

STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

DW 08-070

LAKES REGION WATER COMPANY, INC.

Petition for Financing and Step Increase to Rates

Order Approving Step Increase to Rates

ORDER NO. 24,925

December 30, 2008

APPEARANCES: Ransmeier & Spellman, P.C. by Daniel J. Mullen, Esq. for Lakes Region Water Company, Inc.; Orr & Reno, P.A. by Douglas L. Patch, Esq. for Property Owners Association at Suissevale, Inc.; Office of the Consumer Advocate by Meredith A. Hatfield, Esq. on behalf of residential ratepayers; and Staff of the Public Utilities Commission by Marcia A. B. Thunberg, Esq.

I. BACKGROUND AND PROCEDURAL HISTORY

Lakes Region Water Company, Inc. (LRWC) is a public water utility that serves approximately 1,600 customers in Campton, Conway, Freedom, Gilford, Laconia, Moultonborough, Ossipee, Tamworth, Thornton, Tuftonborough, and Wolfboro.

On October 10, 2007, the Commission opened Docket No. DW 07-105 to investigate the quality of service provided by LRWC. At that time, LRWC was struggling to meet the challenges of operating and maintaining compliance with water quality regulations. LRWC had received Letters of Deficiencies and an Administrative Order from the Department of Environmental Services (DES) due to unsafe and inadequate water service at some of LRWC's systems. Specifically, DES issued an administrative order on October 4, 2007 concerning conditions at Hidden Valley: "DES determined that Lakes Region had: (1) without obtaining the requisite permission from DES, added users to this system by interconnecting it with a second system, known as Hidden Valley Shores; (2) failed to meet certain commitments it made to DES

in response to the 2006 letter of deficiency; (3) violated N.H. Code Admin. Rules Env-Ws 372.12 by failing to have a source capacity of not less than two times either the water system's daily demand or its design flow; and (4) violated Env-Ws 372.23 by failing to maintain a tight seal around the entry ports of two wells being used for public water supply."

In order to correct these deficiencies, LRWC needed to undertake certain capital improvements. Staff and LRWC subsequently filed a settlement agreement, which the Commission approved by Order No. 24,877 (July 25, 2008), wherein LRWC committed to make a filing seeking approval of new financing and recovery of the cost of the necessary improvements. We consider that filing in this docket. Also according to the settlement agreement, LRWC agreed to pursue a general rate increase beyond the step increase if its actual rate of return is sufficiently below its last authorized rate of return.

Prior to Order No. 24,877, on May 15, 2008, LRWC filed a petition for approval to finance approximately \$779,930 to complete a number of capital projects totaling \$1,244,430. The difference between the amount to be financed and the total cost is in part due to the presence of a \$300,000 contribution in aid of construction. LRWC proposes to borrow a total of \$629,930 from its stockholders, Thomas and Barbara Mason, on a 20-year term and at an annual interest rate of 9.75%. The balance of \$150,000 would be provided as an equity contribution from Mr. and Mrs. Mason.

According to the filing, the funds from the financial arrangement would be used to: (1) construct a 325,000 gallon water storage tank and connect a water main at LRWC's Paradise Shores system; (2) install a new well at Indian Mound; (3) install a new pump station at LRWC's Gunstock Glen system and interconnect that system with the neighboring Brake Hill Acres system; (4) purchase of two service vehicles, a hand held meter reader and software, and

miscellaneous shop and field equipment; (5) install and deepen wells, install well meters, booster pumps and related monitoring equipment at Hidden Valley; and (6) install 1,220 feet of new water mains to replace existing PVC mains at 175 Estates.

