STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

DOCKET NOS. DW 10-141, DW 07-105, DW 10-043, and DW 11-021

REPLY TESTIMONY OF ROBERT MONTVILLE

ON BEHALF OF

LAKES REGION WATER COMPANY, INC.

December 12, 2011

I. INTRODUCTION

Q. Please state your name, business address and position.

A. My name is Robert Montville. I am the president and founder of Montville, a small business consulting firm located at 178 Odiorne Point Road in Portsmouth, New Hampshire 03801; (603) 498-7600.

Q. Please state your professional qualifications.

A. I am a small business advisor for clients with sales ranging from one to twenty million dollars. For the past twenty-six years I have worked with owners of companies in the United States helping them develop financial plans that keep their businesses on a course of long-term profitable growth. A brief summary of my qualifications is attached as Montville Exhibit A.

Q. What is your involvement with Lakes Region Water Company?

A. In June 2011, I was hired by Tom Mason, Jr., President of Lakes Region Water Company to assist the company's management in the development of a long-term business plan. The goal of the plan is to eliminate the company's cash flow deficit and provide resources to fund future growth. I have been actively involved in updating and working toward implementation of that plan as part of these proceedings.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. I offer this testimony for the following purposes:

- To respond to questions raised by the Office of Consumer Advocate as to whether Lakes Region Water Company expenditures related to the operation of its business were imprudent. As described below, it is my conclusion that, with only limited exception, all or nearly all of the Company's expenditures related to its business were prudently incurred and necessary for the continued operation of its business.

- To respond to Staff's proposed revenue requirement and evaluate the impact of Staff's proposal on the ability of the Company to operate its business and provide service to the public. As described below, it is my opinion that the revenue requirement proposed by Staff is insufficient for the Company to fund the operation of its water system in order to provide service to the public.
- To respond to Staff's proposed rate of return and, specifically a return of equity of 9.75% for certain investments and 6.0% for others. It is my opinion that this rate of return is inadequate in light of the high level of risk associated Lakes Region Water Company's business providing service to the public. I believe that a rate of return on equity of at least 12% is required due to the inherent risk associated with operation of the Company's business providing service to the public and the need for substantial non-revenue generating capital improvements.
- To respond to Staff's recommendation that the Company should be sold. It is my opinion that without an approved plan to provide for rates that will resolve the Company's current financial needs, a sale of the Company would result in its investors losing all or nearly all of the equity they have invested in the Company in order to provide service to the public. Such a sale would provide little or no benefit to ratepayers because any utility buyer would need to invest substantial capital into the water system and would require recovery of a return on its investment.

III. PRUDENCY OF THE COMPANY'S INVESTMENT IN PUBLIC SERVICE.

Q. In the Office of Consumer Advocate's Testimony, Stephen Eckberg asks that you be appointed as a receiver "to address the myriad managerial and technical issues that result in multiple violations of statutes, rules and prudent utility operations." Eckberg Testimony, Page 19, Lines 1-3. Do you believe that its owners have imprudently managed the company's finances?

A. No. Due to concerns expressed by OCA and Staff regarding the prudency of the management of Lakes Region Water Company, I reviewed the Company's financial information to see if there was data to support a finding that the Company's funds had been used inappropriately. I have also been involved in meetings with the Company, PUC Staff, the OCA and others as part of my engagement to prepare a business plan for the Company to improve its finances, which contributed to my assessment of the Company's management.

Q. What did your financial analysis show?

A. I asked the Company's accountant, Norm Roberge to prepare an analysis of the Company's balance sheet, liabilities and equity, operation revenues and expenses, cash flows and debt. This analysis and a summary are set forth in Montville Exhibit B and confirms my opinion that the Company's funds have not been mismanaged in any real sense.

Q. How then did the Company end up in its current financial condition?

A. As shown in Montville Exhibit B:

- Net Income from water operations over the ten year period from 2001 to 2010 was $521,437 and other income was $51,296. Adding back depreciation to convert to spendable dollars gave the company operating cash of $1,493,032.
- The company spent $2,937,834 on capital improvement but $620,797 were funded by customers (CIAC).
- If the company spent all of its free cash flow on the net capital improvements, it would have generated negative cash flow of ($824,005).
- The Company borrowed $1,377,272 which includes the $110,000 fine, discussed below.
- During this time the Company made interest and principal payments totaling $1,461,523. Payments include the amount of the fine paid to date.
- Combining free cash flow from operations, debt financing, payments on that debt financing, and expenditures on capital improvements the company incurred net negative cash flow from operations of ($908,256).

Q. What does this data indicate is the cause of the Company's current financial condition referenced in the testimony of the OCA and Staff?

A. The analysis shows that the core reason the company is in financial trouble is that the rates and the return on investment has historically been well below the threshold needed to obtain break-even cash flow.

