STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

Docket No. DW 13-041

Lakes Region Water Company, Inc.

CLOSING MEMORANDUM

Lakes Region Water Company (the "Company" or "Lakes Region") offers this Closing Statement in support of its request for emergency rates as follows:

A. THE COMPANY AND ITS SHAREHOLDERS INVESTED MILLIONS OF DOLLARS TO PROVIDE HIGH QUALITY WATER SERVICE TO THE PUBLIC

Lakes Region Water Company operates 17 separate water systems that serve 1,643 customers, fewer than 100 customers per system. It is an extremely difficult business that "involves operation of water systems that could never be operated on a stand-alone basis."[1] These systems have "limited customer revenue[s] to support fixed costs for operations and capital improvements, yet they are subject to many of the same drinking water regulations as larger systems."[2] Even the Commission's web site acknowledges that "the need for replacement of aging infrastructure have made it increasingly difficult for small water utilities to acquire the capital needed to invest in their systems."[3]

In terms of operations, the Company's service to its customers is excellent and considered by regulators to be "a role model for operation of community water systems of its size."[4] Staff witness Mark Naylor agreed, stating: "I respect what the Company

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[1] Testimony of John Dawson, Exhibit 2, Page 5.
[2] Testimony of John Dawson, Exhibit 2, Page 4.
[3] Testimony of John Dawson, Exhibit 2, Pages 4-5.
[4] Testimony of John Dawson, Exhibit 2, Page 6.

does. And, it's clear from Mr. Dawson's testimony and Mr. Mason's testimony, the Company's done some good work in the field and they have fixed a lot of problems and taken care of a lot of problems."[5]

B. DESPITE ITS INVESTMENT, THE COMPANY'S FINANCIAL CONDITION IS DIRE DUE TO THE NATURE OF THE SYSTEMS IT OPERATES

Unfortunately, the Lakes Region Water Company has struggled to improve its financial performance. All parties seem to agree on this point. Mr. Dawson, for example, testified that:

> While the Company has had tremendous success improving the operation of its water systems in recent years, the Company continues struggle financially because of the size of its systems and their limited customer revenues. While larger systems have the ability to finance major repairs or capital improvements, a small water system does not produce sufficient revenues or return on its investment. The Company's staff meets weekly to prioritize repairs and improvements for its systems and optimize its operations to maintain its compliance. However, the costs the Company faces to maintain its compliance continually increase, while customer revenues remain flat in the absence of rate relief or more accurately, negative due to the need to reinvest capital to maintain compliance.[6]

Before the Commission, Mr. Dawson explained the Company's financial needs in more personal terms, stating that: "I talk to Tom frequently about it. I often see his frustration. I know that he's tried to find other sources of financing, and has always hit a roadblock." When asked "would you agree that essentially the customer revenues represent the only source of financing improvements right now?" – his answer required only one word:

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[5] Mark Naylor, Transcript, Day 2, Page 103; see also, Transcript, Day 2, Page 169 (""We have criticisms, but we also recognize the Company has done some excellent work, and has done -- made a lot of progress in last few years.").

[6] Testimony of John Dawson, Exhibit 2, Page 6.

"Absolutely."[7] The Company's "had no choice but to spend money that was part of its return in order to maintain its operations".[8]

Mr. Mason explained that when he joined his father's company in 2007, it faced tremendous financial challenges: its earnings were well below its allowed rate of return, even earning a negative 4% return in 2008.[9] According to Mr. Mason, the Company "cannot reasonably obtain financing for future projects that will be required to maintain compliance in its present financial condition".[10] The Company expects that recovery of its remaining permanent rate recoupment ($39,738 over 12 months), its rate case expenses approved by the Commission ($152,965 over two years), and its deferred asset ($81,921.06 over five years) will significantly improve its financial condition in the future.[11] 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.

