STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DW 04-056

<u>In the Matter of:</u>
<u>Pennichuck Water Works, Inc.</u>
<u>Petition for Permanent Rates</u>

Direct Testimony

of

Jayson P. Laflamme
Utility Analyst III

January 10, 2005

New Hampshire Public Utilities Commission

Pennichuck Water Works, Inc.

DW 04-056

Petition for Permanent Rates

Direct Testimony of Jayson P. Laflamme

Q. Would you please state your full name.

A. My name is Jayson P. Laflamme.

Q. By whom are you employed and what is your business address?

A. I am employed by the New Hampshire Public Utilities Commission (NHPUC) and my business address is 21 South Fruit Street, Suite 10, Concord, New Hampshire.

Q. What is your position at the NHPUC?

A. I am a Utility Analyst III in the Gas and Water Division.

Q. Please describe your duties at the NHPUC.

A. I am responsible for the evaluation of rate and financing filings, including the recommendation of changes in revenue levels that conform to regulatory methodologies. I represent Staff in meetings with company officials, outside attorneys and accountants relative to rate case and financing matters as well as the Commission's rules, policies and procedures.

Q. Would you please describe your educational background.

A. I received a Bachelor of Science Degree in Accounting from Lyndon State College in 1989. In 1998, I attended the NARUC Annual Regulatory Studies Program at Michigan State University. In 2002, I attended the 22nd Annual Western Utility Rate School in San Diego, California.

Q. Would you please describe your work experience.

A. In 1989, I was hired as a Staff Accountant by Driscoll & Company, a CPA firm located in Littleton, New Hampshire. I performed audits, reviews and compilations as well as prepared tax returns for a variety of entities. I was eventually promoted to the position of Manager. In 1997, I was hired as a Utility Examiner in the Audit Division of the NHPUC. In that position, I participated in field audits of the books and records of regulated utilities in the electric, telecommunications, water, sewer and gas industries. I examined reports and filings submitted to the Commission by regulated utilities and performed rate of return analyses. In 2001, I was promoted to my current position as a Utility Analyst III.

Q. What is the purpose of your testimony?

A. My testimony will provide Staff's recommendation with regard to a revenue requirement for Pennichuck Water Works, Inc. (PWW or the Company).

Q. Please provide a brief summary of PWW's request for permanent rates in this proceeding.

A. On May 28, 2004, PWW filed a petition including testimony and supporting schedules requesting approval for a permanent rate increase in order to generate additional revenues of $2,414,183. This represents a 16.39% increase in annual operating water revenues. The Company utilized a 2003 test year in making its determinations.

Q. Are temporary rates currently in effect in this docket?

A. Yes. On September 30, 2004, the Commission issued Order No. 24,377 authorizing a temporary revenue increase of 8.94% to be implemented on a service-rendered basis, effective June 1, 2004.

Q. Before discussing the specifics of Staff's recommended revenue requirement, are there any general comments that you would like to make?

A. Yes. I would like to commend the Commission's Audit Staff for the excellent work they did in this case. The Audit Staff was quite thorough in its review of the Company's test year and discovered many items which were included in its Final Audit Report dated October 28, 2004 that resulted in adjustments which have been incorporated in the determination of Staff's recommended revenue requirement.

Q. Please summarize Staff's recommendation regarding a revenue requirement for PWW in this case.

A. As indicated on Attachment JPL-1, Schedule 1, Staff is recommending a revenue requirement of $15,688,461. This represents an increase of $957,432, or 6.50%, over the proformed test year operating water revenues of $14,731,029. Staff's recommended revenue requirement is calculated on a total rate base of $44,572,746, as computed on Schedule 2 of Attachment JPL-1, and provides for an overall rate of return of 7.50% as detailed in the testimony of Maureen Sirois. The revenue deficiency before applying a tax effect is $578,193. When federal and state taxes are taken into account, the revenue deficiency becomes $957,432.

Q. What was used for a Federal and State tax rate?

A. As indicated on Schedule 1A of Attachment JPL-1, an overall effective tax rate of 39.61% was computed. This is the same effective tax rate computed by the Company in its filing.

Q. Please discuss the rate base amount calculated by Staff on Schedule 2 of Attachment JPL-1.

A. The Proforma Test Year column shows the Company's proposed rate base of $44,627,473 from Schedule 3 of its filing. This amount was determined based on the thirteen-month averages for each rate base component and adjusted by various proforma entries that were proposed by the Company in its filing. The Proforma Adjustments column summarizes Staff's adjustments to the Company's proposed rate base from Schedule 2A of Attachment JPL-1. Staff's adjustments result in a net reduction of $54,727 in the Company's proposed rate base leading to Staff's calculated rate base in the amount of $44,572,746 which is shown in the Adjusted Rate Base column.

Q. Please explain Adjustment # 1 to Plant in Service and Adjustment # 4 to Accumulated Depreciation both in the amount of $15,597.

A. These two adjustments stem from Staff Audit Find # 6. The purpose of these adjustments is to record the retirements of certain mains and hydrants which occurred during the test year but which were not recorded on the Company's books until March 2004. These are offsetting entries which essentially have no impact on PWW's total rate base.

Q. Please explain Adjustments # 2 and # 3 to Plant in Service.

A. Both of these adjustments amend the Company's original entry submitted in its filing concerning so called non-revenue producing capital additions which were placed in service during the test year.

Q. Please explain the concept of non-revenue producing capital additions.

Due to the thirteen-month averaging methodology employed in the determination of rate base for rate making purposes, the full cost of capital additions placed in service during a test year would not normally be reflected in rate base. However, in PWW's last three rate proceedings (DR 92-220, DR 97-058 and DW 01-081) the Commission has allowed a proforma entry in order to recognize the full cost of certain capital additions that were either necessitated by regulatory mandate or represented needed infrastructure improvements. The Commission justified placing these capital additions into rate base at full cost since they did not result in new customers being added to the system and thereby did not provide additional revenues for the Company. In its current filing, PWW submitted an entry in the amount of $1,277,043 to recognize the full cost of certain non-revenue producing capital additions which were placed in service during 2003.

