STATE OF NEW HAMPSHIRE

BEFORE THE

PUBLIC UTILITIES COMMISSION

REPLY TESTIMONY OF

THOMAS MASON

ON BEHALF OF LAKES REGION WATER COMPANY, INC.

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

December 12, 2011

I. INTRODUCTION

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

A. My name is Thomas Mason. I am the President of the Lakes Region Water Company, Inc.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. I offer this testimony in response to that offered by the Staff, the Office of Consumer Advocate (OCA), and the Property Owners Association of Suissvale, Inc (POASI). My testimony responds to the following issues:

- First, my testimony responds to Staff's and OCA's testimony concerning the Company's financial condition and its limited access to capital and debt and debt at reasonable rates. My testimony explains that the Company's financial condition is in large part the result of the water systems it operates to provide service to the public, which consist of small developer-built water systems that were acquired by the Company because they were: (1) not financially viable on a stand-alone basis; (2) not in compliance with regulatory requirements; and (3) in need of significant non-revenue generating[1] capital investment at the time they were acquired by the Company. The Company has provided a benefit to its customers by operating these systems and, as Robert Montville explains, has made substantial investment in their improvement. However, the limited revenues provided by these small water systems and their need for substantial non-revenue generating

[1] "Non-revenue generating" refers to capital investments or projects that do not result in customer growth.

investment is the primary cause of the financial conditions described and the Staff and OCA's testimony.

- Second, my testimony explains that Staff's proposed rate of return for equity: 9.75% for some investments and 6.0% for others, is insufficient in light of the substantial risks presented by the nature of the Company's business of providing service to the public from small developer-built water systems. My testimony supports Robert Montville's recommendation that a minimum return on equity of twelve percent (12%) is required, due to the substantial financial risks that are inherent in the operation of the Company's water systems.
- Third, my testimony agrees with Staff's suggestion that the primary problem facing the Company is lack of access to capital and lower cost debt under terms that are reasonable for the Company and its customers. I explain that I believe it is in the best interest of the Company and its customers for the Commission to approve a procedure for the Company to seek Step Increase using an Alternative Regulatory Treatment under RSA 374:3-a that will enable the Company to implement capital projects that are critical to the improvement of its 17 water systems. I propose terms and conditions for the Commission's consideration that I believe will benefit the Company and its customers.
- Fourth, my testimony responds to the OCA's recommendation that the Company be placed in a voluntary or other receivership and Staff's recommendation that the Company be sold. I explain that receivership or a sale of the Company without a plan in place to address its financial condition would not benefit the Company or its customers, and is not authorized by law.

- Finally, my testimony responds to the testimony offered by the Property Owner's Association of Suissvale, Inc.

III. CAUSES OF THE COMPANY'S FINANCIAL CONDITION

Q. Staff witness Mark Naylor provided testimony, Page 3, Line 2, stating that "[w]hile the company has made progress in addressing some of the problems it has had with its physical water systems, the company's most urgent problem is financial. Lakes Region has capital needs going forward over the next several years in excess of $1 million." He also states that "[a]t issue is the fact that the company does not appear to have the access to the needed capital, at rates reasonable or otherwise.

What is your reaction to this testimony?

A. As Mr. Naylor indicates, the Company has made significant progress addressing the "problems it has had with its physical water systems" but its primary need is financial as it "has capital needs going forward over the next several years in excess of $1 million".[2] This represents a substantial capital addition as the Company's total net plant reported in the Company's 2010 Annual Report is $3,022,644 as of 12/31/2010.[3]

Q. Why are the Company's capital needs significant?

A. The Company's capital needs are a direct result of the physical and economic characteristics of the Company's assets. Lakes Region Water Company is comprised of approximately 1,625 customers located in 17 systems that were largely constructed by developers who constructed water systems in order to sell lots for residential development and failed to provide for their long term operation or financial viability.

Q. What was the condition of these water systems when they were acquired?

[2] Page 3, Lines 2-3.
[3] F-1 Balance Sheet, Line 5.

A. The events that led to the Company's acquisitions of water systems during the period from 2001 to 2010 are provided in Mason Exhibit A. More importantly, Mason Exhibit B provides references to the Commission's Orders that approved the Company's acquisition of smaller water systems that were out of regulatory compliance, often with the support and encouragement from regulatory agencies such as the NH Department of Environmental Services and the Commission's staff.

