

**STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION**

DW 13-041

LAKES REGION WATER COMPANY, INC.

Petition for Emergency Rates Pursuant to RSA 378:9

Order Finding No Basis for Emergency Rates

ORDER NO. 25,516

June 4, 2013

APPEARANCES: Upton & Hatfield, LLP, by Justin C. Richardson, Esq., for Lakes Region Water Company, Inc.; Office of the Consumer Advocate on behalf of residential ratepayers, by Rorie E.P. Hollenberg, Esq.; and Marcia A. Brown, Esq. for the Staff of the Public Utilities Commission.

I. PROCEDURAL HISTORY

On February 4, 2013, Lakes Region Water Company, Inc. (Lakes Region or company) filed a petition for emergency rates pursuant to RSA 378:9. In support of its request, Lakes Region filed the direct testimony of Thomas Mason, President; John Dawson, Supervisor; and Stephen P. St. Cyr of Stephen P. St. Cyr and Associates, a consultant to the company. On February 5, 2013, the Office of the Consumer Advocate (OCA) filed a letter of participation. On February 14, 2013, Staff filed a letter identifying the need for discovery on certain issues on an expedited basis in order to allow a timely review of the petition.

On February 15, 2013, the Commission issued an Order of Notice, directing Lakes Region to provide public notice of a March 6, 2013 adjudicative hearing and ordering Lakes Region to respond on an accelerated basis to any discovery propounded by Staff and the OCA by close of business on February 22, 2013.

The Commission held hearings on March 6 and 7, 2013. The Commission called for responses to record requests no later than March 22, 2013 and written closing statements no later than April 5, 2013. Lakes Region submitted its final responses to outstanding record requests on April 11, 2013 and on April 29, 2013, Lakes Region, OCA, and Staff filed closing statements.

II. POSITIONS OF THE PARTIES AND STAFF

A. Lakes Region

Lakes Region states that it operates 17 separate water systems that serve fewer than 100 customers per system. It argues that it is extremely difficult to operate such systems and that as stand-alone systems, they could never be operated on a sustainable basis. Lakes Region asserts that it provides its customers with excellent water service. Lakes Region observes that its shareholders have invested millions of dollars to provide high quality water service yet the company is still in dire financial need. Lakes Region claims that payments that it had made to its shareholder, Mrs. Mason, which were treated as a “return of capital”, represent the only return the Masons have ever received for their investment in the company. Lakes Region Closing at 18. Lakes Region explains that its imperiled financial condition is due to the inherent nature of operating its small water systems. Lakes Region Closing at 1. Lakes Region argues that it has no choice but to finance improvements through its customers because it is “unbankable”. Lakes Region Closing at 3.

Lakes Region states that the Commission did not include payment for Federal and State income taxes in 2012 in its last authorized revenue requirement because Lakes Region had Internal Revenue Code (IRC) Section 179 net operating loss carry-forwards. *See*, Order No. 25,391 (July 13, 2012) approving permanent rates. Lakes Region states that it incurred income tax liability in 2012. Lakes Region’s original filing for this docket stated that it faced

approximately \$100,219 in estimated 2012 federal and state income taxes and that it would need \$173,634 in additional revenue requirement to cover that liability. This was a result of amended tax filings in February of 2012. At hearing, Lakes Region acknowledged that its amended tax filings had contained errors and that its federal and state income tax liability is now approximately \$50,873. Lakes Region Closing at 4. The amendment of its 2007, 2008 and 2009 returns led to the exhaustion of net operating loss carry-forwards Lakes Region had previously accumulated and therefore it is now liable for federal and state income taxes. Adding an underpayment penalty of \$898 and applying a tax factor of 57.7185%, Lakes Region now requests \$88,140 in additional revenue requirement rather than \$173,634 as requested in its petition. See also Exh. 17.

Lakes Region defended against the accusation made by the OCA and Staff that it did not need to amend its 2007-2009 tax returns and therefore would otherwise continue to have Section 179 carry-forwards. It stated that once it reclassified \$129,878.89 in shareholder pension payments to Mrs. Mason from an operating expense to paid-in capital, it was obligated to report the payments as income. Lakes Region Closing at 5-6. Lakes Region states that the 2012 unfunded tax liability has caused the emergency. Lakes Region Closing at 15.

