

**Nashua Pre-filed Testimony
Of Steven A. Adams
First Southwest Company**

1. What is your name and by whom are you employed?

My name is Steven Adams. I am a Senior Vice President for First Southwest Company, where I have been employed for over 15 years.

2. What is First Southwest Company and what is its relationship to the City of Nashua?

First Southwest Company is the financial advisor to the City of Nashua and we have served in this capacity for the past 15 years. As financial advisor, our role is to advise the City in all aspects of issuing municipal bonds. We assist in preparing financial plans, preparing offering documents, assist with attaining ratings and bond insurance and we are generally responsible for coordinating all of the people responsible for completing a bond issue. As a broker/dealer, we are regulated by the National Association of Securities Dealers and the Securities and Exchange Commission.

3. What is your experience in the preparation and sale of bonds for local governments?

First Southwest Company is one of the largest financial advisory firms in the nation. From January 1, 1999 through August 30, 2004 we served as financial advisor on 2,835 bond issues totaling \$85.2 billion. Of this amount 609 issues totaling \$8.28 billion were specifically for water and wastewater revenue bonds.

In the past 15 years we have assisted the City of Nashua in the issuance of \$264,505,000 general obligation bonds comprised of 16 bond issues.

Because of our experience, First Southwest Company has a vast knowledge of the credit requirements of municipal bond rating agencies and municipal bond insurance companies. In fact, First Southwest Company is one of the largest worldwide customers of Standard and Poor's Rating Service, despite the fact that all of our business with them is public finance business. Additionally, we work with all of the recognized triple A rated municipal bond insurance companies. Our experience working with the rating agencies and insurance companies allows us to understand first hand and in great detail their requirements for investment grade municipal debt.

Additionally, we have served as lead managing underwriting on 830 debt issues totaling \$8.57 billion from January 1, 1999 to August 31, 2004. In terms of number of transactions, only 17 firms in the nation underwrote more bond issues than us. Of the total issues underwritten by First Southwest Company, 271 totaling \$1.262 billion were for water and wastewater revenue bonds. In this category only four firms in the nation wrote more debt issuances than First Southwest Company. Without question, First Southwest Company is one of the nation's leaders in both financial advisory work and underwriting of water and wastewater revenue bonds. This experience allows us to understand the investing community. Our sales force works very closely with most every major institutional investor of municipal bonds. This also helps us to determine the best structures and covenants for municipal financings.

First Southwest Company is also a leader in New England. First Southwest Company has approximately 300 clients in New England. During the past 3 years we have served as financial advisor on more than 1,000 bond and note issues totaling more than \$10 billion.

At First Southwest Company, my primary experience is working with clients that issue water and wastewater and electric utility revenue bonds. I currently work with approximately 20 clients on a continuing basis that issue water and wastewater revenue bonds. These clients vary from large water utilities that issue bonds several times a year to small utilities that issue bonds once every few years.

Prior to working for First Southwest Company, I was employed at the Texas Water Development Board (the "TWDB") as a financial analyst. The TWDB purchased bonds for water and wastewater projects from political subdivisions within the State of Texas. I was responsible for reviewing the credit on those applications and making recommendations for loans to the Board of the TWDB. I was employed at the TWDB for approximately three years. Additionally, I helped conceive and create a State revolving fund that utilized State and federal funds as a part of the 1987 Clean Water Act. The TWDB created and sold revenue bonds backed by the loan revenues to establish this program.

Prior to working for the TWDB, I worked for the City of Austin, Texas where I was an analyst in the Debt Management division of the Budget Office. During that time, I worked on the team that was responsible for issuing general obligation, water and wastewater, electric utility and other debt of the City of Austin. I was employed at the City for approximately one year. During that time, the City of Austin sold numerous revenue bond issues totaling hundreds of millions of dollars.

Within First Southwest Company I spend most of my time studying and developing revenue bond structures. It is for that reason that I have been asked to work with Nashua by our firm.

4. What is the purpose of your testimony?

The purpose of my testimony is to state the opinion of First Southwest Company, from a financial perspective, that the bonds proposed by the City of Nashua are marketable at the rates used in the City's financial plan for the acquisition of Pennichuck's regulated water utilities.

5. Have you examined the borrowing portions of the financial plan?

Yes. I have examined the financing plan the appears as Exhibit GES-7 of George Sansoucy's testimony.

