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November 22, 2019

Debra A. Howland, Executive Director
NH Public Utilities Commission
21 South Fruit Street, Suite 10,
Concord, N.H. 03301-2429

NHPUC 22NOV19PM3:03

Re: IR 19 - 005 *Rate of Return for Small Water Companies*

Dear Executive Director Howland:

I write on behalf of Lakes Region Water Co., Inc., to request that the Commission schedule a hearing prior to commencement of rulemaking based on Staff's November 4, 2019 Report on Technical Session and consider two minor modifications to Staff's proposed Rule. I offer the following comments in support of this request:

I. SUMMARY

Lakes Region would like to thank Staff, the Office of Consumer Advocate and all of the parties for their participation in this proceeding. While agreement was not reached on every issue, the discussions were helpful, professional and a benefit to all parties involved. The main area of disagreement appears to be the degree to which small water systems involve inherently greater risks when compared to other utilities or larger water systems. This is a critical issue because, as the Commission is aware, a rate of return must be "commensurate with returns on investments in other enterprises having corresponding risks." *In re Pub. Serv. Co.*, 130 N.H. 265, 275 (1988) quoting *Federal Power Commission v. Hope Gas Co.*, 320 U.S. 591, 603 (1944); *Company v. State*, 95 N.H. 353, 361 (1949).

Lakes Region provides a summary of the findings by the New Hampshire Department of Environmental Services ("NHDES") and the National Association of Regulatory Commissioners ("NARUC") which highlight the risks faced by owners of small water systems and the need for an improved regulatory approach for small water systems. The NHDES's Water Resources Primer, reports that small water systems in New Hampshire "struggle" to maintain compliance because "[p]er customer costs may be dramatically different than those associated with large systems". NARUC has adopted a series of resolutions which recognize that deficient returns in

the water industry “present a clear challenge to the ability ... to attract the capital necessary to address future infrastructure investment requirements necessary to provide safe and reliable service” and that new regulatory approaches are needed for small water systems because “traditional cost-of-service regulatory model as applied to small water systems may result in regulatory costs that are disproportionately high on a per customer basis, which ultimately impacts customers served by those systems”.

Lakes Region supports Staff’s recommendation because it represents a significant step toward addressing these challenges. However, Lakes Region requests that the Commission consider two minor changes before it commences formal rulemaking:

- First, the Commission should consider setting a minimum, but not a maximum, debt to equity ratio under proposed Rule PUC 610.02 (d)(4); and
- Second, the Commission should consider minor revisions to proposed Rule PUC 610.02 (d)(5) to clarify and improve how the Exemply Performance Adder will be administered and reviewed by the Commission.

II. Background: The Small Water System Dilemma in New Hampshire.

In its Water Resources Primer, the New Hampshire Department of Environmental Services provides an excellent overview of the water industry and the challenges facing small water systems in New Hampshire. Attachment #1. According to the NHDES, small water systems “struggle” to comply with standards established to protect public health under Federal and State laws. The NHDES summarizes the challenges as follows:

8.2.2 New Hampshire Has a High Proportion of Struggling Small Community Systems

Even large community water systems find the Safe Drinking Water Act regulations difficult and costly to meet, so it is no surprise that it is much more difficult for small water systems. Figure 8-7 depicts the many challenges that small water systems may encounter as they provide safe drinking water. New Hampshire has a large proportion of small systems which are widely distributed and often impossible to interconnect. Per customer costs may be dramatically different than those associated with large systems. These small stand-alone systems require fairly sophisticated operations, yet they cannot afford to hire full-time staff that specialize in drinking water. Some small municipal water systems may have to share one part-time staff member with the highway department, the fire department and others.

Conversely, larger systems benefit from economies of scale and can afford to hire highly educated, specialized staff teams with in-depth knowledge of treatment, distribution, and other aspects of drinking water provisions. As a result, customers of the smallest systems often pay the most for the least in services. It is also important to note that providing water supply is a highly capital intensive mission

where even the largest systems struggle to maintain and replace their aging infrastructure.

The financial challenges facing small water systems have been recognized by the National Association of Regulatory Utility Commissioners (NARUC). NARUC has adopted a series of resolutions recognizing that: “as compared to other utility sectors, significant and widespread discrepancies continue to be observed between commission authorized returns on equity and observed actual returns on equity among regulated water and wastewater utilities”;¹ that traditional “[r]atemaking that has worked reasonably well in the past for water and wastewater utilities no longer addresses the challenges of today and tomorrow. Revenue, driven by declining use per customer, is flat to decreasing while the nature of investment (rate base) has shifted largely from plant needed to serve new customers to non-revenue producing infrastructure replacement”;² and that “[d]eficient returns present a clear challenge to the ability of the water and wastewater industry to attract the capital necessary to address future infrastructure investment requirements necessary to provide safe and reliable service”.³

Concerning small water systems NARUC concludes that “traditional cost-of-service regulatory model as applied to small water systems may result in regulatory costs that are disproportionately high on a per-customer basis”.⁴ To overcome these limitations, NARUC adopted recommends that utility regulators adopt “*Best Practices*” for the Regulation of Small Water Systems, including “simplified rate applications for small water systems” and “simplified rate of return mechanisms that may include formulaic rate of return calculations” and other mechanisms.⁵

The definition of a small water system used by DES and NARUC is based on the Safe Drinking Water Act⁶ which classifies a small water system as one serving a population of fewer than 3,300 persons. This is nearly ten times larger than the average size of the small water systems operated by Lakes Region which have an average of 95 customers per system on average (1,805 / 19).⁷ Lakes Region’s water systems should be considered on the extreme end of small. Many of these systems were in non-compliance or the verge of failure when they were acquired by Lakes Region because others were unable or unwilling to do so. *Attachment #3*.

