STATE OF NEW HAMPSHIRE

BEFORE THE

NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

DW 21-137

Pennichuck Water Works, Inc.

Supplemental Information to the Amended Petition for Approved Modification of Accounting Treatment of Leases

On January 20, 2022, the New Hampshire Public Utilities Commission (the "Commission") issued Order No. 26,567 in Docket No. DW 21-137 directing Pennichuck Water Works, Inc. ("PWW" or the "Company") to file supplemental analysis of the applicability of Financial Accounting Standards Board ("FASB") Standards Topics 840 and 842 (as revised and updated) to PWW's accounting practices and the applicable requirements of New Hampshire law pursuant to RSA 374:8 and Puc 607.07(a). The Commission also directed the Company to specifically address the applicability of FASB Accounting Standards Updates No.'s 2016-02 (February 2016), 2018-11 (July 2018), and 2021-05 (July 2021) at regarding treatments of leases pursuant to ASC Topic 842. The Company hereby sets forth its additional analysis in response to the Commission's Order No. 26,567 and in support of its request to withdraw its petition from Docket No. DW 21-137.

A. Application of FASB Topics 840 and 842:

The original lease accounting standard, ASC Topic 840 set by the United States Generally Accepted Accounting Principles ("GAAP"), was in effect since January 1, 1977. This standard provided guidance for public and private companies on the treatment of "capital" and "operating" leases on their financial statements. Under the old lease disclosure regulations, 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; however, operating leases under this standard were noted in the footnotes and not as liabilities or assets on the balance sheets.

In February 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-02 Leases (Topic 842) creating a new standard that requires consideration of the future financial impacts of *all* operating leases onto the balance sheet, along with capital leases, for the first time. The standard requires all leases with a term over one year, regardless of whether they are operating or capital leases (as considered under the old standard) to be capitalized. Pursuant to subsequent updates ASC 842 is effective for years beginning after December 15, 2021[1] for "all other business entities" for which the Company qualifies. The underlying purpose for ASC 842, which superseded ASC 840, is to record all leases on the balance sheets to increase visibility and comparability into the leasing obligations of an entity, as well as the future operating expenses and cash payment requirements under those agreements.

The four criteria for classifying a lease as a capital lease under FASB 13 and ASC 840 are: 1) ownership transfer at end of lease term; 2) bargain purchase option; 3) lease term greater than or equal to seventy-five percent of the useful life of the asset; and 4) present value of the minimum lease payments are greater than or equal to 90% of the fair value of leased property[2]. The Company's current lease for its main office facility located on 25 Walnut Street in Nashua

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[1] FASB Update No. 2016-02 (February 2016) Leases (Topic 842) was initially effective for "other entities" to which the Company qualifies, as of December 15, 2019; however implementation was later deferred by FASB Update No. 2019-10 (November 2019) to December 15, 2020, and by FASB Update No. 2020-05 (June 2020) until December 15, 2021.

[2] See Statement of Financial Accounting Standards No. 13 (FASB 13), November 1976, Paragraph 7 at 8.

was classified as an operating lease under the prior ASC 840 standard because the lease did not qualify as a capitalized lease under this multi-factor test[3]. Under the ASC 840 standard, capital leases were previously recorded on the balance sheet; however, operating leases were disclosed only as a footnote in the financial statements as an operating expense, along with the disclosure of future cash payment requirements. The operating lease expenses could therefore be excluded from balance sheets that could impact financial ratios and bank covenants that would make it difficult to accurately judge a company's indebtedness and current credit worthiness[4]. Given the treatment of the operating lease under ASC 840, the Company accounted for this lease in alignment with its actual monthly and annual cash requirements under that agreement because deferred or pre-paid rental expenses could be excluded from actual cash payments as lease expenses[5]. Additionally, payment of incentives are considered reductions of rental expense by the lease, but are only recognized during the initial term of the lease, each subsequent extension is treated as a new lease under ASC 840[6].

