BEFORE THE STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

Lakes Region Water Company

Petition for Emergency Rate Increase

Docket No. DW 13-

DIRECT TESTIMONY OF
THOMAS A. MASON

I. BACKGROUND

Q. What is your name and business address?

A. Thomas A. Mason, 420 Governor Wentworth Highway, PO Box 389, Moultonborough, NH 03254.

Q. What is your role at Lakes Region Water Company?

A. I am president of the Company and serve on its Board of Directors. The Company is wholly owned by my mother, Barbara Mason.

Q. How did you become involved in Lakes Region Water Company?

A. I joined Lakes Region Water Company in 2007 as Vice President when it was then-owned by my parents, Thomas A. Mason, Sr., and Barbara Mason. Prior to joining the Company, I served as President of LRW Water Service, Inc. ("LRWS") and continue to serve as its President. Over the years, I developed LRWS into a regional business that provides a full range operations and construction services for water utilities: LRWS provides certified operator services for small water systems. LRWS also provides construction services for both large and small municipal and utility water systems, including Pennichuck Corporation, the Town of Alton Water Works Department, the Franconia Board of Water Commissioners and many others.

I joined Lakes Region Water Company in 2007 because my parents were finding it increasingly difficult to operate the Company's 17 drinking water systems. The Company's water systems are very small developer-built systems serving an average of fewer than 100 customers per system. The Company faced difficult challenges as its water system infrastructure aged and regulatory requirements became more stringent. My father believed in his ability to serve the public but, as he also aged, he was unable to meet the difficult financial and regulatory challenges. The Company faced a number of letters of deficiency (LODs) issued by the N.H. Department of Environmental Services (NHDES) related to compliance with drinking water requirements. Because of my experience in operation and construction of water systems as President of LRWS, I joined the Company as Vice President and sought to improve its operational and financial performance.

Q. How has Lakes Region Water Company improved since you joined the Company?

A: Today, five years later, Lakes Region Water Company has resolved all of the LODs issued by the NHDES, except for the Mt. Roberts water supply. However, the Company has worked closely with the NHDES to resolve the Mt. Roberts LOD and, on July 5, 2012, the NHDES permitted the Mt. Roberts well as a small production well under Env-Dw 301, pending a decision by the Property Owners Association Suissevale, Inc. ("Suissevale") whether to remain a wholesale customer or seek its own source of supply and become fully regulated as a public water system.[1] *See* Mason Exhibit 1.

As John Dawson explains in his testimony, the Company operates difficult water systems, but has an excellent record doing so. The Company has 4 full time certified water system operators who are highly trained and experienced and the

[1] If Suissevale decides to remain as a customer, the Company will need to permit Mt. Roberts as a large production well under Env-Dw 302.

NHDES looks to Lakes Region Water Company as a model for its leadership in the operation of small water systems.

Q. Why then is Lakes Region Water Company seeking emergency rates?

A. Lakes Region Water Company has corrected and improved its technical operations, performance and compliance. However, despite significant efforts to improve, its financial condition remains poor and its rates are insufficient to prevent its financial condition from deteriorating. As Mr. St. Cyr explains in his testimony, this is because the Company's approved rates do not include an allowance for payment of $100,219 in Federal and State income taxes the Company incurred in 2012. Without revenues to pay its existing and accrued tax liability in its rates, the Company's already difficult financial condition will deteriorate and undermine its service to customers.

II. SUMMARY OF EMERGENCY RATE REQUEST

Q. Please explain the Company's emergency rate filing.

A. Lakes Region Water Company's filing consists of its Petition for Emergency Rates which explains the legal basis for its filing under RSA 378:9. In support of its Petition, the Company offers the following Testimony:

First, the **Testimony of Stephen P. St. Cyr** explains that the Company's current rates approved from the Commission do not include any allowance for income taxes. Mr. St. Cyr explains that the Company expects to incur $100,219 in Federal and State income taxes in the 2012 tax year.

