BEFORE THE

VIRGIN ISLANDS PUBLIC SERVICES COMMISSION

DOCKET NO. 603

DIRECT TESTIMONY OF HUGO V. HODGE, JR.

ON BEHALF OF

THE VIRGIN ISLANDS WATER AND POWER AUTHORITY

REGARDING THE PETITION FOR PERMANENT RATE RELIEF

FOR THE ELECTRIC SYSTEM

November 15, 2012

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Hugo V. Hodge, Jr. and my business address is: Virgin Islands Water and Power Authority, 9720 Estate Thomas, St. Thomas, U.S. Virgin Islands 00802.

Q. WHAT IS YOUR OCCUPATION?

A. I am the Executive Director of the Virgin Islands Water and Power Authority ("Authority"). In that capacity, subject to the direction of the Governing Board, I have overall responsibility for managing the operations, planning, and financing activities of the Authority.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND?

A. I studied Mechanical Engineering at Georgia Institute of Technology in Atlanta, Georgia for three years as a Co-op Student. In 2001, I attended Southern Polytechnic State University, in Marietta, Georgia and received my Bachelor of Science in Mechanical Engineering. Subsequently, in 2005, I attended Georgia State University and received my Masters degree in Business Administration.

Q. DO YOU BELONG TO ANY PROFESSIONAL ORGANIZATIONS?

A. Yes. I have been a member of the Georgia Economic Developers Association, the National Black MBA Association, and the Southern Polytechnic State Alumni Association, as well as on the Board of Directors for Electric Cities of Georgia. I am currently a board member of the Consortium of Caribbean Electric Utilities ("CARILEC") and the Virgin Islands Next Generation Network ("viNGN") that is involved in evaluating broad band telecommunications issues in the Territory.

Q. PLEASE SUMMARIZE YOUR EXPERIENCE IN THE UTILITY INDUSTRY.

A. From 1988 to 1993, I was employed by Georgia Power Company designing outdoor lighting jobs for both residential and commercial customers, and assisted a large commercial customer to switch from gas to electric heating. During this time, I also worked as an assistant to engineers in conjunction with overhead and underground distribution line crews. Between 1994 and 1996, I worked for the Virgin Islands Water and Power Authority as an Engineering Technician/Aide. I assisted with the supervision of the operation and maintenance of an Israeli Desalinization ("IDE") Unit as well as the installation of a new water intake system. I coordinated power plant inspections and assessment of plant equipment during hurricane recovery efforts in the wake of Hurricane Marilyn. From 1998 to approximately 2005, I progressed from being a Design Engineer to New Business Manager to Engineering Manager for Marietta Board of Lights and Water, leading multifunctional teams on customer choice projects, and managing all functions of the engineering team tasked with development and delivery of dependable electric energy to client. I planned and managed full cycle engineering functions for the largest municipal electric utility in the state of Georgia and was fully accountable for developing load control strategies and other strategies for the recruitment of new commercial and industrial customers. I also tactically planned and executed full cycle marketing and sales functions. Additionally, I was responsible for calculating and balancing loads for system requirements and coordinated system planning and load forecasting. My most recent past employer and position was at Griffin Power, a governmentally owned utility in the State of Georgia, as a Utility Director during 2005 to 2007. During this time, I managed the generation resources and secured adequate means of serving the loads in years to come, planned and implemented the expansion and maintenance of the electrical distribution system, formulated corporate service policies and programs, performed cost-benefit analyses and forecasting for proposed projects and programs, and oversaw preparation and implementation of department budgets. On January 1, 2008, I was named Executive Director of the Authority where I have been responsible for the day-to-day management and operations of the Authority's Electric and Water Systems. In short, I possess over 24 years of experience in the utility industry in marketing, engineering, and managerial roles.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE VIRGIN ISLANDS PUBLIC SERVICES COMMISSION ("COMMISSION" or "PSC")?