To recover its investment in these improvements, LRWC requested three step increases to its rates. The first, proposed to be effective immediately, would incorporate improvements completed at Hidden Valley, 175 Estates, and Indian Mound, as well as common plant that includes vehicles and shop equipment. This first step would increase LRWC's revenues by \$67,990, or about 9%. The second step increase, to be effective July 1, 2008, would cover improvements completed as of June 30, 2008 at Paradise Shores. This second step would increase LRWC's revenues by \$77,914, or about 10%. The third step increase, proposed for effect January 1, 2009, would incorporate the remainder of the capital improvements completed by the end of 2008 and would increase LRWC's revenues by an additional \$36,169, or about 5%. Together, the three step increases would result in an overall increase in LRWC's rates of 24%.

In its petition, LRWC also requested authorization to change the rates it charges its Gunstock Glen customers. In LRWC's last rate case, Docket No. DW 05-137, the approved consolidated permanent rates were not extended to Gunstock Glen since LRWC had just recently acquired that system and was not yet familiar with the system's revenue needs. LRWC now seeks to apply its consolidated rate to the Gunstock Glen customers because of the capital improvements at the Gunstock Glen system and its interconnection with the nearby Brake Hill Acres system.

On May 29, 2008, the Commission issued an Order of Notice setting a prehearing conference for July 2, 2008. On May 21, 2008, the Office of the Consumer Advocate (OCA) filed notice of its intent to participate and, on June 26, 2008, the Property Owners Association at

Suissevale, Inc. (Suissevale), a wholesale customer of LRWC, filed a petition to intervene. A technical session was held subsequent to the prehearing conference and the parties agreed upon a proposed procedural schedule to govern the remainder of the proceeding. The Commission approved the procedural schedule by Order No. 24,883 (August 5, 2008).

On September 4, 2008, the OCA filed the direct testimony of Kenneth Traum and Stephen Eckberg, which is more fully described below. On September 25, 2008, Staff and LRWC filed a stipulation agreement which was presented at the hearing held on September 30, 2008.

II. POSITIONS OF THE PARTIES AND STAFF

A. Lakes Region Water Company, Inc.

LRWC's position is embodied in the terms of the stipulation agreement.

B. Property Owners Association at Suissevale, Inc.

Suissevale attended the hearing but did not take a position on the stipulation agreement.

C. Office of the Consumer Advocate

Through the pre-filed testimony of Messrs. Traum and Eckberg, OCA requests that the Commission deny LRWC's request for a step increase and suggested instead that consideration of LRWC's capital investments be undertaken in a full rate case. OCA stated it opposes the terms of the financing. OCA also stated that in the event LRWC withdraws its financing request and replaces it with an equity infusion, it does not believe specific Commission approval for the equity infusion would be necessary.

As to the step increases, OCA opposes them because they are being requested outside of a general rate case, and it asserts this amounts to single issue ratemaking. OCA stated LRWC does not need all the revenues from the three step increases in order to earn a reasonable rate of

return but it agreed at hearing that it had not quantified that level. Hearing Transcript of September 30, 2008 (9/30/08 Tr.) at 90 lines 6-23.

OCA stated LRWC has not complied with Commission rules and orders. OCA further stated that it is appropriate for LRWC to file a rate case at this time since its last two rate cases were at three-year intervals and it has been three years since LRWC's last rate case.

With respect to its general opposition to step increases outside of rate cases, OCA stated that LRWC's improvements to water supply reliability may lead to additional usage, which in turn will produce additional revenues that should be accounted for. Exh. 8 at 8. OCA testified at hearing that the stipulation agreement resolved its concerns regarding the consideration of revenues pertaining to customers in Gunstock Glen and Suissevale. 9/30/08 Tr. at 72 lines 20-22 and at 73 lines 2-3. OCA was critical of LRWC's depreciation rates and stated they are shorter than at least one other water utility located in the same general area. Exh. 8 at 8. At hearing, however, OCA testified that the stipulation agreement resolved its concern over the depreciation rates.

