



March 27, 2018

ANNUAL REPORT TO THE SOLE SHAREHOLDER

Dear Shareholder:

The Annual Meeting of Pennichuck Corporation will be held at 9:00 a.m. on Saturday, May 5, 2018 at the Crowne Plaza, 2 Somerset Parkway, Nashua, New Hampshire.

Background on the City's Acquisition and Our Corporate Structure. The City's acquisition of the shares of Pennichuck Corporation was completed on January 25, 2012. As part of the acquisition, the corporate structure of Pennichuck Corporation and its subsidiaries was retained. Under the structure, the City of Nashua is the sole shareholder of Pennichuck Corporation. Under the Company's By-Laws, the City in its capacity as shareholder makes its decisions through actions by its Board of Aldermen, in accordance with the City's Charter. No single person – the Mayor or any individual member of the Board of Aldermen – is him or herself a shareholder; rather, the entity of the City itself is the sole shareholder of Pennichuck Corporation represented by the Board of Aldermen and the Mayor.

Pennichuck continues to own five corporate subsidiaries, including three regulated utilities (Pennichuck Water Works, Inc., Pennichuck East Utility, Inc., and Pittsfield Aqueduct Company, Inc.), an unregulated service company (Pennichuck Water Service Corporation), and a real estate holding company (The Southwood Corporation).

As unanimously approved by the City's Board of Aldermen at the time of the acquisition, the corporate structure was retained for several reasons.

First, the City's Mayor and Board of Aldermen desired to maintain some stability and continuity for all of the customers and employees of the Pennichuck companies. Retaining the existing corporate structure minimized the need for any radical changes to the utility companies and operations and encouraged support by all of the communities served by the utilities.

Second, retaining the corporate structure provided continuity for the regulatory and financial status of the companies and their respective businesses. The New Hampshire Public Utilities Commission continues to provide regulatory oversight for the utility companies, and banks, lenders and other contract parties continue to be able to rely on existing contracts and other rules with respect to financing and other operations.

Third, the Mayor and Board of Aldermen unanimously agreed to establish a corporate governance system for the purposes of managing Pennichuck Corporation. This corporate governance system relies upon well-established principles of corporate law, and is established pursuant to Pennichuck Corporation's Articles of Incorporation and By-Laws, as adopted by the City and the Company at the time of the acquisition pursuant to the Merger Agreement.

This well-known corporate governance model, which incorporates well-established principles regarding fiduciary obligations of board members, was structured to provide assurances to the City's rating agencies, potential lenders, the New Hampshire Public Utilities Commission and the many communities we serve that decisions are based on sound business and financial analysis, and in a manner that minimizes political considerations.

Operations, Communities and Customers. Our companies provide water service to a wide range of communities and customers.

Pennichuck Water Works, Inc. provides water service to approximately 28,400 customers in 11 communities which include Amherst, Bedford, Derry, Epping, Hollis, Merrimack, Milford, Nashua, Newmarket, Plaistow and Salem.

Pennichuck East Utility, Inc. provides water service to approximately 7,900 customers in 19 communities which include Atkinson, Barnstead, Bow, Chester, Conway, Derry, Exeter, Hooksett, Lee, Litchfield, Londonderry, Middleton, Pelham, Plaistow, Raymond, Sandown, Tilton, Weare and Windham.

Pittsfield Aqueduct Company, Inc. provides water service to approximately 640 customers in Pittsfield.

Pennichuck Water Service Corporation provides service in connection with the management of water services for 3 communities; billing, collection and customer services for 3 communities; and water meter testing services, as well as contracted water services at various levels, for approximately 85 small independently owned water systems.

The Southwood Corporation owns various parcels of land in the Town of Merrimack.

The Company's mission is to be a premier supplier of water in New Hampshire by providing reliable, high quality and affordable water in sufficient quantities, and be New England's premier supplier of water related contract services by providing high quality solutions to meet our customers' needs.

Strategies supporting the corporate mission have been developed relative to our water resources, employees, financing, customer services and Company assets. These strategies are available on the Company's website, www.pennichuck.com, under the "Management and Financial Information" caption, and the sub-caption of "Strategic Plan."

The Company currently has 117 employees. The employees are committed to supporting the Company's mission. Each of our managers has goals and objectives to support the strategies supporting the mission. Pennichuck is an Equal Opportunity/Affirmative Action Employer. It is

the policy of the Company to hire, train, promote, and otherwise provide terms and conditions of employment without regard to race, color, religion, sex, sexual orientation, gender identity, national origin, ancestry, age, marital status, pregnancy, disability or veteran status. All employment and promotion decisions are based solely on valid requirements, in accordance with the principles of equal employment opportunity and affirmative action.

Financial Performance During the Last Year. The Company's audited consolidated financial statements for the year ended December 31, 2017 are attached to this report.

	(\$ Millions)			
	4 th Quarter		Year-to-Date	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Revenues	\$ 9.7	\$ 8.8	\$ 40.9	\$ 42.7
Operating Expenses	<u>(9.0)</u>	<u>(8.3)</u>	<u>(35.4)</u>	<u>(33.9)</u>
Operating Income	0.7	0.5	5.5	8.8
Interest Expense	(2.7)	(2.8)	(10.8)	(10.8)
Other Income	<u>-</u>	<u>-</u>	<u>-</u>	<u>0.9</u>
Pre-Tax Income (Loss)	(2.0)	(2.2)	(5.3)	(1.1)
Income Tax Provision (Benefit)	<u>1.5</u>	<u>(0.1)</u>	<u>1.1</u>	<u>0.1</u>
Net Income (Loss)	(3.5)	(2.1)	(6.4)	(1.2)
Dividends Paid to the Shareholder	0.1	0.1	0.3	0.3
Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)	2.7	2.3	13.3	16.3

- Consolidated revenues for the fourth quarter increased by \$0.9 million from \$8.8 million in 2016 to \$9.7 million in 2017. The increase can be attributable to the November 7, 2017 PUC Order No. 26,070 for Pennichuck Water Works, Inc. which approved a permanent rate increase of 3.12% on a bills-rendered basis effective December 7, 2016, and a step increase of 7.69% which was effective as of the date of the order, November 7, 2017. Pennichuck Water Works also experienced a slight increase in water usage in the fourth quarter in 2017 over 2016, as well.
- Consolidated year-to-date revenues decreased from \$42.7 million in 2016 to \$40.9 million in 2017. Revenues from the regulated utilities decreased primarily due to lower consumption in 2017, as compared to 2016, as the prior year experienced higher consumption levels due to the dry weather patterns throughout the summer months, as the drought that began in mid-2015 persisted through 2016 and into the very early part of 2017.
- Consolidated operating expenses increased by \$0.7 million for the fourth quarter of 2017, over the same quarter in 2016. The increase is primarily related to increases in property taxes and higher depreciation costs associated with ongoing capital investments.
- Consolidated operating expenses increased by \$1.5 million, for the full year, from 2016 to 2017, mainly due to higher maintenance related costs, increased depreciation costs, property taxes, and pension and labor related costs.