Lakes Region argues that it is unable to pay its federal and state income taxes because it has needed to pay for operating costs and make investments in plant critical to providing service to the public. According to Lakes Region, without the emergency relief requested, its financial condition will deteriorate and its ability to continue to provide service to the public will be impaired. Lakes Region Petition at 2. Even though Lakes Region is earning a positive rate of return, it asserts that this return is overstated in that \$52,202 represents permanent rate recoupment approved in Order No. 25,423 (October 12, 2012) and was booked in 2012 due to

the company's accrual method of accounting. Lakes Region did not begin collecting that amount until November 2012. Also, according to Lakes Region, revenue from this recoupment is not intended to pay future tax expenses that were not provided in rates.

Lakes Region states that its present situation is similar to the facts in *Petition of PSNH*, 130 N.H. 265 (1988) in which the Supreme Court upheld the Commission's findings that an emergency existed; that it was unlikely that Public Service Company of New Hampshire would be in a position to meet its cash obligations as they became due, and that investors in the market were unwilling to provide additional funds due to perceptions of high risk.

B. OCA

In its closing, the OCA asserts that the evidence presented by Lakes Region does not support a finding that an emergency exists and, thus, recommends the petition be denied. The OCA states that the current circumstances arose in early 2012 after Lakes Region re-cast its income tax returns for 2007, 2008, and 2009. When Lakes Region amended its tax returns, it depleted its existing net operating loss and Section 179 carry-forwards and thereby created the purported income tax liability for 2012. Despite Lakes Region's knowledge early in 2012 that it would incur income tax liability, it chose to not make estimated payments during 2012 and instead litigated the customers' responsibility for the tax liability in its then on-going rate case. The OCA states that when that effort failed, Lakes Region filed the instant petition.

In addition, and with knowledge of its impending tax liability, Lakes Region chose to use its cash flow in other ways including a series of distributions to its then sole shareholder. The shareholder pension distributions belie Lakes Region's claim that it is "unable" to pay its income tax liability. Further reducing the apparent urgency of the company's request for emergency rate relief is the fact that, post hearing, Lakes Region has responded to record requests in a manner

that suggests the absence of a need for immediate action.¹ The OCA also argues that raising customer rates is not an appropriate answer to Lakes Region's income tax issue. At a time when the shareholder is partly withdrawing her investment and the company is refusing to seek reasonable debt financing, the company is seeking what approaches 100% customer financing and 100% customer risk of failure. Evidence in the record indicates that Lakes Region's rates are adequate; as a result Lakes Region's cash-shortage is not a burden to place on customers. According to the OCA, to the extent Lakes Region needs an increase in its revenue requirement, that issue should be discussed in its next full rate case. Such a rate case could serve as a context for discussing the company's unsustainable business plan of 100% customer financing and risk.

In the alternative, the OCA suggests that if the Commission grants an emergency rate increase, then certain conditions should be imposed: 1) require Lakes Region to use a fully-reconcilable surcharge mechanism; 2) have Lakes Region separately secure, and account for, the revenues received from customers for income taxes, possibly through the use of an escrow account and escrow agent; 3) penalize Lakes Region for using the services of two outside consultants in this proceeding, because the company continues to experience significant regulatory issues in spite of years of service by these consultants to the company, and these witnesses presented inaccurate evidence and inconsistent testimony to the Commission; and 4) deny Lakes Region recovery of any interest and penalties related to its 2012 tax liability.

C. Staff

Staff recommends the Commission deny Lakes Region's request. According to Staff, analysis of Lakes Region's 2012 earnings show that Lakes Region earned slightly higher than its authorized return. Staff questioned whether the current cash flow crisis warrants emergency

¹ Though Lakes Region stated it could meet the March 22, 2013 deadline for all record requests, it took until April 11, 2013 to complete the submissions.

rates that increase the compensatory rates customers are already paying. Staff believes Lakes Region has not met its burden of proof that it was required to amend its tax returns and exhaust its net operating loss carry-forwards. Staff suggested that it appears the company deliberately accelerated the exhaustion of its tax benefits in order to bolster its case in Docket No. DW 10-141 that it required a provision for income taxes in its rates. Staff claims that Lakes Region chose to issue what are essentially dividends to its shareholder at a time when the company has been in significant financial trouble, has amassed a large balance of past due accounts payable, and cannot or will not obtain the outside financing the utility desperately needs.

