

STATE OF NEW HAMPSHIRE
BEFORE THE
NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

CITY OF NASHUA'S PETITION FOR VALUATION PURSUANT TO RSA 38:9

Docket No. DW04-048

DIRECT TESTIMONY OF BRIAN S. McCARTHY

Q: PLEASE STATE YOUR NAME AND POSITION WITH THE CITY OF NASHUA?

A: My name is Brian S. McCarthy and I am an Alderman-At-Large and President of the Board of Alderman for the City of Nashua having served in that capacity since January, 2004. Prior to that I was Alderman from Ward 5 from 1994 through 2003. I have been Chairman of the Aldermanic Pennichuck Special Water Committee since it was formed on November 13, 2002.

Q: WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A: I am testifying in support of the City's Petition for Valuation under RSA 38:9. I hope to provide the commission with background concerning the City's desire to acquire the assets of Pennichuck Water Works, Inc., (PWW), Pennichuck East Utility, Inc., (PEU), and Pittsfield Aqueduct, Inc., (PAC). It is also my intent to establish how important the ownership and control of these assets is to the City and region. Finally, although it is my understanding that the City's acquisition of these assets is already presumed to be in the public interest because a majority of the City's voters voted in favor of acquiring them, the purpose of my testimony is to provide further support for the presumption of public interest.

Q: WHEN DID THE CITY FIRST BECOME INTERESTED IN THE OPERATIONS OF THE PENNICHUCK COMPANIES, WHICH ULTIMATELY LED TO THE CITY'S PETITION?

A: Pennichuck has operated in Nashua in one form or another since the 1800's. In recent years there has been concern about its growing real estate operations and what some believe is its failure to protect the watershed through those real estate operations. On June 14, 2002 Pennichuck Corporation, the parent of PWW, PEU and PAC, announced that it had petitioned the Commission to approve the indirect acquisition of the subsidiaries by Philadelphia Suburban Corporation (PSC) to be accomplished through the merger of Pennichuck into a wholly owned subsidiary of PSC. Initially Nashua was not opposed to the merger, although there was considerable public concern about an out-of-state company owning and operating the City's water system. That concern was exacerbated by the fact that one of PSC's largest shareholders was a foreign company. Following its intervention in the docket established by the PUC regarding the merger, the City engaged consultants to advise it concerning the merger and to conduct a comprehensive review of the Pennichuck system. Simultaneously, the City participated in discussions with its citizens and representatives of other municipalities relating to the formation of a regional water district.

Q: WHAT WERE THE CONCLUSIONS OF YOUR CONSULTANTS?

A: The consultants presented a number of options to the City including the following:

- a. Recommend the merger not be approved.

- b. Recommend that the merger be approved with conditions.
- c. Take PWW.
- d. Create a regional water district and take the assets of PWW and PEU.

The consultants further concluded that public ownership in general is financially beneficial to customers due to the fact that public entities do not pay taxes or dividends and can raise capital at much lower rates than investor owned utilities.

In addition, public ownership has the opportunity to build equity in the utility over time as the debt is paid down.

Q: WHAT DID THE BOARD OF ALDERMAN DO UPON RECEIPT OF THE CONSULTANTS RECOMMENDATIONS?

A: The recommendations were made on November 1, 2002. As I said earlier, an Aldermanic Pennichuck Special Water Committee was formed on November 13, 2002. Thereafter, on November 26, 2002 by a vote of 14 – 1, the Board of Alderman pursuant to RSA 38:3 determined that it was expedient for the City to establish a water works system and to acquire all or a portion of the water works system currently serving the inhabitants of the City and others. Because it was the intent of the Board to acquire the assets, not only of PWW but also PEU and PAC, the board authorized the mayor to support, along with other municipalities proposed legislation to establish regional water districts and in particular to support the formation of a regional water district including the City.

Q: WAS THAT RESOLUTION OF THE BOARD OF ALDERMAN CONFIRMED BY THE VOTERS OF THE CITY?

