

STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

DW 08-086

EASTMAN SEWER COMPANY, INC.

Petition for Financing Authority
and
Temporary and Permanent Rate Proceeding

Order Approving Permanent Rates

ORDER NO. 24,989

July 24, 2009

APPEARANCES: Stephen P. St. Cyr & Associates, Inc. by Stephen P. St. Cyr for Eastman Sewer Company, Inc.; and Staff of the Public Utilities Commission by Marcia A. B. Thunberg, Esq.

I. PROCEDURAL HISTORY

Eastman Sewer Company, Inc. (ESC) is a regulated utility that provides sewer service to 533 residential customers and two commercial customers in the Town of Grantham. On June 24, 2008, ESC filed a notice of its intent to file rate schedules. On August 18, 2008, ESC filed revised tariff pages designed to increase its annual revenues by \$56,386, or 46.28%, over its current authorized level of rates. ESC noted in its filing that it had been approximately sixteen years since its last full rate proceeding. ESC requested that \$33,241 of the \$56,386 be applied to its capital reserve fund to finance system improvements.¹ ESC requested temporary rates and also requested authorization, pursuant to RSA 369, to borrow \$238,850 from either a bank or

¹ ESC's capital reserve fund was established by the Commission in ESC's initial rate case, *Eastman Sewer Company*, Order No. 20,390, 77 NH PUC 93 (1992). The Commission found that ESC was undercapitalized because the vast majority of the original sewer plant had been expensed for tax purposes, and thus the Commission ordered the establishment of the fund. The \$10,008 collected annually through customer rates is deposited to a separate account and is used exclusively for capital improvements.

from the Eastman Community Association in order to finance system improvements. This loan would be for a ten-year term at an interest rate of 7%.

On September 18, 2008, the Commission issued Order No. 24,896, which suspended ESC's proposed tariff pages and scheduled a prehearing conference for October 29, 2008. On October 6, 2008, ESC mailed a copy of Order No. 24,896 to all of its customers.

On October 29, 2008, ESC amended its filing to increase the amount of its borrowing to \$344,534. ESC did not change any of the other proposed financing terms. ESC also amended its permanent rate filing to recover additional revenues in the amount of \$73,653. It proposed to apply \$48,004 to its capital reserve account.

Hearings were held on temporary rates and on ESC's proposed financing. On December 30, 2008, in Order No. 24,927, the Commission approved temporary rates for effect October 6, 2008, on a service rendered basis. On May 21, 2009, in Order No. 24,967, the Commission approved a settlement agreement between Staff and ESC regarding ESC's financing request. A hearing on permanent rates was held on June 2, 2009 at which time Staff and ESC presented a stipulation agreement.

II. SUMMARY OF STIPULATION AGREEMENT

A. Permanent Rates. Staff and ESC recommend the Commission grant ESC an increase of \$27,299, or 24.41%, in its adjusted test year revenues in order to produce a total revenue requirement of \$139,140. This revenue requirement is based on a stipulated rate base of \$78,700 and an overall rate of return of 9.75%. ESC's capital structure is currently 100% equity.

B. Reconciliation with Temporary Rates. Pursuant to RSA 378:29, ESC agrees to calculate its temporary rate recoupment and submit that analysis to Staff for its review. ESC and Staff expect to submit a joint recommendation to the Commission as to the amount of the recoupment and a proposed surcharge for customer bills. Staff and ESC stated that their recommendation may be combined with a request for recovery of reasonable rate case expenses. If Staff and ESC cannot agree on a joint recommendation, each party will submit its own recommendation to the Commission.

C. Step Adjustment for Capital Additions. Staff and ESC recommend the Commission grant one step adjustment to ESC's rates to cover approximately \$344,534 in the financed capital improvements that will be placed in service. Staff and ESC stated that failure to recognize these costs in ESC's revenue requirement would have a detrimental impact on ESC's rate of return. Staff and ESC estimate the step adjustment will increase revenues by \$52,854, or 47.26%. ESC agrees to submit documentation of its costs to the Staff for review and audit and thereafter, Staff and ESC expect to file a joint recommendation on the implementation of the step adjustment.

D. Treatment of Step Adjustment Revenues. Staff and ESC state that the financing also includes \$30,000 to repay short-term loans from ECA and that, due to the unique circumstances of ESC's ownership by the Eastman Community Association, a non-profit entity, and the fact that ESC has always been undercapitalized and is therefore highly unlikely to ever pay stock dividends, Staff and ESC recommend the Commission allow the annualized value of ESC's principal and interest payments to be paid out of ESC's existing capital reserve account. Staff and ESC recommend the revenues from the step adjustment equal the annualized principal and interest payments of the value of the loan, and be considered as dedicated to the capital reserve account. Staff and ESC recommend the Commission allow ESC to withdraw its monthly loan payment from its capital reserve account without further authorization from the Commission.

