

BEFORE THE STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

Docket Nos. DW 10-141, DW 07-105, DW 10-043, and DW 11-021

Lakes Region Water Company, Inc.

CLOSING STATEMENT OF LAKES REGION WATER COMPANY

A. THE COMPANY'S SERVICE TO CUSTOMERS IS REASONABLY SAFE AND ADEQUATE AS REQUIRED BY RSA 374:1

The Company does not bear the burden of proof under RSA 374:47-a to show that it is not "consistently failing to provide adequate and reasonable service."¹ Nonetheless, the evidence shows that the Company's service is reasonably safe and adequate under RSA 374:1.

On October 10, 2007, the Commission issued an Order of Notice² to investigate the Company's service under RSA 374:47-a. A Settlement Agreement dated May 7, 2008,³ was approved by the Commission,⁴ and the Commission's investigation became "a monitoring docket for a limited period of time into the future, pending the completion of two other processes: a filing by Lakes Region for financing approval and rates, and the Attorney General's investigation into the issues surrounding the re-connection of a well at the Tamworth system."⁵ As a result of the Settlement Agreement, the Company changed its management and invested significant capital to improve its 17 water systems serving 1,625 customers.⁶

The Company never submitted testimony because , since May 8, 2008, the investigation has been a monitoring proceeding. The Company fully participated in the quarterly monitoring

¹ RSA 374:47-a.

² LRW Exhibit 11.

³ LRW Exhibit 12.

⁴ LRW Exhibit 13.

⁵ LRW Exhibit 12, Pages 1-2 (emphasis added).

⁶ The Property Owner's Association of Suissevale, Inc. (POASI or Suissevale) is a single wholesale customer that operates its own system.

meetings, and continued to invest in and improve its systems. On September 17, 2010, Staff recommended that the quarterly meetings be subsumed into the Company's rate case.⁷ Today, Mr. Naylor acknowledges that "the company has made progress in addressing some of the problems it has had with its physical water systems, [and] the company's most urgent problem is financial".⁸ Based on the progress it had made and the fact that its most urgent need was financial, it had no reason to expect that, nearly five years later, the issue of receivership would be raised again. Even Mr. Naylor acknowledged on cross examination, that his testimony did not evaluate the criteria under RSA 374:47-a.⁹

The Commission heard evidence concerning the challenges faced by the Company to operate its 17 small or very small community water systems.¹⁰ According to the NH Department of Environmental Services (NHDES):

It is "widely recognized that small public water systems carry a much higher burden to maintain compliance with the Safe Drinking Water Act. This is due not only to their smaller user base, but often the shortage of financial, managerial and/or technical resources to ensure the continued and reliable delivery of safe water to all customers. In New Hampshire, systems serving fewer than 250 people incur about **77 percent** of the drinking water violations in the state (Triennial Capacity Development Report, September 30, 2008).¹¹

The NHDES cited 475 drinking water violations at the State's 706 community water systems during the period from July 2010 to June 2011.¹² In 2011, the NHDES cited 764 violations,¹³ an

⁷ Transcript, Day 4, Cross Examination of Mark Naylor.

⁸ Staff Advocate Exhibit 11, Page 3.

⁹ Transcript, Day 4.

¹⁰ A community water system is a "a public water system which serves at least 15 service connections used by year-round residents or regularly serves at least 25 year-round residents." RSA 485:1-a, I.

¹¹ LRW Exhibit 18 (underlines added, bold in original).

¹² LRW Exhibits 24 & 25.

