**STATE OF NEW HAMPSHIRE**

**BEFORE THE**

**PUBLIC UTILITIES COMMISSION**

**Petition of Pennichuck Water Works, Inc. for Approved Modification of Accounting Treatment for Leases**

**DW 21-___**

# DIRECT PREFILED TESTIMONY OF GEORGE TORRES

November 12, 2021

**Q. What is your name and what is your position with Pennichuck Water Works, Inc.?**

A. My name is George Torres and I am the Chief Accounting Officer, Treasurer and Corporate Controller of Pennichuck Water Works, Inc. (the "Company" or "PWW"). I have been employed with the Company since February 2006, when I initially served as the Corporation's Accounting Manager. In 2015, I assumed the role of Director of Accounting and Corporate Controller, and was named and appointed as Treasurer in May 2020, in addition to those roles. I also serve as Chief Accounting Officer, Treasurer and Corporate Controller of the Company's parent, Pennichuck Corporation ("Pennichuck").

**Q. Please describe your educational background.**

A. I have a Bachelor of Science degree in Business Administration with a major in Accounting from Montclair State University in Montclair, New Jersey.

**Q. Please describe your professional background.**

A. Prior to joining the Company, I held Controller and Senior Accountant positions for several subsidiaries for the global human resource company Vedior North America, now known as Randstad USA from October 2002 to February 2006. My duties included all financial, accounting, and reporting functions for the subsidiaries as assigned. Prior to joining Vedior N.A., I held various senior accounting positions for several companies in the retail, energy services, and manufacturing sectors.

**Q. What are your responsibilities as Chief Accounting Officer and Treasurer, and Corporate Controller of Pennichuck?**

A. I am responsible for the overall management of the Company's treasury, accounting, financial reporting, compliance and budgeting functions. My responsibilities also include supporting the Chief Financial Officer in the issuance and repayment of debt, as well as quarterly and annual financial and regulatory reporting and compliance. The performance of these responsibilities is on the behalf of Pennichuck Corporation and all its subsidiaries.

**Q. Please provide an explanation of the purpose of this written pre-filed testimony.**

A. The purpose of this written pre-filed testimony is to provide support to the Commission for the following Company request. The Company is seeking authority to account for its lease obligations on a "cash requirement basis" as opposed to the accrual methodology required under the former FASB leasing standard ASC 840 and the new FASB standard under ASC 842. This request, if and when approved, would additionally allow the Company to maintain the accounting for its lease obligations as operating leases, as opposed to capital leases, which would maintain an alignment of its GAAP basis accounting for these obligations with its regulatory accounting treatment basis in conjunction with the Company's approved allowed revenue rate structure, as approved in Dockets No. DW 13-130, DW 16-806 and DW 19-084. This requested approval is especially important as it relates to the accounting for the Company's current lease for its main office facility located on 25 Walnut Street in Nashua. This approval would allow the Company to account for this lease in alignment with its actual monthly and annual cash requirements under that agreement, as opposed to an accrual basis which would require a "straight-line" methodology over the entirety of the term of the lease and its extension periods available. This would cause numerous pro forma adjustments to be prepared and considered in the rate cases for the Company throughout that entire term of the lease in order to properly align the Company's true cash needs in its revenue requirements being sought in those future rate cases. And, as the lease costs for this facility, as well as other de minimis equipment leases, are including in the allocable expenses in the Company's approved Management Fee Allocation to its sister subsidiaries, the pro form impact of these cash to accrual adjustments would in-turn, flow through to rate cases for those other entities throughout the term of the lease obligations.

**B. What is the FASB leasing standard ASC 840 and the new leasing standard ASC 842?**

A. The Accounting Standard Codification ("ASC") Topic 840 was the original lease accounting standard as set by the United States Generally Accepted Accounting Principles ("GAAP"), which has been in effect since January 1, 1977. This previous standard provided guidance for public and private companies on the treatment of "capital" and "operating" leases on their financial statements. The new Accounting Standard Codification ("ASC") Topic 842 came into existence as an attempt to improve the overall financial disclosure for lease obligations by publicly traded companies, originally required under ASC 840. Under the old lease disclosure regulations, (ASC 840) only capital leases were required to be recorded as a liability on the balance sheet, whereas operating leases were included as an element of expense on the income statements of companies, with full disclosure of future payment obligations included in the footnotes of the financial statements. Additionally, ASC 840 also required a straight-line accounting of the total lease expense over the entirety of the lease term.

