of independent community systems serving portions of Epping, Derry, Bedford,

Milford, Plaistow, Newmarket, and Salem.

The Petition was accompanied by testimony from Messrs. Maurice L. Arel, Stephen J. Densberger, Charles J. Staab, Henry G. Mulle, Donald L. Ware, and Ms. Bonalyn J. Hartley. Pennichuck also filed on June 8, 2001, pursuant to RSA 378:27, a Petition for Temporary Rates in the amount of \$1,137,610, or 9.12% over current rates.

With its filing, Pennichuck also submitted an updated Cost of Service Study. That study recommended that the revenue increase sought by the Company should only be applied to non-fire-protection customers, that both public and private fire protection rates were currently adequate.

Pennichuck filed a revised Tariff No. 5-Water, on June 8, 2001. By Commission Order No. 23,736, dated June 29, 2001, a Fourth revised Page 39 and 40 were suspended, a Prehearing Conference and technical session were scheduled for July 12, 2001, and a hearing on Pennichuck's request for temporary rates was scheduled for July 31, 2001.

A prehearing conference was held July 12, 2001, and the petition to intervene from Mr. Fred Teeboom, was granted. The Commission approved the parties' proposed procedural schedule on July 30, 2001, by Commission Order No. 23,748. Subsequent to the temporary rate hearing on July 31, 2001, the Commission issued Order

No. 23,770, dated August 31, 2001, which approved the petitioner's request for a temporary increase in revenues of 8.52%, for effect with bills rendered on or after September 8, 2001.

Staff and Pennichuck held multiple meetings pursuant to the approved procedural schedule and conducted discovery. Intervenor Mr. Teeboom did not participate in the meetings or discovery and participated in a limited manner in the settlement discussions. The discovery and settlement process produced a Settlement Agreement which was signed by the petitioner and Staff and delivered to the Commission on February 4, 2002.

II. POSITIONS OF THE PARTIES AND STAFF

A. Pennichuck Water Works and Staff

Pennichuck and Staff presented a Settlement Agreement (discussed below) which was intended to address all issues relevant to the rate proceeding. Witnesses Bonalyn Hartley and Maurice Arel from Pennichuck Water Works and Mark Naylor from Staff discussed aspects of the Settlement Agreement. Pennichuck and Staff requested Commission approval of the agreement.

B. Fred Teeboom, Intervenor

Mr. Teeboom did not attend the February 5, 2002 hearing. Mr. Teeboom submitted letters dated February 4, 8, and 16, 2002, expressing his objection to the settlement

between Staff and Pennichuck. Mr. Teeboom's objections were that the settlement agreement failed to include an examination of: 1) profits on land transfers from Pennichuck Water Works to Southwood Corporation, a division of Pennichuck corporation; and 2) a basis for the "maintenance charges" of water supply for fire protection of approximately \$1.6 million annually to the City of Nashua.

III. SETTLEMENT AGREEMENT

The Settlement Agreement provides for a permanent revenue increase as well as one step adjustment.

The permanent revenue increase, based on the 2000 test year, would provide Pennichuck with an increase of \$1,083,145 or 8.67%. In calculating this, the signatories agreed to utilize the following components: a rate base amount of \$39,388,529; a rate of return of 8.58%; an adjusted net operating income amount of \$2,725,425; a deficiency before taxes of \$654,111; and a tax factor of \$429,034 or 60.39%.

The step increase proposed in the Settlement Agreement is intended to provide for recovery of certain non-revenue producing plant additions which were placed in service in 2001, subsequent to the test year. The Company and the Staff stipulated that these plant additions were necessary as a result of government mandate, Safe Drinking Water Act

compliance, and other extraordinary circumstances, and that these factors justify departure from traditional ratemaking principles. The Company and Staff agreed to an increase in the revenue requirement as a result of the step increase in the amount of \$718,687, or 5.76%. To calculate the step increase, the parties agreed to utilize the following components: additions to rate base totaling \$3,624,650; a rate of return of 8.58%; net operating income requirement of \$310,995; a tax factor of \$203,983 or 60.39%; real estate taxes in the amount of \$87,277; depreciation expense in the amount of \$138,779; less marginal revenues in the amount of \$22,346.