E. Step Adjustment Capital Additions as CIAC. Staff and ESC recommend that the capital additions subject to the step adjustment be treated as Contributions in Aid of Construction (CIAC). Staff and ESC recommend this accounting include booking completed capital additions to the appropriate Plant in Service accounts, with credits to cash using the proceeds of the bank loan. ESC agrees to simultaneously establish a receivables account on its balance sheet, with an offsetting credit to CIAC, to recognize that the cash received from customers through the capital reserve account represents the contributed capital. Staff and ESC state that this treatment is appropriate because the cash received from customers in the step adjustment is the annualized principal and interest payments on the bank financing, rather than the traditional return on fixed capital plus depreciation expense.

F. Capital Reserve Fund. Staff and ESC recommend the Commission allow ESC's capital reserve fund to be continued. The revenue requirement and resulting permanent rates provide the same \$10,008 as has been included in customer rates since the Commission's Order No. 20,390 (1992). Staff and ESC recommend ESC still seek specific Commission approval to withdraw capital reserve funds, with the exception of the loan principal and interest payments detailed above. ESC agrees to continue to provide an annual accounting of the capital reserve fund with its Annual Report and at any such other time as the Commission or its Staff requests.

G. Rate Case Expenses. Staff and ESC recommend ESC be permitted to recover its reasonable rate case expenses for the temporary and permanent rate phases of this proceeding and for rate case expenses incurred in filing for the step adjustment. Following the receipt of the Commission's order on permanent rates in this docket, ESC agrees to file documentation for its rate case expenses with Staff for its review. Staff and ESC expect to file a joint recommendation on rate case expenses. At the time ESC files its step adjustment ESC shall also file documentation for the rate case expenses associated with the step adjustment filing for Staffs review and recommendation.

III. COMMISSION ANALYSIS

RSA 378:7 authorizes the Commission to fix rates after a hearing upon determining that the rates, fares, and charges are just and reasonable. In determining whether rates are just and reasonable, we must balance the customers' interest in paying no higher rates than are required with the investors' interest in obtaining a reasonable return on their investment. *Eastman Sewer Company, Inc.*, 138 N.H. 221, 225 (1994). Additionally, in circumstances where a utility seeks to increase rates, the utility bears the burden of proving the necessity of the increase pursuant to RSA 378:8.

Pursuant to RSA 541-A:31, V(a), informal disposition may be made of any contested case at any time prior to the entry of a final decision or order, by stipulation, agreed settlement, consent order or default. The Commission encourages parties to attempt to reach a settlement of issues through negotiation and compromise "as it is an opportunity for creative problem-solving, allows the parties to reach a result more in line with their expectations, and is often a more expedient alternative to litigation." *Concord Electric Co.*, Order No. 24,046, 87 NH PUC 595, 605 (2002) (quoting *Granite State Electric Co.*, Order No. 23,966, 87 NH PUC 302, 306 (2002)). Notwithstanding a settlement among the parties, we must independently determine whether the settlement results comport with applicable standards. *Id.* As the parties have presented a

stipulation agreement on permanent rates for our consideration, we review its terms and conditions in deciding the issues before us.

A. Revenue Requirement

The stipulation contemplates a revenue requirement of \$139,140 for permanent rates, which represents an overall increase of \$27,299 or 24.41% over test year revenues. The revenue requirement is based upon a rate base of \$78,700 and an overall rate of return of 9.75%. ESC's capital structure is currently 100% equity.

1. Operating Expenses

The record shows that in 2007, ESC's test year, it recorded a net operating loss of \$9,748, and a revenue deficiency of \$20,960, meaning that ESC did not cover its operating expenses. Hearing Transcript of December 17, 2008 (12/17/08 Tr.) at 10 line 23 to 12 line 4. Moreover, given the increase to its operating costs for having to comply with new groundwater quality requirements, ESC's rate of return is likely to further decline in the future. 12/17/08 Tr. at 21 lines 7-16. Based upon the evidence in the record, we find the reports of ESC's under earning to be credible. Accordingly, we agree with Staff and ESC that ESC's revenue requirement should be increased.

As to the amount of the increase, the stipulation calls for an increase in revenues of \$27,299 or 24.41%, exclusive of those dedicated to the capital reserve account, which is addressed below. Originally, ESC had requested an increase of approximately 22%, but that amount was raised because of adjustments from Staff, particularly relating to property taxes. 6/2/09 Tr. at 11-12. Staff and ESC state that they believe this rate is just and reasonable. 6/2/09 Tr. at 16.