A: Yes. At the November 26, 2002 meeting the Board authorized a special meeting of the voters of the City to be held as a special election for the purpose of confirming the vote of the Board of Alderman, that it was expedient for the City to establish water works system. Thereafter, a very public campaign was conducted by the City to make sure the voters understood what it proposed to do. Pennichuck made clear its opposition. A number of public hearings were held to discuss the acquisition. The public discussion was well covered by the Nashua Telegraph and copies of the articles that appeared in the newspaper are attached as Exhibits A to G. The City was clear throughout this period that it intended to acquire assets located outside Nashua and that it intended to participate in a regional water district. On January 14, 2003, with a turnout of approximately 20% of the registered voters of the City, the resolution of the Alderman was confirmed by a margin of 6,525 to 1,867, or a 78% majority.

Q: FOLLOWING THE CONFIRMATORY VOTE, WHAT DID THE CITY DO?

A: On January 28, 2003, pursuant to RSA 38:6, the Board of Alderman determined that all of the property of PWW, PEU and PAC was necessary for its municipal water service (Exhibit H) and on February 5, 2003 gave notice to PWW, PEU and PAC of the vote and made inquiry whether they would sell the property it had identified. Copies of the notices are attached to Nashua's Petition as Exhibits B, C and D. On March 25, 2003, PWW, PEU and PAC responded to the City's notice, pursuant to RSA 38:7, in the negative. After the Pennichuck companies responded in the negative to the City's inquiry, under RSA 38:6, the City decided it would be in all parties interest to continue to pursue a possible agreement on the

basis of President and CEO, Maurice Arel's, earlier press statement of November 28, 2002 (copy attached as Exhibit I), which indicated that Pennichuck would only accept a superior offer from the City compared to PFC's offer worth \$106 million. He listed items totaling approximately \$13 million. On April 2, 2003, Mr. Arel stepped down and the interim CEO, John Kreick, told city representatives on April 10, 2003 that Pennichuck would entertain an offer for the entire company including the two non-regulated subsidiaries, Southwood Development Corporation and Pennichuck Services Company. Mr. Kreick also advised that negotiations would need to await appointment of a new permanent President and CEO.

Q: FOLLOWING THESE DISCUSSIONS WITH REPRESENTATIVES OF THE PENNICHUCK COMPANIES, WHAT DID THE CITY DO?

A: The City had already obtained a comprehensive report on the Pennichuck companies; the history of its operations; the status of its supply, treatment and distribution system; and the issues of public versus private ownership and control. The City also obtained a preliminary appraisal of the value of the five Pennichuck companies as of December 31, 2002 prepared by George E. Sansoucy, PE, LLC. For purposes of negotiation with Pennichuck, the City hired the law firm of Devine, Millimet & Branch, PA, it also had as its advisors, its long time bond counsel, Palmer & Dodge of Boston, Massachusetts and its long time financial advisors, First Southwest Company, a major investment banking firm in public finance which has in-house expertise on municipal acquisition and operation of water companies. During July 2003, counsel for the City and Pennichuck met and

discussed, inter alia, taxation issues, a possible management contract and financing alternatives. Because the City had been advised by members of its legal staff that it did not have the power to purchase the stock of private companies or the assets of non-utility private businesses (Southwood Corporation and Pennichuck Services Company), the City sought and found a third party willing to buy those companies at a certain price if the City could reach agreement on a overall price with Pennichuck. For the purpose of avoiding prolonged time, expense and litigation, the City ultimately decided to offer a sum for the assets of all five Pennichuck companies that would include a reasonable premium over the appraised value the City had in hand, designed to offset the estimated tax impact of the sale on the Corporation. The offer was for \$121 million dollars and was made on November 20, 2003.

Q: DID PENNICHUCK ACCEPT THE OFFER?

A: No. The offer was rejected on December 15, 2003. The parties met again on January 7, 2004 in an attempt to bridge their differences. On January 27, 2004 Pennichuck indicated that it declined to negotiate further and on February 4, 2004 filed its first lawsuit.

Q: DO YOU BELIEVE PENNICHUCK EVER INTENDED TO SELL ITS ASSETS TO THE CITY?

A: No. I now believe that Pennichuck negotiated with the City throughout this period to allow time for its public relations campaign to turn public opinion against the City's acquisition and the regional effort and in hopes that the November 2003 election results would change the City's policy on the

acquisition. Meetings were difficult to arrange and then typically scheduled weeks in the future.