Staff witness Mark Naylor agreed that the Company's financial condition remains dire,[12] stating that the Company is "unbankable at this point with its balance sheet the way it is".[13] He agreed that the Company's "only source of revenues or capital is money [it] receive[s] in rates".[14] After acknowledging that the Company has "done some good work in the field and they have fixed a lot of problems and taken care of a lot of problems" – he candidly stated that "frankly, I don't know how the Company's made it to this point from a year ago. But this is -- this is quicksand."[15]

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[7] John Dawson, Transcript, Day 2, Page 206.
[8] John Dawson, Transcript, Day 1, Pages 205-206.
[9] Testimony of Thomas Mason, Exhibit 1, Pages 9-10.
[10] Testimony of Thomas Mason, Exhibit 1, Page 6.
[11] Testimony of Thomas Mason, Exhibit 1, Pages 11-12.
[12] Mark Naylor, Transcript, Day 2, Page 169.
[13] Mark Naylor, Transcript, Day 2, Page 38.
[14] Mark Naylor, Transcript, Day 2, Page 100-101.
[15] Mark Naylor, Transcript, Day 2, Page 103.

C. THE COMPANY'S RATES DO NOT INCLUDE REVENUE TO PAY ITS 2012 TAX LIABILITY

The Company's rates approved on July 13, 2012 by Order No. 25,391, did not provide for payment of Federal and State income taxes in 2012. The Company sought recovery of its tax expense in DW 10-141. However, on July 13, 2012, the Commission did not approve rates that included an allowance for payment of Federal and State income taxes due to the availability of net operating losses in the 2009 test year. On September 6, 2012, the Commission denied rehearing.

The Company's financial consultants advised that the Company would incur $100,219 in Federal and State income taxes in 2012. On February 4, 2013, the Company requested that the Commission "allow recovery of $100,219 in estimated Federal and State income taxes incurred in 2012, and that it expects to incur going forward" – subject to reconciliation to the Company's "actual tax liability as determined by the Commission in its next permanent rate case".[16] This is because: (1) the Company incurred a tax liability in 2012 that was not included in its calculated rates; (2) the Company is incurring a tax liability on a going forward basis that is not included in its approved rates.

Admittedly, the Company's accountant and financial consultant made errors in their calculation of the Company's tax liability. In response to Record Request 17, the Company acknowledged these errors and calculated its actual 2012 Federal income tax liability to be $49,975, and an underpayment penalty of $898.[17] The total state taxes were $3,281. The total Federal and State taxes liability incurred in 2012 is therefore $50,873. Applying the tax factor of 57.7185% described on Page 10 of Mr. St. Cyr's Testimony (Exhibit 3) to this amount results in a revenue requirement of $88,140 needed

[16] Petition for Emergency Rates, Pages 1 & 3.
[17] Exhibit 17, Response to Record Request 17. .

to pay Federal and State income taxes, not the $173,634 calculated in the Company's initial filing. While the correction reduces the financial impact the emergency described in the Company's testimony, it does not lessen or reduce the urgency of the Company's request to recover revenues in rates sufficient to provide for payment of taxes incurred in 2012 and on a going-forward basis.

D. THE COMPANY'S INCOME TAX LIABILITY WAS UNAVOIDABLE.

On October 31, 2011, the Company received Staff's explanation that the pension and health care premium payments. Staff stated that: "Staff believes that the classification of such payments to an expense account of any kind is imprudent."[18] Staff further stated that "an adjustment to increase the Company's retained earnings account by the amount of the reclassified shareholder pension and health insurance premium payments may be appropriate."[19] Staff's language is broad and does not suggest limitations.

The Company accepted Staff's position and changed its books to reflect Staff's position. The pension and health care expenses were treated as retained earnings. This change was approved by the Company's Board of Directors which also approved a memo from the Company's accountant, dated June 21, 2011, that explained that the Company would "amend [its] tax returns and correct the amount of loss carry forwards that we have and present a better historical picture than if we made all the changes effective 12/31/10."[20] The Company's goal was simple: accuracy of its financial record. The Company expects and hopes that the Commission would desire no less.

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[18] Exhibit 11 (emphasis added).
[19] Exhibit 11 (emphasis added).
[20] Exhibit 8 (supplemental).

The Company understands Staff's position to be that the Company imprudently amended its prior tax returns for 2007, 2008 and 2009. Presumably, Staff does not suggest that the Company imprudently filed its 2010 and 2011 returns, which were filed on May 23, 2012,[21] after the Company accepted Staff's October 31, 2011 position that "classification of such payments to any expense account of any kind is imprudent."[22] By the date the 2010 and 2011 tax returns were filed, these payments were recorded as income, not as an expense.