Q. What impact does this have on the Company's financial condition?

A. The Company's financial condition is a direct result of the fact that the Company's water systems produced little revenue and needed substantial capital improvements that do not generate customer growth at the time they were acquired. As explained by Robert Montville, the Company's operating and capital expenses increase at levels that exceed the Company's expected returns. While the Company is in theory allowed to request rate increases based on a test year, by the time the test year is complete and the Company's rate request is prepared, filed and approved, the Company's financial needs are no longer reflected by the test year. This is certainly true in this case as the Company's financial needs have continued to evolve since the 2009 test year.

Q. What progress has the Company made to improve the operations of the systems the Company has acquired?

A. As noted by Mark Naylor, the Company has made progress improving the performance of its water systems. The progress is significant. Since the 2009 test year, which is the first year that I assumed control of the Company's operations, the Company has successfully resolved four of the five the Letters of Deficiency (LODs). The Company has also resolved its only outstanding Administrative Order from the NH Department of Environmental Services.

While additional (and significant) work remains to be completed, the fact that the Company has been able to s improve the performance of the systems it acquired is an accomplishment that should not be overlooked. The problem the Company faces, as discussed in Robert Montville's testimony, is that the revenues the Company receives for the service are insufficient to cover its operating costs and provide a return so that the Company can continue to reinvest in its water systems.

Q. Mark Naylor states in his testimony that the Company "has never engaged in a comprehensive planning process by which it acquires capital, deploys it, and timely obtains rate relief." Page 4, Lines 20-21. Do you agree?

A. I disagree for several reasons. First, the Company does engage in comprehensive planning. Mason Exhibit E shows the Company prioritization of capital improvements that are derived from its 5-year Capital Improvements Plan contained in Mason Exhibit F. The Company re-evaluates these plans on an on-going basis as circumstances change or new needs arise. The problem is not a lack of planning. The Company's rates are simply too low to allow it implement the necessary improvements.

Second, the Company engaged Robert Montville to prepare a plan to improve the Company's financial performance. As Mr. Montville explains in his testimony, the Company's primary problem is that its rates simply do not provide sufficient funds to implement the plans it has. The Company has had to defer payment to its consultants and suppliers in order to fund improvements to its water systems. As Mark Naylor noted in his testimony, the Company has on the order of $471,000 in outstanding invoices and is therefore unable to obtain long term funding from banks or other sources.

Q. What about the State revolving funds and ARRA money that, according to Staff's testimony, were refused by the Company?

A. I do not agree that the Company voluntarily refused these funds. As noted in Mason Exhibit A, the Company actively sought ARRA funds in order to implement its priority capital projects, which were then recommended by the NHDES. However, the terms recommended by NH Business Finance Authority required that the Company's owners provide a "personal guarantee" for repayment of the loan and stated that it "cannot recommend approval of the loan." See Mason Exhibit D.

This negative recommendation was only made worse by the fact that the returns that the Company would receive from its rates are based on the physical life of its assets, typically a period of 50 years, while its obligation for repayment of the note was a 20 year period. As a result, even with debt forgiveness, the rates would not be sufficient to risk a personal guarantee of repayment, especially in light of the Company's debt and financial condition.

IV. RATE OF RETURN.

Q. How does the Company propose to overcome its present financial condition and limited access debt and capital?

A. In addition to the specific changes proposed by Stephen P. St. Cyr in his Testimony, I believe that the Company's allowed rate of return on equity should be increased to a minimum of twelve percent (12%) to reflect the inherent risk inherent in operation of its business. While this is greater than the approved rates for larger utilities such as the Pennichuck Companies (ROE 9.75%), Aquarion and others, those utilities do not face financial challenges and risks that are similar to Lakes Region Water Company. Each of these companies is larger and operates larger water systems that serve larger, consolidated population centers. All of the Pennichuck utilities, for example, benefit from its service to the City of Nashua which serves some 24,000 hydraulically connected customers. By comparison, Lakes Region Water's largest system has only 375 customers, and its smaller systems have as few as 45 customers in some cases. See Mason Exhibit B.

It is also important to note that the Company has not earned close to its allowed return in over a decade and has even had negative cash flow in recent years. Due to the nature of its systems, the Company does not expect that it would actually earn its allowed return. Rather, use of a 12% return would provide greater protection against operating cost increases and delay the need for future rate filings, to the benefit of its customers and the Company alike.

V ALTERNATIVE REGULATORY TREATMENT (RSA 374:3-a)

Q. What other changes are necessary?

A. I also believe that the Company needs to modify its rates in a way that will allow it to reassure its lenders of its ability to repay loans for capital projects in order to obtain long term financing at lower rates.