6. Please describe them.

The financing plan is a long-term projection of cash flows of a utility system. It projects operating revenues, operating expenses, capital expenditures, required debt issuances and fund balances. It is based upon the audited financial statements and regulatory filings of Pennichuck; proposed ordinances and structures of the City of Nashua; and expert projections of George Sansoucy & Co. We have worked with George Sansoucy's staff in developing a traditional revenue financing plan. We relied on Sansoucy for the following information:

Operating Revenue Projections;

Operating Expense Projections;

Growth assumptions; and

System purchase price.

We incorporated the future capital costs as projected by Pennichuck.

Once the basic operating revenues and expense were projected, we could determine how many future bond issues were needed to fund the capital program.

We then developed the size and cash flow structure of a traditional municipal utility financing structure as described below.

Based upon the assumptions by Sansoucy and the bond issue requirements of the rating agencies and market place; it appears that the City of Nashua could issue investment grade securities and qualify for municipal bond insurance

7. What does the bond market look for in municipal revenue bonds backed by the revenues of a municipally owned utility?

The credit features of a revenue bond can be broken into four main areas:

- Management
- Financial Strength
- Legal Covenants; and
- Demographics.

I believe that the City can satisfy the minimum requirements for an investment grade credit rating in all four of these areas.

Management

Management can be broken down into two main areas: financial management and operating management. As for the financial management, the City of Nashua already has the necessary expertise in place to serve these functions. The City owns and operates a very successful wastewater utility. All of the required areas of financial management that are required for an investment grade credit rating can easily be assimilated into the City's current management structure. For example, the City already bills and collects funds; invests funds; prepares budgets and audits and all other necessary functions with regard to financial management.

Notwithstanding this current experience, the City has made the policy decision to contract for the financial management and operation and maintenance of the water utility. Accordingly, Nashua is in the process of selecting firms for the financial and operations management of the utility. Several well qualified firms have expressed interest in working with the City to manage the operations and financial management of its utility. It is my opinion that Nashua's management plan will be acceptable to qualify the bonds for investment grade credit ratings and municipal bond insurance.

Financial Strength

While a City owned water utility does not exist at this time, the cash flow projections that have been developed indicate that there is adequate cash flow for the utility to attain an investment grade credit rating and qualify for municipal bond insurance. Since the cash flow model that we have developed is based upon the actual results of Pennichuck, there

is great comfort in the fact that Pennichuck has been in existence for a long time. This is much easier than proving revenues from a completely new venture with no real track record.

Furthermore, the City of Nashua holds a Aa2 general obligation from Moody's Investors Service and a AA+ rating from Standard & Poor's Ratings, Inc. There are very few entities, municipal or corporate, that have ratings this high. While the City's general obligation rating has no direct bearing on the proposed utility rating, the fact that the City is so strong indicates that the City is well managed. It is rare that you will find a City's utility rating higher than its general obligation rating. In some cases, the general obligation rating serves as a ceiling. Nashua's "ceiling" is very high. This will be very helpful for the utility side. Given the history of Pennichuck; the pro-forma cash flow models; and the strong financial position of the City, we believe that the financial strength will be adequate to warrant an investment grade rating and qualify the issue for bond insurance.

Legal Covenants

A traditional revenue bond financing has legal covenants that are defined in the bond resolution. The resolution is a contract between the issuer and the investors and defines the rules by which the utility must operate while any revenue bonds are outstanding. The major provisions of revenue bond resolutions include:

Flow-of-Funds;

Security for the Bonds;

Rate covenant;

Additional Bonds Tests;

Reserve Fund Requirements.

From the standpoint of selling revenue bonds, the ability to negotiate the details of the legal structure with rating agencies and bond insurance companies prior to selling the bonds is a great advantage. Often, existing legal covenants have legal structures that create rating issues for municipal clients. Nashua will not have that issue.

Let me start by defining the flow-of-funds. The flow-of-funds defines how dollars flow through the utility. The bond resolution would require the money is initially deposited into a Revenue Fund. From there, money is used to pay all operating expenses necessary to operate the utility. The Operating Revenues less the Operating Expenses is the Net Revenues. After paying the operating expenses, funds flow to the debt service fund. The debt service fund is used to make payments to the bond holders. Once the debt service fund payments have been made as required, funds flow to the reserve fund to make up for any short falls that may have occurred if those funds had to be used to make debt service payments. Finally, funds flow to “any legal purpose” associated with operating the utility. Generally, these funds are used for capital projects to reduce the need for future debt. Our modeling uses the funds in this manner. This flow-of-funds is consistent with the requirements for investment grade bond ratings and the requirements of bond insurance companies.