A. Yes. As Executive Director of the Authority, I have testified on many occasions before this Commission on matters related to the management and operations of the Authority.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of my testimony is to generally discuss the Authority's petition, the need for permanent rate relief and the steps being taken by the Authority's management to improve the operation and financial condition of the Electric System.

My testimony will be supplemented by that of the Authority's Chief Financial Officer, Mr. Julio Rhymer, and by Mr. Craig Shepard of the firm SAIC, the Authority's rate consultant. They will provide testimony regarding the financial need for the rate increase, the impact on customer bills, if the requested rate increase is approved by the Commission and the financial implications to the Authority if the requested increase is not approved.

Q. WHY DOES THE AUTHORITY NEED PERMANENT RATE RELIEF FOR THE ELECTRIC SYSTEM?

A. In the approximately three years since the Authority received a rate increase in 2009, several things have caused a revenue shortfall for the Authority. Specifically, the Authority is experiencing: (1) less than required revenues due to the approval by the PSC of a lower amount than requested in the 2009 rate case; (2) continuing increases in expenses, including operating expenses and fuel costs, and a regulatory lag in recovering those costs; (3) less than anticipated growth in energy sales in FY 2010 and negative growth in energy sales in FY 2011 and FY 2012; (4) increases in required debt service payments as a result of the issuance of the 2010 Bonds and the 2012 Bonds; (5) extremely slow payment of electric bills by certain Government entities which has resulted, until recently, in an increase in total accounts receivables; and (6) an increased amount of money owed to the Electric System by the Water System. While the Authority's financial position has improved due to the interim rate increase recently granted by the Commission, and the receipt of partial payment from the Government of its outstanding electric bills, the Authority is still in need of a permanent rate increase in order to pay essential expenditures such as those associated with fuel, salaries and wages, capital improvement projects, Other Post Employee Benefits ("OPEB") and debt service. Accordingly, the Authority is seeking permanent annual rate relief of $18,000,000, which is in addition to the interim revenue increase of $8,600,000, or a total annual rate relief of $26,600,000. The Authority requests that such relief be granted by the PSC effective on all bills rendered on and after July 1, 2013.

Q. DID NOT THE INTERIM RATE INCREASE PROVIDE SUFFICIENT RELIEF?

A. No. The Authority appreciates the fact that the Commission recognized its financially precarious position when it granted the Authority interim rate relief. Unfortunately, the approved interim increase is insufficient for the Electric System to achieve financial stability. Given the Authority's continuing difficulty, despite the interim rate relief, in paying its operating costs and debt service obligations on a timely basis and the continuing concerns of national rating agencies and the Authority's independent auditors, there should be little doubt as to the Authority's need to increase its revenues and improve its cash position. The Authority has provided to the PSC and its consultants monthly financial reports and audited financial statements establishing its need for additional permanent rate relief.

Q. WHAT DO THOSE DOCUMENTS SHOW?

A. These documents, especially the Authority's audited financial statements, show its need for increased revenue. As you know, the Authority provides electric service to more than

54,000 customers. Yet during FY 2009, 2010, 2011 and 2012, its ability to provide reliable service to its electric customers consistently deteriorated. For example, with respect to the Electric System, page 48 of the 2011 Audit Report shows a decrease in net assets for FY 2009, 2010 and 2011 in amounts of $6,225,790, $7,466,513 and $11,447,680, respectively. This represents a 5.8 percent decrease in FY 2009, a 7.0 percent decrease in FY 2010 and a 12.3 percent decrease in FY 2011. Page 5 of the June 30, 2012 Electric System Financial Statement shows that the System experienced a decrease in net assets of $22,043,993, or approximately 25 percent, during FY 2012. Pursuant to normal utility practice, the net assets reflect the ability to provide service. A decrease in their value indicates that the normal utility practice of providing for renewal and replacement of net assets is not occurring.