Any company can always improve its performance and the efficiency of its operations. However, there is no reason to believe that the Company's operating funds have been mismanaged. No employees or officers receive unreasonable compensation and it appears that expenses are under control. The financial problems facing the company are a direct result of the fact that its rates are inadequate to cover its operating expenses and to provide a reasonable return on its investment.

Q. What about the $100,000 fine imposed by the State of New Hampshire?

A. This appears to be the only significant example where a poor management decision by the Company had an adverse impact on the Company's operations. This happened under the Company's prior CEO, Thomas Mason, Sr., and it is my understanding that the Company is not requesting recovery of the penalty in rates.

Q. So how did the Company's management fund operations and capital re-investment in light of its negative cash flow?

A. The Company's investors, i.e. Thomas Mason Sr., continued to invest capital in the Company so that it could continue to provide service to the public. Montville Exhibit B shows the following 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.

IV. SUFFICENCY OF THE RATES RECOMMENDED BY STAFF

Q. Based on your review of the Company's business and financial performance, do you believe that the rates recommended by Staff are sufficient to provide an opportunity to earn a reasonable return on the Company's investment in service to the public?

A. No.

Q. Why?

A. The problem the Company (and its customers) now face is the Masons cannot continue to fund the losses without an opportunity to earn a reasonable return on their investment. However, the Company's status as a public utility subject to traditional rate regulation makes it difficult, if not impossible, to earn a return on its investment because of the need to make substantial capital improvements such as pipe replacements, water treatment facilities and supply improvements that do not produce any customer growth. This means that while the Company's expenses increase in real time, its revenues can only increase after a lengthy regulatory review process based on rates that are limited to the Company's historical cost of service.

As discussed in the Testimony of Thomas Mason, Lakes Region Water Company is made up of 17 small to very small water systems. In many cases these systems, prior to their acquisition by the Company, these systems were not properly constructed to meet current standards for service or provided insufficient revenues to operate on a stand-alone basis. These 17 systems simply do not produce sufficient revenue to protect the Company from increases in its operating expenses while it continues to fund capital improvements. As a result, despite the Company's best efforts, it is my opinion that the rates proposed by

Staff will deny it the opportunity to recover its costs of operation and earn a reasonable return on its investment.

Q. What revenues are required to continue to provide recovery of and a reasonable return on the Company's costs to provide service to the public?

A. As part of my engagement for the Company, I prepared a financial analysis of the revenues necessary to provide the Company with an opportunity to earn a return on its investment and resolve its current financial difficulties. That analysis, based on my review of the Company's financial records, is contained in Montville Exhibit C and shows the revenues that are required to recover the Company's cost of service, repay its debt and allow it to continue to make capital improvements that are necessary to provide service to the public.

Q. How would you address the need to implement capital projects?

A. The Company needs to reduce the regulatory delay that occurs between its approved rates and increases in its expenses for operations and capital. I understand that Thomas Mason has proposed an alternative form of regulation to allow the Company. If approved, this may help overcome the regulatory delays facing a small Company that needs to implement substantial capital projects.

III. RATE OF RETURN

Q. Do you believe that Staff's proposed return on equity is adequate in light of the risks faced by its investors?

A. No.

Q. Why?

A. As noted above, the Company's rates are low relative to the required capital investment for continued operation of the Company's 17 water systems and the increases it faces fixed costs for operations. Increases in these expenses effectively prevent the Company from any opportunity to earn a reasonable return on its investment. Under the current rate principles, any capital investment in the Company faces the risk (if not the certainty) that these expense increases will result in no return on the investment.

Q. How do you propose to address this problem?

A. There are at least two potential solutions. One solution would be to allow the Company to receive automatic rate increases based on an index that tracked increases in its expenses. Another approach that I understand is closer to traditional rate setting principles, is to set a rate of return on equity that is commensurate with returns on investments in other enterprises having corresponding risks. Due to the immediate need for rate relief, I recommend this approach.

Q. What would you recommend for a return on equity for the calculation of the Company's revenue requirement?

A. I believe that a <u>minimum</u> of 12% for the Company's allowed return on equity is appropriate based on the risks the Company faces to earn a reasonable return on its investment. For the reasons stated herein, I see it as highly unlikely that the Company would actually earn this rate on equity unless the procedure for approval of the Company's rates is fundamentally changed.

Q. How does this compare to other regulated water utilities?

A. I examined data on the Percentage (%) Return on Equity for Privately Held Water Companies provided by the National Association of Water Companies (NAWC). The attached a spreadsheet shows the rates of return based on their last rate case.

This data shows that the rates of return to the rates of return presented in my “pro active” rate plan/cash flow to restore the company to profitability are reasonable compared to the NAWC data. In addition, as explained in Thomas Mason’s testimony, it is also important to take into account not only the revenues on a company basis, but also the size and the dispersed nature of the 17 developer-built systems that the Company operates. This leads me to conclude that use of a 12% return on equity is appropriate in consideration of the very real financial risks that are inherent in the Company’s business providing water service to the public.