This treatment is required by the Internal Revenue Code, which start with the assumption that revenue the Company receives in rates is considered income. *Internal Revenue Code, 26 USC §61* ("gross income means all income from whatever source derived"); *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209, 107 L. Ed. 2d 591, 110 S. Ct. 589 (1990) (customer funds considered income unless the Company is obligated to return them). The law and, perhaps more importantly, the IRS, starts with the assumption that these revenues "from whatever source derived" is treated as income, unless an exception applies.

It is certainly true that the Company can deduct Trade or Business Expenses. However, under the Internal Revenue Code those expenses must be "attributable" to its trade or business. *Internal Revenue Code*, 26 USC 62 (a) (1) ("The deductions allowed by this chapter ... which are attributable to a trade or business carried on by the taxpayer"). These payments were made to the Company's shareholders, who were no longer involved in the Company's operations or business. As a result, the Company

[21] See Exhibit 8, Response to Record Request 8 (explanation of filing and amendment dates); Exhibit 4 (returns); Exhibit 18 (corrected returns). .
[22] Exhibit 11 (emphasis added).

could no longer claim the payments as a Trade or Business deduction or, as Staff had indicated, as an expense "of any kind".

The issue of whether or not the Company should have amended its 2007-2009 (but not its 2010 or 2011) tax returns is immaterial. Once the Company accepted Staff's position, it could no longer claim a Net Operating Loss based on treatment of payments to its shareholders as an expense. Staff Witness Jayson Laflamme – who has prior experience for an accounting firm –agreed and testified as follows:

> **Q. Well, let me ask you this then. You would agree that, wouldn't you, I assume, that, in 2012, the Company can't claim a net operating loss deduction for a pension expense that no longer exists on its books, right?**
>
> A. (Laflamme) In 2012?
>
> **Q. Yes.**
>
> A. (Laflamme) If the Company isn't reflecting a pension expense on its books, then, no, it can't claim it as a deduction.[23]

Mr. Laflamme later reiterated this point:

> **Q. But the issue I'm trying to get at is, if the Company has, as you had suggested, eliminated an expense from its books, isn't it true that it can no longer claim a loss based on that expense?**
>
> A. (Laflamme) If the expense was eliminated from its books, then the Company would not -- should not claim that deduction on its tax returns..
>
> **Q. Okay. So, regardless of whether the tax returns were amended or not, you know, the Company has a tax issue in 2012?**
>
> A. (Laflamme) Yes.[24]

Staff's agreement that the Company could no longer claim Net Operating Losses based on these shareholder payments effectively renders any question as to whether the

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[23] Transcript, Day 2, Page 43.
[24] Transcript, Day 2, Pages 46-47.

Company should have amended its returns as moot. The important conclusion is that the law no longer allowed the Company to claim these NOLs in 2012.

There are several IRS publications that confirm this conclusion. For example, IRS Publication 538, entitled Accounting Periods and Methods, states that:

> An accounting method is a set of rules used to determine when income and expenses are reported on your tax return. Your accounting method includes not only your overall method of accounting, but also the accounting treatment you use for any material item.
> [...]
> You must use the same accounting method from year to year. An accounting method clearly reflects income only if all items of gross income and expenses are treated the same from year to year.
>
> If you do not regularly use an accounting method that clearly reflects your income, your income will be refigured under the method that, in the opinion of the IRS, does clearly reflect income.
>
> (emphasis added).

This language is terrifyingly simple in what it requires. The Company's "accounting method" must include the same "accounting treatment" for "gross income and expenses" "from year to year." If the Company does not do so, the IRS would "refigure" the Company's income!

Similarly, IRS Publication 542, *Corporations*, provides that: "[a]n accounting method is a set of rules used to determine when and how income and expenses are reported. Taxable income should be determined using the method of accounting regularly used in keeping the corporation's books and records."[25] The fact that the Company revised its books to treat the payments to its shareholders as retained earnings means that the Company could no longer claim a deduction not supported by its books. It cannot be

[25] Exhibit 13, Page 8. (emphasis added)

doubted that the Company would face substantial tax penalties if it tried to claim otherwise.