Clearly, the Authority cannot continue to provide reliable electric service if its net assets continue to decrease as demonstrated above.

Q. DID THE DEFERRED FUEL BALANCE MAKE THE AUTHORITY'S ABILITY TO OPERATE DIFFICULT?

A. Yes. In FY 2009, the Authority's deferred fuel balance increased by $14.7 million to $45.9 million because the Levelized Energy Adjustment Clause (LEAC) did not allow the Authority to recover all of its fuel cost during the year. Similarly, in FY 2010, the Authority's deferred fuel balance increased by $354,000 to $46.2 million as the LEAC did not adequately allow the Authority to recover all of its cost of fuel during the year. Also, in FY 2011, the deferred fuel balance increased by $0.8 million to $47.1 million as the LEAC permitted by the PSC did not adequately allow the Authority to fully recover its cost of fuel during the year. This deferred fuel balance caused the Authority to divert its internally generated funds away from much-needed maintenance and the capital improvement program.

Q. IS THERE ANYTHING ELSE THAT CONFIRMS THE IMPACT OF DECLINING REVENUES AND INCREASING COSTS OF THE AUTHORITY?

A. Yes. The Authority's Chief Financial Officer, Mr. Julio Rhymer, will explain the financial information in greater detail in his testimony. In addition, the Authority's rate consultant, Mr. Craig Shepard of the firm of SAIC, will explain the adjustments to the data required to determine the Authority's revenue requirements which establish the amount of the requested rate increase, based on an appropriate test year.

Q. IN 2009, THE AUTHORITY RECEIVED A RATE INCREASE AND PROMISED TO PERFORM A LOAD RESEARCH AND COST OF SERVICE STUDY. HAVE THEY BEEN COMPLETED? IF NOT, WHY NOT?

A. Instead of a detailed load research study, the Authority prefers to conduct a cost of service study using more conventional methods which could be performed less expensively and more quickly. Given current economic conditions, the Authority encourages the Commission to reconsider and permit it to do a cost of service study using more conventional methods utilizing the funds that the Commission made available for load research. If the Commission remains committed to the Authority performing a detailed load research study, such a study will require at least a three year time frame to accomplish. The Authority acknowledges that it received funding to conduct load research. However, dedicated funds were not provided for a cost of service study, nor were funds available from internally generated funds primarily because of the deferred fuel balance. The Authority would need funding to perform a cost of service study.

Recently, the Authority has begun the process of seeking to engage a firm to devise and submit a detailed plan for the completion of a load research and cost of service study. As suggested by the PSC's technical consultants in 2009, the plan would include:

- Development of a sample design.
- Selection of sample customers.
- Acquisition of necessary metering equipment.
- Installation of special metering equipment at sample customers' premises.
- Collection of data.
- Editing and verification of collected data.
- Analysis of data and reporting of results.

With the assistance of its consultant, the Authority will develop a schedule for completion of the load research and cost of service study.

Q. IS THERE ANY OTHER MATTER YOU WISH TO ADDRESS IN YOUR TESTIMONY?

A. Yes. During recent years, the Authority's rates did not include recovery of certain OPEB costs thereby causing an under-recovery of those costs. The Authority rate filing includes such OPEB costs and asks the Commission to allow its rates to be set at levels sufficient to recover them.

Q. CAN YOU EXPLAIN THE IMPACT DUE TO COSTS AND LIABILITIES RELATED TO OPEB?

A. Yes. Changes to the accounting treatment for OPEB related costs and liabilities have resulted in increased cash needs of the Authority and the Electric System. See the testimony of Mr. Julio Rhymer. Specifically, in FY 2008, the Authority adopted the provisions of GASB Statement No. 45, Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions. As a result of GASB 45 implementation, the Authority started recognizing OPEB costs under the accrual basis of accounting, as opposed to the pay-as-you-go method used before the implementation of such pronouncement. OPEB cost is now recognized based on actuarial calculation of benefits earned by beneficiaries (employees and retirees). This represents a significant increase in costs recognized by the Authority beginning in the year of implementation. However, these increased costs have not been included in Electric System rates approved by PSC.