The size of a water system adversely impacts both financial performance and compliance. In its recent *Capacity Development Annual Report to the EPA* (October 2018), the NHDES reports that small water systems serving populations fewer than 250 people “exhibit a multitude

¹ NARUC, *Resolution Addressing Gap Between Authorized Versus Actual Returns on Equity in Regulation of Water and Wastewater Utilities* (2013), Attachment #2, Page 26.

² *Id.*, Page 26; see also Attachment #2, Page 22.

³ *Id.*, Attachment #2, Page 26.

⁴ NARUC, *Resolution Supporting the Consideration of Regulatory Mechanisms and Policies Deemed “Best Practices” for the Regulation of Small Water Systems* (2013), Attachment #2, Page 24.

⁵ *Id.*

⁶ See e.g. 42 USC sec. 300g-1 (b)(4).

⁷ The American Water Works Association’s 2012 Water and Wastewater Rate Survey uses a “median service population per account” of 3.62 which results in an average population of 344 persons per system. This ratio should be considered high for New Hampshire and for the areas served by Lakes Region because of: an aging, rural demographic; seasonal customer demand; and the absence of commercial or industrial customers.

of hardships to manage and maintain water system compliance (Figure 1), have a limited rate base, and incur the highest number of violations both for health-based parameters and for monitoring and reporting requirements”.⁸ According to the data, 23.54% of these small systems had monitoring and reporting violations in 2018, compared to 5.38% for those serving populations over 1,000 (5.38%).⁹ In the smallest category of systems, compliance with drinking water standards in and of itself is evidence of successful performance.

The proposed changes to the Commission’s PUC 610 Rules reflect over a decade of efforts to address the challenges facing the owners and customers of small water systems in a traditional regulatory environment with mixed results, despite the best efforts of Lakes Region, Staff and all other interested parties. During this period, investors have shouldered the weight of financial risks, often realizing little or no return on their investment. A change is required because the water industry continues to face an enormous “infrastructure gap” due to the need to replace aging infrastructure.¹⁰ To accomplish this, Lakes Region urges the Commission to move forward based on Staff’s recommendation with the following changes:

III. Proposed Rule 610.02 (d)(4) (“Capital Structure Adder”).

Proposed Rule 610.02 (d)(4) referred to as the “Capital Structure Adder” is intended to provide an incentive to utilities that achieve a balanced capital structure. As currently proposed, Rule 620.02 (d)(4) states:

- (4) Capital Structure Adder will be added to the baseline return on equity for a balanced capital structure:
 - a. For a capital structure with equity of 35 to 40 percent, the adder will be 10 basis points;
 - b. For a capital structure with equity of 40 to 44 percent, the adder will be 15 basis points;
 - c. For a capital structure with equity of 45 to 55 percent, the adder will be 25 basis points; and
 - d. For a capital structure with equity of 56 to 60 percent, the adder will be 10 basis points.

The objectives of the proposed Capital Structure Adder are good ones. Debt financing benefits customers because it reduces rates. However, owners of small water systems have great difficulty maintaining an ideal or balanced capital structure for the reasons noted by NARUC. In addition, debt financing can result in revenue shortfalls because the cost of plant improvements is typically recovered *in rates* over the useful life of the improvements. However, the debt

⁸ Attachment #4, Page 2 of 13.

⁹ The data in Attachment #4 are broken down by system size and the number of systems in Attachment #5 to estimate the frequency of monitoring and reporting violations by system size.

¹⁰ See e.g. Attachment #2, Page 22.

financing is recovered over much shorter periods, typically 5 to 20 years. This difference in timing puts pressure on earnings and makes small water systems unattractive to equity investors who have much better opportunities available to them in the marketplace. While refinancing may be possible in theory, financial institutions like CoBank ACB require compliance with financial covenants that restrict the ability to maintain an ideal capital structure. As a result of these and other factors, none of the small water companies regulated by the Commission would qualify for the 25 basis point adder as currently proposed.