Second, the **Testimony of John Dawson** explains that the Company provides superior drinking water service to its residential and wholesale customers that is reasonably safe and adequate under RSA 374:1 and in compliance with drinking water standards established by the NHDES. However, the Company faces an industry-wide challenge due to the need to invest substantial capital in its 17 water systems to maintain compliance. The omission of revenues to pay its $100,219 tax liability adversely impacts the Company's ability to provide service, obtain financing to implement its capital plans. If the Company's tax liability is not corrected, service to the Company's customers and regulatory compliance will be impaired.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to explain why the absence of an allowance for taxes and an opportunity to earn its allowed a return, harms both the Company and its customers as follows:

(1) The Company is unable to make estimated tax payments. In the absence of revenues for taxes in its approved rates, the Company has been unable to make estimated tax payments and may incur penalties and interest for 2012. Any interest and penalties on unpaid taxes directly harm the Company and its customers by taking resources away from operations, maintenance and improvements to its water systems.

(2) The Company's rates prevent it from improving its financial condition, refinancing and eliminating payables and implementing Commission Recommendations. In the absence of revenues for taxes in rates, the Company has been unable to earn a sufficient return, reduce its payables, and maintain its financial condition. This impairs the Company's ability to implement steps desired by the Commission and Staff, such as reducing accounts payable and higher cost debt, and exploring Staff's recommendation to consider sale of the Company to a larger utility.

(3) The Company is unable to obtain financing for future capital projects. In the absence of revenues for taxes in rates, the Company has been unable to obtain financing to execute capital projects to improve its performance and maintain compliance with the NHDES's drinking water standards. While the Company remains largely in compliance with the NHDES drinking water regulations, it cannot reasonably obtain financing for future projects that will be required to maintain compliance in its present financial condition.

Q. Why didn't the Company include an allowance for Federal and State income taxes in its rates approved by the Commission on July 13, 2012?

A. The Company requested an allowance for Federal and State income taxes when it filed its last rate case filing on July 19, 2010 in Docket No. DW 10-141. However, the rates approved by the Commission did not include an allowance for taxes.

Q. Why?

A. The Company's rates approved by Order No. 25,391 on July 13, 2012 were based on a 2009 Test Year. During the 2009 Test Year, the Company had Net Operating Losses Carry-Forwards (NOLs) and Section 179 deductions that were available to offset future taxable income. As a result, the Company incurred no Federal or State income tax liability during the Test Year. Unfortunately, approval of the Company's request for a rate increase was significantly delayed due to extensive but unsuccessful settlement discussions and the need to address all of the issues resolved by Order No. 25,391. As explained by Mr. St. Cyr, the Company accepted several staff recommendations in DW 10-141 which obligated the Company to adjust its earnings and amend its tax returns for prior years. These adjustments had the effect of exhausting the Company's NOLs and Section 179 deductions during the 2011 tax year. As a result, when the Company permanent rates were approved on July 13, 2012, it was already incurring tax liabilities that were not included in its rates.

Q. What did the Company do to avoid an unfunded tax liability?

A. On December 12, 2011, the Company filed testimony and schedules that sought an allowance for Federal and State income taxes that the Company expected to incur in 2012. The issue was an important one as the Company estimated at the time that it would incur $68,000 in tax liability based on its book income.

Staff opposed this request primarily because it felt that adjustments should be limited to the test year, or 12 months thereafter, consistent with Commission precedent. The Company was unable to accept Staff's recommended rates because it would be unable to pay its taxes. The Company had no choice but to request that the Commission approve rates that included an adjustment for payment of taxes.

The Company's permanent rates were approved on July 13, 2012 in Order No. 25,391, but did not include an allowance for Federal or State income taxes. The Company sought rehearing on August 8, 2012. On September 6, 2012, the Commission issued Order No. 25,408 denying rehearing. As a result, despite its best efforts, the Company's approved rates were based on an incorrect assumption that the Company would incur no Federal and State income tax liability in 2012.