According to the Authority's auditors, Ernst and Young, the "lack of inclusion of OPEB costs that are recognized for GAAP purposes in [our] rates has severely affected the ability to recover costs" and has led to a regulatory accounting issue identified in the FY2011 Financial Statement and Supplemental Schedule (FY 2011 Audit). As stated in the FY2011 Audit, the Authority employs an actuary to estimate the costs and liabilities for OPEB. The actuary's estimate of the Authority's accrued OPEB liability was approximately $101.2 million at June 30, 2011 of which the Electric System share is $82 million or 81 percent. The Authority's annual OPEB cost is calculated based on the annual required contribution (ARC), an amount actuarially determined in accordance with GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost (current and future benefits earned) each year and to amortize any unfunded actuarial liabilities over a period of time not to exceed 30 years.

According to Ernst and Young, the net OPEB obligation is the net amount for which the Authority would be obligated and is equivalent to the cumulative annual OPEB cost. The Electric System's annual OPEB obligation for FY2011 was approximately $6.1 million, as identified in the FY2011 Audit. The Electric System's annual estimated OPEB obligation for FY2012 (based on unaudited data) is $6.1 million. Therefore the Authority requests an adjustment to its base rate revenues of $6.1 million to recover its annual OPEB obligations.

Q. IS THERE ANYTHING ELSE?

A. Yes. The Authority recognizes that the rate adjustment it seeks comes at a very difficult time. We are still reeling from the economic consequences resulting from the closure of the oil refinery on the island of St. Croix, the unavailability of the lower cost of fuel with the closure of the refinery, the financial impact of replacing water production by steam desalination with reverse osmosis technology and the resulting shifting of costs from the Water System to the Electric System, and the repayment of an ever increasing unsecured loan from the Water System to Electric System, among others. However, the Authority is in the process of implementing an Energy Production Action plan to address these and other issues (e.g., aging generating resources). The Plan identifies a number of projects approved by the Authority's Governing Board to improve the Systems' efficiency and reliability, many of which have already begun. It will require additional revenue to fully implement it. Moreover, during this period, it is envisioned that representatives of the PSC would work with the Authority to finance the implementation of the plan so as to satisfy the Authority's financial needs, and secure the provision of reliable, affordable electricity in the near and longer term, for the benefit of the Authority's customers and the citizens of the Territory.

Q. WHAT WILL BE THE ECONOMIC EFFECT ON THE AUTHORITY'S CREDIT WORTHINESS IF THE AUTHORITY DOES NOT RECEIVE THE REQUESTED RATE RELIEF?

A. Its ability to access capital markets will be threatened. All three national rating agencies have expressed concern about the near term and long term credit worthiness of the Authority and assigned a negative outlook to the Authority. In addition, as recently as March 2012, Fitch Ratings, Inc. downgraded the Authority's credit rating on all of its outstanding Electric System Revenue Bonds from investment grade to non-investment grade. In addition, Standard and Poor's downgraded the Authority's subordinate debt, and Moody's has placed a negative watch on the Authority. The loss of the investment grade rating of its indebtedness will make it more difficult and costly for the Authority to obtain long-term financing. Moreover, this negative outlook and reduced credit rating will likely have an adverse effect on the availability and cost of subordinated debt, such as the line of credit. In order to prevent a further downgrade in the Authority's national credit rating, at a time when it needs to maintain access to credit markets, the Authority must receive just and reasonable rates.

Q. BESIDES REQUESTING THIS RATE INCREASE, WHAT STEPS HAS THE AUTHORITY TAKEN TO CURE ITS REVENUE DEFICIENCY AND IMPROVE THE OPERATION OF THE ELECTRIC SYSTEM?

