STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION

Investigation to Determine Rate Effects of

Federal and State Corporate Tax Reductions

IR 18-001

DIRECT PREFILED TESTIMONY OF LARRY D. GOODHUE ON BEHALF OF PENNICHUCK WATER WORKS, PENNICHUCK EAST UTILITY AND PITTSFIELD AQUEDUCT COMPANY

March 29, 2018

Q. What is your name and what is your position with Pennichuck Corporation?

A. My name is Larry D. Goodhue. I am Chief Executive Officer, Chief Financial Officer, and Treasurer of Pennichuck Corporation ("Penn Corp"). I am a licensed Certified Public Accountant in New Hampshire; my license is currently in an inactive status.

Q. Please describe the corporate structure of Pennichuck Corporation.

A. Penn Corp is a corporation that is wholly-owned by the City of Nashua, New Hampshire. The City of Nashua acquired its ownership of Penn Corp on January 25, 2012, pursuant to this Commission's Order No. 25,292 (November 23, 2011) (Approving Acquisition and Settlement Agreement). Prior to this acquisition by the City of Nashua, Penn Corp's shares were traded on the NASDAQ public stock exchange.

Penn Corp has five subsidiaries: Pennichuck Water Works, Inc. ("PWW"), Pennichuck East Utility, Inc. ("PEU"), Pittsfield Aqueduct Company, Inc. ("PAC"), Pennichuck Water Service Corporation ("PWSC") and The Southwood Corporation ("Southwood"). PWW, PEU and PAC are regulated by the Public Utilities Commission (the "Commission").

Q. For the three regulated subsidiaries, please describe your role.

A. I am the Chief Executive Officer, Chief Financial Officer and Treasurer of all three, PWW, PEU and PAC.

Q. Please describe your educational background.

A. I have a Bachelor of Science degree in Business Administration with a major in Accounting from Merrimack College in North Andover, Massachusetts.

Q. Please describe your professional background.

A. Prior to joining Penn Corp, I was the Vice President of Finance and Administration and previously the Controller with METRObility Optical Systems, Inc. from September 2000 to June 2006. In my more recent role with METRObility, I was responsible for all financial, accounting, treasury and administration functions for a manufacturer of optical networking hardware and software. Prior to joining METRObility, I held various senior management and accounting positions in several companies.

Q. What are your responsibilities as Chief Executive Officer, Chief Financial Officer and Treasurer of the regulated subsidiaries and Penn Corp?

A. Including my primary responsibilities as Chief Executive Officer, with ultimate responsibility for all aspects of the three regulated subsidiaries, I am responsible for the overall financial management of Penn Corp and its subsidiaries, including financing, accounting, compliance and budgeting. My responsibilities include issuance and repayment of debt, as well as quarterly and annual financial and regulatory reporting and compliance. I work with the Chief Operating Officer of the Company to determine the lowest cost alternatives available to fund the capital requirements of the Company, which result from the Company's annual capital expenditures and its current debt maturities.

Q. What is the purpose of your testimony?

A. My testimony is being provided in response to Commission Order No. 26,096. The purpose of my testimony is to provide information supporting PWW's, PEU's and PAC's request to be exempt from the Commission's proceedings in this investigation docket. My testimony provides (1) relevant historical information regarding the City of Nashua's acquisition of Pennichuck in early 2012; (2) information concerning how the federal and state tax provisions are reflected in the ratemaking structure set forth in the Settlement

Agreement approved by this Commission in Order No. 25,292 in Docket No. DW 11-026 (the "11-026 Rate Methodology"), which currently applies to PEU and PAC; and (3) information concerning PWW and how the federal and state tax provisions are reflected in the ratemaking structure set forth in the recent ratemaking Settlement Agreement approved by Commission Order No. 26,070 in Docket No. DW 16-806 (the "16-806 Rate Methodology"). The 16-806 Rate Methodology currently applies only to PWW, although in PEU's open Docket No. DW 17-128, PEU is asking that the 16-806 Rate Methodology also apply to it.

Q. Please describe how federal tax liabilities are determined by Penn Corp and its subsidiaries.

A. Penn Corp and its subsidiaries file a consolidated federal tax return, as well as a combined return for both NH BPT and BET reporting and tax liability. For GAAP and regulatory accounting purposes, the statutory rate in effect during any given year is used to calculate the tax liability for Penn Corp and its subsidiaries. The overall provision or benefit provided upon pre-tax income is calculated using this statutory rate. The calculation of the deferred portion of the tax provision or benefit is done in compliance with current GAAP standards. As such, any permanent differences between book basis pre-tax income or loss, and tax-basis pre-tax income or loss, must be reflected in the provision or benefit booked on Penn Corp's books and records, as included on Penn Corp's income statements. Any temporary differences between book basis pre-tax income or loss, and tax-basis pre-tax income or loss, is reflected as an adjustment to the deferred tax liability included on the balance sheets of Penn Corp and converts to currently tax provisions or benefits over time as these temporary differences are reduced to zero.