Q. Please continue with your explanation of Adjustments # 2 and # 3.

The basis for Adjustment # 2 is PWW's response to Staff Data Request # 3-23 where the Company made certain corrections in its original supporting computation for non-revenue producing capital additions. The net result of these corrections is an increase in the Company's original entry by an amount of $241,782. Adjustment # 3 is the result of the PWW's response to Tech Session Data Request 1-13 where the Company acknowledged that a certain project known as the "Spitbrook Road / E Dunstable Road Water Main Interconnect" did, in fact, result in additional revenues for the Company. Therefore Staff is proposing that $56,788 related to this project should be eliminated from the Company's proforma entry. After these two adjustments, the net addition to rate base resulting from the recognition of the full cost of the Company's non-revenue producing test year capital additions is $1,462,037.

Q. Please explain Adjustment # 5 to Accumulated Depreciation.

A. Staff Audit Find # 8 identified an issue relative to the Company's depreciation reserves. Specifically, the Audit Staff performed an analysis of the Company's individual plant assets and found that in the case of 257 of these assets their accumulated depreciation exceeded original cost by a combined amount of $557,722. In response to this audit find, the Company conceded that a new depreciation study should be conducted especially in light of the fact that the last depreciation study was performed in 1996 using a 1995 test year. To Staff, however, this audit find served as a signal to the current possibility that the Company's actual booked depreciation reserve may substantially exceed its theoretical depreciation reserve. Staff was further concerned by the fact that a depreciation study would not be completed in time for the results to be incorporated in the current rate proceeding. Therefore the implementation of any necessary adjustment resulting from that depreciation study would be delayed at least until consideration of PWW's next rate case. In Staff Data Request 3-24, the Company was asked to perform an analysis comparing the theoretical depreciation reserve versus the actual booked depreciation reserve for each of its individual plant accounts as of December 31, 2003 using existing depreciation accrual rates.

Q. Was the information that Staff was seeking equivalent to a full depreciation study?

A. No. Staff was not asking the Company to adjust depreciation lives or salvage values. Rather, Staff was asking the Company to use the existing depreciation accrual rates that had been established based upon its last depreciation study in order to determine the variance between the theoretical depreciation reserve and the actual booked depreciation reserve for each individual plant account.

Q. How did the Company respond to Staff's data request?

A. As an alternative, the Company offered to perform a more concise analysis of its actual versus theoretical depreciation reserves based on its broader asset categories. Even though such an analysis would lack the precision of the study originally requested by

Staff, it would mirror that analysis and provide a general indication regarding any variance between the book and theoretical depreciation reserves. Staff agreed to the Company's proposal.

Q. What was the result of the Company's analysis?

A. PWW's analysis (See Attachment JPL-2) indicates the existence of an over-depreciation of assets in that the actual booked depreciation reserve exceeds the theoretical depreciation reserve by an amount of $299,018.

Q. What is the adjustment that Staff is proposing?

A. Given the substantial nature of the variance calculated by the Company, Staff believes that an adjustment should be reflected in the current rate proceeding which would resolve this variance by the time of the Company's next anticipated rate proceeding. Since the Company files for rates approximately every three years, Staff proposes to amortize this variance over a period of three years. This results in an annual amount of $99,673 which would be a debit to accumulated depreciation and a credit to depreciation expense. An adjustment to accumulated depreciation of $49,836 is indicated for Adjustment # 5 in order to reflect the test year averaging methodology that is normally employed for components of rate base. The credit to depreciation expense is recorded as Adjustment # 64 which will be discussed later in my testimony.

Q. Does Staff have any recommendations for the Company with regard to updating its depreciation study?

Yes. Staff strongly encourages the Company to complete and submit a new depreciation study in time for its next rate proceeding. In the future, Staff also encourages the

Company to update its depreciation study roughly every five years in order that it may avoid substantial variances between its booked and theoretical depreciation reserves.

Q. Please explain Adjustments # 6 and # 7 to Cash Working Capital.

A. Adjustment # 6 stems from the Company's response to Staff Data Request 2-30 which indicates that PWW's original entry for cash working capital should be reduced by $1,730 from $52,096 to $50,366. The purpose of Adjustment # 7 is to adjust cash working capital to an amount calculated by Staff which was derived based on the adjusted total operation and maintenance expenses of $7,395,365 shown on Schedule 3 of Attachment JPL-1. A working capital allowance of 63.5 days was applied to this total resulting in an amount of $1,286,591 which when compared to PWW's adjusted thirteen-month average of $1,208,877 results in an increase to cash working capital of $77,714.

Q. Why is Staff using 63.5 days in its calculation of Cash Working Capital?

A. As part of the Settlement Agreement in DR 97-058, the parties agreed that 63.5 days was appropriate at that time for the calculation of cash working capital for PWW. In the absence of a new lead/lag study, Staff believes continued use of this calculation is appropriate.

Q. Please discuss Adjustment # 8 to Prepayments.

A. Adjustment # 8 reduces the prepaid insurance component included in PWW's rate base in order to reflect that portion which is attributable to the Company's affiliates. Attachment JPL-3 shows this calculation. Staff applied the various allocation percentages reflected in Adjustments # 38 - # 45 to the thirteen-month averages for each of the policy components included in prepaid insurance. A full discussion regarding the allocation of the Company's insurance expense appears later in my testimony in the explanation of

Adjustments # 38 - # 45. An amount of $2,819 was computed as the amount of prepaid insurance that should be allocated to PWW's affiliates.

