Pennichuck Water Works, Inc.
DW 19-084

PWW-Rate Proceeding
Responses to Staff Data Requests – Tech 6

Date Request Received: 5/29/20	Date of Response: 6/5/20
Request No. Staff Tech 6-1	Witness: Larry D. Goodhue

REQUEST: Please explain the operational and capital related decision-making processes in place that reduce the opportunity for the Company to make imprudent decisions.

RESPONSE:

When the Commission approved the acquisition of Pennichuck Corporation by the City of Nashua in Docket No. DW 11-026, the Commission set in motion a financial structure of PWW that removed PWW's ability to earn a return on equity. PWW and its parent, Pennichuck Corporation, no longer had access to private equity markets. Therefore, there was no return on equity built into PWW's revenue requirement. This new structure is unlike any other entity regulated by the PUC. This structure has the effect of disincentivizing imprudent decisions made for the desire to maximize return on investment ("ROI"). If a utility has the right to recover a ROI on behalf of investors, every project approved by the PUC has the potential for adding another project for which investors are entitled to a ROI. If deemed imprudent, the investors simply have a reduced overall return on the company as a whole. PWW, on the other hand, has no investors and therefore no financial pressure to pursue potentially imprudent projects that result in a ROI since that element has been eliminated from PWW's rate structure.

Elimination of equity funding also had the effect of tightening PWW's cash flow and left no room for error in how PWW managed the utility. Under tight cash flow conditions, prudency is almost assured because there is no extra cash to cover a non-prudent expenditure. If cash is diverted to imprudent expenses, given that PWW has dollar-for-dollar coverage of its known and measurable expenses, this would result in PWW not having cash for its prudent expenses. This would be especially true if PWW's known and measurable expenses were higher, such as the rate of underlying operating expense increases and inflation of Material Operating Expenses has been 3.5% over the recent three years, yet 3% is being used as a proxy in the revenue requirement proforma calculations for the MOEF. There would be no way of hiding an imprudent expense because the shortfall to cover prudent expenses would become almost immediately evident. The tightness of PWW's coverage for expenses acts as a disincentive to wasting PWW's precious cash on imprudent decisions.

Imprudent decisions are also discouraged because of PWW's loan covenants with its external lenders, both at the Working Capital Line of Credit level, and at the Bonded Debt level. As Staff and the parties are aware, PWW is subject to financial covenants such as minimum debt service coverage ratios and cash reserve and liquidity covenants and concerns associated with its loan instruments, and the Company's overall credit rating and worthiness. If PWW were to violate these covenants, it would put PWW in financial jeopardy of losing access to its current Line of Credit facility, as well as the ability to issue bonds in support of capital projects. This acts as a very strong disincentive to making imprudent decisions.