One of the key permanent differences for Penn Corp and its subsidiaries is the non-deductibility of the amortization of the MARA (Municipal Acquisition Regulatory Asset, as approved under DW 11-026) for tax purposes. As such, the full value of this amortization is a deduction for book purposes each year but without a corresponding tax deduction for federal and state BPT purposes each year. This can result in the three regulated subsidiaries' having a tax provision, even if they have a pre-tax loss for book purposes, if that book loss is less than the value of the MARA amortization in a given year.

One of the key temporary differences for Penn Corp and its subsidiaries is the difference in the depreciation lives of fixed assets for book basis accounting versus tax basis accounting. Water utility assets have a 25-year depreciation life for tax deductibility purposes, whereas the average deprecation lives for the Company's fixed assets are in excess of 40 years. This differential results in a deferred tax liability being created each year, until the book basis depreciation deduction would exceed the tax deduction.

Q. Please describe generally the 11-026 Rate Methodology.

A. The 11-026 Rate Methodology has two primary components of the allowed revenue calculation. The first component is the fixed revenue component tied to the City Bond Fixed Revenue Requirement (CBFRR), and the second component is based upon a blended Return on Rate Base (or Return on Investment; ROI) and Return on Equity (ROE) component. However, DW 11-026 includes significant differences from the traditional treatment of the blending of the ROR and ROE components of allowed revenue.

Prior to the implementation of the 11-026 Rate Methodology, the three regulated subsidiaries of Penn Corp maintained essentially a 50/50 Debt/Equity capital structure, with a cost of debt that was typically in the 5-6% interest rate range, and in rate cases prior to DW 11-026, the regulated subsidiaries were allowed a 9.75% ROE, after adjustment for tax costs and factors. In contrast, under DW 11-026, the regulated companies have a Debt/Equity ratio that is in the range of 95/5, and the ROE is stipulated to be at a fixed factor tied to the 12-month average treasury rate (this rate has been in the range of 5.68% to 5.93%, as calculated and included in the rate cases filed for these companies since 2012), without any adjustment for tax costs or factors. Also, under DW 11-026, because all of the cash tied to the CBFRR is paid to Penn Corp annually as a dividend (comprised of all the weekly and monthly cash transfers for the CBFRR), this small ROE factor applies only to the net income (after deducting the CBFRR dividend) earned in the test year leading up to the company's most recent rate case.

Q. How are federal taxes accounted for under the 11-026 Rate Methodology?

A. Because PEU and PAC no longer have an effective ROE component to the 11-026 Rate Methodology, and because, as described above (and unlike the traditional way ROE is determined), that ROE component is determined without any adjustment for tax costs or factors, there is no impact on rates from federal income taxes, and the impact from state BPT taxes is immaterial. Although a reduction in the federal (and state) income tax rates would normally be a benefit to rate payers in this manner, in the case of PEU and PAC, the benefit associated with favorable tax rates has already been granted to our customers because the weighted average cost of capital included in the 11-026 Rate Methodology is primarily a debt-based weighted average cost of capital, which has already benefited customers in a lower cost of capital applied to the factors included in the allowed revenue calculations.

Q. Please describe generally the 16-806 Rate Methodology.

A. The 16-806 Rate Methodology represents a further divergence from traditional Rate Methodology and is much more in line with a municipal utility-like rate model. In this rate methodology, a ROI calculation is no longer a component of the allowed revenue calculation. This was requested, and approved under Commission Order No. 26,070, to allow the revenue structure of PWW to truly reflect the cash flow needs and requirements tied to the service of debt payment obligations of a company that is nearly 100% funded by debt for its operations. The new methodology has three primary "buckets" of fixed revenue requirements: the CBFRR; the Material Operating Expense Revenue Requirement (MOERR); and the Debt Service Revenue Requirement (DSRR) – plus a Non-Material Operating Expense Revenue Requirement (NOERR). The NOERR component for PWW is currently very small (1.87% of the overall allowed revenue requirement) and allows only for the recovery certain enumerated costs as approved in Commission Order No. 26,070, which approved costs do not include any federal or state tax costs.

Q. How are federal taxes accounted for under the 16-806 Rate Methodology?

A. Federal taxes are accounted for under the 16-806 Rate Methodology as described earlier in this testimony. Importantly, however, because there is no ROI component under the 16-806 Rate Methodology (which would account for any deferred tax liabilities) and because tax costs are not included in either the MOERR or NOERR component, the 16-806 Rate Methodology does not include any costs or factors for federal taxes.