On February 25, 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-02 Leases (Topic 842). The new standard was established to bring the future financial impact of all operating leases onto the balance sheet, along with capital leases, for the first time and, as such, requires *all leases with a term over one year to be capitalized*. It is effective for years beginning after December 15, 2021; however, early adoption is permissible. The ASC 842 strives to record all leases on the balance sheet to allow for increased visibility and comparability into the leasing obligations of an entity, and the future operating expense and cash payment requirements under those agreements. This standard replaced US GAAP standard 840 which accounted for leases as either: (1) capital leases or (2) operating leases. The determination of which was based upon a multi-factor test of the underlying metrics of a given lease, and the accounting treatment required based upon those factors. While capital leases were recorded on the balance sheet, operating leases were disclosed as a footnote in the financial statements as an operating expense, along with the disclosure of future cash payments requirements, and thus could be excluded from Balance Sheet based financial ratios and bank covenants that would make it difficult to accurately judge a company's indebtedness, and current credit worthiness. However, this treatment was not considered to be adverse by most lending institutions, as operating leases, based upon the multi-factor test, were for leased facilities or equipment which would not eventually accrue to the benefit of the lessee as an asset, or would be owned by that lessee entity. The new standard, which may be applicable for many entities that have an overall basis of their operations, where leases constitute the primary basis of their financial status (i.e. a real estate development company), is not as accurately applicable to entities such as Pennichuck, as it lease obligations are truly for the usage of a facility or equipment, that will not eventually become the property of the Company, to the benefit of its customers.

**Q. What impact does the new ASC 842 lease accounting standard have on the Company?**

A. The new lease standard now requires lessees to classify the majority, or all, of its leases as assets and liabilities on their balance sheet for all financial reporting. This will have a financial impact which could significantly increase the reported assets and liabilities of the Company, and can affect its financial covenant compliancy, and/or cause the Companies GAAP basis financial statements to be presented in a manner that is inconsistent with the basis for which its allowed revenues are calculated and approved. The Company is requesting authority with regards to the accounting and treatment of its leases in light of the current and new standard requirements, in order to best align its lease accounting with it approved rate setting methodology. It is important that the Company fully disclose and account for these leases, their current basis, and future indebtedness obligations, in accordance with the standards. But, it prefers to maintain any required disclosures in the footnotes of its audited financial statements, instead of needing to “gross up” the impact of its operating leases as elements on its Balance Sheet. The Company would also prefer to have the impact of its operating leases remain as a portion of its operating expenses, both for GAAP reporting and regulatory reporting purposes, aligning its GAAP basis financial statements with the basis of accounting treatment used to establish its approved allowed revenues. This is especially important given the Company’s current approved rate structure, based upon a multi-bucket cash basis supported calculation of allowed revenues.

The full adoption of these standards would also result in a monthly/annual lease expense recorded in the financial statements that would differ from the cash actually being paid on a monthly basis throughout the term of the lease. These standards require companies to straight-line this expense during the entirety of the lease term, as well as any available extension or renewal terms, if certain conditions are met. As such, for the Company's lease on its headquarters facility, for the initial 10-year term of the lease, the Company would be reporting a greater lease expense than the Company would be expending in cash, as the lease agreement has a provision for the annual lease cost to increase by 10% at both the 5 year and 10 year anniversaries of its inception, with the remainder of the lease, including three 5-year extension periods being at the rate in place beginning in year 11 (with no escalation in monthly cost). Conversely, in the later years of the lease based upon its term, the Company would then be expending a greater amount in cash than would be reported in its financial statements, once again due to the straight-line accounting over the entire term of the lease.

Because our current rate methodology is based upon, and intended to provide, dollar-for-dollar cash flow coverage of our actual operating expenses, as included in the OERR portion of allowed revenues, we must ensure cash flow coverage for this obligation is properly aligned with the financial reporting and accounting for these payments and obligations,

Being forced to adopt ASC 842, and veering away from a regulatory accounting treatment would not only create a potential impairment to our Rate Stabilization Funds and rate methodology (due to a mis-match of GAAP basis operating expenses between rate cases), it would also require an ongoing need to proform the differential between the allowed basis for the lease expenses included in the OERR portion of allowed revenues in all future rate cases. This method would also require a reconciliation of these amounts in the Company's annual reports filed with the Commission, in understanding the true regulatory basis for these significant operating costs.

**Q. Does the Company expect the new standard to have an adverse effect on the accrual basis financial statements of the Company if this request is not approved?**

A. Yes. As stated earlier in my testimony, the Rate Stabilization Funds would potentially become adversely impacted between rate cases with adoption of the new lease standard. For example, assuming the Company exercises all three 5-year options after the initial 15-year term, the company's total cash outlay over the entire 30-year lease would be $11,451,000. This would result in an annual straight-line expense under ASC 842 of $379,591 over the entire lease term. However, in years 1 – 5 the annual cash outlay for the office lease would be $330,000 and in years 6 – 10, the annual cash outlay would be $363,000. This differential would result in a total impact to the MOERR RSF account of $394,177; inclusive of two months of free rent at the end of 2020, in which the reported MOERR expenses would be *higher* than the cash outlay during the initial 10-year period. Conversely, the remaining 20 years of the lease would generate an annual cash outlay of $399,300 versus the straight-line expense of $379,591 which would result in a total reversal of that impact to the MOERR RSF account of $(394,177) in which the reported MOERR expenses would be *lower* than the cash outlay during the last 20 years of the lease agreement.

This would be inconsistent with the design of the MOERR RSF account, and overall intent of the company's rate structure reflecting actual incurred "cash" costs in a given year, versus the straight-line amortized value of a long-term lease.