Staff argues that the Commission is obligated to balance the interests of shareholders and ratepayers and that in light of the adequate level of the company's current earnings, further increasing customer rates would put too great a burden on ratepayers. Lakes Region is slightly over-earning from the revenue requirement last authorized by the Commission yet it is still facing financial difficulties. Increasing rates under the theory of emergency rates would exacerbate Lakes Region's over-earning. Additionally, even if emergency rates were granted, the revenue from those rates would not be received in time to satisfy the tax payments.

III. COMMISSION ANALYSIS

Pursuant to RSA 378:9, "[w]henver the Commission shall be of the opinion that an emergency exists, it may authorize any public utility temporarily to alter, amend or suspend any existing rate, fare, charge, price, classification or rule or regulation relating thereto." "The Legislature...intended to vest in the commission as a fact finding body wide discretionary powers to decide whether a crisis is of sufficient severity to warrant relief and if so the extend of relief." *Petition of Public Service Co.*, 97 N.H. 549, 550 (1951) and *Petition of Public Service Company of New Hampshire*, 130 N.H. 265, 273 (1988). The test for whether an emergency

exists is: “whether reasonable persons may find the affairs of this company are at such a crisis that immediate and substantial disaster threatens unless prompt relief is given.” *Petition of Public Service Co.* 97 N.H. at 551. The crisis need not be unforeseen, sudden, or unexpected. *Id.* at 550-51. The urgency of the petitioner’s needs, rather than the time or manner of their arrival, determines whether emergency rates are warranted. *Id.* at 551.

After reviewing Lakes Region’s petition, the evidence admitted at hearing, and the closing statements submitted by Lakes Region, the OCA, and Staff, we deny the request for emergency rate relief. Lakes Region states that a financial crisis exists and warrants emergency rates because it does not have sufficient cash to pay its 2012 federal and state income tax liabilities. We find that Lakes Region should have sufficient cash to pay its 2012 federal and state income tax liabilities, although it may require reallocation of some funds, or deferral of some planned investments. We further find that the evidence does not support a conclusion that the affairs of this company are at such a crisis that “immediate and substantial disaster threatens unless prompt relief is given.” *Id.*

In determining whether a crisis exists under RSA 378:9, the New Hampshire Supreme Court has looked at whether the utility has continued operating losses. *See New England Tel. & Tel.*, 95 N.H. 58 (1948). In that case, the evidence demonstrated that even after the Commission approved a 10% temporary rate increase, pending its review of the company’s permanent rate request, it was still suffering significant operating losses. The Court in *New England Tel. & Tel.* directed the Commission grant an emergency rate increase to cover operating losses and interest expenses totaling \$770,000 annually. *Id.* at 62. Likewise in *Petition of Public Service Company*, 97 N.H. 549 (1951) the company was experiencing low earnings and had insufficient funds to pay bank loans when due. The court held that the facts supported a case of insolvency and held

that the record was sufficient to support a commission finding of emergency. Finally, in *Petition of Public Service Co. of N. H.*, 130 N.H. 265(1988), the company did not have sufficient cash to meet current business needs, did not have access to capital, and did not have sufficient earnings to maintain credit or support its financial integrity. *Id.* at 268.

We do not agree with Lakes Region that the facts in the instant case are similar to the prior New Hampshire cases. At hearing, Lakes Region agreed that it earned slightly more than its authorized return in both 2011 and 2012.² Lakes Region argues that the over-earning is in theory only, because revenues are artificially inflated by the influx of temporary and permanent rates. This argument, however, is not supported by the facts. In Exhibit 4, Lakes Region reports net operating income for 2012 of \$211,781, even after tax liabilities are accounted for: on page 167 of that exhibit, Lakes Region reports that its 2012 net operating income includes: “provision for income taxes - current \$97,949” and “provision for income taxes - deferred (\$15,059)”. Thus, we do not agree with Lakes Region’s argument that the 2012 net operating income is artificially inflated by revenues from the temporary-permanent rate recoupment and rate case expense recovery. Lakes Region had the means to pay its 2012 tax obligation out of its net operating income at a level higher than \$88,140.

