STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

REPLY TESTIMONY OF

STEPHEN P. ST. CYR

ON BEHALF OF LAKES REGION WATER COMPANY, INC.

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

December 12, 2011

I. INTRODUCTION

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

A. My name is Stephen P. St. Cyr. I am president of Stephen P. St. Cyr & Associates, located at 17 Sky Oaks Drive in Biddeford, Maine 04005, Tel. (207) 282-5222. I prepare Lakes Region Water Company's ("LRWC") PUC Annual Report, financing schedules and testimony, and rate schedules and testimony.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. I offer this testimony in response to the rate schedules proposed by Staff Witness Jayson LaFlamme. My testimony today explains those significant areas where the Company disagrees with the rate schedules proposed by Staff. Also, in response to the testimony provided by Staff Witness Mark Naylor regarding the Company's lack of access to debt and capital markets, I have included a schedule for a proposed 2012 step adjustment in order to allow the Company to maintain sufficient rates in order to continue to provide public service and complete capital projects that may be required in the foreseeable future, based on the Company's 5 year capital improvements plan. The Company requests that the Commission approve treatment of this proposed step increase as an alternative form of rate regulation under RSA 374:3-a, subject to the conditions proposed in the Testimony of Thomas Mason.

III. RESPONSE TO STAFF'S PROPOSED RATE SCHEDULES

Q. Please explain the Company's response to the rate schedules proposed by Staff.

A. There are many areas of agreement between the Company and the PUC Staff. For example, except for a few minor adjustments to rate base, the Company and the Staff agree on the components and amounts in rate base. The significant area of disagreement as it pertains to rate base is whether to use a year end rate base or an average rate base, which I will address later in my testimony. Also, another example of agreement between the Company and the PUC Staff is the capital structure, except for an addition to retained earnings that the Company made as part of its rebuttal. I will also address this later in my testimony. In addition, the Company and the PUC Staff agree on many adjustments to operating revenue and expenses. The significant area of disagreement as it pertains to operating expenses is income taxes.

Q. Please summarize those areas of disagreements.

A. The area of disagreement are as follows:

(1) Use of Year End Rate Base

In its original rate filing the Company prepared rate base on a beginning and ending year average balance and then adjusted the balance to the year end (12/31/09) balance. The PUC Staff requested and the Company provided the monthly balances for each of the rate base components. The PUC Staff then summed the 13 month balances and divided the 13 month balance by 13 to arrive at a 13 month average balance. The PUC Staff, as part of its rate base adjustments, then reversed the Company adjustment to derive the year end balance and replaced it with the 13 month average balance. The Company continues to believe that it is fair and reasonable to use year end balances. It believes so because it is now December 2011 and the permanent rate will not be finalized until some time in 2012. The 2009 rate base items have long been completed, in service and providing service to customers. The Company and the PUC Staff are in agreement that the 2010 additions to plant should be reflected at their year end balances. It would be inconceivable to the Company that its 2010 additions to plant will be fully reflected in rate base but its 2009 additions would not be, due to the average of the balances. This is also true of any plant related items such as accumulated depreciation, acquisition adjustments and CIAC, and the other rate base items. Also, the Company's investments consist largely of non-revenue producing improvements. It is our understanding that the Commission has approved similar treatment in other cases, such as *Unitil Energy Systems, Inc.*, 91 NH PUC 416 (2006).

(2) Use of 12% Return on Equity

The Company proposes a 12% return of equity due to increased financial risks associated with Company's utility plant and non-revenue generating capital requirements. *See e.g. Appeal of PSNH*, 130 N.H. 265 (1988) ("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 corresponding risks."").

The basis for the Company's proposed return on equity is explained in the Testimony of Robert Montville and Thomas Mason. For certain investments, Staff proposed a reduced return on equity of 6%, due to the Company's alleged failure to obtain lower cost debt financing. See Testimony of Jayson LaFlamme, Pages 8 & 9. As explained in the Testimony of Thomas Mason, this lower cost debt financing was not reasonably available. In addition, the cost of debt should not be used to lower the Company's cost on equity.

SPS Schedule 1b therefore uses a 12% return on equity in order to provide an opportunity to earn a return that is commensurate with returns on investments in other enterprises, having corresponding risks to those facing Lakes Region Water Company.

(3) Adjustment to Retained Earnings to Reflect the Reduction for Pension and Health Insurance

In the original filing, which includes an adjusted test year of 2009, the Company incurred pension and health insurance expenses on behalf of its owners. The PUC Staff proposed reducing test year expenses for pension and health insurance expenses. After much discussion, the Company has accepted the need to reduce test year expenses for the pension and health insurance expenses. However, with the Company acceptance of the reduction, the PUC Staff did not make a corresponding adjustment to retained earnings. By reducing test year expenses, net income would increase by the same amount and net income closes into retained earning. Therefore, retained has to be adjusted for the reduction of the pension and health insurance expenses.