Q. **Does the standard impact all years for which the modified lease accounting would be required**?

Yes. All years on a prospective and ongoing basis.

Q. **Does the standard impact the Company's ability to fully meet its bank covenants with regard to profitability ratios if this request is not approved?**

The new lease standard can have a negative impact on our traditional bank/lender coverage ratios due to the required recognition of leases over 12 months in length, on the balance sheet. This in turn, as discussed earlier in my testimony, will create a straight-lined accural of the office lease expense on the income statements which can impact our Debt Service Coverage and Rate Covenants, as we will report a lease expense that is inconsistent with the actual cash outlay for the remaining life of the lease.

Q. **Would this approval be accretive to other rate structure modifications that the Commission has approved for the Company in its recent permanent rate case filings?**

Yes. See DW 16-806 and DW 19-084 (establishment and modification of the RSF reserve cash accounts). Allowing the Company to recognize the office lease expense on a cash basis versus an accrual basis will help preserve any gains in the MOERR RSF restricted accounts as the expense associated with the building lease would match the actual cash outlay. Thereby eliminating any impairment, negative or positive, created by ASC 842 against the restricted cash account.

Q. **What is the Company requesting in this docket, as it relates to the approved accounting treatment of its lease obligations?**

As described earlier in my testimony, the proposed approval requested would consist of allowing the Company to: (1) the ability to forego GAAP accounting for this office lease (as well as its other de minimis copier and equipment leases) as a "capital lease" and be authorized to adopt a regulatory accounting treatment consistent with the previously allowed GAAP treatment as an "operating lease," and (2) the application of this regulatory accounting treatment would allow the recording of the lease obligation(s) in a manner that is consistent with the actual cash requirements, maintaining the recording of the lease costs in the operating expenses of the Company, rather than creating an asset and liability for the lease on the balance sheet of the Company. Ultimately, this would allow for better matching of the MOEFF RSF account activity to the actual cash flow.

Q. **Would this requested modified accounting treatment have a rate impact on the Company's rate payers**?

Directly, this request would not have an impact on rate payers as the reported expense would continue to match the necessary cash requirements of the associated lease liability, in its regulatory basis accounting for allowed revenue requirements of the Company in its rate case proceedings.

Indirectly, if this request were not approved, it is possible rate payers might see an increase in the cost of borrowing, as included in the DSRR portion of its allowed revenues. Lending institutions would potentially then recognize any long-term lease obligations as additional debt, thereby potentially lowering or negatively impacting traditional bank covenant ratios. This would in turn potentially increase the Company's borrowing costs, which would be passed on to rate payers as a part of its DSRR allowed revenues.

**Q. What leases does the Company currently have that would be impacted by this request?**

A. Any lease with a term of over 12 months would be affected by the FASB pronouncements full adoption. However, the main office building lease at 25 Walnut Street is the main driver of this request. The other affected leases are for the Company's postage and copier machines, which as a rule, are de minimis in overall value. However, the Company is seeking authority for all of its operating leases in this filing, as a hybrid approach to lease accounting would not benefit any stakeholders to the Company's financial statements and results.

**Q. Would the new ASC apply to new or preexisting leases or both?**

A. Implementing ASC 842 requires transitioning all existing leases of a term longer than 12 months, from ASC 840. This accounting is required on all existing leases upon adopting the new requirements. Prior year restatement to the Company's financial statements is not required (ASU 2018-11).

**Q. What is the timing for approval of this request?**

A. This matter is time sensitive as it will be applicable beginning with the beginning of the 2022 fiscal year. As such, the Company respectfully requests an order on this request as soon as practical, optimally by December 15, 2021, such that results of an Order can be discussed with the Company's external financial auditors, in planning for the year end 2021 fiscal audit. However, an Order received any time before December 31, 2021 would be acceptable, if the earlier requested date cannot be achieved. Attached to this testimony as exhibits GT-1 thru GT-3 are proforma financial statements showing the impact of this request, and conversely the impact of the FASB pronouncement, should this request not be approved.

**Q. Do you believe that this proposal will be consistent with the public good?**

A. Yes, as it will allow for our accounting to be in conformity and consistent with our current rate structure. Especially as it pertains to the matching of operating expenses as actually incurred during a given fiscal year, and the associated revenues approved for the Company in its last rate case, based upon full cash coverage of necessary and prudent operating expenses. It is also important to reiterate that the lease costs related to the main office is a cost that is shared with the sister subsidiaries of PWW, through the approved 2006 Cost Allocation Agreement. As such, the approval of this request has that magnified affect of simplifying the book to regulatory accounting basis for these operating costs, as shared with Pennichuck East Utility and Pittsfield Aqueduct Company.

**Q. Is there anything else that you wish to add?**

A. Yes. As discussed above, I will respectfully ask the Commission for an order on this docket by December 15th, which will allow the Company's external auditors to review the order to affirm its compliancy with GAAP in time for the 2021 Fiscal Audit.

**Q. Mr. Torres, does this conclude your testimony?**

A. Yes, it does.