Q: FOLLOWING PENNICHUCK'S TERMINATION OF NEGOTIATIONS AND THE FILING OF ITS FIRST LAWSUIT, WHAT DID THE CITY DO?

A: The City moved as quickly as possible in February and March 2004 to appropriate funds for consultants and legal counsel to plan for and pursue eminent domain under RSA 38.

Q: WHY DIDN'T THE CITY FILE A PETITION UNDER RSA 38 EARLIER?

A: The City and its advisors believed that voluntary negotiations were more likely to be successful in the absence of such a petition.

Q: WHAT HAPPENED TO THE EFFORT TO FORM A REGIONAL WATER DISTRICT?

A: During the summer and fall of 2003 a regional water district committee drafted a proposed regional district charter and submitted it to the governing bodies of the various municipalities. It has since been approved by the City of Nashua and seven towns, which now comprise the Merrimack Valley Regional Water District.

Q: WHY DO YOU BELIEVE IT IS IN THE PUBLIC INTEREST FOR NASHUA TO ACQUIRE THE ASSETS OF PWW, PEU AND PAC?

A: Water is a crucial community resource, which should be locally owned and controlled. Pennichuck Corporation has been clear that it (including PWW, PEU and PAC) is for sale and the most likely acquirers are foreign. The City will not accept control of water decisions which are made by a company so removed as to

be unaware and unconcerned with long term effects on the community, nor decisions on long term supply of water or protection of a water source which are based on short term revenue interests rather than sound planning for the future. Moreover, the Board of Alderman has found that the maintenance of an adequate supply of clean, affordable drinking water is essential to the viability of any community; that the maintenance of an adequate supply of water for the protection of life and property is essential to the viability of any community and that the maintenance of an adequate supply of clean, affordable water to be used for commercial purposes within the City is essential to the economic viability and orderly growth of the community. It further found that the maintenance of a water system, which performs these purposes, was best served by the formation of a regional water district representing the several towns and cities impacted by it. Nashua seeks to acquire all of the assets of the three Pennichuck regulated utilities because the City believes it would promote the interest of all customers/rate payers, the general public, the employees of Pennichuck and the owners of Pennichuck. Specifically, Nashua asserts that acquiring the assets of PWW, PEU and PAC, including those outside of Nashua, is in the public interest because it will eliminate any claim for severance losses by any of the Pennichuck companies; it will prevent likely rate increases for that portion of the system which is not acquired by Nashua due to the need to generate additional revenue to offset proportionally higher operating expenses; it will protect the level of service to be received by PEU and PAC customers; and it will mitigate harm to Pennichuck and Pennichuck shareholders by eliminating the need to operate a

small or less efficient and less profitable portion of the system. The will of Nashua voters would be implemented; the goals of the Merrimack Regional Water District, organized under Laws 2003, Chapter 281 would be promoted; rates would be lower over time; service would remain adequate; water supplies would come under long range public control; continued employment of Pennichuck operation and maintenance personnel would be reasonably accommodated; and Pennichuck owners would receive fair value for their assets without the disadvantages of retaining ownership of smaller systems only.

Q: DOES THE CITY INTEND TO CONVEY ANY ASSETS IT ACQUIRES TO THE MERRIMACK VALLEY REGIONAL WATER DISTRICT?

A: If the City is successful in its acquisition of the assets of PWW, PEU and PAC it is the intent of the City to convey those assets to the regional water district. The City's support for and participation in the regional water district is based upon the City's determination that regional control over the water supply and distribution is in the best interest of Nashua as well as the surrounding areas. The City is not, however, a "stalking horse" for the regional water district as has been suggested by the Pennichuck companies. Rather, the City takes the position that its acquisition of the Pennichuck assets outside of Nashua is in the public interest whether or not the regional water district ultimately owns and controls them.

Q: DOES THE CITY HAVE THE TECHNICAL CAPABILITY OF OWNING AND OPERATING A WATER UTILITY?

