THE STATE OF NEW HAMPSHIRE

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December 28, 2018



Debra A. Howland, Executive Director
New Hampshire Public Utilities Commission
21 South Fruit Street, Suite 10
Concord, New Hampshire 03301-2441

Re: DW 18-046: Pennichuck Water Works, Inc. ("PWW")
Pennichuck East Utility, Inc. ("PEU")
Pittsfield Aqueduct Company, Inc. ("PAC")
Consolidated Request for Exemption from Further Participation in IR 18-001
Staff Recommendation to Approve Request

Dear Ms. Howland:

On March 29, 2018, PWW, PEU, and PAC (collectively the "Companies") submitted a consolidated request for exemption from further participation in Commission Docket IR 18-001. The Companies' request was accompanied by the testimony of Larry D. Goodhue, Chief Executive Officer, Chief Financial Officer, and Treasurer of Pennichuck Corporation ("Penn Corp"), the parent company of PWW, PEU, and PAC. Staff reviewed the Companies' filing and propounded pertinent discovery in DW 17-128, PEU's most recent rate proceeding. See attached. Based upon its review, Staff recommends that the Commission approve the Companies' request for exemption from further participation in IR 18-001.

On January 3, 2018, the Commission issued Order No. 26,096 in IR 18-001 for the purpose of opening an investigation to determine the rate effects on regulated public utilities relative to federal and state corporate tax reductions which became effective during 2018. That Order required each New Hampshire regulated utility to file a proposal with the Commission by no later than April 1, 2018, addressing the effects of the federal and state tax law changes. The Companies' filing was assigned Docket DW 18-046. On April 9, 2018, the OCA filed a letter of participation in accordance with RSA 363:28.

The Companies argued that they should be exempt from further participation in IR 18-001 because of the unique circumstances under which the three utilities now operate as a result of the City of Nashua's ("City") acquisition of Penn Corp in January 2012.[1] Specifically, the Companies no longer have access to the equity markets and, thus, are now financed entirely through the issuance of debt. Further, the ratemaking methodologies approved for each of the Companies in DW 11-026, and subsequent dockets, result in no inclusion of federal income taxes and an immaterial amount of state taxes in customer rates. Therefore, the federal and state tax reductions which went into effect during 2018 will have, at best, either a negligible or neutral impact on the Companies' respective customers.

Pittsfield Aqueduct Company, Inc.

The customer rates currently in effect for PAC were derived based on the ratemaking methodology approved in Order No. 25,292 in DW 11-026. That methodology represents a divergence from traditional ratemaking, including the recovery of federal and state income taxes. Under this methodology, rates are derived based on two components: 1) a City Bond Fixed Revenue Requirement ("CBFRR") based on PAC's proportionate share of the debt service on the City's acquisition debt relative to Penn Corp; and 2) a blended return on rate base as adjusted by certain components related to the City's acquisition.

The calculated return on adjusted rate base for PAC under this methodology reflects little, if any, impact related to income taxes for a number of reasons. First, unlike other regulated utilities, the equity portion of PAC's blended return is determined based on a 12-month average Treasury rate that does not include any adjustment for tax costs and factors. Also, the debt/equity ratio reflected in the blended rate of return determined for PAC is significantly weighted towards debt financing with very little equity. In PAC's last rate proceeding, DW 13-128, the calculated rate of return approved by the Commission reflected a debt/equity ratio of 96/4.[2] Finally, the return component of PAC's revenue requirement only applies to the net operating income of the Company after it is significantly reduced by the CBFRR.

In summary, the ratemaking methodology currently applicable to PAC primarily consists of a debt-based weighted average cost of capital which, when applied to adjusted rate base, results in the inclusion of little, if any, state and federal income taxes in the Company's overall revenue requirement.

Pennichuck Water Works, Inc. and Pennichuck East Utility, Inc.

The basic ratemaking methodology that is currently in place for both PWW and PEU represents an even further departure from the Commission's traditional ratemaking approach, and one that is more akin to a municipal utility rate model.[3] As such, the revenue

[1] The City's acquisition of Penn Corp was approved in Commission Order No. 25,292 (November 23, 2011) in DW 11-026.
[2] See Commission Order No. 25,695 dated July 22, 2014.
[3] This ratemaking structure was approved for PWW in Commission Order No. 26,070 (November 7, 2017) in DW 16-806, and for PEU in Commission Order No. 26,179 (October 4, 2018) in DW 17-128.

requirements derived for PWW and PEU under this approach are reflective of the true cash-flow needs and debt service requirements of these two nearly 100% debt financed utilities.