OCA stated the step increase includes a gross up for taxes and yet LRWC does not expect to pay any federal income taxes for 2008. The step increase is based on the assumption that LRWC will pay higher property taxes immediately for the plant items and OCA stated that this does not recognize the likely lag LRWC will experience prior to the actual time it will pay these increased taxes. The plant addition costs include costs billed by LRWC's related party, Lakes Region Water Services, Inc. (LRW), and OCA contended that this agreement is out of date and makes the costs suspect. At hearing, OCA testified that such costs could be allowed up to the lower of cost or market. 9/30/08 Tr. at 77 lines 13-16.

OCA also stated that the Commission's rules allowing for expedited and simplified procedures for small water utilities apply to utilities serving fewer than 600 customers and that LRWC serves approximately 1,600. Although LRWC is a relatively small, family-owned and operated utility, OCA contends that LRWC's ratepayers are entitled to the same regulatory protections as those of larger utilities.

D. Staff

Staff's position is embodied in the terms of the stipulation agreement.

III. STIPULATION AGREEMENT

A. Step Increases to Rates

Staff and LRWC request the Commission approve an overall increase in revenues of approximately 19.13%, based on LRWC's 2007 operating water revenues. This is lower than LRWC's original request of 24%. Staff and LRWC recommend a 9.27% rate of return for the step increases, and an overall rate of return of debt capital (21% of the capital) at a cost rate of 7.47% and equity capital (79% of the capital) at a cost rate of 9.75%. Staff testified at hearing that LRWC's 2007 rate of return was just over 4%. 9/30/08 Tr. at 20 lines 1-2. Staff and LRWC recommend this increase occur by way of three step increases in rates.

Staff testified that it supported pursuing a step increase to rates rather than a full rate case because in its opinion the company is weak financially. 9/30/08 Tr. at 22 lines 1-9. Staff held this concern in Docket No. DW 07-105. Staff cited the fact that LRWC is expanding its rate base by 54% and stated it is important to LRWC's financial health to get the assets into rates as quickly as possible. Id. and 9/30/08 Tr. at 19 lines 6-10. Staff stated that it agrees that it is generally not a good idea to pursue a step increases without looking at all other aspects of a

company's operations but in LRWC's case, "the ability of [it] to provide safe and adequate service depends on it getting the rate relief that it is entitled to." 9/30/08 Tr. at 22 lines 10-18.

LRWC also testified that all of the capital improvements are directed to the adequacy of supply, safety of the water, and reliability of the system and included projects that were required by the DES. 9/30/08 Tr. at 23 lines 11-20. LRWC testified that if the step increases are not approved, LRWC risks not being able to complete the improvements at Hidden Valley, replace the pump station, or complete the interconnection with Gunstock Glen. 9/30/08 Tr. at 24 lines 20-24.

With respect to the first two step increases, LRWC's revenues would increase by \$112,739, or 15.62%. The costs relating to all assets in steps one and two have been reviewed by audit staff for accuracy and reasonableness. The depreciation lives of the assets were set using the Small Water Company Information Booklet produced by the Commission in 1991 and were also based on rates for LRWC previously approved by the Commission. 9/30/08 Tr. at 33 lines 19-20 and at 34 lines 13-19.

Staff and LRWC recommend that the Commission approve implementation of the first two step increases simultaneously on a bills rendered basis for bills issued on or after November 30, 2008 because all of the assets in these steps are now in service and are used and useful.

With respect to step three, Staff and LRWC recommend an increase to LRWC's revenues by approximately \$25,380, or 3.52%. This step contains assets to be completed at LRWC's Hidden Valley and Gunstock Glen systems, as well as completion of a frost barrier and wood frame control room at the storage tank at Paradise Shores. This third step would not be implemented until LRWC files its cost documentation, audit staff reviews the costs and confirms the assets are in service and are used and useful, and the Commission approves recovery of the

costs. The contribution in aid of construction noted earlier would apply to this step increase. Specifically, Suissevale would be making a capital contribution of \$300,000 toward the final cost of the water storage facility at neighboring Paradise Shores. The Paradise Shores and Suissevale water systems are interconnected. Staff and LRWC anticipate the assets to be in service by the end of 2008.