- Interest expense remained flat in 2017 when compared to 2016 due to lower than anticipated capital expenditures in 2017. This was a result of unanticipated deviations in project timing and/or deferrals of project start-up, for the just completed construction season.
- Pre-tax loss for the fourth quarter decreased to \$2.0 million in 2017 versus \$2.2 million in 2016, due to an increase in revenues which was offset by increased operating expenses, primarily property taxes and depreciation costs, year-over-year.
- The pre-tax loss for the year increased from \$1.1 million in 2016 to \$5.3 million in 2017 due to the \$1.8 million in lower revenues discussed previously, as well as the non-repetitive nature of the \$0.9 million in Other Income in 2016, which was primarily related to the sale of the former distribution facility in 2016. These reductions in revenues and other income, coupled with the increased operating costs year-over-year, result in the greater pre-tax loss in 2017.
- Dividends paid to the sole shareholder in both 2017 and 2016 were consistent with, and were paid pursuant to, the CBFRR structure provided for in the New Hampshire Public Utilities Commission's Order approving the City's ownership of the Company.
- Income Tax Provision in the current year reflects the tax accounting for the amortization of the Municipal Acquisition Regulatory Asset, which is not deductible for tax purposes, and as such, constitutes a permanent difference in the deductibility of those amortization expenses for tax purposes, as opposed to their inclusion in the GAAP based financial statements. The Income Tax Provision (Benefit) also reflects the impact of the *2017 Tax Cuts and Jobs Act* which made broad and complex changes to the U.S. tax code which included: (1) reducing the U.S. federal corporate tax rate from 35% to 21%; (2) elimination of the corporate alternative minimum tax (AMT) and changing how existing AMT credits can be realized; (3) changing the rules related to usage and limitation of net operating loss carryforward; and (4) changing the rules related to the limitation of interest expense deductions. Therefore, the year-to-date results reflect a tax provision of approximately -20.8% of pre-tax income for 2017, compared to the statutory tax rate expense of 39.4%.
- Earnings Before Interest, Taxes, Depreciation and Amortization increased in the fourth quarter from \$2.3 million in 2016 to \$2.7 million in 2017 due to increased revenues as discussed previously, offset by operating expense variations (excluding depreciation and interest).
- Earnings Before Interest, Taxes, Depreciation and Amortization for 2017 decreased from 2016 by approximately \$3.0 million, again due to: (1) lower revenues earned year-over-year, (2) the income associated with the "one time" sale of the former distribution facility in 2016, and (3) operating expense increases, excluding interest expense.

Unaudited Cash Flow Statement

Cash Flow on a GAAP basis for the fourth quarter of 2017 as compared to the fourth quarter of 2016, and the year-to-date 2017 versus 2016, are as follows:

	(\$000's)			
	Quarter Ended		Year-to-Date	
	December 31, 2017	December 31, 2016	December 31, 2017	December 31, 2016
Operating Activities:				
Net Income (Loss)	\$ (3,547)	\$ (2,108)	\$ (6,441)	\$ (1,240)
Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by Operating Activities:				
Depreciation and Amortization	2,034	1,837	7,838	6,986
Provision for Deferred Taxes	(7,668)	(61)	(8,054)	190
Gain on Disposition of Property	(31)	(529)	(31)	(529)
Other	14	(30)	(41)	(137)
Changes in Assets and Liabilities:				
(Increase) Decrease in Accounts Receivable	1,021	1,004	387	(1,584)
(Increase) Decrease in Inventory	(12)	16	62	46
(Increase) Decrease in Other Assets	(1,977)	(2,274)	(876)	(273)
Increase (Decrease) in Accounts Payable	(2,213)	3,220	(4,755)	4,480
Increase (Decrease) in Other Liabilities	11,131	2,020	9,648	2,794
Net Cash Provided by (Used in) Operating Activities	(1,248)	3,095	(2,263)	10,733
Investing Activities:				
Purchases of Property, Plant & Equipment, including the Debt Component of AFUDC	(2,641)	(8,043)	(7,716)	(21,886)
(Increase) Decrease in Restricted Cash/Investments	(1,274)	532	5,856	11,410
Proceeds from Sale of Property	-	311	37	946
Change in Deferred Land Costs	(8)	-	(8)	7
Net Cash Provided by (Used in) Investing Activities	(3,923)	(7,200)	(1,831)	(9,523)
Financing Activities:				
Borrowings (Repayments) on Line of Credit	5,296	-	5,574	-
Payments on Long-term Debt	(803)	(737)	(5,209)	(4,227)
Contributions in Aid of Construction	42	33	60	58
Proceeds from Long-term Borrowings	972	1,893	2,475	4,498
Debt Issuance Costs	-	(2)	21	(59)
Dividends Paid	(70)	(70)	(279)	(280)
Net Cash Provided by (Used in) Financing Activities	5,437	1,117	2,642	(10)
Increase (Decrease) in Cash and Cash Equivalents	266	(2,988)	(1,452)	1,200
Cash and Cash Equivalents at Beginning of Period	728	5,434	2,446	1,246
Cash and Cash Equivalents at End of Period	\$ 994	\$ 2,446	\$ 994	\$ 2,446

Balance Sheet

(\$000's)

	As of December 31, 2017 (Audited)	As of December 31, 2016 (Audited)
Assets		
Property, Plant & Equipment, Net	\$ <u>210,498</u>	\$ <u>201,698</u>
Current Assets:		
Cash	994	2,446
Restricted Cash	4,953	6,530
Investments – 2014 and 2015 Bond Project Funds	3,288	7,568
Accounts Receivable	5,699	6,086
Inventory	604	666
Other Current Assets ^{Note 1}	<u>2,257</u>	<u>2,047</u>
Total Current Assets	<u>17,795</u>	<u>25,343</u>
Other Assets:		
Acquisition Premium ^{Note 2}	73,227	75,144
Other Assets	<u>13,271</u>	<u>12,410</u>
Total Other Assets	<u>86,498</u>	<u>87,554</u>
TOTAL ASSETS	\$ <u>314,791</u>	\$ <u>314,595</u>
Shareholders' Equity and Liabilities		
Shareholders' Equity	\$ <u>13,905</u>	\$ <u>20,578</u>
Bonds, Notes and Mortgages	<u>197,905</u>	<u>200,758</u>
Current Liabilities:		
Line of Credit	5,574	-
Current Portion of Long-Term Debt	5,575	5162
Other Current Liabilities	<u>4,292</u>	<u>9,798</u>
Total Current Liabilities	<u>15,441</u>	<u>14,960</u>
Other Long-Term Liabilities:		
CIAC, net	47,458	40,364
Deferred Income Taxes	12,847	20,869
Accrued Pension Liability ^{Note 3}	9,792	9,010
Other Long-Term Liabilities	<u>17,443</u>	<u>8,056</u>
Total Other Long-Term Liabilities	<u>87,540</u>	<u>78,299</u>
TOTAL SHAREHOLDERS' EQUITY AND LIABILITIES	\$ <u>314,791</u>	\$ <u>314,595</u>

Notes to Balance Sheet

Note 1 (Other Current Assets) – At December 31, 2017, approximately \$1.1 million of this balance is comprised of prepaid property taxes, which will be expensed in the first quarter of 2018, relating to taxes paid in November and December of 2017 for the second half of the property tax year ended March 31, 2018.

Note 2 (Acquisition Premium) – In accordance with GAAP, the Acquisition Premium is being written-off over the 30-year life of the principal of the City Acquisition Debt.