(4) Adjustment for Federal Income Tax and State Business Tax

In the Company's filing, it used the standard federal tax rates applied to taxable income and 8.5% state business tax rate applied state business gross profits. Please note that federal taxable income between $100,000 - $335,000 is taxed at 39%. The Company just applied the standard methodology used by the Commission and its Staff in its and other past proceedings. However, the PUC Staff reduced the Company's income tax liability to zero due to the availability of net operating losses that could be carried forward in future years to offset taxable income.

I disagree with the PUC Staff's adjustment for several reasons. First, in developing adjusted test year expenses, the Company is allowed to adjust test year expenses for known and measurable changes. One of the objectives of the rate case is to become profitable, to actually make some money instead of losing money. A consequence of becoming profitable, is realizing taxable income and paying income taxes.

The income tax expense from the Company's test year expenses unfairly punishes the Company for the losses it has incurred in prior years. This 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.

Second, the recognition of any difference between income tax expense and the amount of income tax paid is already recognized as a reduction to rate base. See JPL-1 Rate Base - Deferred Taxes of $105,511. While the Company is not advocating the removal of the deferred taxes from rate base, if the PUC Staff eliminates the income tax expense, then it should also eliminate the deferred taxes from rate base, since such deferred taxes are created from the timing difference between taxes incurred and taxes paid.

Third, by only allowing income taxes if such taxes are paid deviates from the accrual accounting from which the Company's books, financial statements and filing are prepared. Staff's adjustment focuses only on that one item.

As a result, the Effective Tax Factor is shown on SPS-1b and incorporated in the schedules.

Q. Why is the Company concerned about access to capital in order to meet these requirements?

The Company is concerned about its access to capital because it has significant capital needs over the course of the next 5 years. While the Company has struggled financially, it has been approved by the State to access state revolving funds ("SRF"). After much consideration, the Company decided not to pursue the SRF because traditional rate making did not generate enough revenue to repay the loan. The recovery period of the assets was longer than the repayment of the loan. It is unreasonable to expect the Company to borrow funds and pay back such funds over 20 years when many of the assets are being recovered over 40 -50 years. Their simply is not enough cash being received to pay the principal and interest on the loans. Its own bank, TD Bank, has not been willing to finance projects given the Company's present financial position.

Mr. Naylor, in his testimony, raises the question "How will the Company address its pending capital needs if it is in such poor financial condition?" The answer is that the current rate case is intended to give the Company the opportunity to earn a return on and recovery of its investments and to cover its ongoing operating expenses. The Company expects improved earnings in 2011 due to the PUC's approval of temporary rate in this rate case. The PUC Staff's revenue requirement level will allow the Company's financial condition to improve from poor to fair. The Company's revenue requirement level will allow the Company's financial condition to improve from poor to good.

While the Company expects its financial condition to improve, in order to address its pending capital needs, it needs the PUC to approve a 2012 step adjustment. The 2012 step adjustment is based on recovery of the Company 2011 and 2012 additions to plant. The Company has had discussion with its bank about such a financing and the bank has been willing to consider such a financing once permanent rates are approved and provided that there is an additional rate increase that enables the Company to pay back the loan. As such, the Company is proposing a step adjustment, which will allow for recovery of the investments over the life of the loan.

For the purpose for my testimony, I have assumed a term of 10 years for repayment of a loan to finance capital projects. As explained in Thomas Mason's testimony, the Company is willing to work with the parties on the projects, the financing and the recovery such that the revenues from the step adjustment would be placed in a separate account and such revenues would be used to pay principle and interest on the loan. The fundamental problem is not the Company's access to fund but its ability to generate enough revenue in order to pay the principal and interest on the debt. The 2012 step adjustment will solve that fundamental problem.

Q. Please summarize your testimony.

A. The Company and the PUC Staff agree on more than we disagree on. The significant areas of disagreement are the year end versus 13 month average rate base, the 12% return on equity versus the 9.75% / 6.00%, and the income taxes. It is important that the rate base reflect year end balances because such rate base balances are fully employed in the service to customers and as such the investment should be fully reflected. It is important that the return on equity recognize the risk of owning and operating a varied, geographically distant, multiple-satellite water system and its needs based on its physical and financial conditions. It is also important to allow income tax expense. It is the Company's hope and desire to become profitable at the conclusion of the rate case, to realize taxable income and to pay income taxes. As such, it is important that the Commission approve the Company's proposed combined revenue requirement from general customers of $1,045,185. Equally important is the PUC approval of the 2012 step adjustment for the recovery of the 2011 and 2012 over the 10 year loan period. Approval of the Company's revenue requirement and the 2012 step adjustment will enable the Company to meet its present and future obligations.

Q. Does this conclude your testimony?

A. Yes.