Staff testified that it was not concerned that LRWC may be over-earning from these step increases. 9/30/08 Tr. at 20 lines 8-19. Staff testified that the step increases simply provide LRWC with the revenues that result from applying its cost of capital to the new plant additions and from direct incremental expenses related to those plant additions. Id.

B. Financing Request and Cost of Capital

LRWC has withdrawn its request for financing approval. In lieu of a loan from the company's stockholders, LRWC will now accept an equity infusion in the total amount of \$724,430 to substantially fund the capital projects that are the subject of rate recovery in this proceeding. Staff and LRWC state that this equity infusion substantially strengthens LRWC financially. Specifically, the equity increases the company's revenue requirement and rate of return and benefits customers since there are no loan payments of principle and interest. 9/30/08 Tr. at 14 lines 20-22 and at 15 lines 12-13. At hearing, Staff testified that the Commission has long been monitoring LRWC's debt to equity ratio. 9/30/08 Tr. at 15 lines 22-24. With the additional equity, and applying a 9.27% overall weighted cost of capital to the plant additions in each of the step increases, Staff and LRWC agree that LRWC's resulting capital structure is reasonable.

C. Consolidated Rate for Gunstock Glen Customers

Staff and LRWC recommend the Commission approve application of LRWC's consolidated rate to customers of its Gunstock Glen system. Gunstock Glen was acquired in 2004 and presently has its own individual rate. In support of consolidated rates, Staff and LRWC state the pump station is being remodeled and re-piped and the system is being interconnected with the nearby Brake Hill Acres system. A SCADA control system is being added in order to control, coordinate, and monitor three wells in the systems and to remotely report to the office. The additional revenues LRWC will derive from the consolidated rate has been accounted for in developing the step increases Staff and LRWC recommend. Since the capital improvements at the Gunstock Glen system are to be included in the third step increase, Staff and LRWC recommend that the consolidated rate be applied to Gunstock Glen customers on a service rendered basis as of the date of the Commission's future order approving the third step increase.

D. Rate Case Expenses

Staff and LRWC recommend the Commission allow LRWC to recover rate case expenses relating to its request for new rates in this proceeding. Staff and LRWC agree that rate case expenses will not include costs related to the financing portion of this docket, costs relating to the Staff's audit, or costs relating to routine bookkeeping or accounting associated with the assets that form the basis for rate recovery in this docket. Staff and LRWC recommend LRWC be allowed to submit its request for recovery of rate case expenses to Staff, with supporting documentation, and that Staff review that documentation and make a joint recommendation with LRWC to the Commission. If the settling parties are unable to reach agreement on a joint

recommendation, Staff and LRWC will each file a separate recommendation to the Commission for its consideration.

IV. COMMISSION ANALYSIS

Changes in rates utilities charge to customers are governed by RSA Chapter 378. Specifically, RSA 378:7 authorizes the Commission to establish rates for utilities that are lawful, just, and reasonable. In determining just and reasonable rates, the Commission must balance the consumers' interest in paying rates no higher than are required with the investors' interest in obtaining a reasonable return on investment. *Eastman Sewer Co.*, 138 N.H. 221, 225 (1994). 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. Traditional rate-of-return principles permit a utility to recover prudently incurred operating expenses along with “the opportunity to make a profit on its investment, in an amount equal to its rate base multiplied by a specified rate of return.” *See Appeal of Conservation Law Foundation*, 127 N.H. 606, 634 (1986). We apply these principles to our analysis of the rate increases proposed by Staff and LRWC.

We will consider the proposed step increases to rates first. As represented in the stipulation agreement and testimony at hearing, the capital improvements that comprise the first step increase involve projects located in Hidden Valley, 175 Estates, and Indian Mound and also include common assets such as vehicles and shop equipment. These capital improvements were completed and placed in service during 2007 and comprise a total of \$296,803 in net plant in service. The second step increase involves the Paradise Shores/Emerson Road tank project that audit staff also found to be in service.