The security for the bonds is the legal pledge that the bondholders have to secure the debt. We recommend that the bondholders have a lien on and pledge of the net revenues of the system as defined above. This pledge acknowledges that a system must pay its operating expenses in order to be of any value to the bondholders. This pledge is consistent with municipal revenue bonds sold throughout the nation and is readily accepted in the market. This pledge will allow the bonds to be investment grade rated and qualify for municipal bond insurance.

The rate covenant defines the minimum rate that the issuer legally obligates itself to charge. We recommend that the rate covenant require that rates are high enough to produce net revenues that exceed debt service by 110%. This rate covenant will qualify the bonds for investment grade credit ratings and municipal bond insurance.

The additional bonds test is a mathematical revenue test that an issuer must meet in order to sell subsequent bond issues with a parity pledge to outstanding bonds. It protects the current bondholders from an issuer issuing so much debt that it deteriorates the financial condition of the issuer enough to warrant a ratings downgrade. From the issuer's standpoint, it can issue bonds by meeting the requirements of the bond ordinance without having to attain specific permission to issue debt from the bondholders. The primary calculation associated with this covenant is that the net revenues from the previous year must equal 125% of current and proposed average annual debt service. All of our pro-forma models take this calculation into account. We project that any debt that needs to be issued to meet the capital improvement plan as projected by Pennichuck will fall within the limits of the additional bonds test. This additional bonds test will qualify the bonds for investment grade credit ratings and municipal bond insurance.

Water system revenue bonds typically require a reserve fund held for the benefit of the bond holders. The reserve fund generally is equal to the lesser of (i) ten percent of the bond issue size; (ii) 125% of the average annual debt service requirements, or (iii) maximum annual debt service requirements. This definition is a part of the Federal tax law that defines arbitrage rebate requirements for issuers of tax-exempt bonds; therefore, it is an industry standard that will be in Nashua's revenue bonds covenants. We will also allow for this reserve fund to be provided by a bond insurance company in the form of a reserve fund surety policy. The determination as to whether or not to fund the reserve fund with cash or an insurance policy is made at the time of issuance when we will have a better understanding of expected investment rates and the cost of the insurance policy. Either funding option will qualify the bonds to attain an investment grade rating and to qualify for bond insurance.

Demographics

The southern New Hampshire area has excellent demographics, according to Standard & Poor's Corporation and Moody's Investors Service, Inc. Although both cite a decline in the local economy over the last three years, they both indicate that the economy still exceeds state and national employment averages and believe that the City's location and

tax advantages will support growth in the future. Given the high ratings of the City's general obligation bonds and the comments of the rating agencies, one can conclude that the demographics of the Nashua area support investment grade bond ratings and meet the minimum requirements of bond insurance companies.

8. Can a bond issue incorporating the interest rates and payment schedule of the plan be sold by the City of Nashua?

The United States has a very sophisticated municipal bond market. Through September of 2004, the average daily trading volume of municipal bonds exceeded \$14.6 billion. As of March 31, 2004, a total of \$1.9 *trillion* of municipal bonds were outstanding. Clearly, there is a liquid market for municipal bonds. Today, over 80 percent of Americans receive their water from publicly owned water utilities. Almost all of those utilities are investment grade rated. Water system revenue bonds are a large part of the municipal bond market. Investment grade water system revenue bonds are essentially a commodity. Because the market is so large and liquid, the issue of interest rates depends on market rates, not issuer specific rates.

Since projecting interest rates is difficult, at best, we used higher than market projections in developing the model. For example, the model that we used has a 5.0% interest rate. If we were to sell bonds at November 2004 interest rates, the bonds would likely be sold at rates below 4.6% based upon actual sales. While we know that the Federal Reserve System may continue raising short-term interest rates, they have a stated goal of not impacting long-term interest rates. In fact, since the Federal Reserve has raised short-term rates, long-term tax exempt rates have fallen. Based upon these facts, we believe that the rates and structure in our model are achievable.

9. Is this the only financing plan possible for the City of Nashua?

No. There are many financing options. The model we prepared contemplates using 25 year fixed rate debt with ten year call provisions. This structure is by far the most common and most conservative approach; however many utilities, particularly large utilities have incorporated very sophisticated fixed and variable rate programs that

include the use of derivative products. The plan that we used is the most conservative and simplified approach.

10. Have you taken into account the possibility that the Nashua Regional Water District may take over the system?

Yes, it is our plan to inform the rating agencies, bond insurance companies and investors, that the City reserves the right to transfer the assets and the debt to a regional water district. We will covenant that such a transfer will not change the credit rating, the tax-exempt status and the legal covenants relating to the bonds outstanding. We can accomplish this if the district attains the same customer base and ratemaking powers.

11. Does this conclude your testimony?

Yes.