A. The Authority has taken many steps. First, the Authority timely submits its LEAC filing to the PSC in an attempt to recover its fuel costs as soon as possible after fuel is delivered. The Authority has in the past and plans to petition in the future for approval of a monthly LEAC. Second, the Authority has refunded certain outstanding indebtedness in order to take advantage of lower interest rates and to reduce monthly debt service payments. Third, the Authority has also considered financing new capital projects in order to improve System reliability and efficiency. Fourth, the Authority has decided not to run spinning reserves in order to reduce costs. Fifth, the Authority's Governing Board has reduced the Electric System Budget by approximately $2.2 million in FY 2013. Sixth, the Authority has deferred, until recently, performing major overhauls and maintenance on its generating units, which regrettably on the island of St. Thomas resulted in interruptions in service to its customers. That maintenance and renovations is now underway in part as a result of the rate financing mechanism (RFM) approved by the Commission in October 2011, which became effective on April 1, 2012. Seventh, the Authority has leased from General Electric a combustion turbine generating unit to provide a temporary generating resource while certain generating units on the island of St. Thomas are undergoing major repairs. The leasing of the combustion turbine has improved overall electric generation efficiency and reduced fuel costs. Since the leased unit began operation in May 2012, the monthly overall system average production cost benefit ranges between $0.035 to $0.066 per kWh and far exceeds the cost of the RFM surcharge of $0.023 per kWh. The magnitude of the savings from this will offset the impact of the requested rate increase. Eighth, the Authority has been working with representatives of the central government to speed up payments and reduce outstanding accounts receivable balances. That effort has paid off, as evidenced by the recent payment by the central government of over $15 million on its past due accounts receivables. In addition, the Authority has issued a request for proposals for a collection agency to collect the rest of its significantly past due account receivables. Ninth, the Authority has prioritized making payments to vendors, contractors and others so as to have monies on hand to pay the costs of fuel, salaries and wages, and debt service. Tenth, pursuant to the Stipulation dated September 27, 2011; the Authority has taken steps to retain an independent advisory contractor ("IAC") to assist it in improving the efficiency of its production of electricity. In this regard, it is seeking to put out its request for proposals ("RFP") for the IAC by the first quarter of 2013, provided all predicate approvals have been obtained. The Authority has submitted its draft RFP to the PSC and its consultants for their input. As you may be aware, the IAC is expected to provide technical advisory services to the Authority and to help develop recommendations related to deferred maintenance, capital improvement and performance programs associated with the operation and maintenance of the Randolph Harley Power Plant.

Eleventh, the Authority has entered into power purchase agreements to provide approximately 18 MW of solar power. Twelfth, the Authority has initiated a wind resource study in conjunction with the Virgin Island Energy Office to evaluate the feasibility of implementing wind energy projects. Thirteenth, the Authority is working with Qualifying Facilities (QF) entities on the implementation of biofuels projects for the islands of St. Thomas and St. Croix. Fourteenth, the Authority is performing a full environmental assessment of the impact of installing a submarine cable to connect with Puerto Rico's electric utility. Fifteenth, the Authority has applied for a Federal grant to fund the development of a solar energy microgrid on the island of St. John. Sixteenth, the Authority is seeking a loan from the Rural Utility Services to fund the development of an Advanced Metering Infrastructure (AMI). Finally, the Authority has issued two requests for qualifications ("RFQ") in order to identify and determine the interest of qualified companies to implement and operate a turkey solution to supply the Authority with liquid natural gas ("LNG") or liquefied petroleum gas ("LPG") or propane to be burned in the Authority's existing generating units in lieu of fuel oil. Thirteen potential suppliers have responded, of which five propose LPG, and eight propose LNG. After review of the responses, the Authority plans to negotiate with one or more qualified respondents in order to implement the project to use LPG or LNG as a primary fuel, instead of fuel oil, in order to take advantage of much lower prices for gasified fuels and thereby minimize or even eliminate the need for higher priced fuel oil to run its generating units. This is in accordance with the Authority's Energy Production Action Plan which can be viewed on its website at www.viwapa.vi. The Authority is requesting funding in the form of a regulatory asset to cover the costs of pursuing alternative and renewable energy projects.