At hearing, LRWC testified that the tank project was used and useful as of the July 4, 2008 weekend. 9/30/08 Tr. at 24 lines 12-14. As noted earlier, these improvements are non-

revenue producing and were directed at providing safe, adequate, and reliable service to customers. 9/30/08 Tr. at 21 lines 3-7 and at 23 lines 11-20. Having reviewed the nature of these improvements and the necessity of responding to deficiencies identified by DES, we find LRWC's capital additions for steps one and two to be prudent, used, and useful pursuant to RSA 378:28 and we will allow them into rate base.

We further find, consistent with *Appeal of Conservation Law Foundation*, that LRWC is entitled to earn a reasonable rate of return on these assets. Staff and LRWC have proposed using an overall rate of return of 9.27% which is based on a weighting of LRWC's present debt and equity, including the recent equity infusion from Mr. and Mrs. Mason. Exh. 2 at 22. As indicated in the schedules supporting the stipulation agreement, this overall rate of return, or weighted average cost of capital, includes 21.06% of debt capital at a cost rate of 7.47% and 78.94% of equity capital at a cost rate of 9.75%. The 9.75% cost of equity was approved in LRWC's last rate case. *See Lakes Region Water Company, Inc.*, Order No. 24,692, 91 NH PUC 516 (2006). Even though Staff and LRWC propose an overall rate of return that is higher than LRWC's most recent rate case, 8.23%, we find this overall rate of return to be reasonable. In particular, we agree with Staff and LRWC that the recent equity infusion makes LRWC stronger financially and is beneficial to customers since it reduces the company's need to make principal and interest payments. It is precisely this additional equity that accounts for the change from 8.23% to 9.27%, since the return on equity has stayed the same at 9.75%.

We further find this rate of return is reasonable notwithstanding OCA's assertion that LRWC does not plan to pay federal income taxes for 2008. In setting a rate of return, we are permitting a recovery of capital costs which typically includes a provision for federal income tax. Whether a utility pays taxes in any year is dependent on numerous factors and not just its

performed return on rate base. Normal utility accounting will provide for adjustments to deferred federal income tax, such as deducting it from rate base, in the event a utility incurs a tax liability less than that amount of taxes provided for in its revenue requirement.

With respect to costs included in steps one and two pertaining to LRWC's affiliate agreement, Staff testified that it was important to have a more recent agreement on file since Mr. Tom Mason would be assuming a management position with LRWC while he also still held a management position with LRW Water Service, Inc. (LRW). 9/30/08 Tr. at 32 lines 1-9. This more recent agreement has in fact been filed in this docket, as Exhibit 7 in response to a record request. Concerning LRW and LRWC's relationship, Mr. Mason testified that LRW repairs leaks, performs maintenance, and is involved in the installation of plant for LRWC. 9/30/08 Tr. at 28 lines 12-16. LRW does not perform work exclusively for LRWC and performs work for developers and municipalities. Id. lines 18-19. Mr. Mason testified that LRW charges LRWC a rate that is less than LRW's going rate. 9/30/08 Tr. at 29 lines 15-20. This rate of compensation was initially a concern of OCA's; however, OCA stated that it would not object to LRW's fees so long as they represented LRW's cost or were at market, which ever was lower. The costs are less than LRW's going rate and are therefore at or below market. In light of this evidence, we find that the costs charged by LRW are reasonable and we will permit LRWC to recover the costs related to LRW's services in steps one and two.

As to the impact of the two step increases to rates, we understand that they will increase LRWC's annual revenues by \$112,739. This represents a 15.62% overall increase, but, as Staff and LRWC noted at hearing, the effective rate of increase is 17.57% due to the influence of wholesale revenues from LRWC's contract with Suissevale and due to the inclusion of expected revenues from Gunstock Glen customers once consolidated rates are applied to them. Exh. 2 at 4

and 24. In light of the increase in LRWC's plant in service of approximately 54%, we find that the step one and two increases are just and reasonable pursuant to RSA 378:7.