This method is not provided for in ASC 842; therefore, instead of recognizing lease expenses on a cash requirements basis, the new rule eliminates the distinction requiring recognition of straight-line rental payments (including deferred or pre-paid expenses) over the term of the lease therefore recognizing rental expenses as a liability and "right of use" asset on a "straight line" methodology over the entirety of the term of the lease and its extension periods[7].

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[3] See Direct, Pre-filed Testimony of George Torres at Page 4, lines 10-20, attached to the Company's petition.
[4] See FASB Update No. 2016-02 (February 2016), Lease (Topic 842), Section A at 1.
[5] Under ASC 840, leases were either capital or operating leases, however capital leases resulted in recognition of a liability on a company's balance sheet, whereas operating leases did not impact the balance sheet. ,"ASC 840 vs ASC 842: Differences between Old and New Lease Accounting Standard," Justin Shermaria, Feb. 6, 2020 at 1.
[6] See ASC 840-20-25-6, Section 4.3, see also, FASB 13 (November 1976), Section 14 at 10.
[7] "Under ASC 840 the difference between the actual cash payment and expense recognized each period for an operating lease is accounted for in a deferred/prepaid rent account; however, under ASC 842, this difference is no longer accounted for in a separate balance sheet account. The new accounting standard captures the difference between the cash payments and the expense recognized for an operating lease as the net change in the lease liability and the right-of-use asset each month." "Rent Expense: Straight-Line Rent Calculation for Leases under US GAAP

The Company filed the Petition and Amended Petition in this Docket under the belief that the new ASC 842 treatment will have financial impacts by significantly increasing the reported assets and liabilities of the Company[8]. The Company sought the Commission's approval of modified treatment of its operating leases under ASC 840 because it believed ASC 842 would result in a monthly/annual lease expenses recorded in the financial statements that would differ from the cash actually paid on a monthly basis throughout the term of the lease[9]. Since the current rate methodology is based upon dollar-for-dollar cash flow coverage of the Company's actual operating expenses, the straight-line method required under ASC 842 could result in over-reported expenses in the early years of lease impacting MOERR expenses with under-report cash flow outlays[10]. The straight-line method may also impact future MOERR RSF coverage due to reported expenses being lower than actual cash outlays in later years[11].

The Company also sought the Commission's approval of continued treatment of the 25 Walnut Street lease under ASC 840 to avoid potential impacts to the Company's financial covenant compliance due to increased debt to equity ratios, and/or cause the Company's GAAP basis financial statements to be presented in a manner that is inconsistent with the basis for which the Company's revenue requirements are calculated and approved under prior Commission orders.

However, if a regulated entity (such as PWW) changes accounting methods and the change affects allowable costs (in this case the straight-line accrual of all lease expenses

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Explained," Justin Shermaria, Sept. 4, 2020 at 5.
[8] See Direct, Pre-Filed Testimony of George Torres, at Pages 5-8, and Exhibit GT-3 "Analysis of Impacts of ASC 840 and ASC 842" attached to the Petition.
[9] See Direct, Pre-Filed Testimony of George Torres, at Page 7, lines 7-21.
[10] See *Id*.
[11] See *Id*.

including lease extensions impacting MOERR expenses)[12], then PWW should be permitted to implement ASC 842 as it would be for regulatory purposes, as set forth in FASB Update No. 2016-02, Section B, Amendments to Subtopic 980-250[13]. In light of this section, and the regulatory accounting practices established by the Commission under the Uniform Classification of Accounts for Water Utilities, as discussed below, the Company is permitted to report the operating leases on a cash requirements basis to avoid impacts to allowable rate costs.