¹³ LRW Exhibit 27.

increase in enforcement from 0.67 to 1.08 violations per community water system per year.¹⁴

The Company operates 17 small or very small water systems¹⁵ serving an average of fewer than 100 customers per system! Applying the state-wide average for violations for community water systems yields an expected rate of 11.39 to 18.36 violations per year for the Company's 17 systems. Drinking water violations are by no means acceptable. However, the few violations presented to the Commission are an unfortunate consequence of the very small water systems it operates which have a "much higher burden to maintain compliance with the Safe Drinking Water Act."¹⁶

The Commission's web site acknowledges this burden, stating:

The number of regulated water utilities has declined considerably in recent years, primarily due to the acquisition of smaller utilities by larger ones. Whereas the Commission regulated 39 water utilities in 1999, today it regulates 20. This is a trend that has taken place across the country, as requirements of the Safe Drinking Water Act (SDWA) and the need for replacement of aging infrastructure have made it increasingly difficult for small water utilities to acquire the capital needed to invest in their systems.¹⁷

Mr. Naylor agreed that the Company's systems presented many of the challenges identified by the NHDES, including: "Regulatory requirements [that are the] same as larger systems"; "Aging or inadequate infrastructure"; "Incomplete as-built plans & system records"; "Issues with quantity and quality"; "Lack of reserves/access to funding"; and "Smaller revenue base/fewer customers".¹⁸ The challenges are compounded because its systems were "developer built",¹⁹ out

¹⁴ LRW Exhibit 25. The increase appears to be the result of the NHDES's state-wide effort to reinforce "its sanitary survey enforcement and outreach to address outstanding deficiencies that could impact system reliability and operations" that commenced in 2010. LRW Exhibit 24, Page 6.

¹⁵ The NHDES considered systems serving fewer than 250 people to be "very small systems". See e.g. LRW Exhibit 24, Pages 1 & 3.

¹⁶ LRW Exhibit 18.

¹⁷ LRW Exhibit 19 (emphasis added).

¹⁸ LRW Exhibit 18; Transcript, Day 4.

¹⁹ See e.g. LRW Exhibit 6, Page 9 ("These systems were built by developers who typically did not have the long-term maintenance and operation of the assets in mind when they were constructed and therefore are physically

of regulatory compliance, and physically and financially inadequate before they were acquired and many were acquired at the request of the Commission or the NHDES.²⁰

Mr. Naylor acknowledged that his testimony did “not discuss the company’s DES compliance except to state that ‘the company has made progress in addressing some of the problems it has had with its physical water systems.’”²¹ The progress has been significant: since the Commission’s investigation was opened in 2007, the Company has resolved all of its outstanding Letters of Deficiency (LODs), except for the additional capacity at Mt. Roberts which is being addressed under a schedule approved by the NHDES.²² The NOVs issued on January 20 & 24, 2012 were appropriately addressed. The Company took immediate steps on November 23, 2011, the day following the sanitary survey, before the NOVs were issued.²³ The NHDES confirmed on March 23, 2012 that the NOVs had been addressed to its satisfaction.²⁴

The Company continues to improve its systems: In 2009, it invested \$233,201 in capital additions.²⁵ In 2010, it invested \$110,056 in capital additions.²⁶ This does not include the investment by the Company’s shareholders in the Mt. Roberts project to supply the Paradise Shores (Suissevale & Balmoral) system that will need to be addressed in a future proceeding.²⁷ The key issue before the Commission, is the determination of rates that will be “sufficient to

deficient. Lakes Region Water Company acquired many of these systems because they were already troubled and unable to run profitably on a stand-alone basis.”).

²⁰ LRW Exhibit 6, Pages 20, 31 & 13-19 (Company History).

²¹ LRW Exhibit 23 (emphasis added).

²² LRW Exhibit 14.

²³ Response to Record Request 5. The NOVs were issued due to an extension of the deadline for the corrective action plan as NOVs are issued if the system “does not have a state-approved Corrective Action Plan (CAP) by 30 days of the survey visit.” LRW Exhibit 24, Page 4. While corrective actions were taken the day after the sanitary survey, some corrective measures such as submission of samples (Deer Cove) and a water conservation plan (Indian Mound) were extended beyond the 30 day period.

²⁴ Response to Record Request 5.

²⁵ Response to Record Request 9.

²⁶ LRW Exhibit 8, Page 30, 51-52 (Annual Report for 2010).