Q. Please discuss Staff's Adjustments to Unamortized Deferred Debits.

A. Adjustments # 9, # 10 and # 11 are each based on Staff Audit Finds. Adjustment # 9 is related to Staff Audit Find # 1 concerning the allocation of a portion of the Company's recruiter fees expense to affiliates (See Adjustments # 26 and # 65). Staff applied the allocation percentage of 23% indicated in Staff Audit Find # 1 to the thirteen-month average for the Employee Recruiter Fees deferred debit account in the amount of $80,042 as calculated from the Company's general ledger**.** This results in an amount of $18,410 which should be allocated to PWW's affiliates. Adjustment # 10 is based on Staff Audit Find # 2 which indicates that the Company's Leasehold Improvements account balance in the amount of $34,140 should be reduced by an amount of $12,500 to $21,640. Since this balance was recorded on December 31, 2003, only 1/13 of the total is reflected in average rate base. Therefore, Staff is proposing an adjustment that reflects only 1/13 of the total $12,500 adjustment, or $962. Adjustment # 11 is related to Staff Audit Find # 3 regarding the elimination of those expenses relative to the unsuccessful Gunstock Glen water system acquisition. The purpose of Adjustment # 11 is to also eliminate the thirteen-month average of the deferred debit account related to the Gunstock Glen acquisition from the Company's rate base. Staff calculated an amount of $10,323 based on the entries contained in PWW's general ledger.

Q. Please discuss Proforma Adjustment # 12 regarding Unfunded FAS 106 Costs?

A. The purpose of this adjustment is to more accurately calculate the Company's rate base. In DA 92-199, Commission Order No. 20,806 and its accompanying Stipulation addressed FAS 106 regarding accounting for post-retirement benefits other than pensions. In that proceeding, PWW was identified as a "Special Circumstance Company". Paragraph IV.8 of the Stipulation in that proceeding states, "*For the Special Circumstance Companies any unfunded amounts included in rates will be treated as a rate base reduction, offset by taxes.*" PWW's original filing did not include an amount for unfunded FAS 106 costs in its rate base calculation. However, in its response to Staff Data Request 1-1, PWW provided the necessary rate base reduction for unfunded FAS 106 costs in the amount of $333,028.

Q. Please discuss the Operating Income Statement for PWW presented on Schedule 3 of Attachment JPL-1.

A. The Proforma 12 Months column presents PWW's proposed proforma net operating income from Schedule 1 of its filing which was calculated based on its actual operations during the 2003 test year and adjusted by various proforma entries to expenses. The Company determined its test year proforma net operating income to be $2,415,740. The Proforma Adjustments column summarizes Staff's adjustments to operating income and expenses from Schedule 3A of Attachment JPL-1. Staff's adjustments result in a net tax effected increase in the Company's proforma net operating income of $349,023. The Proforma Test Year column shows Staff's calculated net operating income in the amount of $2,764,763. The last two columns entitled Revenue Deficiency and Test Year Proforma are intended to show in detail the effect of Staff's calculated revenue requirement from Schedule 1 of Attachment JPL-1 on the Company's net operating income.

Q. Please discuss Staff's proposed adjustment to Other Operating Income.

A. In its response to OCA Data Request 2-6, the Company indicated that it had recorded one-half, or $54,933, of the total lease revenue it had received from cellular tower attachments in a below-the-line account – non-utility revenue. The Company's response to OCA Data Request 2-6 further gave the impression that this accounting treatment was approved in its last rate proceeding (DW 01-081). Staff reviewed the Settlement Agreement as well as Commission Order # 23,923 from that proceeding and did not find that any such approval had been granted. Staff does not agree with the Company's proposed treatment of cell tower revenue in this case. Staff believes that since this revenue is derived from utility plant which has been previously paid for by utility customers, that 100% of the revenue derived from cell tower attachments to this plant should be booked above-the-line. Staff is proposing that the $54,933 in cell tower lease revenue booked as non-utility revenue should be reclassified to other operating revenue. Similarly, Staff is also proposing that cell tower lease expenses in the amount of $9,179 that were indicated in the Company's response to Staff Data Request 3-21 also should be reclassified from non-utility expense to other operating revenue. The net amount of Adjustment # 13 is $45,754.

Q. Please discuss Staff's proposed adjustments to Production Expenses.

A. Staff has proposed seven adjustments to Production Expenses which result in a net decrease of $60,081 in this expense category.

Q. Please explain Staff's adjustment resulting from the NHPUC Staff Audit.

A. Adjustment # 14 pertains to Staff Audit Find # 10 and eliminates a total of $38,542 in billings from the Merrimack Village District that were actually incurred during 2002 but recorded by the Company as an expense during the test year.

Q. Please discuss Staff's adjustments to the Company's proforma wage entries.

A. Adjustments # 15 and # 16 adjust the Company's proposed proforma wages for two union personnel – a circuit rider and a maintenance person – that were to be hired in 2004. The Company's response to Staff Data Request 2-14 provided the actual effective dates as well as the actual annual wages for these two employees. Staff used this information to reduce by $21,692 the Company's original proforma of $47,268 to an amount of $25,576. Adjustment # 17 adjusts the Company's proposed wage proforma in the amount of $14,560 for a lab technician who was promoted from part-time to full-time status during 2004. Staff used information contained in the Company's response to Staff Data Request 2-6 in order to compute the correct proforma adjustment of $6,848 which is a decrease of $7,712.

Q. Please explain Staff Adjustments # 18, # 19 and # 20 to PWW's electric costs.

A. The Company proposed a proforma adjustment to reflect increases in both its energy charge and delivery charge paid to Public Service of New Hampshire (PSNH) that became effective in 2004. Adjustment # 18 amends the Company's energy charge adjustment in order to show that this increase became effective in February 2004. The Company's proforma was based on an entire year when only 11 months should be reflected in the proforma test year. Staff determined an effective reduction in this portion of the Company's proforma in the amount of $4,759. The purpose of Adjustment # 19 is to record a subsequent increase in the energy charge which took effect in August 2004; after the Company submitted its filing. That increase which was approved by Commission Order No. 24,358 (August 2, 2004) in Docket No. DE 03-175 resulted in an additional $0.0043/KWH increase in PSNH's energy charge from $0.0536/KWH to

$0.0579/KWH. (See Attachment JPL-4) Staff calculated that an additional $14,564 in electric costs resulting from this subsequent increase in the energy charge should be included as a proforma to the test year. Adjustment # 20 amends the Company's proposed delivery charge proforma which was calculated based on an overall percentage increase of 0.76% and an effective date of August 1, 2004. In Commission Order No. 24,369 (September 2, 2004) of Docket No. DE 03-200, an increase in PSNH's delivery charge was approved which ultimately resulted in a 0.4% increase in Rate G and a 0.2% increase in Rate GV effective October 1, 2004. (See Attachment JPL-5) Based on the methodology described by the Company in its response to Staff Data Request # 2-17, Staff calculated a decrease of $1,940 in the Company's proposed proforma for its delivery charge. Adjustments # 18, # 19 and # 20 result in a combined net increase of $7,865 in the Company's electric cost proforma from $59,647 to $67,512.