Specifically, there are three components which comprise the total revenue requirements derived for PWW and PEU: 1) the utility's proportionate share of the CBFRR; 2) the utility's operating expenses; and 3) the utility's principal and interest payments on debt. None of these categories, however, include any federal or state income tax expense. Further, PWW and PEU's current ratemaking approach does not include a rate of return on rate base component. As such, there is also no coinciding income tax affect reflected in rates as is normally the case with the inclusion of rate of return on rate base.

The Companies' filing further described circumstances whereby the recent federal tax legislation may possibly result in the imposition of taxes on the utilities which would result in their actually seeking rate relief from the Commission. One such possibility relates to the interest expense deduction limitation which normally would not apply to regulated utilities. However, the tax code is currently silent as to whether such would extend to regulated utilities that are part of a consolidated group with a non-regulated parent, as is the case with Penn Corp and its utility subsidiaries. The Companies are currently working with its tax consultants and legal representatives relative to the appropriate interpretation of this provision. This issue, however, will not be resolved until the 2018 consolidated corporate tax return for Penn Corp and its affiliates is filed in late 2019.

In conclusion and for the reasons described above, Staff recommends that the Commission approve the Companies' consolidated request for exclusion from further participation in IR 18-001. Prior to filing this recommendation, Staff provided a draft to the Office of the Consumer Advocate ("OCA"). However, the OCA offered no comment regarding Staff's recommendation.

Thank you for your assistance with this matter. If you have any further questions, please do not hesitate to contact me.

Sincerely,

Jayson P. Laflamme
Assistant Director, Gas-Water Division

Attachment: PEU's Pertinent Discovery Responses from DW 17-128

cc: Service List

**Pennichuck East Utilities, Inc.**
**DW 17-128**

Petition For Change in Rates
Responses to Staff Data Requests – Set 3

| | |
|---|---|
| Date Request Received: 3/22/18 | Date of Response: 4/5/2018 |
| Request No. Staff 3-10 | Witness: Donald L. Ware |

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REQUEST: **Re: Commission Order No. 26,096 in Docket IR 18-001**: With regard to recent tax changes which have recently gone into effect, ie, the federal 2017 Tax Act, the NHBPT rate change from 8.20% to 7.90%, and the NHBET rate change from 0.72% to 0.675%, please provide the anticipated impact, along with supporting calculations, that these tax changes would have relative to the Company's pro-forma rate base and pro-forma operating income, as well as their impact on the Company's proposed rate increase under the following scenarios:

a) The Company's current ratemaking methodology as approved in Docket DW 11-026 and clarified in DW 13-126.
b) The Company's proposed ratemaking methodology in the instant docket.

RESPONSE:

a) The Company's revenue requirement under its current rate making methodology as approved in Docket DW 11-026 is not impacted by the reduction in Federal and State Income Tax rates because there is no return on equity. The impact of the reduction in Federal and State Income Tax rates on a Return on Investment that is 100% debt based is as detailed on the attached spreadsheet. Whereas the ROI creates an interest expense which is deductible for both State and Federal income tax purposes, a lowering of the tax rates results in an increase in net income on Schedule 1 of the 1604.06 schedules, due to the fact that the income tax line in other expenses goes down, resulting in a higher net income. That higher net income is grossed up by a lower tax factor on Schedule A of the 1604.06 schedules, resulting in the revenue requirement reflecting the collection of the interest on the debt used to support rate base. The lower the tax rate, the higher the net income on Schedule 1 which in turn is grossed up by a tax factor directly related to the ROI on Schedule A. Hence a 100% debt funded Utility has a revenue requirement that is unchanged by changes in the tax rate as the increase in net income which results in an increase in taxes on Schedule 1, which is directly offset by a higher tax factor on Schedule A, and ultimately results in the same revenue requirement.

b) The Company's proposed ratemaking methodology in the instant docket does not have income taxes in the calculation of any of the revenue requirement accounts that make up the total revenue requirement. Income taxes would normally be collected as part of the Material Operating Revenue Requirement but is not incorporated into the proposed rate making structure as the current rate structure results in a net operating loss, and negative income taxes, and a net operating loss carry over for both Federal and State Income tax purposes.

For additional support to this data requests please see the testimony provided by Mr. Larry Goodhue in the Consolidated Response to NHPUC Docket IR 18-001 filed on March 29, 2018.