²⁷ The Company anticipates that the transfer of the Mt. Roberts plant and property will likely require approval as an affiliate agreement under RSA 366, and its costs will be subject to review by the Commission under RSA 378.

yield not less than a reasonable return on the cost of the property of the utility used and useful in the public service less accrued depreciation” under RSA 378:27 & 28.

The evidence shows that while mistakes were made by its prior management in the past, these mistakes have been corrected and its service today is reasonably safe and adequate. The number of its certified operators from two – when the Commission started its investigation – to six today. It has improved the operation of its systems and the number of violations that have occurred in recent years do not exceed the state-wide average for community water systems. Given the nature of the systems it operates,²⁸ this is a significant accomplishment. Additional work remains to be done and performance can always be improved. However, there is no evidence to suggest that its service to the public today is unreasonable or inadequate.

B. STAFF’S RECOMMENDED RATES ARE INADEQUATE TO PROVIDE NOT LESS THAN A REASONABLE RETURN UNDER RSA 378:27 & 28

The Company, Staff and the Consumer Advocate²⁹ stipulated to the rate schedules contained in Staff Witness Jayson Laflamme’s testimony, except in four areas. In the Reply Testimony of Stephen St. Cyr,³⁰ the Company requested four adjustments to Staff’s recommendation for permanent rates: (1) Use of Year End Rate Base for the Test Year; (2) Use of a 12% Return on Equity; (3) Adjustment to Retained Earnings; and (4) Expenses for Federal Income and State Business Taxes.

Use of Year End Rate Base. Staff witness Jayson Laflamme acknowledged that the rate schedules contained in his testimony used a test-year average for additions to rate base which meant that the Company’s additions to plant during the test year were not “fully reflected” in

²⁸ Lee LWR Exhibit 6, generally, and Page 31.

²⁹ At the hearings, the Consumer Advocate adopted Staff’s recommended rates in lieu of the rate adjustments proposed in the OCA’s testimony.

³⁰ LRW Exhibit 5.

rates.³¹ However, he agreed year-end rate base is appropriate for plant additions that did “not result in increased revenues to the utility” and were “reasonably necessary by either mandate of some regulatory authority or other directive.”³² The Company’s 2009 additions were included in its 2009 Annual Report as part of Form F-8 and reviewed by Audit Staff.³³ However, Mr. Laflamme testified that he did not know whether the 2009 additions increased the number of customers, customer revenues, nor whether they were due to a regulatory or other mandate.

Stephen P. St. Cyr provided testimony that “the Company’s [test-year] investments consist largely of non-revenue producing improvements” and that “the Commission has approved similar treatment in other cases, such as *Unitil Energy Systems, Inc.*, 91 NH PUC 416 (2006).”³⁴ In response to Record Request 9, the Company provided its breakdown of its \$233,201 in 2009 plant additions. The Company’s Response shows that only \$2,783 (1.2%) were for revenue producing additions such as new meters or services. The remaining \$230,418 (98.8%) were for non-revenue generating assets such as replacement pumps, main replacements, and other plant additions.

All of the non-revenue generating assets are necessary to comply with the NHDES regulations, which regulate nearly every aspect of the system. The Company’s Response provides citations to some of the relevant regulations. For example, the Company’s additions for booster stations are mandated by rule: “[w]here booster pumps are used, total booster pump capacity shall be at least equal to peak flow.” Env-Ws 372.20 (b). Similarly, pumps and pump house replacements in 2009 were implemented to comply with Env-Ws 372.21 (pump house design), Env-Ws 372.22 (pump design) and Env-Ws 372.19 (peak flow requirements). Even if

³¹ LRW Exhibit 32.

³² LRW Exhibit 32.

³³ Staff Advocate Exhibit 4, Pages 9-10.

³⁴ LRW Exhibit 5, Page 3.

the Company's replacement excavator (\$41,200) and truck (\$18,865) were pro-rated, the allocation leads to the same result as the Company spent \$170,353 (98.4%)³⁵ on plant additions to meet regulatory requirements versus \$2,783 (1.6%) for revenue-generating additions.