Q. Why didn't the Company file a new rate request before the 2012 tax year?

A. The Company had no reason to believe its rates would not include an allowance for taxes prior to Staff's testimony on October 14, 2011. Thereafter, it did everything it could to request recovery of taxes in rates in DW 10-141. The Company honestly believed the omission of revenue for taxes from its rates approved on July 13, 2012 was an oversight and sought clarification rehearing. It would have been unreasonable and expensive to file a new rate case in 2012 while DW 10-141 was still pending, and the Company could not afford to do so in its financial condition even if it were reasonable to consider such a request.

III. THE COMPANY'S APPROVED RATES DO NOT ALLOW IT TO MAKE ESTIMATED TAX PAYMENTS.

Q. Please explain why the Company has been unable to make estimated tax payments.

A. I personally asked the Company's accountant and others to evaluate whether the Company could have lawfully avoided amending its tax returns or avoid its 2012 Federal or State income tax liability. Unfortunately, once the Company accepted Staff's recommendations to reclassify persuasive and other expenses as income, and its shareholder loans as equity, it had no other legal alternative but to amend its prior returns, which resulted in its NOLs and other deductions being exhausted in 2011.

Q. Why didn't the Company control costs in order to set aside money to pay estimated Federal and State income taxes?

A. The Company could not reasonably cut costs in order to generate the revenue needed to pay estimated Federal and State income taxes. The Company meets on a weekly basis and carefully reviews its finances and the expenses needed to continue to operate its water systems in compliance with the NHDES requirements. As John Dawson explains, the Company has made significant reductions in its operating costs. Unfortunately, it is not possible to reduce costs to generate the revenue required to make estimated tax payments.

Q. How do we know that the Company's costs are reasonable and under control?

A. In 2010 and 2011, the Company retained Robert Montville, who comprehensively reviewed the Company's expenditures. His conclusions were presented to the Commission as part of his testimony in the Company's rate case. He determined that, with the exception of the penalty imposed in the Tamworth case (which the Company paid off in 2012), the Company has pro-actively controlled its costs. This continues to be the case. The Company makes every effort to limit expenditures and restore the Company's finances. Unfortunately, the small water systems the Company operates do not provide significant opportunities for savings that could have been used to make estimated tax payments.

Q. Why didn't the Company use earnings from its allowed rate of return to make estimated tax payments?

A. The Company has consistently earned well below a sufficient return and cost increases and the need to invest capital to maintain regulatory compliance do not allow the Company to earn enough to make estimated tax payments in 2012.

After implementing Staff's recommendations in DW 10-141 to reclassify its pension and health insurance expenses, eliminating interest expenses for the Mason note, and adjusting paid-in-capital, the Company's rate of return for the years 2007 to 2010 were as follows (*see* Mason Exhibit 2A):

Year	**Actual**	**Allowed**
2007	4.12%	8.23%
2008	(-3.96)%	8.23%
2009	2.13%	8.425%[2]
2010	5.70%	8.425%

In 2011, the Company collected a temporary rate recoupment authorized by Order No. 25,196, that resulted in recoupment of three months of temporary rate increases in 2011 for services rendered in 2010. As a result, the Company's actual rate of return increased to 10.13% (*see* Mason Exhibit 2B). While performance clearly improved in 2011, the need to invest capital in order to maintain compliance prevented the Company from retaining sufficient earnings for tax payments. The Company did not have sufficient earnings to pay estimated taxes in 2012 without deferring projects that would jeopardize its compliance with drinking water standards.

Q. What impact do capital projects required by the NHDES have on the Company's earnings?

A. The impact of capital projects required by the NHDES on earnings is substantial. For example, the Company completed and placed in service approximately $113,629 and $115,550 in capital improvements in 2011 and 2012 for its water systems. These improvements are "non-revenue generating" because they did not result in additional customer revenues. As a result, the Company's earning in 2012 were effectively reduced by the ongoing need to reinvest capital while its rates did not reflect the actual costs to operate in compliance with the NHDES drinking water standards at the time the Company renders bills.