Pennichuck East Utility, Inc.
DW17-128
Staff DR 3-10 - Tax Impact spreadsheet
4/5/2018

| | | 2017 Tax Rate | 2018 Tax Rate |
|---|---|---|---|
| Debt | - | $ 1,000,000 | $ 1,000,000 |
| Combined Fed and State Corporate Tax Rate | - | 39.61% | 27.27% |
| Bond Interest Rate | - | 5.00% | 5.00% |
| ROI Required | - | $ 50,000 | $ 50,000 |
| Income Tax Deduction for Bond interest paid | - | $ 19,805 | $ 13,635 |
| Sch 1, Post Income Tax Required Net Income | - | $ 30,195 | $ 36,365 |
| Schedule A Tax Factor | - | 60.39% | 72.73% |
| Schedule A Revenue Requirement | - | $ 50,000 | $ 50,000 |

**Pennichuck East Utilities, Inc.**
**DW 17-128**

Petition For Change in Rates
Responses to Data Requests from 4/19/2018 Tech Session

Date Request Received: 4/19/18 — Date of Response: 5/4/2018

Request No. – Tech Session Data Request 6 — Witness: Larry D. Goodhue

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REQUEST: Please provide a schedule detailing the current balance of Pennichuck Eash Utility's ("PEU's") deferred tax liability. Please demonstrate how that liability is treated under PEU's rate proposal through the use of examples that support the Goodhue testimony in the tax docket. These schedules should demonstrate why there is no asset to return to the Company's ratepayers.

RESPONSE:

PEU's response addresses this request in two parts. Part A provides the schedule showing the current balances of PEU's deferred tax liability account and the impact on those balances, for generally accepted accounting principles ("GAAP") purposes. Part B explains why these financial accounting impacts have no impact on PEU's customer rates under the modified ratemaking methods currently applied or proposed in this proceeding.

A. Financial Accounting Balances for Deferred Taxes.

PEU maintains its financial accounts in accordance with GAAP. These principles require the establishment of a Deferred Tax Liability ("DTL") and a Deferred Tax Asset ("DTA") in certain circumstances. In general, DTLs and DTAs arise because there are differences between the determination of income for GAAP, on the one hand, and federal or state income tax laws, on the other hand.

A common source for a DTA is the difference in treatment of depreciation expense. Depreciation expense for longer-lived assets for GAAP purposes is often computed on a straight-line basis, while tax laws often allow use of an accelerated depreciation method. Because the straight-line method produces lower depreciation (and higher income) compared to an accelerated method, the company will temporarily report higher income for GAAP purposes than tax purposes. In such a case, GAAP requires the recording of a DTL that reflects the fact that the company will owe additional income tax when the accelerated method "reverses" and results in higher income in later years that the straight-line method. Similarly, GAAP often requires the establishment of a DTA where tax laws allow a company to carry forward a tax benefit, such as net operating losses, to future years. The DTA/(DTL) can be different for federal and state purposes, as state tax laws often differ from federal tax laws, especially with respect to certain federal accelerated depreciation rules.

The federal Tax Cuts and Jobs Act was enacted on December 22, 2017. Among other things, this substantial tax reform legislation lowered the federal corporate income tax rate from 35% to 21% effective for tax years beginning after December 31. 2017. Because this rate reduction was certain by the end of the year, PEU was able to adjust its DTA/(DTL) to reflect this rate for financial statement purposes for the 2017 year.

The following tables indicate the net DTA/(DTL) recorded on PEU's financial accounting books as of 12/31/2016 and 12/31/2017, showing the impact of the applicable federal and state tax rates.

As of 12/31/2016, the Federal DTA/(DTL) Calculation:

| | DTA/(DTL) | Federal Deferred Tax Liability at 34% Rate |
|---|---|---|
| Depreciation | (12,709,703) | (4,321,299) |
| Amortization | (165,500) | (56,270) |
| Bad Debt Reserve | (1,642) | (558) |
| Subtotals | (12,876,845) | (4,378,127) |
| Less: Valuation Allowance For OCI | | 181,341 |
| Total Deferred Tax - Fed | | (4,196,786) |

As of 12/31/2016, the State DTA/(DTL) Calculation:

| | DTA/(DTL) | State Deferred Tax Liability at 5.61% Rate * |
|---|---|---|
| Depreciation | (10,055,489) | (564,113) |
| Amortization | (165,500) | (9,285) |
| Bad Debt Reserve | (1,642) | (92) |
| Subtotals | (10,222,631) | (573,490) |
| Less: Valuation Allowance For OCI | | 0 |
| Total Deferred Tax - State | | (573,490) |
| Total Deferred Tax Liability – Combined | | (4,770,276) |

* *The state rate is reduced to reflect the fact that state income taxes may be deducted for federal income tax purposes. Accordingly, the state tax rate is computed by multiplying the state statutory rate by 1 minus the applicable federal statutory tax rate (for 2016: 8.5% x (1-.34) = 5.61%).*