Note 3 (Accrued Pension Liability) – During 2017, approximately \$1.1 million was contributed into the Pension Plan, while approximately \$.6 million in benefit payments were made to participants and approximately \$2.4 million of investment gains and appreciation was added to the plan.

Capital Expenditures

Capital expenditures in the fourth quarter of 2017 were \$2.9 million compared to \$8.1 million in the fourth quarter of 2016. For the year 2017, capital expenditures were \$8.0 million as compared to \$20.8 million in 2016.

The major expenditures for 2017 were as follows:

Amherst St. Area Main Improvements	\$ 1,144,000
Main St. Area Main Replacements Phase 1	\$ 800,000
Meter Replacements	\$ 561,000
Asset Management / GIS / DPaC	\$ 544,000
City Sewer Project – Main Replacements	\$ 416,000
PWW-PEU Interconnection Design & Evaluation	\$ 348,000
Route 101 Widening, Bedford	\$ 263,000
Maple Hills Water Main Improvement, Derry	\$ 248,000

Rate Case – Pennichuck Water Works, Inc.

On September 23, 2016, Pennichuck Water Works, Inc. (“PWW”) filed a request with the New Hampshire Public Utilities Commission (“NHPUC”) for a rate increase of 17.21% over its current rates for the test year 2015, for which 7.86% was related to a permanent rate increase, and 9.35% was related to a prospective step increase (associated with capital investments and other allowable expenditures in the twelve months following the test year). The overall requested rate increase is subject to the normal regulatory filing process with the NHPUC, as followed for all prior rate case filings, and as such, the final permanent rate increase granted would be effective retroactive back to the filing date, once approved by the NHPUC. The step increase, once approved and granted, would be earned on a forward looking basis, as of the date of the order granting such increase. In addition, as a part of the rate case filing, PWW requested that a temporary rate increase of 6.21% be granted as a subset of the final permanent rate

increase, with the intention that this temporary rate increase would be approved very early in 2017. In spite of this 6.21% temporary rate request, the Company, NHPUC Staff and the Office of Consumer Advocate agreed to a temporary rate increase at “current rates,” and as such, there was no impact on ratepayers for any temporary rate increases during 2017.

The request for the overall permanent rate increase was based upon increases in PWV’s operating costs since the last allowed rate increase in 2010/2011 (for the 2009 test year), as well as revenues needed to pay the debt service on over \$40 million of infrastructure replacements made since PWV’s last rate case, with those dollars being invested in its real property assets, distribution and treatment systems, and other necessary capital items, to ensure continued compliance with the Safe Drinking Water Act and prudent ongoing replacement of aging infrastructure to properly maintain the Company’s operating systems.

On November 7, 2017, the PUC issued Order No. 26,070 approving a permanent rate increase of 3.12% and a 7.69% step increase for its customers. The permanent rate increase is effective on a “bills-rendered” basis on and after December 7, 2016. The step increase is effective as of the date of the order, November 7, 2017.

Rate Case - Pennichuck East Utility, Inc.

On October 18, 2017, Pennichuck East Utility, Inc. (“PEU”) filed a request with the Public Utilities Commission (“NHPUC”) for a rate increase of 21.24% over its current rates for the test year 2016, for which 20.08% of this increase is related to a permanent rate increase and 1.16% is related to a prospective step increase (associated with capital investments and other allowable expenditures in the twelve months following the test year). The overall rate increase is subject to the normal regulatory filing process with the NHPUC, as followed for all prior rate case filings, and as such, the final permanent rate increase granted will be effective retroactive back to the filing date, once approved by the NHPUC. The step increase, once approved and granted, would be earned on a forward looking basis, as of the date of the order granting such increase. In addition, PEU requested that a temporary rate increase of 13.70% be granted as a subset of the final permanent rate increase, with the intention that this temporary rate increase would be approved in early 2018, and with permanent rates being set in the summer or fall of 2018.

The last general rate increase for PEU was in 2014, based upon 2012 as a test year. Since then, PEU’s operating expenses have increased ratably, and for some items like local property taxes, well above the rate of inflation. Additionally, since the beginning of 2013, the Company has borrowed and invested over \$7.5 million in new capital assets to serve its customers through ongoing investments in infrastructure replacements and system improvements. The rate increase being requested will allow PEU to pay the debt service attributable to these new capital investments, pay its necessary operating costs, and continue to meet the needs of its customers now and into the future.

Water Infrastructure and Conservation Adjustment (WICA)

On January 31, 2017, Pennichuck Water Works, Inc. filed a petition with the New Hampshire Public Utilities Commission (NHPUC) to approve a Water Infrastructure and Conservation Adjustment (WICA) surcharge to be effective June 1, 2017, approve proposed 2017 WICA

projects, and preliminarily approve proposed 2018 WICA projects. This petition process was in a “suspended” state for most of 2017, as the results of the PWW Rate Case, if approved per the Settlement Agreement, would terminate the WICA program and replace it with a new program inclusive in those rates. The new program would be analogous to the WICA program, but would be eligible for all capital improvement projects and expenditures, not just certain main replacement projects. The new program, if approved in that rate order, would be called the Qualified Capital Project Adjustment Charge (QCPAC), and would be subject to ongoing and annual filings and compliancy with the NHPUC.

On November 7, 2017, the PUC issued Order No. 26,070 which approved replacement of the current WICA program with an annual QCPAC, which will apply an annual surcharge between rate cases. This surcharge will be based on essentially all of the capital projects undertaken and completed by PWW each year.

Financing

On June 8, 2017, Pennichuck East Utility, Inc. completed a financing transaction with the New Hampshire Department of Environmental Services under the State of New Hampshire’s Drinking Water Revolving Loan Fund in the amount of \$2,400,000 for a 20-year term at an interest rate of 1.96%. The loan will fund the installation of a Merrimack River crossing interconnection pipeline connecting the distribution main owned by Pennichuck Water Works, Inc. in the Town of Merrimack to the existing Pennichuck East Utility, Inc. distribution system in the Town of Litchfield.

On June 8, 2017, Pennichuck East Utility, Inc. completed a financing transaction with the New Hampshire Department of Environmental Services under the State of New Hampshire’s Drinking Water Revolving Loan Fund in the amount of \$570,000 for a 30-year term at an interest rate of 1.96%. The loan will fund the replacement of approximately 2,400 linear feet of water main on Brady Avenue in the Maple Hills Community Water System in Derry, NH.

On June 8, 2017, Pennichuck East Utility, Inc. completed a financing transaction with the New Hampshire Department of Environmental Services under the State of New Hampshire’s Drinking Water Revolving Loan Fund in the amount of \$245,000 for a 20-year term at an interest rate of 1.96%. The loan will fund the replacement of approximately 1,200 linear feet of water main on Hillcrest Road in Litchfield, NH.

On October 19, 2017, Pennichuck East Utility, Inc. filed a petition with the Public Utilities Commission relative to debt financings, to be serviced by CoBank ACB, as well as the refinance of intercompany loans with Pennichuck Corporation. Pennichuck East Utility, Inc. seeks approval for (1) a term loan of up to \$500,000 to fund 2017 capital projects not funded by SRF loans, (2) a 3-year \$3.0 million Fixed Asset Line of Credit to provide for short-term financing of capital projects, and (3) the refinance of three Intercompany Loans with Pennichuck Corporation, in the amount of \$2,858,919, for a new term of 30 years. The order on these financings is still pending with the NHPUC as of this date.