Q. PLEASE SUMMARIZE THE BASIS AND IMPACT OF THE AUTHORITY'S REQUEST FOR RATE RELIEF?

A. The detailed basis and impact of this request are set forth in testimony of Mr. Rhymer and Mr. Shepard, which I have read and fully support. In general, the Authority is seeking an across-the-board increase in base rates designed to produce approximately $18,000,000, in addition to the interim rate increase, on an annual basis on bills rendered on and after July 1, 2013. For FY 2014, the requested across-the-board annualized increase equates to an approximately 5.1 percent increase above revenues using the current rates, which include the interim rate increase. This increase is also equal to approximately 2.5 cents per kWh sold based on projected energy of 723,918,000 kWh in fiscal year ended June 30, 2014. The requested increase of 2.5 cents per kWh increases the monthly bill for residential service by approximately $10 based on average residential usage of 400 kWh per month.

It should be noted that the requested increase provides for an amount available from revenues for capital improvements and working capital of approximately $4.3 million, which does not meet the desired level for capital improvements based on the capital budget and level of depreciation. The Authority is purposely requesting a level of rate relief that is below the level required for long term financial stability of the Electric System in order to minimize the rate increase to our customers at this time. This is being done in recognition of the current difficult economic conditions and high cost of fuel.

It should be further noted that the requested increase is based on projected sales which have some degree of uncertainty. In addition to the difficult economic conditions, several large hotels are in the process or are considering supplying their electric power needs by self generation. This would adversely impact the level of revenues projected to be recovered from this requested rate relief. To date, these customers have not provided the Authority with any formal indication of their intent to withdraw from the Electric System, and it is anticipated that they would retain service from the Authority in a standby mode. In order to address the potential change in status for these customers, the Authority is in the process of developing a Standby Service tariff that will be submitted to the PSC for approval.

Based on the initiatives to be funded through the RFM surcharge, coupled with the Authority's planned capital improvement initiatives, the Authority projects that on

St. Thomas the Randolph Harley plant will achieve a heat rate in the near term in the range of 13,500 to 13,700 British thermal unit (Btu) per kWh versus the initial overall heat rate of the Randolph Harley plant, which was in the range of 17,000 Btu per kWh prior to implementation of the RFM surcharge. The initiatives are projected to generate savings of $0.072 per kWh for the St. Thomas plant - and system-wide savings of $0.043 per kWh - compared to the period before implementation of the RFM surcharge.

In addition, on St. Croix, the current Richmond plant heat rate is approximately 14,800 Btu per kWh primarily due to unanticipated problems forcing Unit 20 out of service. Prior to this, the Richmond plant average heat rate ranged from 13,500 to 13,700 Btu per kWh without credit for water production. The Authority projects returning to an average heat rate in the range of 13,500 to 13,700 Btu per kWh for the Richmond plant with implementation of its capital improvement program contemplated by this rate filing. This is projected to improve plant reliability and arrest plant deterioration. This is also projected to result in additional savings of $0.023 per kWh for the Richmond plant or a system-wide savings of $0.01 per kWh. This, together with the savings from the Randolph Harley plant on St. Thomas, is anticipated to yield a total system-wide savings of $0.053 per kWh. This fuel cost savings is projected to substantially exceed the impact of the requested base rate relief of $0.025 per kWh.

Should the PSC not grant the requested rate relief, the Authority's provision of service will continue to deteriorate over time, it will not be able to pay all of its operating costs and debt service obligations nor invest in the improvements identified above and will further reduce its credit rating and access to the financial market at a reasonable cost.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.