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July 11, 2024

Via Electronic Mail

Hon. Sherri Golden, Board Secretary
New Jersey Board of Public Utilities
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RE: I/M/O the Petition of Fayson Lake Water Company for Approval of a Financing Transaction, BPU Docket No.: WF24030184

Dear Secretary Golden:

Please accept for filing in the above-referenced matter the New Jersey Division of Rate Counsel's ("Rate Counsel") comments concerning Fayson Lake Water Company's ("Fayson Lake" or "the Company") March 18, 2024 petition to the New Jersey Board of Public Utilities ("Board") requesting authorization to issue up to \$1.415 million of long-term debt to finance the costs of the construction and installation of new 8" and 6" water mains replacement for the Fayson Lake community and to finance the transaction closing costs.

Consistent with the Order issued by the Board in connection with *In the Matter of the New Jersey Board of Public Utilities' Response to the COVID-19 Pandemic for a Temporary Waiver of the Requirements for Certain Non-Essential Obligations*, BPU Docket No EO20030254, dated March 19, 2020, these documents are being electronically filed with the Secretary of the Board and with Fayson Lake. No paper copies will follow.

A.

Background

Fayson Lake, a regulated public utility with offices in Kinnelon, New Jersey, is engaged in the distribution and sale of water utility service to approximately 890 customers, all of whom reside in the Fayson Lake community located in Kinnelon, Morris County.

On March 18, 2024, Fayson Lake filed a petition (“Petition”) and supporting documents with the Board for a financing transaction where the Company seeks authorization for a bank loan up to \$1,415,000 to finance the installation of new 8” and 6” water main replacements and telemetry equipment for the Fayson Lake community.

The proposed loan transaction will be in two phases. The first phase was during the construction period, which was in 2023 and early 2024. The funds used during construction and financed by the “Construction Loan” are intended to be a one-year, interest only loan.

Fayson Lake intends to convert the Construction Loan into a 15-year Term Loan on January 1, 2025. After the conversion, Fayson Lake will be required to make monthly interest and principal payments on the Term Loan until the note is retired, in 15 years.

Interest on principal drawn during the construction period was set at the Prime Rate plus 100 basis points, provided the rate is not less than 8.35 percent. Fayson Lake reported that the actual interest rate on the Construction Loan is 9.5%. Following the conversion to a 15-year Term Loan on January 1, 2025, and for the first five years thereafter, the interest rate will be based on the 5-year US Treasury Note rate then in effect plus 300 basis points, but not less than 6 percent. At the time that Fayson Lake’s financing petition was filed it was projected that the interest rate would be 7.15% at the time of conversion. The interest rate for the Term Loan will reset after five years based on the then-current 5-Year Treasury Note rate and will remain in effect for years five through ten of the Term Loan. The same resetting process will take place in year ten and the new rate will remain in effect for years ten through fifteen of the Term Loan.

B. Rate Counsel Analysis

From Rate Counsel's perspective there are four key considerations in evaluating Fayson Lake's financing request. They are as follows:

- Are the new facilities that are financed by the debt necessary and reasonable.
- Are the terms of the loan and the associated closing costs reasonable.
- Will the new financing promote a reasonable capital structure for Fayson Lake.
- Is Fayson Lake reasonably capable of meeting its debt obligations.

Each of these considerations is addressed below.

Are the New Facilities Necessary and Reasonable

The focus of Rate Counsel's review was limited to the financial impact on Fayson Lake and its customers. Rate Counsel did not conduct engineering assessments of the need for the new facilities, or the costs incurred to install the new water mains. However, Rate Counsel did not see anything in the Petition or in Fayson Lake's discovery responses that caused it to question the necessity for the new water mains.

Are the Terms of the Loan and the Associated Costs Reasonable

In response to a discovery request, Fayson Lake stated that bank loans typically take two years to process and require an independent engineer and bond counsel, which add time and costs to the borrower and ratepayers. Lakeland Bank, however, provided financing to Fayson Lake on a previous loan for which Fayson Lake is currently making regular principal and interest payments. Thus, Fayson Lake has an existing financial relationship with Lakeland Bank. Lakeland Bank is unique in its ability to provide financing for Fayson Lake at a lower cost than would be possible with other banks and financial institutions. Fayson Lake estimates that its total transaction costs associated with the loan will be only \$16,000 -- \$6,000 for legal counsel and \$10,000 for bank engineering. Thus, from a transaction cost perspective, it appears that Lakeland Bank is the most reasonable alternative.