On November 29, 2017, Pennichuck Water Works, Inc. filed a petition with the Public Utilities Commission relative to debt financings, to: (1) issue up to \$32.5 million of tax-exempt or taxable bonds through the NH Business Finance Authority and (2) to put a 2-year, renewable, \$10 million

Fixed Asset Line of Credit (FALOC) in place with TD Bank, NA, in order to provide for short-term financing of capital projects each year coupled with the annual QCPAC surcharge, and annual issuances of bonds under the \$32.5 million facility described above. On February 2, 2018, the NHPUC approved a portion of this order, allowing for the issuance of the \$32.5 million in bonds early in the second quarter of 2018; the order on the FALOC with TD Bank, NA, is still pending.

Other Events

PFOA Contamination Issues

During 2016, the Company was significantly involved in assisting the New Hampshire Department of Environmental Services (“NHDES”) in assessing and bringing remediation solutions to bear, in light of the PFOA contamination issues discovered in the towns surrounding the Saint Gobain Performance Plastics (“SGPP”) site in north Merrimack. This included self-instituting comprehensive and regular testing of the Company’s water supplies and water systems, not only in the area adjacent to this site, but taking and processing at least one set of tests at all water sources that the Company owns throughout the State. This was done in order to detect if any levels of contamination existed in the water sources, to aid the NHDES in completing their statewide assessment, and to allow the Company to respond with certainty to any of its customers as to any detectable levels. With regards to the water supply systems directly adjacent to or connected to the Merrimack Village District, the Company has been taking weekly or monthly samples since this contamination site was disclosed in March of 2016. The results of these tests were that none of the Company’s water sources had detectable levels exceeding EPA lifetime advisory levels, or the State’s emergency and now permanent standard detection levels.

Additionally, at the request of the NHDES, the Company was asked to enter into a contract with SGPP for the design of the expansion of public water to residents in the northern portion of Litchfield, where private wells had been contaminated, in some cases well above acceptable levels. Based upon the results of that design work, the Company was then contracted by SGPP to expand the public water system owned by the Company in Litchfield to approximately 400 property owners, including nearly 10 miles of new water mains and nearly 10 miles of new service lines. The cost of the design work and the expansion of the water system has and is being paid totally by SGPP, and was contributed to the Company as Contributions in Aid of Construction (CIAC), as assets to be owned by the Company, the Town, or the residents (in the case of the service lines) going forward.

Additionally, the Company has been asked by NHDES to contract for similar design services with SGPP for expansion of its public water system in southern Bedford as well as an additional 38 residences in Litchfield, due to this contamination site. Once approved by SGPP and the NHDES, it is anticipated that SGPP will enter into another contract with the Company for the expansion of the Company’s water system in those areas, construction of which would expect to begin within 60 days of the approvals, and would be fully paid for by SGPP, and included in CIAC assets at such time as those projects were completed. As of March 20, 2018, SGPP and NHDES entered into a Consent Decree, and as such, the Company is currently working with SGPP in the scheduling of these projects, including the construction management agreements tied to this activity.

A similar effort on behalf of Textiles Coated International, Inc. ("TCI") in the town of Amherst, due to PFOA contamination related to their previous existence as a manufacturer in that town, has also begun at the request of the NHDES. The Company was contracted to do design services for the expansion of the public water system in that area of Amherst, by TCI, and construction of the expansion of that part of the system began in 2017, and will be fully completed in the Spring of 2018. Once again, the entire cost of this project was borne by TCI, and will become part of the Company's owned infrastructure as CIAC assets.

Company Goals – 2017

The Company's main goals for 2017 and status at the end of the year are as follows:

- Completion of the Pennichuck Water Works, Inc. rate case with the New Hampshire Public Utilities Commission, which was completed with the order received in November 2017.
- Filing of rate cases for the Company's Pennichuck East Utility, Inc. subsidiary, which was filed in September 2017.
- Successfully negotiate a new collective bargaining agreement in the fourth quarter, to replace the current contract which was set to expire on October 31, 2017. A new 3-year contract was successfully negotiated prior to the expiration of the former contract, and the new contract is in existence until October 31, 2020.
- Continue the roll-out and implementation of the Company's comprehensive Asset Management System. Ongoing installation, implementation and enhancement of this platform was accomplished in 2017, and continues into 2018.
- Complete a round of bond financing for Pennichuck Water Works, Inc. for 2017-2020 capital expenditure needs. The initial issuance of bonds under this overall facility are expected to be issued in early April 2018.
- Secure other financing needs for ongoing infrastructure replacement for Pennichuck East Utility, Inc. and Pittsfield Aqueduct Company, Inc. Financing approvals are in process for both companies, at this time.
- Completion of a Safe Yield Analysis of the watershed. The initial phases of this were completed in 2017, with further analysis and results expected in Q2 of 2018.
- Complete the build-out of the expansion of the distribution system in response to the PFOA contamination issues, all funded by the identified Potential Responsible Parties (PRP) in cooperation with the New Hampshire Department of Environmental Services.

Other detailed information is included in the Company's financial statements.

Sincerely,



Larry D. Goodhue
Chief Executive Officer,
Chief Financial Officer
and Treasurer

Pennichuck Corporation and Subsidiaries

Consolidated Financial Statements

December 31, 2017 and 2016

(with Independent Auditors' Report Thereon)

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INDEPENDENT AUDITORS' REPORT

Board of Directors and Stockholder
Pennichuck Corporation and Subsidiaries

Additional Offices:
Nashua, NH
Andover, MA
Greenfield, MA
Ellsworth, ME

We have audited the accompanying consolidated financial statements of Pennichuck Corporation and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income (loss), comprehensive income (loss), changes in stockholder's equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pennichuck Corporation and Subsidiaries as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Melanson Heath

March 21, 2018

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
As of December 31, 2017 and 2016
(in thousands, except share data)

	<u>2017</u>	<u>2016</u>
ASSETS		
Property, Plant and Equipment, net	\$ 210,498	\$ 201,698
Current Assets:		
Cash and cash equivalents	994	2,446
Restricted cash - RSF	4,953	6,530
Restricted cash - Bond Project Funds	3,288	7,568
Accounts receivable - billed, net	3,420	4,137
Accounts receivable - unbilled, net	2,265	1,921
Accounts receivable - other	14	28
Inventory	604	666
Prepaid expenses	598	532
Prepaid property taxes	1,143	1,163
Deferred and refundable income taxes	516	352
Total Current Assets	<u>17,795</u>	<u>25,343</u>
Other Assets:		
Deferred land costs	2,257	2,248
Deferred charges and other assets	10,911	10,058
Investment in real estate partnership	103	104
Acquisition premium, net	73,227	75,144
Total Other Assets	<u>86,498</u>	<u>87,554</u>
TOTAL ASSETS	<u><u>\$ 314,791</u></u>	<u><u>\$ 314,595</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS - CONTINUED

As of December 31, 2017 and 2016

(in thousands, except share data)