The Company's 2009 plant additions have been in service for nearly three years. Staff's use test year average rate base understates the Company additions to plant and it will lose the opportunity to recover and earn a return on the costs of its additions to plant that are in service contrary to RSA 378:27 & 28. While customer growth would normally "offset" use of test year average, the additional revenues are insignificant. As a result, the Company requests that the Commission adjust Staff's recommended rates to reflect the use of year end rate base as shown in LRW Exhibit 5, Pages 13 & 14 (Attachment SP-1, Schedule 2 at Column 6 and Schedule 2a).

Use of 12% Return on Equity. Mr. Laflamme testified that his schedules reduced the Company's initial proposal for a 9.75% rate of return on equity to combination of 9.75% and 6%, resulting in a rate of return of 8.08%. Mr. Laflamme explained that the reason for the reduction was his belief that the Company's "reluctance" pursuing lower-cost financing such as the State Revolving Fund ("SRF"). He also indicated that its shareholder had borrowed some of those funds from its personal home equity loan at an interest rate of 2.24%.

Mr. Laflamme indicated that the 9.75% rate of return on equity was appropriate for small water utilities. He considered Pennichuck Water Works to be a small water utility in that sense, but acknowledged that it is part of a publicly traded company and the state's largest public water utility with some 25,000 customers. He further agreed, as stated in the *Appeal of PSNH*, 130 N.H. 265, 275 (1988), that "a just and reasonable rate is one which reflects, among other things, a rate of return 'commensurate with returns on investments in other enterprises having

³⁵ The total of \$230,401 in non-revenue additions in Response to Record Request 9, less \$41,200 for the replacement excavator and \$18,865 for the truck replacement.

corresponding risks.”” However, in recommending that a portion of the Company’s return on equity be lowered to 6%, he did not account for the fact that the Company’s 17 small or very small systems have higher corresponding risks.

The Commission heard considerable and credible evidence that the reason the Company did not accept the SRF/ARRA funds was not due to a reluctance on the part of the Company. As explained by Mr. Mason:

In arriving at its decision to withdraw its projects from the AARA Funding, LRWC took into consideration a) the NH Business Finance Authority evaluation, b) the fact that the note had to be personally guaranteed by its shareholders, and c) the disparity between the length of note (20 years) and payback from the customer (40-50 years). LRWC management could not justify the risk knowing that the yearly debt load would not be supported by its customers. LRWC was in a negative cash flow situation and could not see how it could afford to support another note.³⁶

The evidence confirms that the Company had no choice but to refuse the funds. In 2008, the Company’s rate of return was negative 3.41%, and in 2009, it earned a rate of return of only 2.2%.³⁷ If the Company had accepted the ARRA funds, it would have dramatically worsened its cash flow condition because it would need to repay the ARRA loan over a 20 year period while earning on the underlying improvements over a period of 40 to 50 years. This, in combination with the requirement for a personal guarantee secured by non-utility property owned by the Company’s investors, precluded the Company from using the ARRA funds. The Company simply could not accept the funds because the financial terms would have worsened the financial risks it faced operating very small water systems and likely resulted in confiscation of non-utility property held by its shareholders to repay the ARRA note.

The Commission heard testimony from Robert Montville that explained that he reviewed the Company’s expenses from 2001 to 2010 and, with the exception of the fine imposed for the

³⁶ LRW Exhibit 6, Page 19.

³⁷ LRW Exhibit 7, Page 15.

Tamworth case, found that “the Company’s funds have not been mismanaged in any real sense.”³⁸ He testified that the Company’s financial condition is not the result of poor management or lack of capital planning, but due to the fact that “the rates and the return on investment has historically been well below the threshold needed to obtain break-even cash flow”.³⁹ As summarized in his testimony, during the period from 2001 to 2010:

The owners put in \$802,591. They paid themselves back \$95,511 during this period and absorbed \$110,000 court fine.

In order to continue to provide service to the public, the Company has had to stop or delay paying its vendors, who now take on the position of being its creditors for approximately, \$457,027.