To illustrate the domino effect if PWW were to violate a financial covenant, the following set of circumstances could and would occur. If the Company was to violate a financial covenant on the Working Capital Line of Credit maintained at Pennichuck Corporation for the benefit of all of the Companies in the corporate group (including PWW, PEU, PAC and PWSC), without an ability to cure, then the bank would demand immediate repayment of the sums outstanding on the line, and (if the Company was in a non-curable default) it would mean it did not have the cash or operating profits to accomplish that, which would then cause a full event of default and "default triggers" on all of the Company's other debt obligations (which means they would all also be in default). And, what could trigger this is one of the following: (1) not being able to "clean out" the line of credit fully for a period of 30 consecutive days each calendar year, or (2) not meeting the minimum debt service coverage ratio from the Company's EBITDA coverage and profitability. As such, the Company is forced to make prudent decisions throughout the year, in order to maintain adequate profitability from allowed revenue levels (rates), as well as maintaining a continuity of effective usage of cash throughout the year, in order to accomplish the required annual "clean out." Additionally, if the Company does not meet its Bond covenants, which include a Debt Service Coverage test, as well as and All Bonds Test (which is based upon certification of compliancy at current operating levels to service all Funded Debt at the highest point of debt service for any year in the future) it would be prohibited from issuing any bonded debt into the markets. And, the annual issuance of Bonds into the market is needed to secure the funds needed to meet the requirements to completely "clean out," re-term those funds with long term debt in support of capital projects, and repay the Company's Fixed Asset Line of Credit ("FALOC") each year by April 30 (as required by that debt instrument). If the Company acted imprudently, and as such, violated its Bond covenants, then the Company could not issue Bonds, clean out the FALOC, and would be in default under the FALOC. This default on the FALOC would trigger a cross-default on the W/C Line of Credit, and once again start the process of debt default "dominoes" to fall. In addition, as the Company (unlike a normal IOU, with a return on equity component) knows that its sole shareholder has no desire to make any additional equity investments into the Company, and is an unsecured creditor of Pennichuck Corporation, another highly effective disincentive is in place to prohibit imprudence in decisions of spending by the Company(ies). With a municipal shareholder in place for Pennichuck Corporation, a dynamic is in place that also prohibits overall decisions of this nature, as has been explained by the intervenor to this case. The last thing that elected officials of our shareholder would want to have happen is for a public discourse to be started to remedy a situation where either an equity infusion to the Company was needed, or a cure for the Company's default on its note payable obligations to the City needed to be addressed, due to the imprudence of decisions by the Company's management and Board of Directors. The Company's Board of Directors review the operating results of the Companies with management on a monthly basis, as it pertains to expenses compared to budgeted/allowed levels, and comparative to prior year operating levels, all with an eye towards prudency of expenditures, given the constraints and concerns by the Company's lenders, as well as its corporate shareholder. This entire sequala of dominos acts as a disincentive to making imprudent decisions.

The fact that PWW is overseen by and reports to multiple boards, key stakeholders, lenders and the PUC itself also acts as a disincentive for PWW to make imprudent decisions. PWW answers to two boards: PWW's Board of Directors and Pennichuck Corporation's Board of Directors. It also answers to commercial lenders for Pennichuck Corporation and PEU, as well as Bondholders for PWW, and the NHDES for its SRF and DWGTF loans. Both the Penn Corp and PWW Boards are active in reviewing PWW budgets and operations, as addressed above. And, the annual budgets of all of the Companies in the Pennichuck group are subject to Board approval annually, as well as any financings procured by the Companies require both Board and Shareholder approvals.

Regulations also discourage PWW from making imprudent decisions. PWW is regulated by the NH Public Utilities Commission and files comprehensive Annual Reports with the Commission on a yearly basis. These reports contain details on PWW's corporate structure, financial strength, and provide a yearly opportunity to question PWW concerning its activities. PWW also provides the Commission with an annual QCPAC filing in which the Company provides a detailed summary of the prior year's capital projects, the current year's projects and capital projects over the following two years (and all of which are reviewed and approved by the Board). As such, capital projects are subject to annual review by Staff and data requests for additional detail. Quarterly updates are provide following each QCPAC filing and are themselves subject to additional review and data requests. Such reviews also occur with each request for approval of financing, and again Staff is entitled to review and raise questions about the use and function of financing requests for capital projects.

These Annual Reports are subject to audit by the Commission's Audit Staff. Audit Staff ensures that PWW's books and records comply with the Commission's Chart of Accounts. Pennichuck Corporation and its subsidiaries are also audited by its outside auditors who also ensure the integrity of the Corporation's books and records and compliance with GAAP/FASB. These reports and audits are in place to confirm overall accuracy in PWW's accounting, act as another deterrent to imprudent decisions, and promote a high level of transparency of PWW's books and records.

All of the above demonstrate that the financial incentive for imprudent decisions has been removed and there are substantive checks and oversight protections built into how PWW manages the water utility. PWW reports to multiple boards, stakeholders, lenders, and to the Commission; all of whom have an interest in seeing that PWW makes prudent decisions. This oversight and vetting of management decisions protects against inefficiency and promotes responsible decision-making in ways that are transparent and accountable. Therefore, when the Commission reviews the Company's utility actions under a prudence review, the Commission has tangible, auditable evidence of PWW's exercises of due care and of the multiple management systems in place that PWW must use when vetting decisions.