Lakes Region recommends a simpler approach that reduces the number of tiers and rewards utilities that include low cost debt financing for the following reasons:

- A. *An incentive to reduce debt is not necessary.* The use of debt financing already benefits customers and burdens investors. It is not necessary to reduce the rate of return on equity to provide an incentive to reduce debt.
- B. *The Commission should encourage debt financing for capital projects whenever possible.* Debt financing provides critical benefits to directly customers. It is used to provide new treatment systems; to replace aging infrastructure; to acquire troubled water systems; and to provide other benefits to customers. The proposed rule Commission should encourage the use of low cost debt to improve service to customers whenever possible.
- C. *The reduction in the rate of return on equity when debt exceeds 55% is not necessary or beneficial.* The proposed rule reduces the rate of return on equity when debt exceeds 55%. However, if the goal is to attract equity to maintain a balanced capital structure, the best mechanism to do this is to recognize the need for equity in the rate of return. A four tiered structure that reduces returns on equity as debt increases adds complexity without significant benefits or incentives.

In light of the above, Lakes Region recommends that the Commission revise and simplify proposed Rule 610.02 (d)(4) to read as follows:

- (4) Capital Structure Adder will be added to the baseline return on equity for a balanced capital structure:
 - a. For a capital structure with debt of at least 40 percent, the adder will be 10 basis points; and
 - b. For a capital structure with debt of at least 45 percent, the adder will be 25 basis points.

IV. Proposed Rule PUC 610.02 (d)(5) (“Exemplary Performance Adder”).

Lakes Region requests that the Commission consider a minor revisions to proposed Rule PUC 610.02 (d)(5) which provides for an Exemplary Performance Adder. As currently proposed, Rule 610.02 (d)(5) states:

An Exemplary Performance Adder of up to 50 basis points shall be added to the baseline return on equity if the commission determines that a small water utility substantially exceeds utility performance of similarly situated small water utilities in a rate filing in any of the following areas:

- a. Development of an Asset Management Program for achieving and maintaining the desired level of service at the lowest appropriate cost to customers;
- b. Reduction in system leaks and unaccounted for water;
- c. Cost containment initiatives;
- d. Improved water quality;
- e. Improved customer service.

Lakes Region agrees with the intent of the proposed rule. However, the proposed rule as written is likely to be difficult to implement and administer for the following reasons:

- A. *The Proposed Categories are unclear.* As written, the proposed rule is unclear but appears to provide for an adder only when changes occur: e.g. for “*Development of an Asset Management Program*”; for “*Reduction in system leaks*”; for “*Improved water quality*”; or for “*Improved customer service*”. The wording should be changed to make clear that the Exemplary Performance Adder is available whenever performance is exemplary. It should not be limited to circumstances when a change of performance occurs during a test year or immediately prior to a rate case.

This is important because “Exemplary Performance” typically results from long-term capital investment in plant that may take years to design, permit, finance and construct. The costs of those improvements may be recovered over decades, not in a single rate case. For example, “reduction” in system leaks typically requires main replacement projects; “improved” water quality typically results from major investment in treatment systems or new sources of supply. The benefits of these improvements are long lasting. However, a rate case has a much shorter life cycle, typically 3 to 5 years. To encourage investment in small water systems, the Exemplary Performance Adder should be available as long as performance remains “exemplary”.

- B. *The comparison to “similarly situated utilities” should be removed because it is unclear, unworkable and will complicate rate cases.* The proposed rule requiring a comparison to similar water systems to evaluate performance seems reasonable in theory. In practice it is unclear and impractical to compare ‘similarly situated’ small water systems because of their many differences. For example, a system that has 300 customers is not comparable to one that has only 50; a system with a

wholesale customer is not comparable to one that does not; a system with seasonal customers or demand is not comparable to one of year round residents; a system that has aging infrastructure is not comparable to one that does not; a system in an area with arsenic, uranium or other treatment requirements is not comparable to one that does not.

If the comparison requirement is left in place, it would result in complicated comparisons or even litigation over which, if any, third-party owned systems were comparable based on incomplete information. This would be a costly and time-consuming distraction. The more important questions to be considered in rate or other proceedings before the Commission are: whether the investments are prudent, used and useful, etc.; whether the service to customers is reasonably safe and adequate or just and reasonable under RSA 374:1; or whether there are customer or service problems that require resolution. The focus in a rate case should be the rates and service provided by the utility, not on speculation as to the rates or service provided by others.

As a result, Lakes Region recommends that the Commission revise proposed Rule PUC 610.02 (d)(5) to read as follows:

An Exemplary Performance Adder of up to 50 basis points shall be added to the baseline return on equity if the commission determines that a small water utility **provides exemplary service to customers substantially exceeds utility performance of similarly situated small water utilities in a rate filing** in any of the following areas:

- a. **Use Development** of an Asset Management Program for achieving and maintaining the desired level of service at the lowest appropriate cost to customers;
- b. **Water Conservation Reduction in (system leaks and unaccounted for water);**
- c. Cost containment initiatives;
- d. **Improved w**Water quality;
- e. **Improved e**Customer service.

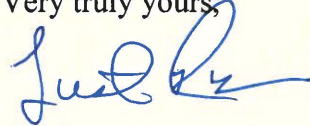
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Lakes Region thanks the Commission, Staff, the Office of Consumer Advocate and all of the other interested parties for their participation in this proceeding.

If you have any questions, please feel free to contact me or the Company.

Very truly yours,

A handwritten signature in blue ink, appearing to read "Justin Richardson", with a stylized flourish at the end.

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Enclosures