Q. **How do you propose that this be achieved?**

A. The Company's proposal is attached as Mason Exhibit F, I have asked the Company's rate consultant, Stephen St. Cyr to prepare a rate schedule showing a step increase to finance improvements to be identified by the Company with input from DES, the Commission Staff, the OCA and other interested parties. The Company will seek the best financing available from public or private sources. At the time the Company sought approval of the financing, the Company would request alternative rate treatment to allow the Company to finance the debt portion of the projects in rates over the life of the note.

Using this approach, the Company would have the ability to negotiate the most favorable financial terms for the utility's customers at the lowest interest rate and longest terms available. Currently, the Company's lenders have focused on the need for very short term loans which would not be favorable for the Company or for its customers. However, if the Company is able to allocate its revenues for step increases to particular capital improvements in a manner approved by the Commission, this will allow the Company to obtain financing for capital improvements at the lowest costs to customers.

Q. What is the legal authority for this approach?

A. The Company requests approval of this approach as an alternative form of rate regulation, RSA 374:3-a, and proposes terms and conditions for the Commission's consideration in Exhibit F.

VI. POTENTIAL SALE OF THE LAKES REGION WATER COMPANY

Q. Mark Naylor and Staff recommend that the Company be sold. What impact would this have on the Company's investors?

A. In the Company's current financial situation, a sale would likely result in a complete loss of shareholder equity for its plant in service. Due to its small size, the Company's value to a potential buyer is the potential revenue to the buyer. However, under its present rates and capital requirements, the Company is a financial risk to a potential buyer.

Q. Why is this?

A. The best and most obvious answer to this lies in the nature of the physical assets the Company operates. While the Company's 1,626 customers appear to be nominally attractive, they are distributed among 17 separate community water systems having an average of less than 100 customers each. 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 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. While the Company has been able to realize some marginally economies of scale by operating all of these water systems as a single business unit, they are far smaller and scattered than what a buyer would seek in the marketplace.

Q. What impact would the sale of the Company have on its customers?

A. The sale of the Company would also have a negative impact on the Company's customers. As Mark Naylor recognizes, the Company faces the need to make substantial non-revenue producing capital investments in excess of $1 million. An investor-owned utility buyer would require not only a reasonable return on the Company's current rate base, but also would require a return on its investment in improvements to the system.

Because of the extent of those investments, any buyer would need to make substantial rate increases to provide those improvements.

Q. In your opinion, would a potential third party purchaser be willing to step in and make those improvements?

A. No. The reason is simple. The Company's small size makes it unattractive because its revenues are relatively insignificant to any overall investment portfolio. Lakes Region Water is simply not an attractive investment option for a larger water utility.

VII. RECEIVERSHIP

Q. The Office of Consumer Advocate has submitted testimony recommending that Lakes Region Water Company be placed into some form of a "voluntary receivership." Testimony Stephen Eckberg, Page 17, Line 18. What is the Company's position concerning this proposal?

A. The Company opposes receivership because it will not solve the Company's main problem which is the need for rate increases and access to capital. These are rate making issues and are not an adequate legal basis for receivership.

RSA 374:47-a provides for receivership in cases where there is a failure "to provide adequate and reasonable service to its customers, and that such failure is a serious and imminent threat to the health and welfare of the customers of the utility." As noted above, the Company has resolved all but one of its pending letters of deficiency and continues to make improvements to its system.

VIII. RESPONSE TO POASI

Q. POASI expresses concern in its testimony regarding the development of supply wells and an additional water line. Pages 4-6. What is your response?

A. The Company has never indicated that the water storage tank would resolve all water supply issues. The water tank was constructed to address the peak demands for water that occur during weekends and vacation weeks. The dedicated water line was suggested by the NHDES because the original line, installed in 1993, is undersized for the 350 homes it serves.

Q. What is your response to POASI's concerns as to the land costs and other issues associated with the Mt. Roberts property? Ref Page 6, line 202-:

A. As POASI recognizes in its testimony, the land was purchased by Tom & Barbara Mason in order to assist an employee address financial issues related to her marriage. At the time it was purchased, there was no information concerning its potential use for water supply or other purposes related to the Company. It was a private investment that was entirely at risk, not subject to rates and its use for public service was not contemplated.

More generally, the decisions the Company has made concerning improvements to the POASI system have been based on the best information and resources available. The concerns presented in the POASI testimony reflect the difficult business environment in which the Company operates. The POASI system, like those owned and operated by the Company, do not provide sufficient revenues to make all of the improvements that may be required by law without substantial rate impacts. That is a problem inherent in the water systems themselves and is not the result of the Company's capital plans or any lack thereof.

At present, the Company has removed development of the Mt. Roberts wells from consideration in this case. However, the Company will continue to work with POASI to help address its water supply needs using the most cost-effective means available.