	<u>2017</u>	<u>2016</u>
STOCKHOLDER'S EQUITY AND LIABILITIES		
Stockholder's Equity:		
Common stock; \$0.01 par value; 1,000 shares authorized, issued and outstanding	\$ -	\$ -
Additional paid in capital	30,561	30,561
Accumulated deficit	(16,961)	(10,241)
Accumulated other comprehensive income	305	258
Total Stockholder's Equity	<u>13,905</u>	<u>20,578</u>
Long-Term Debt, Less Current Portion and Unamortized Debt Issuance Costs	<u>197,905</u>	<u>200,758</u>
Current Liabilities:		
Line of credit	5,574	-
Current portion of long-term debt	5,575	5,162
Accounts payable	1,543	5,975
Accrued property taxes	115	-
Deferred revenue	66	63
Accrued interest payable	1,625	1,704
Other accrued expenses	394	980
Accrued wages and payroll withholding	358	271
Customer deposits and other	191	805
Total Current Liabilities	<u>15,441</u>	<u>14,960</u>
Other Liabilities and Deferred Credits:		
Deferred income taxes	12,847	20,869
Accrued pension liability	9,792	9,010
Unamortized debt premium	2,964	3,082
Deferred investment tax credits	504	537
Regulatory liability	9,955	760
Accrued post-retirement benefits	3,047	2,578
Customer advances	84	84
Contributions in aid of construction, net	47,458	40,364
Derivative instrument	374	453
Other long-term liabilities	515	562
Total Other Liabilities and Deferred Credits	<u>87,540</u>	<u>78,299</u>
TOTAL STOCKHOLDER'S EQUITY AND LIABILITIES	\$ <u>314,791</u>	\$ <u>314,595</u>

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Operating Revenues	\$ <u>40,893</u>	\$ <u>42,697</u>
Operating Expenses:		
Operations and maintenance	21,312	20,820
Depreciation and amortization	7,762	6,942
Taxes other than income taxes	<u>6,343</u>	<u>6,159</u>
Total Operating Expenses	<u>35,417</u>	<u>33,921</u>
Operating Income	5,476	8,776
Interest Expense	(10,833)	(10,784)
Allowance for Funds Used During Construction	27	358
Other, Net	<u>(3)</u>	<u>545</u>
Loss Before Provision for Income Taxes	(5,333)	(1,105)
Provision for Income Taxes	<u>(1,108)</u>	<u>(135)</u>
Net Loss	<u>\$ (6,441)</u>	<u>\$ (1,240)</u>

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Net Loss	\$ (6,441)	\$ (1,240)
Other Comprehensive Income (Loss):		
Unrealized gain (loss) on derivatives	3	(28)
Reclassification of net income realized in net income	76	123
Income tax benefit relating to other comprehensive income	<u>(32)</u>	<u>(38)</u>
Other Comprehensive Income	<u>47</u>	<u>57</u>
Comprehensive Loss	<u><u>\$ (6,394)</u></u>	<u><u>\$ (1,183)</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY

For the Year Ended December 31, 2017

(in thousands, except per share data)

	<u>Common Stock</u> <u>Shares</u>	<u>Amount</u>	<u>Additional</u> <u>Paid in</u> <u>Capital</u>	<u>Retained</u> <u>Earnings/(Deficit)</u>	<u>Accumulated</u> <u>Other</u> <u>Comprehensive</u> <u>Income (Loss)</u>	<u>Total</u>
Balance as of January 1, 2017	1,000	\$ -	\$ 30,561	\$ (10,241)	\$ 258	\$ 20,578
Common dividends declared-\$279.25 per share	-	-	-	(279)	-	(279)
Net loss	-	-	-	(6,441)	-	(6,441)
Other comprehensive income (loss):						
Unrealized gain on derivatives, net of taxes of \$1	-	-	-	-	1	1
Reclassification of net income realized in net income, net of taxes of \$31	-	-	-	-	46	46
Balance as of December 31, 2017	1,000	\$ -	\$ 30,561	\$ (16,961)	\$ 305	\$ 13,905

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY

For the Year Ended December 31, 2016
(in thousands, except per share data)

	Common Stock		Additional	Retained	Accumulated	
	Shares	Amount	Paid in	Earnings/(Deficit)	Other	
			Capital		Comprehensive	Total
					Income (Loss)	
Balance as of						
January 1, 2016	1,000	\$ -	\$ 30,561	\$ (8,721)	\$ 201	\$ 22,041
Common dividends declared-						
\$279.91 per share	-	-	-	(280)	-	(280)
Net loss	-	-	-	(1,240)	-	(1,240)
Other comprehensive income (loss):						
Unrealized loss on derivatives,						
net of taxes of \$(11)	-	-	-	-	(17)	(17)
Reclassification of net income						
realized in net income, net of						
taxes of \$49	-	-	-	-	74	74
Balance as of						
December 31, 2016	1,000	\$ -	\$ 30,561	\$ (10,241)	\$ 258	\$ 20,578

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Operating Activities:		
Net Loss	\$ (6,441)	\$ (1,240)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Depreciation and amortization	7,838	7,019
Equity component of AFUDC	(9)	(137)
Amortization of deferred investment tax credits	(33)	(33)
Provision for deferred income tax	1,141	189
Undistributed loss in real estate partnership	1	-
Gain on disposition of property	(31)	(529)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable billed and unbilled	387	(1,584)
Decrease in inventory	62	46
(Increase) decrease in prepaid expenses	(46)	185
(Increase) in deferred charges and other assets	(625)	(456)
(Increase) in refundable income taxes	(164)	(2)
Increase (decrease) in accounts payable and deferred revenue	(4,429)	4,480
Increase (decrease) in accrued interest payable	(79)	386
Increase in other	205	2,409
Net cash provided (used) by operating activities	<u>(2,223)</u>	<u>10,733</u>
Investing Activities:		
Purchase of property, plant and equipment including debt component of allowance for funds used during construction	(7,716)	(21,886)
(Increase) decrease in restricted cash	5,857	(5,826)
Proceeds from sale of marketable securities	-	17,236
Proceeds from sale of property	37	946
Change in investment in real estate partnership and deferred land costs	<u>(8)</u>	<u>7</u>
Net cash used by investing activities	<u>(1,830)</u>	<u>(9,523)</u>

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2017 and 2016
(in thousands)

	<u>2017</u>	<u>2016</u>
Financing Activities:		
Borrowings (payments) on line of credit, net	\$ 5,574	\$ -
Payments on long-term debt	(5,209)	(4,227)
Contributions in aid of construction	61	58
Proceeds from long-term borrowings	2,475	4,498
Debt issuance costs	(21)	(59)
Dividends paid	<u>(279)</u>	<u>(280)</u>
Net cash provided (used) by financing activities	<u>2,601</u>	<u>(10)</u>
Increase (Decrease) in cash and cash equivalents	(1,452)	1,200
Cash and cash equivalents, beginning of period	<u>2,446</u>	<u>1,246</u>
Cash and cash equivalents, end of period	<u><u>\$ 994</u></u>	<u><u>\$ 2,446</u></u>

Supplemental Disclosure on Cash Flow and Non-cash Items
For the Years Ended December 31, 2017 and 2016 (in thousands)

	<u>2017</u>	<u>2016</u>
Cash paid during the period for:		
Interest	\$ 10,706	\$ 10,263
Income taxes	167	123
Non-cash items:		
Contributions in aid of construction	8,072	3,309
Forgiveness of debt	77	77

The accompanying notes are an integral part of these consolidated financial statements.