Finally, in an opinion recently discovered by counsel, *Hillsboro National Bank v. Commissioner of Internal Revenue*, 460 U.S. 370 (1983), the United States Supreme Court discussed the "Tax Benefit Rule", which supports the conclusion that, even if the Company did not amend its returns, it could not claim net operating losses in 2012. The Court stated that "[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in tax, and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous." 460 U.S. at 383. The Tax Benefit Rule provides that: "When the event proving the deduction improper occurs after the close of the taxable year, even if the statute of limitations has not run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year...." 460 U.S. at 379, Note 10.

As a result, even if the Company did not amend its prior returns to correctly report its payments to shareholders as income, the Tax Benefit Rule would require those improper deductions to be treated as income when it filed its tax return in 2012. Of course, in that scenario, the Company, or the IRS, would need to "refigure" what the prior tax liability should have been. The Company's decision to provide this information to the IRS offers the advantage of a clear record of the Company's tax treatment on its books.

E. THE ABSENCE OF AN ALLOWANCE FOR FEDERAL AND STATE INCOME TAXES THREATENS TO IMPAIR SERVICE TO CUSTOMERS

The Company could not make estimated tax payments without taking money away from its operations and capital improvements. Thomas Mason stated in his testimony that "[i]f this problem is not corrected, it will undermine service to the public and harm both the Company and its customers."[26]

According to John Dawson, if the Company had taken funds away from its operations or capital improvements program, "[a] couple things would happen. First thing is, we would most likely be out of compliance, almost absolutely be out of compliance. And, the second thing is, again, I've touched on this, but the quality of service to our customers would definitely go downhill. We would probably not be able to make some capital improvements that were necessary that the customers deserve. And, it would negatively affect the operations of the Company."[27] It "would definitely [have] negatively affect[ed] the quality of service, without a doubt. I mean, there's capital improvements that have to be made. You know, whether we want to make them or not, they have to be made. Whether they're mandated or not, we have to move forward. And, any amount of money that's taken away from the operations of Lakes Region Water Company's water systems is going to negatively affect service."[28]

[26] Testimony of Thomas Mason, Exhibit 1, Page 14.
[27] Transcript, Day 1, Page 205.
[28] John Dawson, Transcript, Day 1, Page 196 (Payment of taxes that are not included in rates);.

F. MR. NAYLOR'S VIEW THAT THE COMPANY CREATED ITS EMERGENCY OR COULD HAVE AVOIDED BY NOT AMENDING ITS RETURNS IS UNREASONABLE AND DOES NOT REFLECT THE LAW

The Company obviously asked for an allowance for tax expense in its last rate case. As Mr. Naylor explained, this request was denied because the Company's rate request was "based on a 2009 test year, [and] it wasn't appropriate" to make adjustments more than 12 months subsequent to the test-year.[29]

The Company asked Mr. Naylor to explain if the Company's actual unfunded 2012 tax liability "could be recovered through a reconciliation in a 2012 rate case?"[30] Mr. Naylor responded that this could not be done because "[t]here's no provision for that. That's not how rate-setting works."[31] In other words, in his view the revenue for taxes the Company anticipated and requested could never be recovered.

Mr. Naylor agreed that "[a] rate request is a major financial and administrative undertaking" for the Company.[32] He was then asked: "Should the Company then have, even before its last rate case was approved [in 2012], updated its test year in that last rate case? I mean, how do they get to getting taxes into rates in 2012? What should they do differently?"[33] Mr. Naylor agreed that it was not reasonable to expect the Company to update its test-year to request a tax expense prior to 2012, and, once 2012 arrived, it was too late! His testimony as to what the Company could have done differently was as follows:

A. (Naylor) What should they have done?

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[29] *But see*, Puc 1604.09 (c) *Adjustments to Test Year* ("A utility shall make adjustments in projections to reflect what the utility reasonably anticipates for … (2) All items which are fixed, determinable, and likely to occur in the future, but which did not occur during the test year.").
[30] Transcript, Day 2, Page 121.
[31] Transcript, Day 2, Page 121.
[32] Transcript, Day 2, Page 124.
[33] Transcript, Day 2, Page 124.