Q. Please discuss Staff's proposed adjustments to Transmission and Distribution Expenses.

A. Staff has proposed four adjustments to Transmission and Distribution Expenses which result in a net decrease of $62,841 in this expense category.

Q. Please discuss Staff's proposed adjustment regarding PWW's flushing program.

A. In Adjustment # 21, Staff is proposing a reduction in the costs reflected in the Company's test year relative to its main flushing program. The Company initiated a comprehensive system wide flushing program during the test year in order to rectify certain quality issues within its system. It is the Company's intention to continue this program on an annual basis. The Company's response to Staff Data Request 2-3 indicates that a total of $111,600 was spent during the test year on the flushing program. Because 2003 represents the initial year of the comprehensive flushing program, it is Staff's concern that the costs incurred during that year may not be representative of the costs that will be incurred on this program in subsequent years. The Company's responses to both OCA Data Request 1-2 and Staff Data Request 3-14 indicate that the total spent on the flushing program from January through October 2004 was only $57,401. Staff surmises that this represents the majority of the total costs that will be incurred during 2004 due to the weather and temperature factors which would be encountered during November and December. Staff further believes that the costs incurred on the flushing program during 2004 would more accurately reflect the costs that the Company may expect to incur on an annual basis in subsequent years due to the experience that the Company has now gained with regard to the flushing program and the resulting efficiencies that such experience would produce. Staff is proposing an adjustment of $54,199 to reduce the test year costs incurred on the flushing program to that level anticipated for 2004.

Q. Please discuss Staff's adjustments to the Company's proforma wage entries.

A. Adjustment # 22 adjusts the wage proforma proposed by the Company for a Utility Technician I who was hired in April 2003. The 2003 wages earned by this employee coupled with the Company's proforma result in an annual wage of $40,655. The Company's response to Technical Session Data Request 1-4 indicated that this employee earned an hourly wage of $15.28 as of the end of the test year which translates into an annual wage of $31,782. Staff therefore determined a reduction in the Company's proforma adjustment of $8,873. Adjustment # 23 adjusts the Company's proposed proforma wages for 2 utility technicians who were to be hired in 2004. The Company's response to Technical Session Data Request 1-6 provided the actual effective dates as well as the actual annual wages for these employees. Staff used this information to calculate a combined increase of $3,726 in the Company's wage proforma from $25,742 to $29,468. Adjustment # 24 amends the Company's proposed proforma wages for a cad operator position that was to be filled during 2004. The Company's response to Staff Data Request 2-14 provided the actual effective date as well as the actual annual wages for this employee. Staff used this information to calculate a decrease of $3,495 in the Company's wage proforma from $20,000 to $16,505.

Q. Please discuss Staff's proposed adjustment to Customer Accounting Expense.

A. PWW's 2003 Annual Report states that a $16,411 increase in its meter reading expense account from 2002 to 2003 was due to "transitional issues related to the new meter reading technology". In its response to Staff Data Request 2-4, the Company explained that beginning in late 2002 it began to install radio read devices on its water meters. However, during 2003 the Company began experiencing technical problems with these devices which among other things forced the Company to return to the meter locations in order to reread those meters. Staff does not feel that it is appropriate to include costs in the test year that are the result of recurring technical difficulties with the Company's new meter reading technology especially when there is an expectation that such technology will eventually lead to greater cost efficiencies. Therefore Adjustment # 25 reduces the Company's test year meter reading expense by $16,411 to the 2002 expense level.

Q. Please discuss Staff's proposed adjustments to Administrative & General Expenses.

A. Staff is proposing a total of 36 adjustments to this category which together result in a net decrease in expenses of $245,163.

Q. Please describe Staff's adjustments to Administrative & General Expenses that are the result of issues raised in the NHPUC audit of PWW.

A. Adjustment # 26 pertains to Staff Audit Find # 1 and reduces test year expenses by $664 for recruiter fee expenses that should have been allocated to PWW's affiliates. A related adjustment (# 65) which is discussed later in my testimony also pertains to the same audit find. Adjustment # 27 relates to Staff Audit Find # 3 and removes $10,966 from test year expenses for costs incurred relative to PWW's unsuccessful acquisition of the Gunstock Glen water system. Adjustment # 28 stems from Staff Audit Find # 11 and reduces test year expenses by $10,657 for temporary labor charges that should have been charged to PWW's affiliates. Adjustment # 29 in the amount of $20,637 pertains to Staff Audit Find # 13 to reduce test year expenses by that portion of Retiree Health – OPEB expenses that should have been allocated to PWW's affiliates. Adjustments # 30 and # 31 relate to Staff Audit Find # 14. Adjustment # 30 reduces test year expenses by $3,703 for that portion of Post Employee and Health Expense that should have been allocated to PWW's affiliates.

Q. Please explain why the amount of Adjustment # 30 differs from the amount indicated in Audit Find # 14 of $3,841.

A. In its review of the Company's general ledger, Staff found that the account balance of Post Employee and Health Expense was $16,099 instead of $16,703 as was indicated in the Final Audit Report. Therefore the allocation factor of 23% when applied to $16,099 results in a decrease in expenses of $3,703.

Q. Please explain why Staff is proposing an entry to annualize the test year Post Employee and Health Expense.

A. There is only one quarter of activity related to the Post Employee and Health account included in the test year since this was a program that was only initiated during the fourth quarter of 2003. Therefore, Adjustment # 31 in the net amount of $37,188 annualizes both the expense as well as the affiliate allocation related to this expense in order that the proforma test year may reflect a full year of activity for this new program.