PENNICHUCK CORPORATION AND SUBSIDIARIES
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Description of Business and Summary of Significant Accounting Policies

Description of Business:

Pennichuck Corporation (“the Company,” “we,” or “our”) is a holding company headquartered in Merrimack, New Hampshire with five wholly owned operating subsidiaries: Pennichuck Water Works, Inc., (“Pennichuck Water”) Pennichuck East Utility, Inc., (“Pennichuck East”) and Pittsfield Aqueduct Company, Inc. (“PAC”) (collectively referred to as our Company’s “utility subsidiaries”), which are involved in regulated water supply and distribution to customers in New Hampshire; Pennichuck Water Service Corporation (“Service Corporation”) which conducts non-regulated water-related services; and The Southwood Corporation (“Southwood”) which owns several parcels of undeveloped land.

The Company’s utility subsidiaries are engaged principally in the collection, storage, treatment and distribution of potable water to approximately 36,590 customers throughout the State of New Hampshire. The utility subsidiaries, which are regulated by the New Hampshire Public Utilities Commission (the “NHPUC”), are subject to the provisions of Accounting Standards Codification (“ASC”) Topic 980 “*Regulated Operations*.”

Summary of Significant Accounting Policies:

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation.

Use of Estimates in the Preparation of Consolidated Financial Statements

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Property, Plant and Equipment

Property, plant and equipment, which includes principally the water utility assets of the Company’s utility subsidiaries, is recorded at cost plus an allowance for funds used during construction on major, long-term projects and includes property funded with contributions in aid of construction.

Maintenance, repairs and minor improvements are charged to expense as incurred. Improvements which significantly increase the value of property, plant and equipment are capitalized.

Cash and Cash Equivalents

Cash and cash equivalents generally consist of cash, money market funds and other short-term liquid investments with original maturities of three months or less.

Restricted Cash - RSF

This restricted cash balance consists of funds maintained for the Rate Stabilization Fund ("RSF"), which was established in conformity with the requirements of NHPUC Order 25,292, as explained more fully in Note 11 of these financial statements. The RSF is an imprest fund of \$5 million, which is subject to funding above or below the imprest fund balance, reflecting actual revenue performance as it relates to prescribed revenue levels supported by the RSF. The excess or deficient amount (versus the \$5.0 million imprest balance) is subject to return or collection to rate payers over the succeeding three-year period of time, as of the rate order issued with the next promulgated rate case filing. On November 7, 2017, the NH PUC approved and issued Order No. 26,070 which established new rates for Pennichuck Water. In addition, the rate order then authorized the reallocation of the existing \$5,000,000 Rate Stabilization Fund among the Company's three utilities. Such that, Pennichuck Water's allocated share of the RSF would now be \$3,920,000, with the remaining balance of \$1,080,000 to be allocated between Pennichuck East and Pittsfield Aqueduct. The purpose for splitting and allocating the existing RSF is to provide additional reserves which ensure sufficient capital to enable the Company to support its operations. For the years ending December 31, 2017 and 2016, the balances in the RSF were \$4.9 million and \$6.5 million, respectively.

Restricted Cash – Bond Project Funds

This restricted cash balance consists of funds remaining from the issuance of the Series 2014 and 2015 tax-exempt bonds (the "Bonds") in December of 2014 and October of 2015, respectively. The proceeds from those bond issuance transactions are maintained in separate restricted cash accounts, with Trustee oversight, and are subject to withdrawal as a reimbursement of eligible capital project expenditures for the years 2014 through 2019, as defined by the indenture and issuance documents associated with each offering. The restricted cash accounts are also used as a "conduit" for the transfer of money from operating cash to restricted cash, allowing the Trustee to make the required payments to bondholders for principal and interest due semi-annually.

As of December 31, 2016, the funds in these restricted cash accounts totaled approximately \$7.6 million. During 2017, approximately \$3.3 million was withdrawn from the restricted cash accounts to make the principal and interest payments for the Bonds, on January 1 and July 1. Also during 2017, approximately \$4.3 million was withdrawn from the restricted cash accounts, and transferred to the Company's operating cash accounts, for reimbursements of qualifying capital projects completed and "used and useful" during 2017, which were initially funded from working capital. In December 2017, approximately \$3.3 million was transferred into these restricted cash accounts from the Company's operating cash accounts, to provide the funds needed to make the net principal and interest payments due on January 1, 2018 for the Bonds. As of December 31, 2017, the funds in these restricted cash accounts totaled approximately \$3.3 million.

Concentration of Credit Risks

Financial instruments that subject the Company to credit risk consist primarily of cash (including cash equivalents and restricted cash) and accounts receivable. Cash balances are invested in financial institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). At December 31, 2017 and 2016, the Company had approximately \$9,000,000 and \$16,950,000 in excess of FDIC insured limits, respectively. Our accounts receivable balances primarily represent amounts due from the residential, commercial and industrial customers of our regulated water utility operations, as well as receivables from our Service Corporation customers.

Accounts Receivable – Billed, Net

Accounts receivable are recorded at the invoiced amounts. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable, and is determined based on historical write-off experience and the aging of account balances. We review the allowance for doubtful accounts quarterly. Account balances are written off against the allowance when it is probable the receivable will not be recovered.

Accounts Receivable – Unbilled, Net

We read our customer meters on a monthly basis and record revenues based on meter reading results. Information from the last meter reading date is used to estimate the value of unbilled revenues through the end of the accounting period. Estimates of water utility revenues for water delivered to customers but not yet billed are accrued at the end of each accounting period. Actual results could differ from those estimates.

Inventory

Inventory is stated at the lower of cost or market, cost being determined using the average cost method which approximates the first-in, first-out (FIFO) method through December 31, 2016. Effective January 1, 2017, inventory is stated at the lower of cost or net realizable value, cost being determined using the average cost method which approximates the FIFO method.

Deferred Land Costs

Included in deferred land costs is the Company's original basis in its undeveloped land-holdings and any land improvement costs, which are stated at the lower of cost or market. All costs associated with real estate and land projects are capitalized and allocated to the project to which the costs relate. Administrative labor and the related fringe benefit costs attributable to the acquisition, active development, and construction of land parcels are capitalized as deferred land costs. No labor and benefits were capitalized for the years ended December 31, 2017 and 2016.

Deferred Charges and Other Assets

Deferred charges include certain regulatory assets and other assets. Regulatory assets are amortized over the periods they are recovered through NHPUC-authorized water rates. The Company's utility subsidiaries have recorded certain regulatory assets in cases where the NHPUC has permitted, or is expected to permit, recovery of these costs over future periods. Currently, the regulatory assets are being amortized over periods ranging from 2 to 25 years.

Unamortized Debt Issuance Costs

Unamortized debt issuance costs are amortized over the term of the related bonds and notes. The Company's utility subsidiaries have recorded unamortized debt issuance costs in cases where the NHPUC has permitted or is expected to permit recovery of these costs over future periods. The debt issuance costs are being amortized over the lives of the associated debt.