In light of the fact that ESC has not raised its rates in approximately 16 years, and considering the increase in operational costs over that time, we do not regard an increase of this amount as unreasonable. Accordingly, we approve the amount of the increase to permanent rates as agreed upon by Staff and ESC.

2. Step Adjustment

The stipulation recommends that a step adjustment be employed in the future to accommodate the repayment of a bank loan to be obtained by ESC. This bank loan will be used to fund certain capital improvements to be made by ESC totaling \$344,534. The capital improvements include: (1) West Cove B Pump Station at a cost of \$7,209; (2) Grinder, Influent Flowmeter and ph Meter at a cost of \$75,486; (3) Headworks Modification, including building, site work, and design engineering at a cost of \$135,192; (4) West Cove A pump station, pump replacement, generator and transfer switch at a cost of \$66,846; and (5) West Cove A overflow structure at a cost of \$59,800. In Order No. 24,967 (May 21, 2009) we approved Eastman's financing request and concluded that these proposed improvements were necessary for the continued provision of safe and adequate service to ESC's customers. *See id.* at 5.

In the stipulation, Staff and ESC stated their belief that not allowing these costs in ESC's revenue requirement would have a detrimental impact upon ESC's financial position. This contention is well founded given ESC's present revenue shortfall irrespective of the expenditures for capital improvements. As we have already recognized the necessity of these capital improvements, and as we recognize that failing to account for these costs in ESC's revenue requirement would be detrimental to ESC's continued operations, we conclude that ESC may recover the prudent costs of these projects.

In addition to the capital improvements discussed above, ESC will be using some of the proceeds of the bank loan it obtains to repay short-term debt of about \$30,000 owed to its parent, Eastman Community Association (ECA). As noted in the stipulation, ECA is a non-profit entity which owns ESC. ESC, because it is perennially undercapitalized, is unlikely to ever pay dividends to its owner. Further, ESC's lack of a significant rate base leaves it without any means to generate the cash flow to repay short-term loans used for operating expenses. As a result of these circumstances, a unique method of accounting for and repaying the loan between ECA and ESC must be used.

We agree with Staff and ESC that allowing payments to be made from the loan proceeds through the capital reserve account is a reasonable means of accounting for and assuring payment of the short-term loan between these related entities. In addition, we conclude that repaying this short-term debt with long-term debt obtained on favorable terms is an appropriate use of ESC's loan proceeds, though we reaffirm our conclusion that, in the future, ESC should seek timely rate relief so as to avoid taking such loans. *See id.* We further agree with Staff and ESC that although generally ESC must obtain Commission approval before making expenditures from its capital reserve account, it ought to be able to make the specified loan payments to ECA without further authorization. Accordingly, for the above reasons, we find it reasonable for ESC to recover the money needed to repay ECA.

As to the increase in rates required to cover the proceeds of the bank loan being applied as a step adjustment to permanent rates effective upon the completion of the capital projects, we note that we have previously employed step adjustments to rates as a means of ensuring that a regulated utility retains its ability to earn a reasonable rate of return after implementing large capital projects that increase the utility's rate base after a test year. *See, e.g., Pennichuck Water*

Works, Inc., Order No. 24,751 (May 25, 2007) at 16. The step adjustment avoids placing a utility in an earnings deficiency immediately after a rate case in which the revenue requirement was based on a historical test year. *See id.* We understand from Staff and ESC that the capital improvements are needed for the continued provision of safe and adequate service and that the loan terms ESC has secured to pay for the above capital expenditures and short-term loan, are favorable. Under circumstances where the improvements are essential, but not yet completed, and where they will be made with money obtained on favorable conditions, we find that the use of a step adjustment for the recovery of this money is preferable in these circumstances to requiring ESC to return for a new rate case once the projects are completed.

As to the amount of the step adjustment, the stipulation states that an additional \$52,854, or 47.26%, in revenues will go to ESC after the adjustment. The stipulation also provides, however, that before any adjustment will be made, ESC must submit documentation to the Commission for review and audit and that the Staff and ESC will then make recommendations to the Commission regarding the final amount of the adjustment. Thus, customers have notice of the amount of the future increase while ESC retains some flexibility in the use of its funding to complete its projects, yet remains subject to the Commission's review of its costs. We find that this is a reasonable method of controlling the costs of the projects and of insuring that the costs recovered in fact represent the prudent costs incurred in the completion of the necessary improvements. Accordingly, we approve the step increase to repay the loan proceeds covering the capital improvements and the debt repayment to ECA, but will issue a future order defining the amount of the increase once the capital improvements are completed and in service and Staff has conducted its audit.