B. <u>Application of New Hampshire Law - RSA 374:8, Puc 607.07(a) and the Uniform Classification of Accounts for Water Utilities:</u>

The Commission, pursuant to RSA 374:8(a) established a system of accounts and records to be used by public utilities for their business within the state and prescribe a system of accounts for each class of utility and the manner in which the accounts are kept. See RSA 374:8(a), see also, *Appeal of City of Nashua*, 121 N.H. 847, 876 (1981) (Uniform Classification of Accounts for Water Utilities adopted by order of the Commission dated December 30, 1992, now RSA 374:8.), and *Appeal of Concord Natural Gas Corporation, et al*., 121 N.H. 685, 690 (1981) (holding PUC has authority to adopt rules to establish a system of accounts and records to be used by public utilities, specifically rules excluding advertising and activities from operating expenses). The Company, as a water utility, must maintain its accounts and records in conformity with the "Uniform Classification of Accounts for Water Utilities" (Uniform Classification of Accounts) established by the Commission pursuant to PUC Rule 607.07(a)[14]. The Uniform Classification of Accounts, last updated by the Commission in June 2015, provides

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[12] See Exhibit GT-3 "Analysis of Impacts of ASC 840 and ASC 842", attached to the Company's Petition in Docket No. DW 21-137.

[13] See FASB Update No. 2016-02 (February 2016), Section B, at 277.

[14] (a) Each utility shall maintain its accounts and records in conformity with the "Uniform Classification of Accounts for Water Utilities" established and issued by the commission as a uniform system of accounts pursuant to RSA 374:8. See PUC Rule 607.07(a).

for the accounting of capital and operating leases pursuant to Statement of FASB Standards Nos. 13 (as amended to ASC 840) and 71, which allows the Commission to elect to approve the entries made by a utility's accounts in recording the effect of utility leases.[15] FASB 13 applies to the accounting treatment of leases (consistent with the Company's existing practices) and FASB Standard No. 71 (now ASC 980) provides for the application of Standard No. 13 for the treatment of leases but also provides for the adoption of accounting methods consistent with changes adopted by a rate-making regulatory entity[16]. FASB 13, as amended, requires straight-line recognition of lease expenses, but does not recognize those expenses as either liabilities or assets on the balance sheet, and further allows for segregation of deferred or pre-paid rental expenses from actual cash expenses, as discussed above. FASB 13 also provided companies with an operating lease to account for rental expenses on a non-straight-line basis if there was a systematic and rational basis for that practice[17]. Since the Commission has not updated the Uniform Chart of Accounts to include ASC 842 lease recognition rules, the Company is only required to comply with FASB 13 and ASC 840.

The Company's amended petition requested that the Commission grant this approval under the belief that said approval was needed to maintain conformity with the present Uniform

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[15] B. Leases shall be accounted for by the utility as described in Statement of Financial Accounting Standards Nos. 13 (as amended) and 71 published by the Financial Accounting Standards Board; however, the Commission may elect to approve the entries made to the utility's accounts in recording the effect of utility leases. See "Uniform System of Accounts for Water Utilities", published by the NH Public Utilities Commission, June 2015, Section 1(e)(5)(B) at 18.

[16] "If a regulated enterprise changes accounting methods and the change affects allowable costs for rate-making purposes, the change would be implemented in the way that is implemented for regulatory purposes." See Statement of Financial Accounting Standards No. 71, Financial Accounting Standards Board, Appendix A, Paragraph 32 at 15 (December 1982).

[17] "Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expenses nevertheless shall be recognized on a straight-line basis *unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used*." [*emphasis added*] See Statement of Financial Accounting Standards No. 13 (FASB 13), Accounting for Leases, as amended, Paragraph 15 at 10 (2008).

Classification of Accounts rules in conformance with PUC rule 607.07(a). While continued recognition of the 25 Walnut Street lease is permitted under the Uniform Classification of Accounts at Section 1(e)(5)(B) for regulatory purposes, the amended petition requested Commission approval to set GAAP so the Company could maintain one set of books and records. See Uniform Classification of Accounts, Section 1(e)(5)(B) at 18.