Q. Please discuss Staff Adjustment # 32 to Administrative & General Expenses.

A. Staff Audit Find # 17 concerned Officer and Marketing related wages, benefits and vehicle charges that had been allocated to Pennichuck Corporation but charged in full to PWW. Adjustment # 32 reduces PWW's test year expenses by $82,075 for that portion of these Officer and Marketing related wages, benefits and vehicle charges that should have been allocated to PWW's affiliates.

Q. Please explain why the amount of Adjustment # 32 differs from the amount indicated in Audit Find # 17 of $81,455.

A. There appears to be a miscalculation contained in Audit Find # 17 relative to the benefits allocation to Pennichuck East Utility (PEU). The amount indicated in Audit Find # 17 as PEU's benefit allocation is $11,184. However, this amount should be $11,804 (15% x $78,690); a difference of $620.

Q. Please continue with your discussion regarding Staff's adjustments to Administrative & General Expenses resulting from the NHPUC audit.

A. Adjustment # 33 in the amount of $6,209 is related to Staff Audit Find # 18 and reduces test year expenses by that portion of officer wages that the Audit Staff found was erroneously charged to PWW instead of Pennichuck Water Service Company (PWSC). Adjustments # 34 and # 35 both pertain to Staff Audit Find # 19. Adjustment # 34 relates

PWW's share of legal costs that were incurred in the negotiation of the employment contract with the new President/CEO. This adjustment in the net amount of $4,542 reflects the capitalization of these costs as well as their amortization over the three year term of the employment contract. Adjustment # 35 in the amount of $1,369 reduces test year expenses by PWW's share of board fees that were actually incurred in 2002. Adjustments # 36 and # 37 relate to expenditures incurred during the test year that the Audit Staff deemed to be of a non-recurring nature. Adjustment # 36 involves $14,265 in parking rental fees that were incurred at the 4 Water Street office facility. As of April 1, 2004 the Company is no longer headquartered at this facility, therefore these charges are non-recurring and thus should be eliminated from the test year. Adjustment # 37 concerns expenditures for the former CEO's retirement party which amounted to $2,049. The Audit Staff also determined that these expenditures were also of a non-recurring nature and therefore they should be removed from the test year.

Q. Please discuss Adjustments # 38 through # 45 regarding Insurance Expense.

A. Several adjustments have been made relative to the Company's test year insurance expense and more specifically the allocation methodology employed by the Company to allocate the premiums associated with its various policies to its affiliates. These adjustments are based in part on the Final Audit Report submitted by the Commission Audit Staff and specifically Staff Audit Find # 12. Staff also propounded data requests regarding the Company's various insurance policies within the context of this proceeding.

Q. Please explain Staff's adjustments concerning PWW's General Liability Policy.

A. Adjustment # 38 in the amount of $14,760 as well as Adjustment # 39 in the amount of $35,968 were provided to the Audit Staff by the Company. The amount of Adjustment #

38 represents the total of recurring monthly journal entries made throughout the test year in order to allocate a portion of PWW's general liability insurance premiums to Pittsfield Aqueduct Company (PAC) and Pennichuck East Utility (PEU). During the course of the audit, the Company realized that both PAC and PEU each are covered by their own respective general liability insurance policies for which they pay premiums. Thus it was determined that the recurring journal entries had been recorded in error and should be added back to PWW's test year insurance expense. Adjustment # 39 is related to the same issue previously discussed in Adjustment # 38 whereby PWW also allocated a portion of its general liability insurance costs to each of its affiliates including PAC and PEU through its management fee allocation. Since PAC and PEU each own their own general liability insurance policies, the allocation of that portion of PWW's test year premium through the management fee to these companies in the amount of $35,968 should also be added back to the Company's test year insurance expense.

Q. Did the Company also propose adding back the general liability insurance premiums originally allocated to The Southwood Corporation (TSC) as well as Pennichuck Water Service Company (PWSC)?

A. Yes. However, Staff disagrees with that portion of the Company's proposed adjustment. Both TSC and PWSC are covered under the same general liability insurance policy as PWW. Therefore, Staff feels that it is appropriate for these two companies which share the benefit of general liability insurance coverage with PWW to also share a portion of the cost of this coverage. Without this allocation of cost, the Company's customers would be subsidizing the insurance coverage of the two non-regulated companies for the sole benefit of Pennichuck Corporation's shareholders.

Q. Please discuss Staff Adjustment # 40 concerning PWW's Boiler and Machinery Insurance.

A. Adjustment # 40 is also based on an adjustment provided by the Company to the Audit Staff in order to allocate a portion of the boiler and machinery policy premium to PAC and PEU. This premium had not previously been allocated through the management fee. Staff used the same allocation percentages from the management fee calculation that were previously used for the general liability policy with 13% of the premium going to PEU and 3% of the premium going to PAC. The total cost of the boiler and machinery policy allocated to these two companies was determined to be $849.

Q. Did the Company provide different allocation percentages for the allocation of the boiler and machinery policy premiums to PAC and PEU?

A. Yes. The Company provided an allocation percentage of 0.4% for PAC and 1.8% for PEU. These percentages were based on the pro-rata share of the combined premium paid on PWW's, PEU's and PAC's separately owned general liability policies. Staff does not agree with this allocation methodology in that Staff does not understand the correlation between the premiums paid on the separately owned general liability policies and the premiums paid on the boiler and machinery policy which provides joint coverage for PWW, PEU and PAC. Staff, instead, favors the use of the allocation percentages contained in the Company's current management fee arrangement which have been previously analyzed by Staff and approved by the Commission.

Q. Please explain Adjustment # 41 concerning PWW's Excess Umbrella Insurance.

A. Adjustment # 41 is also based on an adjustment provided by the Company to the Audit Staff in order to allocate a portion of the excess umbrella policy premium to PWW's affiliates. This premium had not been previously allocated through the management fee. Staff used the same allocation percentages from the management fee calculation that were previously used for the general liability policy as follows: PEU 13%; PAC 3%; PWSC 6%; TSC 1%. The total allocated cost of the excess umbrella policy to PWW's affiliates was determined to be $8,104.

Q. Did the Company not include TSC and PWSC in its original proposed adjustment for the excess umbrella costs provided to the Audit Staff?