The Company has converted/paid current assets and liabilities (erosion of the balance sheet) in the amount of \$146,401.

Without the Mason’s investment and the vendors funding its operations, the Company would have been out of business a few years ago.⁴⁰

This testimony reflects the challenges recognized by the NHDES and the Commission that any utility faces operating small or very small community water systems. To address the inadequacies in the Company’s rates, Mr. Montville therefore recommended that a return on equity of 12% be used based on his review of rates of return approved for comparable utilities prepared by the American Water Works Association data, and based on the revenues necessary to generate revenues sufficient to allow it meet its cash requirements and access debt and capital. The risks the Company faces operating 17 water systems are widely recognized and inherent to the systems the Company operates. It is entirely appropriate and necessary to recognize those risks by an adjustment to the Company’s rate of return on equity.

³⁸ LRW Exhibit 7, Page 3.

³⁹ LRW Exhibit 7, Page 5.

⁴⁰ LRW Exhibit 7.

Adjustment to Retained Earning. Staff disallowed an expense for payment of health insurance and pensions to its shareholders. In response to a data request, Mr. Laflamme agreed that the payment of health insurance and pension should “be used to offset loans or equity injections from the shareholders” and that “an adjustment to increase the Company’s retained earnings account by the amount of the reclassified shareholder pension and health insurance premium payments may be appropriate.”⁴¹ However, Mr. Laflamme did not provide the necessary adjustment that he would recommend.

In his reply testimony, Stephen St. Cyr adjusted the Company’s income and retained earnings to reflect the treatment of shareholder pension and health care as income.⁴² The adjustment has the effect of increasing the Company’s test-year earnings by \$52,645.⁴³ The Company amended its 2010 Annual Report and its 2007, 2008 and 2009 federal returns to reflect the increase in income. The treatment of these expenses as income reduces the losses recorded by the Company in prior years.

Adjustment to Federal Income Taxes and State Business Taxes. Mr. Laflamme eliminated all federal income and state business taxes from the Company’s revenue requirement. He reasoned that “the Company stated [in discovery] that its federal net operating loss carry forward was \$228,981” in the 2009 test year and that “Staff does not anticipate an immediate need for the Company’s current revenue requirement to include a provision for income taxes.”⁴⁴ However, in making this adjustment, he failed to adjust for the increase in income as a result of his disallowance of health care and pension expenses (\$52,645 per year). In response to data requests, however, he agreed that “an adjustment to increase the Company’s retained earnings

⁴¹ LRW Exhibit 31.

⁴² LRW Exhibit 5, Page 4 & Pages.

⁴³ LRW Exhibit 5, Page 21, Schedule 3a.

⁴⁴ Staff Exhibit 1, Page 10.

account by the amount of the reclassified shareholder pension and health insurance premium payments may be appropriate.”⁴⁵

The Company accepted Mr. LaFlamme’s disallowance of the health care and pension expenses and amended its Annual Report and its 2007, 2008, and 2009 tax returns to treat the disallowed expenses as income.⁴⁶ The addition of \$52,645 per year in income effectively eliminates the \$228,981 net operating loss carry-forward, especially in light of the temporary rates came into effect in 2010 in this proceeding. As a result, the Company will incur tax liability on a going forward basis.

In his reply testimony, Stephen P. St. Cyr re-instated the Company’s income tax liability.⁴⁷ He noted that the adjustment “harms the Company and its customers by: (a) reducing the cash available to meet operating expenses and pay its debt obligations; (b) reducing the Company’s opportunity to earn a reasonable return thereby accelerating the need for future rate relief, the costs of which are ultimately borne by the customers; and (c) reducing the Company’s ability to re-invest capital in the water system, which is particularly acute due to the need to make large capital investments in non-revenue generating assets.”⁴⁸

In any case, the assumption that the Company would not be subject to taxation is incorrect due to the Company’s acceptance of Staff’s disallowance of expenses resulting in an additional \$52,645 per year in income. As shown in LRW Exhibit 5, Page 19 (Schedule 3, Column 6) and Page 23 (Schedule 3b), Mr. St. Cyr calculates that an adjustment of \$68,732 is necessary to provide for state and federal income taxes the Company will incur going forward.