FASB 71 (ASC 980) allows the Commission, as regulator and as authorized pursuant to RSA 374:8 and Puc 607.07, to establish GAAP for a utility and this clause has not been removed in the subsequent ASC's[18]. The Uniform Classification of Accounts, as set by the Commission, includes lease treatment in Section 1(e)(5)(B), consistent with the prior ASC 840 standard, but has not yet been amended to include the ASC 842 recognition. Since the Commission established the Uniform Classification of Accounts for regulatory rate-making purposes, the Company should therefore continue to utilize its current lease recognition practices. As stated above, Update No. 2016-02, Section B modified subtopic 980-250 regarding implementation of accounting changes that affect allowable costs for rate-making purposes. The Company asserted in its Petition (as amended), pre-filed testimony and attached exhibits, that the straight-line accrual of the operating lease would impact allowable costs for rate-making purposes and potentially impact debt service costs, which may also impact ratepayers. To the extent full implementation of ASC 842 affects allowed costs for rate-making purposes, the Company is permitted by Section B to track its leases consistent with the methods approved by the Uniform Classification of Accounts.

Upon prior advice of its external auditor, the Company was under the belief that additional approval was required. However, upon questions by Department of Energy Staff

[18] See FASB 71, Appendix B, Paragraph 32 at 15.

through discovery and the Technical Session, the Company sought clarification of this statement from its auditor. See Attachment A - PWW responses to DOE Date Request Set 1, DOE 1-1, 1-2. As a result of that process, the auditor subsequently followed up with the Company stating that the Company could continue its current lease recognition practices consistent with the Uniform Classification of Accounts for regulatory purposes. The auditors asserted that, whether or not an Order was issued on this petition (original or amended), the Company would still need to gross up the value of all of its leases on its balance sheet, with a "Right of Use Asset" and a corresponding "Lease Liability," but with no impacts on the Company's income statements for either GAAP or regulatory purposes. The assets and liabilities will be revalued and amortized over the lives of the underlying leases, in an equal manner, leading up to the termination of the underlying obligations. In addition, the Company reviewed existing debt covenants with its primary lender, TD Bank. Those particular covenants already account for the lease expense in its compliance calculations; therefore, this change would not impact on PWW's existing debt covenants. Given this change of position by its auditor, consistent with questions by the Department of Energy, the Company requested withdrawal of its petition on January 18, 2022.

Although the Company asserts that its current cash requirements recognition of lease expenses is in compliance with the regulatory accounting pursuant to Section 1(e)(5)(b) of the Uniform Chart of Accounts; the Company requests a waiver of the straight-line recognition found in FASB 13 (ASC 840) as amended, pursuant to Section 1(i), to the extent its request for continued cash requirements recognition of lease expenses for its operating leases is inconsistent with the Uniform Classification of Accounts. The Commission may approve a written request for waiver if the waiver request is written and shown to be in the public interest and the request demonstrates the existing peculiarities or unusual circumstances warrantying departure from prescribed procedure or techniques but will result in a more accurate portrayal of the Company's financial condition.[19] The Company's request for waiver, as consistent with Section 1(i) maintains conformity with existing practices and rate base cash requirements, accurately portrays the cash flow expenses incurred by the Company on an annual basis and will not overstate or conversely understate lease expenses by avoiding the straight-line accrual of the lease and its extensions under the prior ASC 840 and ASC 842 on its financial statements. Reducing or avoiding additional costs for keeping separate accounting books or pro forma adjustments is in the public interest for PWW's ratepayers, and by extension, the customers of PEU and PAC due to lease expense being a component of the approved and consistently applied management fee allocation for certain includable and allocable costs.