Q. -- to avoid this dilemma?

(Naylor) Made a better decision about amending its tax returns and exhausting the carry-forwards. I think Staff provided testimony in the rate case on that. That the Company had substantial operating loss carry-forwards available to shield any net income for a number of years to come, --

Q. But Mr. Laflamme --

A. (Naylor) -- and the Company chose, in order to make a case, it appears, in the rate case last year, chose to amend its returns and eliminate those carry-forwards. And, it came to the Commission and said "well, look, now we don't have any carry-forwards to shield our income, so please give us taxes." And, the Commission said "no".

Q. Okay. But you heard Mr. Laflamme say that the Company couldn't have claimed those loses in 2012, because they were no longer reflected on its books. So, the fact that the amendments did or didn't occur is irrelevant, isn't it?

A. (Naylor) It's not irrelevant at all. The Company made the decision to take those steps. The Company made the decisions that they made.

Q. So, is it your opinion that the Company could have simply not amended its returns, and then claim those net operating losses, even though it had converted the shareholder loan to equity and it had treated the pension expenses as income?

A. (Naylor) The amounts could have been just simply booked below the line. There are costs that a utility incurs, a very good example would be charitable donations and things like that, that are not recoverable for rate purposes, but are legitimate expenses, in terms of the Company's income statement. And, those expenses could very easily have been treated as below-the-line going forward.

Q. Okay. Do you have -- I don't know the exhibit number, Staff -- the response to Staff 1-8 [LRWC 1-8?]? This was Mr. Laflamme's response. I know we marked it as an exhibit yesterday.
[...]
Q. Could you read the first sentence for me please in Mr. Laflamme's response.

A. (Naylor) Well, let me ask Mr. Laflamme. It's his response.

Q. Okay.

A. (Laflamme) "Staff believes that the reclassification of such payments to an expense account of any kind is imprudent. Rather" –

Q. Okay. Sorry, I didn't mean to interrupt you. I thought you were done with the sentence.

A. (Laflamme) No, that's all.

Q. Okay. So, I mean, I see a little bit of a conflict here, because, when I hear Mr. Laflamme say "we can't treat these pension expenses as any form of an expense", and the Company accepted that treatment, I don't think we can classify them as an expense above the line or below the line. But, apparently, you see it differently. Is that what I'm to understand?

A. (Naylor) Well, I'll let Mr. Laflamme answer the question additionally. But I think it's -- I think it's implied in that sentence that, when he refers to "the classification of such payments to an expense account", he's talking about above the line, includable in rates.

Q. But I asked Mr. Laflamme a pretty direct question. And, I thought that his answer -- I thought the question was "could the Company have claimed a net operating loss for expenses that it had basically recognizes as income on its books?" And, I thought the answer was "in 2012, no, the Company couldn't do that." So, I understand you suggest that you have a different view, is that right?

A. (Naylor) Well, I think it's a different -- we're talking about two different things. We're talking about ratemaking and we're talking about tax law.

Q. But that's a pretty risky thing to do, from a tax perspective, to treat revenue collected in rates, paid to your company's shareholders as health insurance benefits or pensions as an expense? I mean, do you really think the IRS is going to agree with that position?

A. (Naylor) It's a "risky thing"? A risky thing for the Company to claim as an expense payments that it made on behalf or to shareholders?

Q. Right. So, when the Company accepted that reclassification out of, and I believe Mr. Laflamme says right in his response there in front of you, to move it to retained earnings, isn't that what he says?

A. (Naylor) "Offset loans or equity injections from the shareholders."

Q. And, what does it say about "retained earnings"?

A. (Naylor) "Staff believes that an adjustment to increase the Company's retained earnings account by the amount of the reclassified shareholder pension and health insurance premium payments may be appropriate."

Q. Uh-huh. So, --

A. (Naylor) That's a current -- that's a current period accounting entry.

Q. Right. But, if the Company were to claim those net operating losses for those payments, but on its books they were treated as an increase in retained earnings, don't you think that's a problem?

A. (Naylor) I don't know if it's a problem. We asked you what the authority is that the Company was following for amending it's tax returns, and you've provided nothing. So, to suggest that somehow now the Staff is your tax authority is ludicrous.