Neither is the company suffering from continuing operating losses akin to *New England Tel. & Tel.* To the contrary, the company has *no* operating losses. Lakes Region’s rate of return calculation in Exhibit 4 reflects a rate of return “commensurate with returns on investments in other enterprises having corresponding risks.” *Petition of Public Serv. Co. of N.H.*, 130 N.H. 265, 275-76 (1988) citing *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). In fact, its earnings are 29 basis points above its authorized return.

²Hearing Transcript of March 6, 2013 (3/6/13 Tr.) at 76 lines 6-12.

We recognize that, notwithstanding its earnings in 2011 and 2012, Lakes Region's financial situation is poor and we are aware that a crisis need not be unforeseen in order to warrant emergency rates. We differentiate, however, between the factual circumstances in the two *Public Service Company* cases³ and the *New England Tel. & Tel. case* where there was evidence that the companies faced insolvency and the situation at hand. Lakes Region diverts discussion from the adequacy of its rates to the challenges of operating small systems and that these systems could never be operated on a stand-alone basis. Lakes Region implies that its financial woes are due to the inherent nature of operating such systems rather than Lakes Region's own financial decisions.

We disagree. Though small systems present challenges, we find no financial crisis to warrant the imposition of emergency rates, pursuant to RSA 378:9. Current rates are adequate to meet expenses. The company met and slightly exceeded its authorized return and it is not experiencing operating losses. The company has failed to meet its burden of demonstrating that it faces a financial crisis to warrant the extraordinary remedy of emergency rate relief.

It is clear, however, that the financial state of the company is not strong, and managerial decisions have done nothing to improve its financial health. Significant amounts of capital have been required in some of Lakes Region's water systems in recent years and Lakes Region or its shareholders, the elder Mr. and Mrs. Mason, have invested heavily in the company. Shareholder investments totaled over one million dollars over the last five years. Lakes Region Closing at 18. Lakes Region testified that it made \$113,629 in capital improvements in 2011 and \$115,550 in capital improvements in 2012. Exh. 1 at 10. These investments are consistent with the needs of older systems. We are aware of the pressure water utilities face in meeting state and federal

³ *Petition of Public Service Company*, 97 N.H. 549, 550 (1951) and *Petition of Public Service Company of New Hampshire*, 130 N.H. 265 (1988).

water quality standards, as well as the challenges of aging infrastructure. When a water utility makes a business of acquiring older systems, as has Lakes Region, such a business requires that utility to acquire and deploy needed capital for those older systems in order to meet its obligation to provide safe and adequate service pursuant to RSA 374:1.

Despite its need for capital, however, Lakes Region made payments to its remaining shareholder, Mrs. Mason. The payments began in 2011 and ended in September 2012 and totaled \$123,356. 3/6/13 Tr. at 94, lines 13-16. At hearing, Lakes Region's accountant referred to them as "return of capital". 3/6/13 Tr. at 127 lines 14-15. See also Exh. 4 at 164, "Increase (Decrease) Additional Paid in Capital." While we understand Lakes Region made the payments in order to address the personal needs and challenges of the company's shareholder following the death of her husband, these payments were not mandatory and were not in the utility's best interests.

Removing cash from a utility that reported in its recent rate case, Docket No. DW 10-141, that it has severe financial and cash flow problems is not a decision designed to support the financial health of the company. Such shareholder payments have a destabilizing effect on the company and have caused Lakes Region to continue to have a substantial level of past due accounts payables.⁴ These cash payments exceed the \$88,140 tax liability for which the company seeks emergency rate relief.

Other actions also cause us concern. In 2012, Lakes Region states that it amended several of its prior year tax returns in response to reclassifying shareholder pension and health care costs and a shareholder loan. Staff and the parties agree that by amending the returns, Lakes Region substantially reduced the availability of net operating loss carry-forwards and Section 179 carry-forwards that could have shielded future income. Despite requests in discovery and at

⁴ As of December 31, 2011, Lakes Region's accounts payable totaled \$524,368. Exh. 4 at 166.

hearing, Lakes Region produced no definitive evidence that its decision to amend its federal tax returns was required by the Internal Revenue Code. Instead, Lakes Region produced general information such as IRS publication 538 *Accounting Periods and Methods* and Publication 542 *Corporations* that were not relevant to the decision to amend the tax returns.