A. Yes. However, Staff disagrees with that exclusion since both TSC and PWSC are covered under the same excess umbrella policy as PWW. Staff feels that it is appropriate for these two companies which share the benefit of insurance coverage with PWW to also share a portion of the cost of this coverage. Without this allocation of cost, the Company's customers would be subsidizing the insurance coverage of the two non-regulated companies for the sole benefit of Pennichuck Corporation's shareholders.

Q. Did the Company provide different allocation percentages for the allocation of the excess umbrella policy premiums to PAC and PEU?

A. Yes. The Company provided an allocation percentage of 0.4% for PAC and 1.8% for PEU. These percentages were based on the pro-rata share of the combined premium paid on PWW's, PEU's and PAC's separately owned general liability policies. Staff does not agree with this allocation methodology in that Staff does not understand the correlation between the premiums paid on the separately owned general liability policies and the premiums paid on the excess umbrella policy which provides joint coverage for PWW's affiliates including PEU and PAC. Staff, instead, favors the use of the allocation percentages contained in the Company's current management fee arrangement which have been previously analyzed by Staff and approved by the Commission.

Q. Please discuss Staff Adjustment # 42 concerning PWW's Workers Compensation Insurance.

A. This adjustment stems from Staff Audit Find # 12 where it was found that a portion of the Company's total workers compensation premium related to PWSC's operations in Salisbury, Massachusetts. A total of $2,627 should have been directly charged to PWSC during the test year. Therefore, Staff is proposing that this amount be removed from the Company's test year expenses.

Q. Please discuss Staff Adjustments # 43 and # 44 regarding PWW's Workers Compensation and Fiduciary Insurance Policies.

A. In response to Technical Session Data Requests 1-9 and 1-10 the Company indicated that its workers compensation insurance premiums as well as its fiduciary insurance premiums should be allocated to its affiliates at a percentage rate of 29%. Adjustment # 43 allocates the test year premium for workers compensation insurance after deducting the amount that should have been directly charged to PWSC as discussed previously with regard to Adjustment # 42. This results in an allocation of the remaining portion of the workers compensation premium in an amount of $10,919. Adjustment # 44 provides for the allocation of a portion of the test year fiduciary insurance premium in the amount of $711.

Q. Please explain Staff Adjustment # 45 concerning PWW's Damage to Dams Insurance.

A. Adjustment # 45 stems from Staff Audit Find # 12 regarding the allocation of Damage to Dams insurance. The Audit Staff determined that 3%, or $156, of the test year premium for this policy should be allocated to PAC. No amount was allocated to PEU because that company does not own any dams.

Q. Please discuss Staff Adjustment # 46 pertaining to the reallocation of the Executive Vice President's test year compensation.

A. In 2004, the Company's Executive Vice President was promoted to President of Pennichuck Water Service Company (PWSC); a non-regulated affiliate of PWW. In Staff Data Requests 2-13 and 3-16, the Company was asked to provide the Executive Vice President's monthly time reports for the months of January through October 2004. The Company provided these reports which show the time spent by the Executive Vice President on each of the Pennichuck affiliates. This information provides the basis for the allocation of the Executive Vice President's compensation amongst the various Pennichuck companies. Staff created an analysis showing the distribution of the Executive Vice President's time during the first 10 months of 2004. (See Schedule 2 of Attachment JPL-6) Staff then compared this analysis with the allocation of the Executive Vice President's time during 2003 which was provided to the Audit Staff in the Company's response to Audit Request # 91. (See Schedule 3 of Attachment JPL-6)

Q. What did this comparison show?

A. It revealed that the time devoted by the Executive Vice President to PWSC increased significantly from 2003 to 2004. Specifically, during 2003 approximately 2.51% of the Executive Vice President's time was devoted to PWSC. In comparison, through the first 10 months of 2004, that portion of the Executive Vice President's time spent on PWSC increased to 28.16%. With regard to PWW, the percentage of the Executive Vice President's time decreased from approximately 69.92% in 2003 to 64.43% in 2004. Staff's analysis appears to indicate that the Executive Vice President is now devoting much more time to PWSC and somewhat less time to the other affiliates including PWW. Since, the Executive Vice President is now serving as President of PWSC, Staff believes that this trend will continue into the foreseeable future. Staff further believes the Executive Vice President's test year compensation should be adjusted in order to reflect the current distribution of time spent per company.

Q. Did Staff prepare an analysis regarding the Executive Vice President's test year compensation.

A. Yes. Staff created an analysis which compared the actual compensation distribution recorded by the Company during the test year (per the Company's response to Audit Request # 91) to what that compensation distribution would have been based on Staff's compiled time distribution percentages for 2004. (See Schedule 1 of Attachment JPL-6) The left hand side of this analysis shows the actual test year allocation of the three compensation components (salary, benefits and vehicle costs) for the Executive Vice President. The right hand side of the analysis shows the distribution of these compensation components based on the 2004 distribution percentages.

Q. Please explain the columns entitled "Penn Corp Allocation (A/F # 17)" which appear in both sections of this analysis.

A. These reflect adjustments that are based on Staff Audit Find # 17 allocating officer compensation originally charged to Pennichuck Corporation (PCP) to the five Pennichuck affiliates using the management fee allocation percentages. Staff felt that since this allocation had been reflected in an earlier Staff adjustment (# 32) that it also should be reflected as part of this analysis.

Q. Based on this analysis, what adjustment is Staff proposing?

A. The far right-hand column of Schedule 1 of Attachment JPL-6 shows Staff's calculated test year adjustments in the three compensation components for each Pennichuck affiliate with the adjustments specifically pertaining to PWW highlighted in bold. This shows that as a result of the redistribution of the Executive Vice President's test year compensation, officer salaries should be reduced by $21,278, officer benefits should be reduced by $8,329 and officer vehicle charges should be reduced by $1,101. The net effect of Adjustment # 46 is a combined reduction in test year expenses of $30,708.