The total percentage increase under the Settlement Agreement would be 14.43%. The Company and Staff agreed that the increase would be effective not later than with service rendered on and after the effective date of the Commission's permanent rate order in these proceedings.

The Company and Staff agreed to maintain the Company's present rate design and to recover the revenue increase resulting from the Stipulation Agreement from all customers except private and public fire protection customers. This rate design, they assert, is supported by the Company's updated Cost of Service and Rate Design Study, dated July

2001.

The Settlement Agreement provides that the Company would recover, through a surcharge to be applied over a twelve month period, (a) the difference between the revenue level produced by the permanent rates authorized in these proceedings and the Company's temporary rates for bills rendered on and after September 8, 2001 and until the effective date of the Commission's Order and (b) the Company's reasonable rate case expenses approved by the Commission in these proceedings. The rate increase relating to the step adjustment would not be subject to recoupment for the period since temporary rates took effect.

IV. COMMISSION ANALYSIS

RSA 378:7 authorizes the Commission to fix rates pursuant to an order after a hearing. The Commission is obligated to investigate the justness and reasonableness of the proposed rate. *Eastman Sewer Company, Inc.*, 138 N.H. 221, 225 (1994).

A. Revenue Deficiency

Traditional rate-of-return principles permit a utility to recover prudently incurred operating expenses along with "the opportunity to make a profit on its investment, in an amount equal to its rate base multiplied by a specified

rate of return." *Appeal of Conservation Law Foundation*, 127 N.H. 606, 634 (1986). The Settlement Agreement provides for an 8.58% rate of return and incorporates a 10.0% return on equity, and 7.38% long term debt component. (Hearing Transcript at 26)

We note from the record that Staff recommended a return on equity of 8.75%. (Direct Testimony of Maureen L. Sirois, January 9, 2002, page 2). Pennichuck's expert, Mr. Henry Mulle, had recommended a return on common equity of 11.75%. (Direct Testimony of Henry G. Mulle, June 2001, page i). The 10% cost of equity number was explained by Mr. Naylor at the hearing to be a settlement number. (Hearing Transcript at 73). The importance of a high costs of equity number to attract investment capital was stressed by Pennichuck. (Direct Testimony of Henry G. Mulle, June 2001, pages 9-11). This Commission's obligations extend to balancing the consumer's interest in paying no higher rate than required against the investors' interests in obtaining a reasonable return on their investment. *Eastman Sewer Company, Inc.*, 138 N.H. 221, 225 (1994). The Court in *Eastman* affirmed this Commission's discretionary actions providing a margin of profit sufficient to attract capital. Accordingly, we will exercise that discretion and approve the recommended cost of

equity of 10%. As the step adjustment indicates, Pennichuck faces future capital improvements to comply with federal Safe Drinking Water Act requirements and we deem it important for the company to be in a sound borrowing position to attract capital investment.

Staff stated that the plant, equipment, and capital improvements identified in the Settlement Agreement, Schedule 2 and 2A, used and useful. Staff testified at hearing that Commission Staff had performed a comprehensive audit of Pennichuck's books and that it agreed with the remaining rate base adjustments that were included in the Settlement Agreement. (Hearing Transcript at 49 and 50). The Commission accepts Staff's recommendations and the Settlement's treatment of these issues.

In connection with the Company's requested revenue needs, Intervenor Mr. Teeboom questioned the treatment of profits on land transfers from Pennichuck Water Works to Southwood Corporation. Our investigation of this matter indicates we addressed the sale of this property by Pennichuck to a below-the-line account in DR 80-134, Commission Order No. 14,454, 65 NHPUC 393 (1980). Our approval of the removal from rate base of this parcel of 1,490 acres of land at book cost, rather than market value, was affirmed in *Appeal of the City of Nashua*, 121 N.H. 874 (1981). The Commission also approved the company's reorganization in Docket No. DF 83-105, Commission Order No. 16,373, 68 NHPUC 253 (1983). As part of that order, the Commission accepted stipulations that water quality buffer zones would inhere to land sold for

development. So to the 1983 accounting of the 1,490 acre parcel below-the-line, the rate treatment of that transaction was conclusively determined by the New Hampshire Supreme Court and cannot be revisited here. The later transfer of part of the parcel to Pennichuck's affiliate, Southwood, was recognized by the Commission in orders dating back to 1983, Order No. 16,373, and we will not revisit it now, almost 20 years later.