Q. Well, I'm not suggesting that at all.

A. (Naylor) The Company has to be accountable for the decisions it has made. It's not Staff that is the problem for you here.

Q. Mr. Naylor, you just told us that you felt the Company "imprudently exhausted its net operating losses", which I assume you mean it should have claimed them in 2012 in a greater amount. But Mr. Laflamme is saying that some of those losses should be treated as retained earnings, which I assume means income, right?

A. (Naylor) So, your operating results would have been different, either in whatever year those adjustments were made, whether it's a 2011, 2012. It's a current period accounting entry. Meaning, adjustments take place in the period in which the decision is made to make those adjustments. To me, it does not imply going back to prior years. There's no other conclusion to draw from the Company's decision to amend its tax returns, other than the fact that it was going to make a case to the Commission that it now had tax liability. What other reason? I mean, --

(emphasis added).

There are several fundamental flaws in Mr. Naylor's position that the Company created its own emergency:

- First, Mr. Naylor belief that the Company purposefully amended its tax returns to increase its tax liability to "make a case" before the Commission is simply untrue. There is no support for this in the evidence. In fact, Mr. Mason testified under oath and in writing that his financial advisors advised him that the Company was "obligated the Company to adjust its earnings and amend its tax returns for prior years."[34] The Company believed it had no choice under the law. Even if it did not amend its returns, the law is clear that the Company could not have claimed deductions for NOLs that were no longer reflected on its books.
- Second, the Company derived absolutely no financial benefit by amending its prior tax returns to increase its tax liability. It had no incentive to do so and in fact it incurred substantial liability by doing so, including liability, penalties and interest for the unpaid tax in 2012. It also incurred the cost for its accountant and to Mr. St. Cyr to amend the returns at a time when it could have used the cash for other purposes, such as capital improvements or payment of liabilities on its balance sheet.
- Third, Mr. Naylor mistakenly believed that it is the Company's burden to prove it had to amend its returns. This is not the case. The Company's burden is to show that it incurred an unfunded tax liability in 2012 that resulted in an emergency. The Company can meet its burden by showing that it "accepted Staff's recommendations to reclassify [pension] and other expenses as income".[35] Upon treatment of these payments to shareholders as "retained earnings" (as Staff proposed), the Net Operating Loss deductions were no longer reflected on its

[34] Testimony of Thomas Mason, Exhibit 1, Page 7.
[35] Testimony of Thomas Mason, Exhibit 1, Page 8.

books. The Internal Revenue Code then compelled the conclusion that these payments must be included in gross income. No trade or business or other deductions apply. While Staff speculates that some other treatment might be possible, similar to charitable contributions or advertising, this is pure speculation that is unsupported in the record, and flatly contradicted by the Internal Revenue Code. In any event, it is the Internal Revenue Code that creates the tax liability, not the Company's decision to memorialize its method of accounting for the payments in an amended return.

Unfortunately, Staff's refusal to acknowledge the payments to shareholders as retained earnings causes the Company to continue to incur regulatory expense in an effort to recover an allowance for tax obligation that was clear under the law and entirely foreseeable. The Company, its customers, or both are likely to suffer as result.

G. THE COMPANY'S THEORETICAL RATE OF RETURN DOES NOT MEAN THAT AN EMERGENCY DOES NOT EXIST

It is true that Mr. St. Cyr's calculation of the Company's Net Operating Income in 2012 is $211,777.[36] This includes $52,202[37] in permanent rate recoupment approved by Order No. 25,423 on October 12, 2012. The Company booked this as income in 2012 as required by the accrual method. However, the Commission authorized recovery of the recoupment over twelve months on October 12, 2012. The Company did not begin to collect the recoupment until customers paid its November 1, 2012 bills. More fundamentally, the recoupment recovers for the deficiency in rates for the period from September 17, 2010 to October 12, 2012. The Company's recoupment merely reimburses the Company for its cost of service. The funds are meant to pay for the cost

[36] Response to Staff 1-5, Exhibit 4, Page 167.
[37] Response to Staff 1-5, Exhibit 4, Page 168.

of service, rate case expenses, and other liabilities for the service provided. The rate recoupment was not available nor intended to pay future tax expenses that were not provided in its rates. Obviously, if the Commission had included payment of income taxes in Order No. 25,391, the Company would have used the recoupment for that purpose. However, the Commission did not provide for payment of taxes and the recoupment was intended to pay for the cost of service provided as far back as 2010. As a result, the Company's calculation of its theoretical rate of return overstates its earnings because it includes recoupment of 2010, 2011 and 2012 that were not recovered in rates!