Concerning other terms and conditions of the loan, there are requirements in the loan agreements that trouble Rate Counsel. Exhibit B to Fayson Lake's Petition contains the loan documents. Among those documents is the "Promissory Note Rider". The first page of that document (Exhibit B, page 9 of 66), under the subtitle "Other Conditions," contains the following conditions:

Borrower shall furnish all approvals from the BPU, including but not limited to: loan approval to execute the documents, documentation of statute guaranteeing sufficient rates will meet DSCR [Debt Service Coverage Ratio] requirement upon permanent phase, and schedule of rate increases.

Rate Counsel is particularly concerned that Fayson Lake has agreed to terms with which it cannot possibly comply. The Board does not issue "statutes." Nor does the Board, or should the Board, guarantee the rates it approves will meet Fayson Lake's debt service coverage requirement. The Board simply does not have the authority to guarantee a utility's financial result. It is the utility's obligation to operate its system in a safe and reliable manner, to meet customer demands and to manage its finances so that it can meet its obligations. It is also the utility's responsibility to foresee the need for timely rate relief. But the Board cannot guarantee any financial result for Fayson Lake.

Rate Counsel is also concerned that Fayson Lake is obligated under the "Promissory Note Rider" to provide the lender a "schedule of rate increases." Here again, the Company has agreed to have the Board provide something it does not and cannot provide. The Board acts on utility rate requests. Unless there is an approved phase-in plan, or something similar, the Board typically does not approve of future rate increases and thus, there is no schedule of rate increases to be provided.

Rate Counsel is concerned that the obligations described above and agreed to by Fayson Lake are not things that the Board can honor and, as a result, could place Fayson Lake in default with the lender.

Will the New Financing Promote a Reasonable Capital Structure

This is another troublesome area for Fayson Lake. In recent years immediately prior to the proposed financing, Fayson Lake maintained an equity ratio that was excessively heavy on equity – as high as 74% on December 31, 2023. The new financing, however, swings the balance in the opposite direction. Following the transaction, Fayson Lake’s capital structure will contain only approximately 33% common equity capital. This results because the construction project is being financed entirely with new debt, and the new construction represents a more than 70 percent increase in Fayson Lake’s total net plant balance.

Neither a 74% equity ratio nor a 33% equity ratio is reasonable or sustainable for a regulated utility or its creditors. In fact, Fayson Lake’s stated goal is to achieve a 50/50 capital structure. That goal is not immediately achievable, however. The additional margins that will be generated over the next few years under rates proposed by Rate Counsel in Fayson Lake’s concurrent base rate proceeding, however, should gradually increase the Company’s equity ratio through retained earnings. Moreover, while a 33% equity ratio is not an efficient capital structure long-term, from the ratepayers’ perspective, the cost to customers of the new debt is less than the cost of common equity. Therefore, ratepayers will receive cost savings so long as Fayson Lake can adequately service its debt obligations while gradually growing its equity ratio.

Is Fayson Lake Reasonably Capable of Meeting its Debt Obligations

The new loan agreement requires that Fayson Lake maintain a minimum Debt Service Coverage Ratio of at least 1.20. In shorthand, this means that the Company’s rates must generate earnings that are, at minimum, 20% greater than its debt service requirements, which include principal and interest payments.

Using the formula for calculating the Debt Service Coverage Ratio specified in the loan agreement Rate Counsel determined that the rate increase it recommends in Fayson Lake’s companion base rate proceeding results in a 1.48 Debt Service Coverage Ratio. The resulting 1.48 Debt Service Coverage Ratio is significantly greater than the 1.20 Ratio that Fayson Lake is required to maintain. The calculated margin above the minimum coverage requirement

indicates the Company's financial capability to adequately service its outstanding debt and to gradually increase its equity ratio through retained earnings.