As to the effective date of the proposed step increases, we note that Staff and LRWC recommend an effective date of November 30, 2008, on a bills rendered basis. At hearing, Staff testified that this date was selected to ensure that customers receiving quarterly bills would not be paying for recovery of assets that were not yet used and useful. 9/30/08 Tr. at 32 lines 17-24 and at 33 lines 1-4. According to Staff, some assets were not used and useful until early August. Thus, by setting a November 30, 2008 effective date for quarterly bills that would reach back 90 days to September 1, 2008, Staff could be assured that all assets were used and useful for that September 1 effective implementation date. Id. We find this approach to be reasonable and consistent with RSA 378:28 and we will approve implementation of steps one and two simultaneously for bills rendered as of November 30, 2008. We note that this bills rendered implementation is effectively a service rendered implementation effective September 1, 2008 and thus we find that it complies with N.H. Code Admin. R. Puc 1203.05.

We next consider Staff and LRWC's request that LRWC be allowed to recover additional capital improvements made in Paradise Shores, Hidden Valley, and Gunstock Glen in the form of a third step increase. According to the terms of the stipulation agreement, these improvements are expected to be in service and used and useful by the end of 2008. The exact cost and rate impact calculation of the capital improvements are estimated at this time and Staff and LRWC seek Commission approval for LRWC to make a future filing to recover these costs. Staff and LRWC expect the net plant in service for this third step to be \$61,325 for Paradise Shores, \$96,177 for Hidden Valley, and \$88,975 for Gunstock Glen. The revenue requirement needed

for LRWC to recover its investment in the assets and earn a reasonable rate of return is expected to be \$25,380. Exh. 2 at 16.

Although this third step is characterized by Staff and LRWC as involving improvements intended to address safety, adequacy, and reliability of the water system as in steps one and two, there is a distinction with at least one of the projects. The improvements pertaining to Paradise Shores are “more of a planned project” according to the testimony of Mr. Mason, and involve completion of a frost barrier and wood frame control room. 9/30/08 Tr. at 28 line 1 and at 53 lines 16-21. By contrast, we understand the work pertaining to Hidden Valley is a continuation of work relating to LRWC’s compliance with DES’s October 4, 2007 administrative order. Similarly, the improvements to the pump station at Gunstock Glen and its interconnection with the Brake Hill Acres system is intended to address water supply concerns. Thus, we are disposed to approve recovery of these improvements but not the planned improvements at Paradise Shores

We are mindful that this Commission has limited the use of the step adjustment mechanism so as to allow recovery of expenditures which are in service and are necessary for the provision of safe and adequate service. *Pennichuck Water Works, Inc.*, Order No. 23,923, 87 NH PUC 97, 102 (2002). Typically, these expenditures are for larger capital projects which, if not recoverable, would have a detrimental impact on a utility’s rate of return. *See Hampstead Area Water Company, Inc.*, Order No. 24,626, 91 NH PUC 225, 230 (2006). For these reasons, consistent with the stipulation, we will allow LRWC to file for approval of a step increase to its rates for the improvements at Hidden Valley and for the improvements at Gunstock Glen; however, we will not allow recovery of costs through a step increase of the remaining improvements at Paradise Shores.

We next turn to the issue of applying consolidated rates to customers in LRWC's Gunstock Glen system. According to the stipulation agreement, the request to increase Gunstock Glen customers' rates to LRWC's consolidated rate is to occur contemporaneously with LRWC's recovery of improvements identified in step three. As noted earlier, this third step increase and consolidated rate is to occur at some point in the near future. Because of the prospective nature of this request, and the prospective nature of applying consolidated rates to these customers, we find it reasonable to defer consideration of applying consolidated rates to Gunstock Glen customers to the time LRWC makes the appropriate filing.