It is also true that the allowed return needs to be reduced by $73,419 in interest on debt (Exhibit 4, Page 167) and principal on debt shown on the Company's cash Flow Statement to be $143,588. The Cash Flow Statement also reports the Company's unpaid accounts payable as "cash" which creates the mistaken impression that funds are available to pay taxes when they are not.

Staff acknowledges that "There's a tax expense for income statement purposes to reflect a cost that the Company's incurred in that year. And, then, there's also an entry on the balance sheet to reflect the fact that there is a payable to the government for those dollars."[38] The bottom line is that once the Company's liabilities (including repayment of its vendors) are accounted for, there were no funds remaining to pay taxes.

[38] Mark Naylor, Transcript, Day 2, Pages 166-167.

Admittedly, over a period of nearly two years ending in October 2012, the Company paid $129,878.89 to its shareholders.[39] During this period, Mr. Tom A. Mason (Sr) was dying from a terminal illness and his mother needed to survive.[40] The Masons have invested over a million dollars in the Company over the last five years[41], not including Mt. Roberts. The Company's Board of Directors therefore authorized payment of "living and health care compensation" that was "to be recorded in the Capital Reduction Account."[42]

It is important to note that no witness suggested that the shareholders had been unjustly enriched. In fact, this payment – which was treated as a return of capital they invested – represented the only payment the Masons ever received for their investment. Mr. St. Cyr testified before the Commission on this point and stated as follows:

> **Q. Well, I don't know if you can identify for me the time period. But how far back would we have to go, in your opinion, before we found a time at which the Masons received something in addition to this $123,000 that you've identified on this schedule?**
>
> A. (St. Cyr) Yes. I don't believe the Company -- I don't believe the Masons have ever taken money out of the Company until 2011.
>
> **Q. But what -- I mean, what about earnings that have been paid to the shareholders? I mean, how far back do we have to go before we find that, okay, we have some money here, $123,356, and that's value provided to the shareholders, right?**
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> A. (St. Cyr) Well, as I said before, it's essentially giving the Masons the money back that they have put in.

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[39] Exhibit 10, Response to Record Request.
[40] Transcript, Day 1, Pages 93-94 ("A certain amount of the equity coming back to my mother, because of, you know, without the pension, without anything, with my dad passing away, that she needs to still survive."); Transcript, Day 1, Page 174 ("There's been a ton of money that my parents have put in. And, in the last five years, they've put in over a million dollars. There's no obligation to pay that all back. When my dad was sick and, you know, pretty much, in the rest home and everything else, my mother needed money. And, so, we made arrangements to get her some money with return of capital for a period of time, until she got, you know, that he passed away and things got better.").
[41] Transcript, Day 1, Page 174, supra.
[42] Minutes of the Board of Directors, Exhibit 8, Response to Record Request 8.

Q. Right. What other forms of consideration have they received over this last five-year period or whatever period you want to look at?

A. (St. Cyr) They have not received any compensation for the capital that they have invested.

Q. So, do you know, I mean, if we were to look at this number, and compare that to what the Company's kind of net investment is, I mean, what sort of a -- is this an excessive payment or what is this?

A. (St. Cyr) This is, you know, if they invested a million dollars, and I know that it was more than that, you know, this is approximately 10 percent of that amount. And, again, this represents two years. So, they would have got back 5 percent of what they invested over the years for 2011 and 2012.

Q. Uh-huh. And, then, during the years before that, what did they receive?

A. (St. Cyr) They did not receive anything.[43]

The evidence and financial schedules arguably could have been presented more clearly. However, the point is simple. The Masons invested over a million dollars to provide service to the public. In 2011, as their health deteriorated, they received a portion of the investment back which was booked as a reduction in equity. It cannot be argued or even suggested that the Masons earned a return on their investment. All of their returns were reinvested by the Company into capital improvements to serve the public.