C. <u>Analysis of the three Accounting Standards Updates to Topic 842:</u>

The Commission requested specific analysis of the application of ASC 842 to the Company's accounting practices in the context of three FASB Accounting Standards Updates No.'s 2016-02 (February 2016), 2018-11 (July 2018), and 2021-05 (July 2021). As stated above, the Company's 25 Walnut Street lease is an operating lease under ASC 842, as established by Update No. 2016-02 issued in February 2016. The Company, given its unique makeup, is not a public company or a not-for-profit corporation and is classified as an "other business" pursuant to Update No. 2016-02[20]. Given the Company's classification as "other

[19] A waiver from any provision of this system of accounts shall be made by the Commission upon its own initiative or upon the submission of written request therefore from any water company, or group of water companies, provided that such a waiver is in the public interest and each request for waiver expressly demonstrates that: existing peculiarities or unusual circumstances warrant a departure from a prescribed procedure or technique which will result in a substantially equivalent or more accurate portrayal of operating results or financial condition consistent with the principles embodied in the provisions of this system of accounts and the application of such alternative procedure will maintain or improve uniformity in substantive results as among water companies. See "Uniform System of Accounts for Water Utilities", Section 1(i) at 33.

[20] See FASB Update No. 2106-02 (February 2016), Section A at 7.

businesses" it was not required to implement ASC 842 until December 15, 2019[21]. As stated above, ASC 842 for other businesses was later deferred until December 15, 2021 by two subsequent updates as a result of impacts from COVID[22]. Upon further review, Update No. 2016-02, Section B authorized use of regulatory basis of accounting for leases to the extent implementation of ASC 842 affects allowable expenses for rate-making purposes. See Update No. 2016-02, Section B (February 2016), at 277.

The Board later updated ASC 842 in July 2018 through Update No. 2018-11 to address concerns with implementation of the new standard and included a transition mechanism for deferred comparative reporting to give entities additional time to establish updated models for tracking and reporting leases[23]. This update also addressed, for lessors only, separating lease and non-lease components in the lease contract and allocation of contract consideration to separate components[24]. Since ASC 842, as originally published in February 2016 was not yet effective when Update No. 2018-11 was issued, and because the Company is a lessee and it had not made an early election to be subject to this rule, this update did not apply.

Finally, the Board issued Update No. 2021-05 in July 2021 applicable only to lessors that (1) have variable lease payments that do not depend on a referenced index or rate and (2) would have resulted in the recognition of a selling loss at lease commencement if the lease was classified as either a sales or direct financing type lease[25]. Since the Company is a lessee, Update No. 2021-05 does not apply or otherwise impact the Company's accounting practices for recognition of leases.

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[21] See *Id*. at 7.
[22] See FASB Update No. 2019-10 (November 2019) delayed implementation to December 15, 2020, and FASB Update No. 2020-05 (June 2020) further delayed implementation until December 15, 2021.
[23] See FASB Update No. 2018-11 (July 2018) at 1.
[24] See *Id*. at 1.
[25] See FASB Update No. 2021-05 (July 2021) at 1.

D. **Conclusion**

The Commission is empowered to establish the regulatory accounting for the Company for rate-making purposes pursuant to RSA 374:8 and Puc 607.07(a). Since the implementation of ASC 842 and straight-line accrual of operating lease expenses could affect allowable costs for rate-making purposes, the Company should be authorized to continue tracking and recording its leases on a cash requirements basis consistent with the Uniform Classification of Accounts. To the extent necessary, the Company requests a waiver of application of straight-line accrual of operating lease expenses pursuant to Section 1(i) of the Uniform Chart of Accounts. If a waiver is not required, then the Company respectfully requests that the Commission grant its request to withdraw its Petition (as amended) and close the docket for the reasons set forth above.

Respectfully submitted,

PENNICHUCK WATER WORKS, INC.

By Its Attorneys

RATH, YOUNG AND PIGNATELLI, P.C

Dated: February 4, 2022 By: ______________________________

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Certificate of Service

I hereby certify that a copy of this supplemental filing, including the attachment, have this day been forwarded to the Office of Consumer Advocate via electronic mail at ocalitigation@oca.nh.gov.

Dated: February 4, 2022

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James J. Steinkrauss