C. THE AFFILIATE AGREEMENT BENEFITS THE COMPANY’S CUSTOMERS

⁴⁵ LRW Exhibit 31.

⁴⁶ LRW Exhibit 9.

⁴⁷ LRW Exhibit 5, Pages 4-6.

⁴⁸ LRW Exhibit 5, Page 5.

The Affiliate Agreement between the Company and LRW Service benefits the Company's customers. The reason is simple: the Company received over \$18,000 in revenues during the test year it would not otherwise receive by billing LRW Service for sampling and other services when its employees were working in the same area.⁴⁹ Mr. Mason testified that: (1) the rates that LRW Service charges the Company are below market; (2) he does not generally bill for his time when LRW Service completes a project for the Company; and (3) LRW Service has allowed the Company to pay for capital projects as funds are available. The rate that LRW Service pays is \$19 per hour which is the hourly rate that LRW Service would pay to hire a part time employee to perform the same service. However, Mr. Mason testified that he would be willing to pay up to \$25 per hour.

The OCA proposed to change the rate paid by LRW under the Affiliate Agreement from \$19 to \$50 per hour. However, if LRW Services were required to pay \$50 per hour, it would simply hire an employee at the market rate of \$19 per hour to perform the same service. The Company would then lose over \$18,000 (\$11,600 in 2010 & 2011)⁵⁰ it receives from LRW Service during the test year.

It is *critical* that the Commission approve the Affiliate Agreement to the extent that it allows LRW Service to construct projects for the Company because the Company benefits from the relationship with LRW Service. If the Company were required to bid out its capital projects: it would be required to pay in full upon their completion and its ability to complete capital projects would be greatly reduced; it would lose the revenues it receives under the agreement; and it would lose the benefits of below market rates and Mr. Mason's availability to manage

⁴⁹ *SRE Attachment 2, Para. 4* ("The Company stated in response to discovery that the total number of hours billed by LRWC to LRWWS during the test year was 983.5 @ \$19/hour."); *SRE Attachment 6* ("These services performed for the affiliate are normally conducted on the same day that Employee 4 "sampling agent" would be in the area to sample and do pump house checks for the Company's operating water systems in the area.").

⁵⁰ Response to Record Request 4.

capital projects at no cost to the Company. The Company recommends that the Commission approve the agreement in its entirety and would accept a condition that the rate for use of Company employees be increased to \$25 per hour.

D. THE COMPANY'S PETITION FOR FINANCING SHOULD BE APPROVED

The Company requested that the Commission approve debt amounting to \$216,547 as set forth in LRW Exhibits 1 & 2. The Company is unaware of any testimony in opposition to its request. Staff witness Jayson Laflamme stated in his testimony that:

It is Staff's recommendation that the Commission should grant approval of this debt. Based on its analysis of these prior year issuances, Staff believes that the loans were prudent towards enabling LR WC to provide a safe and adequate supply of water to its customers. Further, where these loans were used to purchase various items of plant and equipment, Staff believes that these additions were prudent and reasonable and that the acquired assets were both used and useful to the Company in its operations. Lastly, the terms associated with each of the loans appear to be reasonable and will not adversely impact customer rates.⁵¹

The Company therefore requests that the Commission approve its petition for financing in LRW Exhibits 1 & 2.

⁵¹ Staff Exhibit 1, Page 7.

Respectfully submitted,

**LAKES REGION WATER
COMPANY, INC.**

By its Counsel,

UPTON & HATFIELD, LLP

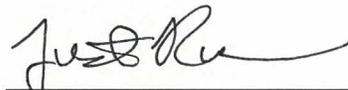


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Dated: April 9, 2012

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was this day forwarded to all parties on the official service lists for DW 10-141, DW 07-105, DW 10-043, and DW 11-021.



Justin C. Richardson