B. Rate Design

The Settlement Agreement provides for continuation of the present rate design structure and collection of the revenue increase from all customers except private and public fire protection. Pennichuck did not request an increase to fire protection customers based upon recommendations included in the Cost of Service Allocation Study performed by AUS Consultants of Wormleysburg, Pennsylvania in the last rate case, and updated here. Mr. Teeboom questioned why the city of Nashua paid a \$1.6 million maintenance charge for fire protection, and argued that the payment was too high. Pennichuck has not requested any change to the methodology used to allocate revenue requirements to Pennichuck's wholesale customer, the City of Nashua, nor has Pennichuck requested an increase in the rates for private and public fire

protection.

Administrative Rule Puc 1604.01(a)(7) requires utilities to submit cost of service studies to aid the Commission in its analysis of how rates are allocated among customer classes. Staff has thoroughly examined the Cost of Service Allocation Study in this docket and examined Pennichuck's Report on Cost of Service, dated February 19, 1993, relative to the rate case in Docket No. DR 97-058. In both studies, no recommendation to increase the fire protection allocation was made. Staff agreed with this recommendation, it is consistent with the Cost of Service methodology previously approved for this Company, and we accept this cost allocation.

No increase will be applied to the fixed annual rate for the Town of Milford, other than what is already provided for in the terms of that contract. Anheuser-Busch will see an increase in its rates, but based on the formula contained in its contract.¹ According to the revised Report of Proposed Rate Change, submitted to the Commission on February 1, 2002, and discussed at the Hearing, Anheuser-Busch will see a rate

¹The Settlement Agreement states: The volumetric charge and revenues allocated to the Anheuser-Busch contract shall be applied as defined in the Schedules of the company's updated Cost of Service Allocation Study consistent with the percentage of the volumetric charge defined in the terms and conditions of the Anheuser-Busch contract. (Settlement Agreement Page 5).

increase of 17.33%, which includes the step adjustment. We find that the recommended rate design is reasonable.

C. Step Adjustment

Step adjustments are employed as a means of ensuring that a regulated utility retains its ability to earn a reasonable rate of return even after implementation of large capital projects. Its purpose is to avoid placing a utility in an earnings deficiency immediately after a rate case based on a test year ratemaking methodology. Step adjustments can be implemented following a rate proceeding, taking advantage of that proceeding to substantially reduce the time for regulatory review and approval of anticipated capital additions.

The Commission has also reserved the use of step adjustments to avoid regulatory lag in providing a utility with its authorized return on invested capital. Regulated water utilities, in complying with the requirements of the federal Safe Drinking Water Act (SDWA), have been particularly challenged to maintain a reasonable rate of return while making new significant investments.

In each of Pennichuck's recent rate proceedings, it has received approval for a step adjustment in its rates in order to recover significant levels of investment occurring

after its test year, while helping to obviate another early rate case filing. See, Commission Order No. 22,883, 83 NHPUC 197 (1998); and Commission Order No. 21,451, 79 NHPUC 667 (1994). This Settlement Agreement allows Pennichuck to implement a single step increase in rates, effective with the date of our final order in this proceeding. This step adjustment allows the Company to recover certain so-called non-revenue producing plant additions made in 2001, subsequent to the 2000 test year. Staff has reviewed the plant additions, identified on Schedule 4 of the Agreement, and agrees that these additions were necessary as a result of government mandate, SDWA compliance, or such other extraordinary circumstances as to justify a step adjustment at this time. Staff also agrees that each plant addition is used and useful and in service to the public, in compliance with RSA 378:28. The Settlement Agreement provides for the step adjustment to be implemented on a service-rendered basis as of the date of this Order. Further, under the Settlement Agreement, the revenues resulting from this step adjustment cannot be reconciled with the temporary rates in effect during the pendency of this proceeding. That is, they will be collected only on a going-forward basis.