Q. Please discuss Staff Adjustment # 47 regarding test year salary accrual adjustments.

A. This adjustment pertains to Staff Audit Find # 9 regarding the discovery that the Company's test year included 53 pay periods. Normally, this would have no effect on a company's payroll expenses if an accrued wage adjustment were recorded at the end of the year. But in the case of PWW, while an accrued wage adjustment had been recorded for union employee wages, no accrued wage adjustment had been recorded for non-union employee wages. This resulted in a number of the Company's payroll accounts including an additional week of wage expense. In its responses to Staff Data Request 3-19 as well as Technical Session Data Request # 1-7 the Company determined both the 2002 and 2003 accrued wage adjustments pertaining to its non-union employees if they were recorded. Based on these responses, Staff developed an analysis to show the proforma effect on the test year by recording these proposed accrued wage adjustments. (See Attachment JPL-7)

Q. Please briefly explain Attachment JPL-7.

A. The Wage Adjustment section shows the entries that would have been recorded during the test year had the adjustments provided by the Company in its response to Technical Session Data Request 1-7 been recorded. The 2002 accrued wage adjustments would have been reversed during the test year resulting in a reduction in expenses while the 2003 accrued wage adjustment would have been recorded as an addition to test year expenses. The net result of these entries would have been a net reduction in test year wage expenses of $40,670. The Payroll Tax Adjustment section shows the effect on payroll tax expense resulting from the proposed accrued wage adjustments. The FICA tax percentage of 7.65% is applied to most of the categories with the exception of officers' wages and the health insurance opt-out. Only the Medicare Tax percentage is applied to officers' wages since it is anticipated that each officers' earnings are in excess of the Social Security Tax ceiling of $87,000. No tax percentage was applied to the health insurance opt-out category. Staff determined that the payroll tax effect of recording the accrued wage adjustments would result in a $2,336 reduction in test year payroll tax expense. The Management Fee and Work Order Based Allocation Adjustment section determines the effect on affiliate allocations that result from the proposed accrued wage adjustments. The allocation percentages were derived from the Company's schedules pertaining to these two allocations that were included in PWW's filing. Staff determined that the effect on affiliate allocations of the proposed accrued wage adjustments result in a $9,860 reduction in allocations to affiliates, thus test year expenses should be increased by this amount. As indicated at the bottom of Attachment

JPL-7, the net accrued wage adjustment determined by Staff results in an overall $33,146 reduction in test year expenses.

Q. Please discuss Staff Adjustment # 48 regarding expenses pertaining to the 4 Water Street Facility.

A. The Company's filing contained a proforma adjustment pertaining to the anticipated increase in the office lease expense resulting from the 2004 change in office locations. In its response to Staff Data Request 3-22, the Company indicated that various expenses related to the 4 Water Street facility were now included in the base rent of the new office facility. These expenses are listed in Adjustment # 48 with the exception of Parking Rental Expense which was eliminated from test year expenses by Adjustment # 36. Staff determined PWW's test year share for each of these expense items after taking into consideration both the PWW and PCP management fee allocations. Staff determined that a total of $34,885 should be deducted from the Company's test year expenses.

Q. Please discuss Staff's adjustments to the Company's proforma wage entries pertaining to Administrative & General Expenses.

A. Adjustment # 49 in the amount of $10,000 removes the Company's proforma entry for an accounting administrator position that was to be filled in September 2004. According to the Company's response to Staff Data Request 3-4, this position is now not expected to be permanently filled until 2005. Adjustment # 50 adjusts the Company's proposed proforma wages for a staff accountant that was to be hired in 2004. The Company's response to Staff Data Request 2-14 provided the actual effective date and annual wages for this new employee. Staff used this information in determining a $5,500 reduction in the Company's proposed proforma from $25,000 to $19,500. Adjustment # 51 in the amount of $15,000 removes the Company's proforma entry for a customer service representative position that was to be filled in July 2004. According to the Company's response to Staff Data Request 3-4, this position is now not expected to be permanently filled until 2005.

Q. Please explain Staff Adjustment # 52 pertaining to the Executive Vice President.

A. The purpose of Adjustment # 52 is to eliminate the Company's proforma adjustment related to a 2004 salary increase for the Executive Vice President. Page 7, Line 16 of the Direct Testimony of Bonalyn J. Hartley states, "*Effective April 1, 2004, the Executive Vice President of the Company also became President of Pennichuck Water Service Company and received a 4% increase* . . ." In addition, the description contained within the corresponding proforma entry on Schedule 1, Attachment C, Page 3 of the Company's filing includes the following: "*Salary increases of 4% for promotion of Executive VP to President of Service Co* . . ." Staff believes that since this salary increase appears to be directly attributable to the Executive Vice President's promotion as President of PWW's unregulated affiliate, it is not appropriate to include this increase as a proforma addition to PWW's test year expenses. Rather, this salary increase should be borne entirely by Pennichuck Water Service Company. The amount of Staff's adjustment in the amount of $3,679 is based on the Company's response to Staff Data Request 2-12.

Q. Please discuss Staff Adjustment # 53 regarding Non-union Employee Benefits.

A. Adjustment # 53 concerns the Company's proforma entries regarding the benefit adjustments for its non-union employees. The Company determined that the benefit adjustment for non-union employees was equal to 50% of the corresponding wages while the benefit adjustment for union employees was determined to be equal to 45% of the corresponding wages. Page 34 of the Commission Audit Staff's Final Audit Report states the following: "*Staff observed that the office staff benefits rate of 45% is the same as Operations employees. Benefit percentages are calculated on a per-employee basis at the end of each year. The Company has found that all employees benefits have been consistent within one or two percent. Accordingly, the Company feels that the current practice of calculating benefits for operations employees, then using that (percentage) for office staff, is the most effective use of resources, saving time and money.*" In Staff Data Request 2-19, the Company was asked to provide support for the 50% benefit rate for non-union employees. The Company's response indicated that the benefit rate for non-union employees at the end of the test year was 46%. The Company further stated, "*We used the 50% rate for benefits as the percentage of payroll varies from month to month depending on salaries, benefit increases, terminations, new hires, changes in employee family status (eg. Married, family, or divorced), etc. Benefit rates are set for the year to standardize a rate and to avoid complex calculations.*" Based upon the information provided in the Audit Report as well as the Company's response to Staff Data Request 2-19, Staff believes that the percentage used to determine the benefit adjustments for non-union employees should be adjusted to 45%. Adjustment # 53 results in a decrease of $9,757 in the proforma non-union employee benefits expense.