As of 12/31/2017, the Federal DTA/(DTL) Calculation:

| | DTA/(DTL) | Federal Deferred Tax Liability at 21% Rate |
|---|---|---|
| Depreciation | (13,439,633) | (2,822,323) |
| Amortization | (118,317) | (24,847) |
| Bad Debt Reserve | (5,296) | (1,112) |
| Subtotals | (13,563,246) | (2,848,282) |
| Less: Valuation Allowance For OCI | | 149,682 |
| Total Deferred Tax - Fed | | (2,698,600) |

As of 12/31/2017, the State DTA/(DTL) Calculation:

| | DTA/DTL) | State Deferred Tax Liability at 6.24% Rate ** |
|---|---|---|
| Depreciation | (10,969,447) | (684,603) |
| Amortization | (157,855) | (9,852) |
| Bad Debt Reserve | (5,296) | (331) |
| Subtotals | (11,132,598) | (694,785) |
| Less: Valuation Allowance For OCI | | 0 |
| Total Deferred Tax - State | | (694,785) |
| Total Deferred Tax Liability – Combined | | (3,393,385) |

** *The state rate is reduced to reflect the fact that state income taxes may be deducted for federal income tax purposes. Accordingly, the state tax rate is computed by multiplying the state statutory rate by 1 minus the applicable federal statutory tax rate (for 2017: 7.9% x (1-.21) = 6.24%).*

Based on these computations, the impact of the change in federal income tax rate can be demonstrated by the following calculation, which shows the resulting reclassification of a portion of the adjusted DTA/(DTL) as a regulatory liability as of December 31, 2017:

| | |
|---|---|
| Federal Deferred Tax Liability at the old 34% rate<br>DTL times 34% | (4,611,503) |
| Federal Deferred Tax Liability at the new 21% rate<br>DTL times 21% | (2,848,282) |
| Effect of the Rate Change | (1,763,222) |
| Add: Adjustment to Net Operating Loss carryforward<br>Due to the Rate Change and limitations on NOL<br>Usage in the tax year | 142,479 |
| Net Regulatory Liability recorded | (1,620,743) |

B. Treatment of Deferred Tax under PEU's Rate Proposal

While the federal tax law changes will impact PEU's financial statements as shown above, these changes will have no impact on PEU's customer rates because deferred tax assets or liabilities are not taken into account for any aspect of the ratemaking methods applicable to PEU, either currently or under the method adjustments proposed in this proceeding.

In general, under traditional ratemaking procedures, deferred taxes would be a deduction from Rate Base in those calculations, and as such, changes in federal and state tax rates would have a direct impact on the underlying values used to calculate both the ROE and ROI, as well as the weighted average cost of capital, in arriving at allowed revenue levels for a utility. In such traditional cases, regulators may be concerned that utilities have collected income tax expense assuming higher rates, but now may not ultimately be required to pay such liabilities due to new lower statutory rates.

As the parties are aware, PEU and the other Pennichuck utilities are not subject to the traditional ratemaking method, but rather have been subject to the modified method first established in Docket No. DW 11-026, and under the method approved in DW (with respect to PWW) and proposed in this docket (if ultimately approved by the Commission). Under these methodologies, PEU's customer rates have not, and would not, reflect any impact for federal or state income tax expense or liabilities.

Under the proposed modified rate structure, the three "buckets" of revenue (CBFRR, OERR and DSRR) are all calculated as cash flow coverage revenues, directly related to the fixed level of revenue needed for the CBFRR funding, the 110% coverage of the total debt service for all other external debt obligations under the DSRR, and dollar for dollar coverage for prudent operating expenses (excluding income taxes and interest expense) for the OERR, based upon the test year.

Neither PEU's deferred tax accounts nor the regulatory liability established for GAAP purposes as a result of the change in federal tax rates will have any impact on the determination of rates under this "cash-flow" methodology. Accordingly, changes in the federal or state statutory tax rates have no impact on PEU's customer rates.

## SERVICE LIST - EMAIL ADDRESSES - DOCKET RELATED

**Pursuant to N.H. Admin Rule Puc 203.11 (a) (1): Serve an electronic copy on each person identified on the service list.**

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**FILING INSTRUCTIONS:**

a) **Pursuant to N.H. Admin Rule Puc 203.02 (a), with the exception of Discovery, file 7 copies, as well as an electronic copy, of all documents including cover letter with:**

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21 S. FRUIT ST, SUITE 10
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b) **Serve an electronic copy with each person identified on the Commission's service list and with the Office of Consumer Advocate.**

c) **Serve a written copy on each person on the service list not able to receive electronic mail.**