C. Rate Counsel Recommendation

Rate Counsel has carefully reviewed the Petition and is not opposed to its approval. The Company is engaged in the distribution and sale of water utility service to approximately 890 customers in its New Jersey service territory. The proposed financing is necessary and appropriate as part of the Company's overall strategy to provide safe, adequate, and reliable service to its New Jersey customers. Barring unforeseen circumstances, the proposed debt financing issues should not jeopardize Fayson Lake's long-term financial integrity. Moreover, it appears that the Company has or will have sufficient income to meet additional debt service coverage requirements without jeopardizing its ability to provide safe, adequate, and reliable service to its New Jersey customers.

Even though Rate Counsel is generally supportive of the authorizations sought in the Petition, approval of the Petition should not include an authorization to include in rate base any specific assets that Fayson Lake has or will acquire from this financing. Nor should the Board's authorization in this Petition be construed as acceptance for future ratemaking purposes of the resulting capital structure and capital costs. The determination of any assets to be included in rate base and the ratemaking impact of serving customers, including the impact of the transaction on Fayson Lake's capital costs, will be addressed in future base rate proceedings.

Rate Counsel recommends that a Board order approving the Company's Petition contain the following conditions:

1. Upon conversion of the Construction Loan to a 15-year Term Loan, Fayson Lake shall provide evidence that the Construction Loan and its associated requirements have been met and are fully satisfied.
2. Upon conversion of the Construction Loan to a 15-year Term Loan, Fayson Lake shall provide to the Board Staff and Rate Counsel: a) the aggregate principal amount of the loan, including any unpaid interest accrued during the construction period, b) the initial interest rate established for the Term Loan to be effective for years one through five, and c) an identification and quantification of all financing-related costs

- incurred and to be paid by Fayson Lake associated with acquiring the loan including, but not limited to, bank engineering and bank transaction and closing costs.
3. Fayson Lake shall furnish to the Board, the Board Staff, and to Rate Counsel copies of executed documents filed with other regulatory agencies, if any, relating to the new debt.
 4. The new debt authorized herein shall not be redeemed at a premium prior to maturity without further Board approval, unless the estimated present value savings derived from the difference between interest on a new debt issue of comparable securities and those securities refunded is on an after-tax basis greater than the estimated present value of all redemption, tendering and issuing costs, assuming an appropriate discount rate.
 5. Fayson Lake shall furnish to the Board copies of all executed amendments and/or supplements, if any, Fayson Lake's Mortgage and Deed of Trust, or any successor mortgage thereto.
 6. The Board's Order in this proceeding shall not be construed as certification that the new debt will be represented by tangible or intangible assets of commensurate value or investment costs.
 7. The Board's Order in this proceeding shall not be construed as directly or indirectly fixing, for any purpose whatsoever, any value of any tangible or intangible assets now owned or hereafter to be owned by Fayson Lake.
 8. The Board's Order in this proceeding shall not affect nor in any way limit the exercise of the authority of the Board, Rate Counsel, or the State of New Jersey, in any future Fayson Lake proceedings with respect to rates, franchise, service, financing (including method of sale of securities), accounting, capitalization or any other matters affecting the Petition.
 9. The authority granted in the Board's Order in this proceeding shall become null and void and of no effect with respect to any portion thereof that is not exercised by December 31, 2025.
 10. The Board's Order in this proceeding shall not constitute pre-approval of any cost or authorization for rate recovery. All capital costs are subject to review in Fayson Lake's next base rate proceeding.

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These provisions will satisfy Rate Counsel's concern that the Board's approval is limited to the transactions as described herein, does not imply authorization to include any specific assets or amounts in rate base, does not imply authorization for any other ratemaking treatment, and does not establish any precedent regarding approval of future financing petitions.

Respectfully Submitted,

By: /s/ Susan McClure
Susan McClure
Deputy Rate Counsel

SM/fjr

C: Service list

**I/M/O the Petition of Fayson Lake Water Company for
Approval of Financing Petition
BPU Docket No. WF24030184**

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