3. Contributions in Aid of Construction

Next, Staff and ESC agreed that the capital additions covered by the bank loan mentioned above ought to be treated as CIAC. The stipulation agreement includes a provision calling for the creation of a new receivables account on ESC's balance sheet, with an offsetting credit to CIAC. According to ESC, it will essentially be treating the money from the bank loan as revenue going into the capital reserve account, and then the payments on the loan as coming out of that account. 6/2/09 Tr. at 18-19. The underlying purpose of this accounting method is appropriate, according to Staff and ESC, because the step adjustment, which will be for recovering the money spent on the capital improvements, is more accurately described as repaying the loan obtained to pay for the work, rather than a traditional return on plant constructed for utility service. Moreover, without this treatment of the funds, ESC would have a cash flow deficit and might not be able to complete these essential projects. 6/2/09 Tr. at 19, 21-22. We agree that the somewhat special circumstances of the finances of ESC make this different treatment of the payment for these capital improvements appropriate, and we find that Staff and ESC's suggested method of accounting is a just and reasonable one that recognizes the unique means by which ESC is funding its improvements.

4. Capital Reserve Account

In ESC's initial rate case, the Commission found that because ESC had expensed the construction of its system and had thus recovered the costs of construction, those costs could not be allowed in its rate base. *Eastman Sewer Company*, Order No. 20,390, 77 NH PUC 93, 98-99 (1992). As a result, ESC has a rate base of approximately \$80,000 although it has plant in service valued at more than \$2,000,000. This exclusion from rate base means that, effectively, ESC cannot earn more than its operating expenses, nor recover any money for capital

improvements or other expenditures. Accordingly, another method of dealing with ESC's undercapitalization had to be established and, after considering proposals from the parties, in Order No. 20,390 a capital reserve account was created as the preferred method of ensuring adequate available funds. *Id.* at 99-100. From that time to this, ESC has been required to collect from customers and deposit into this account \$10,010 annually and to obtain Commission approval before expending money from this account.

The stipulation calls for the continuation of this account, as well as its requirements that ESC deposit certain sums into it annually and that ESC request approval before making expenditures from it. Given the continued undercapitalization of ESC, we agree that this account ought to be maintained.

Regarding the amounts deposited, as mentioned above, the revenues from the step adjustment would be paid into the capital reserve account and then directed from that account to the repayment of the bank loan. Accordingly, at the point the step adjustment goes into effect, ESC will annually deposit \$52,854 into that account in addition to the \$10,010 already required to be deposited. Since we have already found that the step adjustment is proper and that this account is suited to this purpose, we agree with the changes to the deposits made to this account. We note that Staff has stated that it understands that in 10 years, once the loan is repaid, the step adjustment revenues would cease and, at that time, this account would revert to its current funding level. 6/2/09 Tr. at 20. We share Staff's expectation that, absent some intervening event, the capital reserve account should be so treated. Moreover, we agree with Staff and ESC that except for the money withdrawn to pay the bank loan as described in section III (A)(2) of this order, ESC must continue to receive Commission approval prior to spending money retained in that account. In sum, we conclude that continuing this account, but allowing a temporary

alteration to its terms to accommodate extraordinary expenditures, will allow ESC to have the necessary funds to make needed capital improvements.

5. Rate of Return

The rate of return in the stipulation is 9.75%. According to Staff, this amount was used because it had recently been approved by the Commission in another water utility rate case and that in its opinion ESC presents essentially the same risk as that utility. 6/2/09 Tr. at 8-9. We find that this is a reasonable return and we will approve it.

B. Recoupment

As stated earlier, ESC was granted temporary rates at 18.74% above its test year revenues, or an additional \$20,960. *Eastman Sewer Company, Inc.*, Order No. 24, 927 (Dec. 30, 2008) at 5. The permanent rates that are the subject of this order are, as noted, an increase of 24.41%, or \$27,299. ESC is entitled to recover the difference pursuant to RSA 378:29 and the stipulation agreement calls for ESC to file its reconciliation report and proposed surcharge and recovery period following issuance of this order. It is expected that Staff will review ESC's filing and offer a recommendation on ESC's proposal. We will await these filings and will rule on ESC's temporary and permanent rate reconciliation at a later date.