Contributions in Aid of Construction

Under construction contracts with real estate developers and others, the Company's utility subsidiaries may receive non-refundable advances for the cost of installing new water mains. These advances are recorded as Contributions in Aid of Construction ("CIAC"). The utility subsidiaries also record to plant and CIAC the fair market value of developer installed mains and any excess of fair market value over the cost of community water systems purchased from developers. CIAC are amortized over the life of the related properties.

Revenues

Standard charges for water utility services to customers are recorded as revenue, based upon meter readings and contract service, as services are provided. The majority of the Company's water revenues are based on rates approved by the NHPUC. Estimates of unbilled service revenues are recorded in the period the services are provided. Provision is made in the consolidated financial statements for estimated uncollectible accounts.

Non-regulated water management services include contract operations and maintenance, and water testing and billing services to municipalities and small, privately owned community water systems. Contract revenues are billed and recognized on a monthly recurring basis in accordance with agreed-upon contract rates. Revenues from unplanned additional work are based upon time and materials incurred in connection with activities not specifically identified in the contract, or for which work levels exceed contracted amounts.

Revenues from real estate operations, other than undistributed earnings or losses from equity method joint ventures, are recorded upon completion of a sale of real property. The Company's real estate holdings outside of our regulated utilities are comprised primarily of undeveloped land.

Investment in Joint Venture

Southwood uses the equity method of accounting for its investment in a joint venture in which it does not have a controlling interest. Under this method, Southwood records its proportionate share of losses under “Other, net” in the accompanying Consolidated Statements of Income (Loss) with a corresponding decrease in the carrying value of the investment.

Income Taxes

Income taxes are recorded using the accrual method and the provision for federal and state income taxes is based on income reported in the consolidated financial statements, adjusted for items not recognized for income tax purposes. Provisions for deferred income taxes are recognized for accelerated depreciation and other temporary differences. A valuation allowance is provided to offset any net deferred tax assets if, based upon available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. Investment tax credits previously realized for income tax purposes are amortized for financial statement purposes over the life of the property, giving rise to the credit.

Change in Accounting Principles

Effective January 1, 2017, the Company adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2015-07, *Fair Value Measurement (Topic 820), Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. Under the amendments in this ASU, investments for which fair value is measured at net asset value per share (or its equivalent) using the practical expedient are not categorized in the fair value hierarchy. The amendments are to be applied retrospectively. The changes are reflected in the fair value leveling tables in Note 5.

Effective January 1, 2017, the Company adopted FASB ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*, which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost or net realizable value test. Net realizable value is defined as estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Prior to 2017, the Company reported inventory at the lower of cost or market. This guidance is applied prospectively as determined by the standard. There is no prior year or current year effect to the financial statements as a result of this change.

New Accounting Standards to be Adopted in the Future

Revenue from Contracts with Customers

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. This standard also includes expanded disclosure requirements that result in an entity providing users of financial statements with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity’s contracts with customers. This standard will

be effective for the Company for the year ending December 31, 2019. The Company is currently in the process of evaluating the impact of adoption of this ASU on the financial statements.

Leases

In February 2016, the FASB issued ASU 2016-02, *Leases*. The ASU requires all leases with lease terms more than 12 months to be capitalized as a right of use asset and lease liability on the balance sheet at the date of lease commencement. Leases will be classified as either finance leases or operating leases. This distinction will be relevant for the pattern of expense recognition in the income statement. This ASU will be effective for the Company for the year ending December 31, 2020. The Company is currently in the process of evaluating the impact of adoption of this ASU on the financial statements.

Credit Losses

In June 2016, the FASB issued ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. The ASU requires a financial asset (including trade receivables) measured at amortized cost basis to be presented at the net amount expected to be collected. Thus, the income statement will reflect the measurement of credit losses for newly-recognized financial assets as well as the expected increases or decreases of expected credit losses that have taken place during the period. This ASU will be effective for the Company for the year ending December 31, 2021. The Company is currently in the process of evaluating the impact of adoption of this ASU on the financial statements.

Note 2 – Property, Plant and Equipment

The components of property, plant and equipment as of December 31, 2017 and 2016 were as follows:

(in thousands)	2017	2016	Useful Lives (in years)
Utility Property:			
Land and land rights	\$ 3,305	\$ 3,079	-
Source of supply	65,608	61,450	3 - 70
Pumping and purification	31,075	30,851	7 - 64
Transmission and distribution, including services, meters and hydrants	161,193	145,202	15 - 91
General and other equipment	16,541	15,000	7 - 75
Intangible plant	790	790	20
Construction work in progress	1,978	10,022	
Total utility property	280,490	266,394	
Total non-utility property	5	5	5 - 10
Total property, plant and equipment	280,495	266,399	
Less accumulated depreciation	(69,997)	(64,701)	
Property, plant and equipment, net	\$ 210,498	\$ 201,698	

The provision for depreciation is computed on the straight-line method over the estimated useful lives of the assets, which range from 3 to 91 years. The weighted average composite depreciation rate was 2.56% and 2.54% in 2017 and 2016, respectively.

Note 3 – Accounts Receivable

Accounts receivable consisted of the following at December 31, 2017 and 2016:

(in thousands)	<u>2017</u>	<u>2016</u>
Accounts receivable - billed	\$ 3,457	\$ 4,188
Less allowance for doubtful accounts	<u>(37)</u>	<u>(51)</u>
Accounts Receivable - billed, net	<u>\$ 3,420</u>	<u>\$ 4,137</u>
Accounts receivable - unbilled	\$ 2,265	\$ 1,921
Less allowance for doubtful accounts	<u>-</u>	<u>-</u>
Accounts Receivable - unbilled, net	<u>\$ 2,265</u>	<u>\$ 1,921</u>

Note 4 – Deferred Charges and Other Assets

Deferred charges and other assets as of December 31, 2017 and 2016 consisted of the following:

(in thousands)	<u>2017</u>	<u>2016</u>	<u>Recovery Period (in years)</u>
Regulatory assets:			
Source development charges	\$ 952	\$ 1,041	5 - 25
Miscellaneous studies	980	854	2 - 25
Unrecovered pension and post-retirement benefits expense	<u>8,244</u>	<u>7,457</u>	(1)
Total regulatory assets	10,176	9,352	
Supplemental executive retirement plan asset	<u>735</u>	<u>706</u>	
Total deferred charges and other assets	<u>\$ 10,911</u>	<u>\$ 10,058</u>	

(1) We expect to recover these amounts consistent with the anticipated expense recognition of these assets.

Note 5 – Post-retirement Benefit Plans

Pension Plan and Other Post-retirement Benefits

The Company has a non-contributory, defined benefit pension plan (the “DB Plan”) that covers substantially all employees. The benefits are based on years of service and participant compensation levels. The Company’s funding policy is to contribute annual amounts that meet the requirements for funding under the U.S. Department of Labor’s Pension Protection Act. Contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

Post-retirement medical benefits are provided for eligible retired employees through one of two plans (collectively referred to as our “OPEB Plans”). For employees who retire on or after the normal retirement age of 65, benefits are provided through a post-retirement plan (the “Post-65 Plan”). For eligible non-union employees who retire prior to their normal retirement age and who have met certain age and service requirements, benefits are provided through a post-employment medical plan (the “Post-employment Plan”). Future benefits under the Post-65 Plan increase annually based on the actual percentage of wage and salary increases earned from the plan inception date to the normal retirement date. The benefits under the Post-employment Plan allow for the continuity of medical benefits coverage at group rates from the employee’s retirement date until the employee becomes eligible for Medicare, which are fully funded by the retiree. The liability related to the Post-65 Plan will be funded from the general assets of our Company.