Q. Are State BET and BPT handled differently under either methodology?

A. As described in other sections of this testimony, the treatment of BPT is very much identical to the treatment of federal income taxes. The BET is a bit different because it is essentially a minimum tax calculation for state taxes in New Hampshire, based upon amounts incurred each year for payroll, interest and dividends. This tax calculates a minimum tax liability in the state for corporations, based upon these factors, but also creates a BET credit to offset BPT liability in a year. If the BET credit is not fully used in a year, it can be carried forward (up to 15 years) to offset future BPT liability. As a result, all calculations of the tax provision on a GAAP basis for inclusion in each company's income statements and balance sheets is done using the statutory rate for BPT, as the BET rate is simply in place to provide for a minimum level of actual tax payments by corporations in each calendar year. Importantly, however, because there is no ROI component under the 16-806 Rate Methodology (which would account for any deferred tax liabilities) and because tax costs are not included in either the MOERR or NOERR component, the 16-806 Rate Methodology does not include any costs or factors for state taxes.

Q. Is it appropriate for PWW, PEU or PAC to record on its books a deferred liability to reflect an estimated reduction in federal income tax resulting from the 2017 Tax Act or the reduction in the State of New Hampshire BET and BPT?

A. PWW, PEU and PAC, along with Penn Corp and its other non-regulated subsidiaries have recorded an adjustment to its deferred tax liability for 2017. For the non-regulated companies in the group, this reduction has been flowed through the income statements of those entities as an income tax benefit. However, for the regulated subsidiaries, the impact of the change in deferred tax liability has been reclassified as a deferred regulatory liability. As to the impact of the federal tax rate reduction on current year GAAP basis tax liability (inclusive of the permanent differences discussed earlier), the impact of that rate change has been recorded in the tax provision or benefit recorded for each of the entities in the entire group. As noted above, however, the 16-806 Rate Methodology does not include any costs or factors for federal taxes.

Q. Is it appropriate for PWW, PEU or PAC to recognize a deferred liability to reflect an estimated reduction in the utility's revenue requirement resulting from an excess deferred tax reserve caused by the reduction in the corporate federal income tax rate?

A. By reclassifying the impact on the deferred tax liability of the regulated utilities to a deferred regulatory liability, the regulated subsidiaries have adjusted for this. However, it is important to note that the impact of doing this is either immaterial (under 11-026) or no longer applicable (under 16-806). In fact, the impact of the federal tax act may have the opposite effect on the regulated utilities of Penn Corp. Under this tax act, not only do the regulated subsidiaries not get the benefit of this reduction in the tax rates, but it may also be subject to certain limitations on deductions, which may cause the actual tax liabilities of the regulated subsidiaries to increase. Included in the tax act are new minimum federal tax liabilities, as well as interest expense deduction limitations, which may cause the regulated subsidiaries to seek rate relief to cover the resulting tax costs.

Q. Do these tax changes have any other impacts on the rate structure of PWW, PEU or PAC?

A. As discussed immediately above, the eventual impact of the interest expense deduction limitation may require an increase in rates for PWW, PEU and PAC. There is a section of the IRS code that stipulates that the interest expense deduction limitation does not apply to regulated utilities, but it is silent as to how that is to be interpreted for consolidated groups of companies that include non-regulated subsidiaries and a non-regulated parent. It is also not currently clear how any federal changes would impact a company's BPT calculations or liabilities. Penn Corp is working with its tax consultants and legal counsel in following developments on the interpretation of this provision in the Code, as the first time it would truly be impactful would be when the 2018 corporate income tax return is due to be filed with the IRS in late 2019.

Q. Does the 2017 Tax Act contain any other changes relevant to the rate structure of PWW, PEU or PAC?

A. The eventual impact of the interest expense deduction limitations could result in further changes to the rate structure being requested in future rate cases, as the companies would need to be able to generate sufficient cash to meet all of their obligations, including any tax payments.

Q. What action do you propose that the Commission take with respect to PWW, PEU and PAC under Order 26,096?

A. Given PWW's, PEU's and PAC's unique corporate structure, lack of equity funding and reliance entirely on debt funding, it is much differently situated than the other public utilities that were identified in The Office of Consumer Advocate's Petition that led to

Order No. 26,096. As I described earlier in my testimony, the 2017 Tax Act will, at best, have a neutral impact on the three subsidiaries' ratepayers, and more likely will ultimately result in an increased tax burden. Thus, the regulated subsidiaries' involvement in this docket will not be an efficient use of the Commission's time as the regulated subsidiaries are not similarly situated to the other companies involved in this docket.

In addition, PEU currently has an open rate case docket, DW 17-128. Because PEU is currently under the 11-026 Rate Methodology and is requesting that the 16-806 Rate Methodology apply going forward, there is an existing vehicle for the Staff, the OCA and the Commission to explore the issues raised by the 2017 Tax Act and changes in state tax law and how those changes may impact the three companies under both rate methodologies.

Because of these unique differences and the pending rate docket, we are requesting that the three regulated subsidiaries be excused from participating in IR 18-001 and avoid the costs that may be associated with participating in that docket. Instead, all of these issues can be addressed in DW 17-128.

Q. Mr. Goodhue, does this conclude your testimony?

A. Yes it does.