Q. Please explain Staff Adjustment # 54 regarding Employee Benefits.

A. Adjustment # 54 calculates the adjustment to benefits expense resulting from Staff's Adjustments to the Company's various wage proformas discussed previously in my testimony. The computation incorporates the 5% decrease in non-union employee benefits discussed previously (See Adjustment # 53) and results in a decrease of $32,244 in the proforma employee benefits expense.

Q. Please explain Staff Adjustment # 55 amending the Company's proforma insurance entry.

A. The Company proposed a proforma adjustment to insurance expense in the amount of $41,653 in order to reflect increases in its various insurance premiums which became effective in 2004. As a result of the NHPUC Staff Audit as well as the discovery conducted in this rate proceeding, much of the underlying data used by the Company in the determination of this proforma entry was amended. Staff created an analysis which recalculates PWW's insurance proforma using the updated information obtained in the course of discovery in this case. (See Attachment JPL-8) Staff's analysis results in a $17,256 increase in the Company's original proforma to an amount of $58,909.

Q. Please explain Staff Adjustment # 56 pertaining to the Public Utilities Tax Assessment.

A. In its response to Audit Request # 105 (See Attachment JPL-9), the Company indicated that its proforma entry pertaining to the Public Utilities Tax Assessment should be amended to an amount of $8,506. This is a $2,570 decrease from the Company's original proforma of $11,076.

Q. Please discuss Staff's adjustments to the proforma Management Fee allocated to affiliates.

A. Adjustment # 57 pertains to the wage and benefit proformas that have been previously adjusted by Staff and which impact the Company's management fee proforma. This adjustment reduces the Company's proforma management fee allocation to affiliates for wages and benefits and thus increases PWW's test year expenses by an amount of $9,679. The next adjustment relates to Adjustment # 52 where the non-union employee benefit percentage was reduced from 50% to 45%. Adjustment # 58 records the effect of this change on the proforma management fee. This adjustment also reduces the Company's proforma management fee allocation to affiliates for benefits and thereby results in an increase in the Company's total test year expenses by an amount of $1,359. Adjustment # 59 amends the insurance portion of the Company's proposed management fee proforma. The calculation of Staff's proposed revised insurance allocation appears on Attachment JPL-8. The allocation percentages on this schedule are based on Staff Adjustments # 38 - # 45 which have been previously discussed in my testimony. Adjustment # 59 results in a $9,166 addition to the Company's proposed insurance allocation of $3,402 in order to arrive at the new allocation amount of $12,568 which is detailed on Attachment JPL-8.

Q. Please discuss Staff's adjustments to the proforma Work Order Based Allocation to affiliates.

A. Adjustment # 60 pertains to the wage and benefit proformas that have been previously adjusted by Staff and which impact the Company's work order based allocation to affiliates for wages and benefits and thus increases test year expenses by an amount of $4,713. The next adjustment relates to Adjustment # 52 where the non-union employee benefit percentage was reduced from 50% to 45%. Adjustment # 61 records a decrease in the proforma work order based allocation to affiliates for benefits and thereby increases the Company's test year expenses by an amount of $1,071.

Q. Please explain Staff Adjustment # 62 to Property Taxes.

A. The Company's filing contained two proforma entries which together increased test year property taxes by an amount of $109,075. These adjustments were recorded in order that the test year property tax expense would reflect the full 2003 tax rate as well as the taxable additions in 2003 that had not been previously assessed. The Company's response to Staff Data Request 2-25 indicated two corrections in the tax rates used by the Company in determining its proforma entry. These changes result in a $189 decrease in the Town of Merrimack proforma taxes and an $11,190 decrease in the City of Nashua proforma taxes. The combined effect of Adjustment # 62 is an $11,379 reduction in the Company's proforma property tax adjustment.

Q. Please discuss Staff's proforma adjustments to Depreciation Expense.

A. In Staff Data Request # 2-26, the Company was asked to provide the test year depreciation expense that was recorded for assets that were retired during the test year. In its response, the Company provided an amount of $27,998. Staff is proposing Adjustment # 63 to reduce the test year depreciation expense by this amount since there will be no further depreciation on these assets during subsequent years. Adjustment # 64 is related to Adjustment # 5. The $99,673 reduction in depreciation expense represents Staff's proposed amortization in the Company's calculated variance between its booked and theoretical depreciation reserves as explained previously in my discussion regarding Adjustment # 5. (See Attachment JPL-2)

Q. Please explain Staff's proforma adjustment to Amortization Expense.

A. Adjustment # 65 pertains to Staff Audit Find # 1 regarding $8,649 in recruiter fee expenses that should have been allocated to PWW's affiliates. A related entry

(Adjustment # 25) pertains to the same audit find and is explained in the discussion regarding Administrative and General Expense adjustments.

Q. Please briefly explain Schedule 3B of Attachment JPL-1.

A. This schedule calculates the income tax effect of the above described revenue and expense adjustments. Adjustments # 13 - # 65 result in a net increase of $577,948 in the Company's proforma net operating income. The tax effect of this is a marginal increase in the New Hampshire Business Profits Tax by an amount of $49,126 calculated at a rate of 8.50% as well as a marginal increase in Federal Income Taxes by an amount of $179,800 calculated at a rate of 34.00%.

Q. Has Staff computed the rate impact of its recommended revenue increase.

A. Yes. Based on the Company's proposal that none of the revenue increase be applied to fire protection rates, the 6.50% revenue increase translates into a 7.71% rate increase for all other rate classes. The 7.71% increase is in comparison to rates in effect prior to this case and the implementation of temporary rates. For an average residential customer with a 5/8 inch meter and using 12,400 cubic feet of water a year, the annual bill would be approximately $333.90, an increase of $23.88 per year, or $1.99 per month.

Q. Does this conclude your direct testimony?

A. Yes.