Based upon the foregoing, it is hereby

ORDERED, that Lakes Region Water Company, Inc.'s request to increase its revenue requirement by \$112,739 is APPROVED; and it is

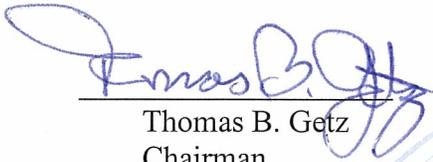
FURTHER ORDERED, that Lakes Region Water Company, Inc. is authorized to implement the rate increase for its consolidated rate for bills issued on or after November 30, 2008 with the condition that bills issued on or after November 30, 2008 may not charge customers the rates approved herein for service rendered prior to September 1, 2008; and it is

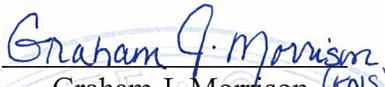
FURTHER ORDERED, that Lakes Region Water Company, Inc. may file with the Commission compliance tariffs for its new consolidated rates within ten (10) days from the date of this order; and it is

FURTHER ORDERED, that Lakes Region Water Company, Inc. shall file with the Commission within thirty (30) days a total of its rate case expenses for this docket, a proposed recovery period, and a proposed surcharge amount for customers; and it is

FURTHER ORDERED, that Lakes Region Water Company, Inc. may file for recovery of improvements at Hidden Valley and Gunstock Glen, as discussed herein, through a step increase to rates.

By order of the Public Utilities Commission of New Hampshire this thirtieth day of December, 2008.

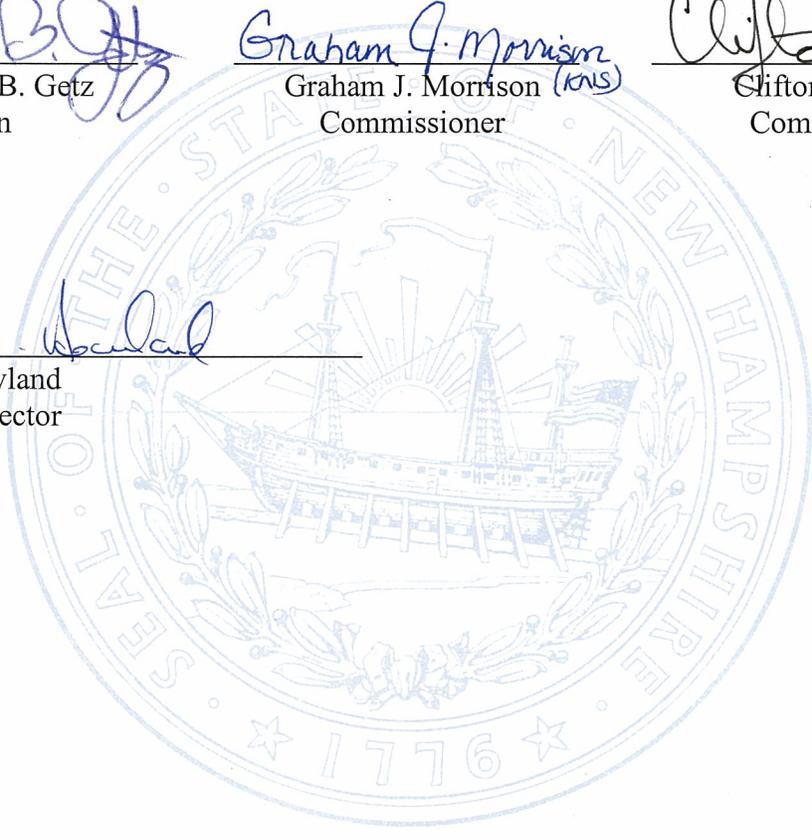

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Docket #: 08-070

Printed: December 30, 2008

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INTERESTED PARTIES

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