After reviewing the record and the large capital

expenditures Pennichuck made subsequent to the 2000 test year, and as identified in Schedule 5, we find the step adjustment to be reasonable. We are aware that "any attempt to judge reasonableness [of rates] apart from [the traditional ratemaking] process would...risk...unconstitutionality." *Richards v. Campaign for Ratepayers Rights*, 134 N.H. 148, 160 (1991), citing *Appeal of Conservation Law Foundation*, 127 N.H. 606, 639 (1986). Mr. Naylor, Director of the Commission's Gas & Water Division has advocated for cautious use of step adjustments and we concur. We believe the limitation of the items included in the step adjustment in this case, so as to allow recovery only of expenditures of an extraordinary nature for items which are in service and necessary for the provision of safe and adequate service, is consistent with meeting our obligations that rates be just and reasonable.

D. Customer Bill Impacts

As a result of the settlement, Pennichuck will see an overall 8.67% increase in the base portion of revenues. With the addition of the step increase, effective as of the date of this order, Pennichuck will realize an additional revenue increase over prior rates of 5.76%. (Hearing Transcript at 59.) Thus, the overall rate increase relative to rates in effect before this rate case will be 14.43%.

The Commission notes that Pennichuck originally requested an overall increase in its revenues of 20.09%. Pennichuck did not request an increase to fire protection customers. The percentage increase to the non-fire protection customers will therefore be higher than the overall 14.43% revenue increase.

Pennichuck's witness, Bonalyn Hartley, testified that the average residential customer in the core system will be charged approximately \$310 annually. (Hearing transcript at 32). Prior to the rate case, a residential customer using 12,400 cu ft per year paid approximately \$259.60 per year. A customer using this same amount would pay an additional \$50.42 per year, or \$12.60 per quarter, for the same volume of water as a result of this rate case.

Presently, the annualized bill for a typical residential customer, under the temporary rates approved for bills rendered September 8, 2001, would be \$286.80. The increase in rates that customers will now realize, from temporary to permanent rates, will be an additional increase of \$23.22 per year for the average residential customer or about 1% over rates currently in effect. (Hearing Transcript at 32 and 33, hearing Exhibit 19).

On February 19, 2002, Pennichuck informed the

Commission that due to the complexity of recoupment of the difference between the temporary rate increase of 8.52% and permanent rate increase of 8.67%, it would forego recoupment of that amount. This amount would have been collected as a surcharge for the period January 31, 2002 through March 1, 2002. The difference between the rates for the period September 8, 2001 through January 31, 2002, however, will be included in the rate case surcharge to customers. The entire rate increase will thus be billed on a service rendered basis beginning the effective date of this order.

We believe the impact of the rate increase upon customer bills is reasonable and justified as a result of a thorough examination of the record.

E. Rate Case Expenses and Temporary Rate Surcharge

Pennichuck has submitted, in summary form as well as with extensive backup documentation, expenses related to bringing its rate case before this Commission. Of the \$100,298 submitted, \$91,667 represents rate case expenses and \$8,631 represents recoupment of the difference between temporary rates and permanent rates. The Settlement Agreement provides for a surcharge for rate case expenses, and recovery of the temporary rate/permanent rate difference over a 12-month period. Staff has reviewed the submittals and

recommended disallowance of \$1,366 from the originally submitted expenses as not related to this rate case and has proposed that the remaining expenses be allowed. We will approve the rate case expenses recommended by Staff and approve their collection through the methodology set forth in the Settlement Agreement.

Based upon our review of the record and testimony at hearing, we conclude that the Settlement Agreement and the rates established therein are just and reasonable.

Based upon the foregoing, it is hereby

ORDERED, that the Settlement Agreement reached between Pennichuck and Staff is APPROVED; and it is

FURTHER ORDERED, that Pennichuck's rate case expenses as specified above are APPROVED; and it is

FURTHER ORDERED, that Pennichuck shall submit a compliance tariff within five days in conformance with this order.

By order of the Public Utilities Commission of New Hampshire this first day of March, 2002.

Thomas B. Getz
Chairman

Susan S. Geiger
Commissioner

Nancy Brockway
Commissioner

Attested by:

Debra A. Howland
Executive Director and Secretary