Further, the emergency rates Lakes Region seeks will not alleviate the purported crisis, even if we were to find a crisis exists. And though it was aware of the tax obligations after amending the prior returns, Lakes Region stated it had not sought a payment plan or other arrangement with tax officials, or to make partial payment on its state and federal tax obligations. This lack of effort on the part of Lakes Region further suggests that the company is not experiencing a “crisis” associated with its overdue taxes. This is in great contrast to the operating loss situations of *Petition of Public Service Company* and *New England Tel. & Tel.*

The fact that Lakes Region is earning its authorized return, or is possibly over-earning, demonstrates that Lakes Region’s overriding problem is one of cash flow, not one of inadequate or non-compensatory rates. It is apparent that Lakes Region’s lack of access to, or lack of ability to acquire outside debt or equity capital, is a very serious impediment to improving the financial strength of this utility. Although *New England Tel. & Tel.* involved a utility that was unable to sell stock, a nexus existed between granting an emergency rate increase and resolving the crisis. Here, by raising rates to solve the cash flow problems customers would essentially be forced to assume the role of equity investors. Lakes Region’s lack of access to capital requires it to rely solely on the earnings it generates through operations to meet all of its capital improvements obligations, and repayment of its substantial accounts payable. The Commission has stated that the ability to raise capital on reasonable terms is “a cornerstone of any evaluation of a public utility’s capabilities.” *Lakes Region Water Company*, Order No. 24,877, 93 NH PUC 310, 314

(2008). Lakes Region has stated that it is unable to obtain equity from anyone. 3/6/13 Tr. at 119. The “return” of capital to the shareholder in 2011 and 2012 suggests that future injections of equity capital are unlikely. Emergency rates, if granted, will not alleviate the financial strain that the lack of access to capital creates.

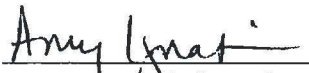
For the above reasons, although we accept that the company is facing difficult cash flow challenges, we do not find a threat of imminent and substantial disaster to conclude emergency rates under RSA 378:9 are justified. Because we do not find that an emergency exists, we need not determine emergency rates and we need not address OCA’s proposed conditions. Lakes Region, just as any other regulated utility, has tools at its disposal to manage its financial capabilities. Given that Lakes Region’s current customer rates are set to recover its expenses and authorized earnings, the company must work within its current revenues to address its financial problems. The company can re-evaluate its plans for capital expenditures; it can look for ways to reduce operating costs including payroll costs; it can review its priorities for vendor repayment; and it can work with the IRS, as the evidence at hearing has shown it has not yet done, to make arrangements for payment of its tax obligations.

Because its financial status is not strong, in Order No. 25,391 (July 13, 2012), we encouraged the company to recruit and hire a manager with a strong financial background to assist the company in addressing financial, compliance, and planning matters and authorized an increase in rates to cover that expense. Order at 24. We further requested that the company enhance its managerial capabilities with a reconstituted Board of Directors. While these changes to Lakes Region’s management have not yet had a reasonable amount of time to effect positive changes, we direct Staff to work with Lakes Region to develop a schedule of updates on the financial status of the company and its plans for a viable system in the future.

Based upon the foregoing, it is hereby

ORDERED, that Lakes Region Water Company, Inc.'s Petition for Emergency Rates pursuant to RSA 378:9 is DENIED.

By order of the Public Utilities Commission of New Hampshire this fourth day of June, 2013.



Amy L. Ignatius
Chairman

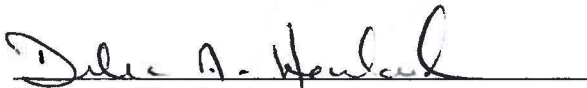


Michael D. Harrington
Commissioner



Robert R. Scott
Commissioner

Attested by:



Debra A. Howland
Executive Director

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Executive.Director@puc.nh.gov
amanda.noonan@puc.nh.gov
Christina.Martin@oca.nh.gov
dpatch@orr-reno.com
jayson.laflamme@puc.nh.gov
jrichardson@upton-hatfield.com
lrosado@orr-reno.com
lrwater@lakesregionwater.com
lrwater@lakesregionwater.com
marcia.brown@puc.nh.gov
mark.naylor@puc.nh.gov
robyn.descoteau@puc.nh.gov
Rorie.E.P.Hollenberg@oca.nh.gov
stephenpsteyr@yahoo.com
steve.frink@puc.nh.gov
susan.chamberlin@oca.nh.gov