Q. What is the combined effect of rates that do not include an allowance for taxes or the actual costs for the Company's plant in service?

A. The net result is that the Company has an obligation to provide service to the public in compliance with the NHDES drinking water regulations but because its approved rates do not reflect the actual cost of service and do not include any allowance for Federal and State income taxes, the Company has no real opportunity to earn a reasonable return on its investment, and, despite its best efforts, the Company did not have the ability to pay its estimated 2012 tax liability under its approved rates.

IV. THE COMPANY'S RATES ARE INSUFFICIENT TO MAINTAIN ITS FINANCIAL CONDITION AND IMPLEMENT COMMISSION RECOMMENDATIONS AND ALLOW IT TO IMPLEMENT CAPITAL IMPROVEMENTS.

Q. How has the Company financial condition changed since its last rate case on March 9, 2012?

A. During the Company's last rate case, it reported that payables totaled $506,815.65 as of March 9, 2012. *See* Mason Exhibit 3. As shown in Mason Exhibit 4, payables have increased to $642,350.49 as of December 11, 2012. However, the primary factor in the Company's outstanding payables is rate case expenses and

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[2] Order No. 25,391 increased the Company's allowed rate of return based on a 2009 test year.

the Company anticipates recovery of revenue that will significantly reduce this amount. This includes as shown in Mason Exhibit 4:

(1) $39,738 in permanent rate recoupment that had not been billed as of December 11, 2012;

(2) $152,965.97 in rate case expenses over two years as approved by the Commission on January 17, 2013 in Order No. 25,454, that have not been billed to customers; and

(3) $81,921.06 as a Deferred Asset to be recovered over five years as provided by Order No. 25454.

Recovery of the above is expected to reduce the Company's outstanding payables from $642,350.49 as of December 11, 2012 to $449,646.52, which is reduction of $57,169.13. Recovery of the $81,921.06 deferred asset and investment in the Mt. Roberts project and other capital investments in the Company's next rate case should further improve the Company's financial condition. If the Company had been allowed to collect tax revenue in 2012, its financial condition would be significantly improved.

Q. How is this relevant to the Company's request for emergency rates?

A. Unfortunately, all of the Company's efforts to control costs, reduce payables, and invest in its water systems will be lost without revenue in rates to pay for taxes. As Mr. St. Cyr indicated, the Company's tax liability for the 2012 tax year is expected to be $100,219. The absence of revenue for taxes in rates will cause its financial condition to deteriorate and render its efforts to reduce payables ineffective.

Q. What impact does this have on the Company's ability to provide service and implement capital projects?

A. The Company's capital improvement plans are discussed in the Testimony of John Dawson. Completion of capital improvement projects are extremely important to meet the Company's obligation to provide service to the public. In the Company's current financial condition, with no revenue in rates for payment of taxes, the Company is effectively unable to seek debt or equity financing to complete projects that the Company expects will be needed to meet its obligations to serve the public.

Q. In the Company's last rate case, Staff recommended that you seek to sell the Company. How does the omission of revenues for tax liability impact your ability to consider and implement Staff's recommendation?

A. The Company has stated publicly that it has and will consider Staff's recommendation. Any discussions related to sale of the Company are highly confidential and I offer no testimony as to the existence or non-existence of such discussions. However, in the absence of rates sufficient to pay the Company's estimated tax liability, and reduce its outstanding payables, it is my personal opinion that a sale of the Company is unlikely to occur.

V. CONCLUSION

Q. RSA 378:8 provides "Whenever 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." In conclusion, please explain why do you believe that an emergency exists in this case?

A. The absence of any allowance for Federal and State income taxes in 2012 has caused the Company's financial condition to deteriorate, despite significant progress that has been made to improve operations and regulatory compliance. The Company is unable to obtain financing needed to invest in its 17 drinking water systems to maintain long-term compliance with the NHDES's drinking water regulations and replace its aging infrastructure. If this problem is not corrected, it will undermine service to the public and harm both the Company and its customers.

Q. Does this conclude your testimony?

A. Yes.