H. AN EMERGENCY EXISTS WITHIN THE MEANING OF RSA 378:9

RSA 378:9 provides that "[w]henever 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." However, the term "emergency" is not defined.

[43] St. Cyr, Transcript, Day 1, Pages 203-204.

An emergency could be understood in the traditional sense to mean an event or situation which requires the assistance of emergency personnel, such as firemen or police. Such events would have a rate impact and RSA 378 governs rates. However, it seems unlikely that the Legislature intended such a narrow interpretation. Rate relief will not put out fires or apprehend suspects. The term emergency, when considered in the context of RSA 378, must be understood to mean a financial condition which threatens a company's ability to serve the public which cannot be addressed using traditional rate principles alone.

The Supreme Court decisions involving emergency rates suggest such a meaning. For example, in the *Petition of PSNH*, 130 N.H. 265, 270 (1988), the Supreme Court upheld the Commission's finding that an emergency existed where it was "unlikely that PSNH would be in a position to meet its cash obligations as they became due: namely, interest and principal payments on debts, expansion of service to customers, and fuel expenses, payroll, and other related expenses" and investors in the market were "unwilling to provide additional new funds for PSNH due to investor perceptions of high risk". As the Commissioners are undoubtedly aware, the emergency was purely financial in nature and investors were unwilling to invest in the Company. There was no suggestion that PSNH's service had failed. It simply could not obtain financing to complete necessary capital additions. It cannot be doubted that Lakes Region Water Company faces such a condition. Staff Water Division Director Mark Naylor described the Company's financial condition in one word as "un-bankable".

In an earlier case, the Supreme Court observed that even temporary rates were "obviously a time consuming procedure" and that "the urgency of this petitioner's needs

and not the time nor manner of their arrival is decisive" as to whether an emergency exists. *Petition of PSNH*, 97 NH 549, 551 (1951). The Court stated that: "the test to determine whether the emergency statute may apply here is to inquire 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." *Id.*

This case is also highly relevant to Lakes Region Water Company's present condition because, not only is a rate cases a 'time consuming procedure' – as the Court observed – in this case the cost of rate cases are a major contributor to its financial condition. The Company's rate case consultants represent the vast majority of its debts. While it has obtained approval to recover a substantial portion of these debts over three years, a request for a new rate case would only worsen matters worse over the short term.

It is also important to note that Staff argues that it would not support recovery of tax expenses for 2012 in a traditional rate case. In Staff's view, the tax expense incurred in the past is a past liability and it would not support a mechanism to recover a tax that was unpaid, even though the Company's allowed rates were calculated under the incorrect assumption that it would incur no tax liability. Staff argues that the Company's earned rate of return shows that an emergency exists, but this calculation erroneously includes revenue from prior years but no repayment of the liabilities incurred.

Finally, in *New England Telephone & Telegraph Company v. State*, 95 N.H. 58, 62 (1948), the Supreme Court stated that "[t]he minimum of emergency relief to which the company is entitled is a sum which will put a stop to the continuing operating losses of the company and pay accruing interest upon the company's bonds allocated to its New Hampshire property".

I. CONCLUSION

The Company has met its burden to show that an emergency exists due to the absence of any allowance for Federal and State taxes in the Company's rates. The Company has made substantial improvements in its operations and performance that will be lost if revenues to pay taxes are not provided. An allowance for revenues to pay the Company's actual 2012 tax liability, plus its going-forward tax liability will ensure that the Company and its customers realize the benefits of its shareholders' investments in plant, without resulting in rates that exceed the Company's actual cost to provide service.

WHEREFORE Lakes Region Water Company respectfully requests that the Commission grant its Petition for Emergency Rates and grant such other relief as justice may require.

Respectfully submitted,

LAKES REGION WATER COMPANY, INC.

By its Counsel,

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Dated: April 29, 2013

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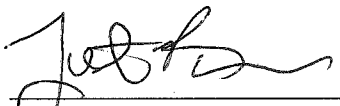
CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was this day forwarded via Electronic Mail to all parties on the official Discovery Service List for DW 13-041.



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