C. Rate Case Expenses

Under the terms of the stipulation, ESC is permitted to recover in its rates its reasonable rate case expenses from both the temporary and permanent phases of this proceeding, as well as any expenses it will incur in the presentation of materials for the step adjustment outlined above. ESC is to file documentation of its expenses in the temporary and permanent rate phases following the issuance of this order for Staff review. Then, the parties are to offer recommendations as to which costs are properly recoverable. A similar procedure is to be

followed after a decision on the amount of the step adjustment. As the amounts of the expenses are not known at this time, our order serves only to uphold Staff and ESC's agreement that ESC may recover its reasonable rate case expenses. We withhold any further order on those expenses until proper documentation has been submitted and reviewed and recommendations have been made for our consideration.

D. Rate Impacts

Having approved the revenue requirement and the proposed method for a step adjustment, we now consider the impact on a typical customer, keeping in mind that the amount of the step adjustment may change, and that there are other expenses, such as those underlying the rate proceedings, which are not yet fully determined. According to schedule 6 of attachment A to the stipulation, ESC's customers currently pay a total of \$223.32 annually for sewer services and to fund the capital reserve account. Under the stipulation the new rates, including the step increase, would be \$372.06 annually per customer, an increase of \$148.74 or 66.60%. 6/2/09 Tr. at 14-15. The majority of the increase will be to fund the capital reserve account to pay the bank loan. While the increase, after the step adjustment, will be substantial, there has been no increase in rates for many years and costly but necessary capital improvements must be made to the system. In these circumstances, we find the increase and the resulting rates to be just and reasonable.

E. Conclusion

Having reviewed the record, including the stipulation and evidence presented at hearing, we find that the revenue requirement adopted by the signatories is reasonable and will produce just and reasonable rates. We further find that the terms of the stipulation represent an appropriate balancing of ratepayer interests and the interests of ESC under current economic

circumstances. We find that the proposed investments in ESC's plant used to serve its customers are prudent. We therefore adopt and approve the terms of the stipulation as consistent with the public interest. We note that the stipulation leaves unresolved the amounts of recoupment, the step adjustment and rate case expenses, all of which we will address in future orders.

Based upon the foregoing, it is hereby

ORDERED, that the terms of the stipulation agreement are hereby adopted and APPROVED as discussed herein; and it is

FURTHER ORDERED, that Eastman Sewer Company, Inc. is authorized to collect from customers permanent rates, as discussed herein; and it is

FURTHER ORDERED, that Eastman Sewer Company, Inc. continue to fund its capital reserve account and obtain Commission approval for disbursements from that account except as provided in this order; and it is

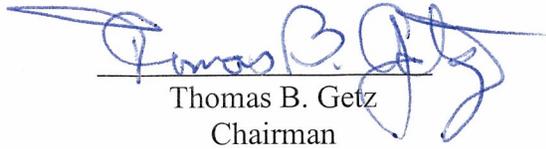
FURTHER ORDERED, that Eastman Sewer Company, Inc. is authorized to file for a step increase to its rates as provided for in the stipulation agreement; and it is

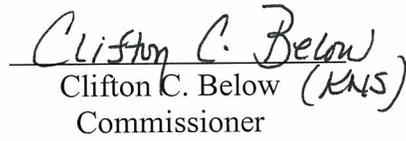
FURTHER ORDERED, that Eastman Sewer Company, Inc. is authorized to recover from all customers the difference between its temporary and permanent rates, subject to the submission of documentation on recoupment within thirty (30) days of this order; and it is

FURTHER ORDERED, that Eastman Sewer Company, Inc. shall file its accounting of rate case expenses for the temporary and permanent rate phases of this proceeding within thirty (30) days of this order; and it is

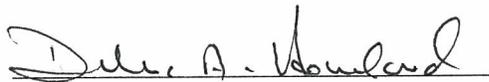
FURTHER ORDERED, that Eastman Sewer Company, Inc. file with the Commission a compliance tariff within fourteen (14) days of the date of this order.

By order of the Public Utilities Commission of New Hampshire this twenty-fourth day of
July, 2009.


Thomas B. Getz
Chairman


Clifton C. Below (KNS)
Commissioner

Attested by:


Debra A. Howland
Executive Director



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07/24/09 Order No. 24,989 issued and forwarded to all parties.
Copies given to PUC Staff.

Docket #: 08-086

Printed: July 24, 2009

FILING INSTRUCTIONS: PURSUANT TO N.H. ADMIN RULE PUC 203.02(a),

WITH THE EXCEPTION OF DISCOVERY, FILE 7 COPIES (INCLUDING COVER LETTER) TO:

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NHPUC
21 SOUTH FRUIT STREET, SUITE 10
CONCORD NH 03301-2429