A: Yes. Nashua is the second largest City in NH and interestingly the only City in the State which does not own its water system. It provides all the municipal services of a large, urban municipality, including but not limited to wastewater

collection and treatment, storm water collection, streets and highways, solid waste disposal and police and fire departments. Moreover, Nashua owns and manages a large and complex physical plant, including but not limited to, a city hall, schools, a public works building, a police station, fire stations and a wastewater treatment plant. This physical plant has a value of approximately \$300 million (as compared to the \$85 million of value of the Pennichuck assets the City seeks to acquire). Nashua provides all of these services and performs all of these functions through a capable and professional staff. The City is also in a better position than an investor owned utility to implement a water conservation program. Water conservation is an important priority for the City. Finally, as I will discuss in greater detail below, the City intends to contract out the day- to- day operation of the system and management oversight to skilled operating companies.

Q: DOES THE CITY HAVE THE MANAGERIAL CAPACITY OF OWNING AND OPERATING A WATER UTILITY?

A: Yes. A water utility is a good example of a function in which skilled operating companies are available to physically operate the system while the City retains ownership and the financial benefits that come from municipal ownership. It is Nashua's intent in the management of the water system to employ contractors to perform the day-to-day operation and maintenance of the system and to exercise certain management oversight. The City has sought expressions of interest in these contract operations and has received eleven (11) positive responses, including one from Pennichuck Service Company, Inc. The City is reviewing

drafts of solicitations for proposals in this regard. The first is for direct operation and maintenance of the assets and the second is for the management oversight function. The City intends to have contracts in place when ownership transfers. The City will also provide the legal framework for the operation of the water system by adopting a Water Ordinance, a draft of which is presently being reviewed. It is intended, and probably required in order to comply with covenants that are likely to be incorporated into bonds that will finance the acquisition, that the City Finance Director and her staff will perform all treasury functions. In addition to the operating and oversight contractors, the City has its own Public Works Department which presently operates its wastewater collection and treatment facilities in close conjunction with the operations of PWW.

Q: DOES THE CITY HAVE THE FINANCIAL CAPABILITY TO OWN AND OPERATE A WATER UTILITY?

A: Yes. RSA 33-B permits the City to issue bonds for the acquisition of revenue producing facilities such as a water works system. These bonds are referred to as revenue bonds and are secured by the revenues from the water works system as opposed to government obligation bonds which are secured by a pledge of the faith and credit of the municipality, or in other words, by the ability of the municipality to raise taxes. Because Nashua will be able to roll its expenses of acquisition into the revenue bonds used to pay for the acquisition, Nashua taxpayers will not ultimately bear any cost of the acquisition or purchase. Nashua can also borrow through the issuance of revenue bonds, funds necessary for extraordinary capital improvements. Nashua intends such borrowing

simultaneous with its acquisition borrowing for capital improvements to the water treatment plant. The operations and maintenance of the water works system, including repayment of the revenue bonds, will be funded by rates. Because of the City's lower cost of money and operation, it believes ratepayers in the short-term will experience rates no worse than those charged by the Pennichuck Companies. Over time, the City expects to charge rates lower than what ratepayers could expect if the Pennichuck Companies returned ownership. Because the City will make a payment in lieu of taxes (PILOT) for any property it acquires, its ownership will not impose any burden of the taxpayers of any municipality in which the property is located.

Q: WOULD THE TECHNICAL MANAGERIAL AND FINANCIAL CAPABILITIES YOU HAVE DESCRIBED BE IMPACTED IF THE COMMISSION PRECLUDED NASHUA'S ACQUISITION OF ANYTHING OTHER THAN THE CORE SYSTEM OF PWW?

A: No. Such a ruling by the PUC would reduce the size of the system Nashua could acquire but only minimally. Our consultants have advised the City that the so-called core system represents most of the value of PWW and includes the water treatment plant and all the reservoirs as well as the distribution system hydraulically connected to the treatment plant. Nashua does not believe PEU or PAC would be entitled to severance damages if the acquisition was limited to the core system or that PWW would be entitled to any premiums because of any claimed benefit its assets provided to PEU or PAC. If severance damages were, however, ordered by the Commission the impact is believed to be marginal on

subsequent rates. Nashua has always expressed the preference to purchase assets rather than pay severance in an effort to avoid any impact on rates. If Nashua was limited to the core system, its technical, managerial and financial capabilities would not be impacted except perhaps improved to the extent it was required to pay less for the assets and had lower costs of operation. Nashua's capabilities would not otherwise be affected.

Q: DOES THIS CONCLUDE YOUR TESTIMONY?

A: Yes.