Upon retirement, if a qualifying employee elects to receive medical benefits under our Post-65 Plan, we pay up to a maximum monthly benefit of \$341 based on years of service.

The following table sets forth information regarding our DB Plan and our OPEB Plans as of December 31, 2017 and for the year then ended:

(in thousands)	DB Plan	OPEB Plans
Projected benefit obligations	\$ 27,558	\$ 3,660
Employer contribution	1,111	11
Benefits paid, excluding expenses	(643)	(52)
Fair value of plan assets	17,766	612
Accumulated benefit obligation	24,760	-
Funded status	(9,792)	(3,047)
Net periodic benefit cost	1,368	218
Amount of the funded status recognized in the Consolidated Balance Sheet consisted of:		
Current liability	-	-
Non-current liability	(9,792)	(3,047)
Total	<u>\$ (9,792)</u>	<u>\$ (3,047)</u>

The following table sets forth information regarding our DB Plan and our OPEB Plans as of December 31, 2016 and for the year then ended:

(in thousands)	DB Plan	OPEB Plans
Projected benefit obligations	\$ 23,899	\$ 3,165
Employer contribution	970	10
Benefits paid, excluding expenses	(1,056)	(47)
Fair value of plan assets	14,889	586
Accumulated benefit obligation	21,547	-
Funded status	(9,010)	(2,578)
Net periodic benefit cost	1,284	194
Amount of the funded status recognized in the Consolidated Balance Sheet consisted of:		
Current liability	-	-
Non-current liability	(9,010)	(2,578)
Total	<u>\$ (9,010)</u>	<u>\$ (2,578)</u>

Changes in plan assets and benefit obligations recognized in regulatory assets, for the year ended December 31, 2017, were as follows:

(in thousands)	DB Plan	OPEB Plans
Regulatory asset balance, beginning of period	\$ 7,067	\$ 390
Net actuarial loss incurred during the period	871	259
Prior service cost incurred during the period	-	16
Recognized net actuarial (gain)/loss	(345)	(14)
Regulatory asset balance, end of period	<u>\$ 7,593</u>	<u>\$ 651</u>

Changes in plan assets and benefit obligations recognized in regulatory assets, for the year ended December 31, 2016, were as follows:

(in thousands)	DB Plan	OPEB Plans
Regulatory asset balance, beginning of period	\$ 6,658	\$ 237
Net actuarial gain incurred during the period	737	145
Prior service cost incurred during the period	-	17
Recognized net actuarial (gain)/loss	(328)	(9)
Regulatory asset balance, end of period	<u>\$ 7,067</u>	<u>\$ 390</u>

Amounts recognized in regulatory assets for the DB and OPEB Plans that have not yet been recognized as components of net periodic benefit cost of the following as of December 31, 2017:

(in thousands)	DB Plan	OPEB Plans
Net actuarial loss	\$ 7,593	\$ 815
Prior service cost	-	(164)
Regulatory asset	<u>\$ 7,593</u>	<u>\$ 651</u>

Amounts recognized in regulatory assets for the DB and OPEB Plans that have not yet been recognized as components of net periodic benefit cost of the following as of December 31, 2016:

(in thousands)	DB Plan	OPEB Plans
Net actuarial loss	\$ 7,067	\$ 570
Prior service cost	-	(180)
Regulatory asset	<u>\$ 7,067</u>	<u>\$ 390</u>

The key assumptions used to value benefit obligations and calculate net periodic benefit cost for our DB and OPEB Plans include the following:

	2017	2016
Discount rate for net periodic benefit cost, beginning of year	4.02%	4.21%
Discount rate for benefit obligations, end of year ^(a)	3.50%	4.02%
Expected return on plan assets for the period (net of investment expenses)	7.00%	7.00%
Rate of compensation increase, beginning of year	3.00%	3.00%
Healthcare cost trend rate (applicable only to OPEB Plans)	7.50%	8.00%

^(a) An increase or decrease in the discount rate of 0.5% would result in a change in the funded status as of December 31, 2017, for the DB Plan and the OPEB Plans of approximately \$2.1 million and \$324 thousand, respectively.

The estimated net actuarial loss for our DB Plan that will be amortized in 2018 from the regulatory assets into net periodic benefit costs is \$361,000. The estimated net actuarial gain and prior service cost for our OPEB Plans that will be amortized in 2018 from the regulatory assets into net periodic benefit costs is \$13,000.

In establishing its investment policy, the Company has considered the fact that the DB Plan is a major retirement vehicle for its employees and the basic goal underlying the establishment of the policy is to provide that the assets of the DB Plan are invested in accordance with the asset allocation range targets to achieve our expected return on DB Plan assets. The Company's investment strategy applies to its OPEB Plans as well as the DB Plan. The expected long-term rate of return on DB Plan and OPEB Plan assets is based on the Plans' expected asset allocation, expected returns on various classes of Plan assets, as well as historical returns.

The assets of our Post-65 Plan are held in two separate Voluntary Employee Beneficiary Association (“VEBA”) trusts. The VEBA plan assets are maintained in directed trust accounts at a commercial bank.

The investment strategy for the Company’s DB Plan and OPEB Plans utilizes several different asset classes with varying risk/return characteristics. The following table indicates the asset allocation percentages of the fair value of the DB Plan and OPEB Plans’ assets for each major type of plan asset as of December 31, 2017, as well as the targeted allocation range:

	DB Plan		OPEB Plans	
		Asset Allocation Range		Asset Allocation Range
Equities	63%	30% - 100%	69%	30% - 100%
Fixed income	37%	20% - 70%	29%	0% - 50%
Cash and cash equivalents	0%	0% - 15%	2%	0% - 15%
Total	100%		100%	

The following table indicates the asset allocation percentages of the fair value of the DB Plan and OPEB Plans’ assets for each major type of plan asset as of December 31, 2016, as well as the targeted allocation range:

	DB Plan		OPEB Plans	
		Asset Allocation Range		Asset Allocation Range
Equities	64%	30% - 100%	68%	30% - 100%
Fixed income	36%	20% - 70%	30%	0% - 50%
Cash and cash equivalents	0%	0% - 15%	2%	0% - 15%
Total	100%		100%	

Management uses its best judgment in estimating the fair value of its financial instruments. However, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts that we could realize in a sales transaction for these instruments. The estimated fair value amounts have been measured as of year-end and have not been reevaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates.

Investments in common stock and mutual funds are stated at fair value by reference to quoted market prices. Money market funds are valued utilizing the net asset value per unit based on the fair value of the underlying assets as determined by the directed trustee.

The DB Plan also holds assets under an immediate participation guarantee group annuity contract with a life insurance company. The assets under the contract are invested in pooled separate accounts and in a general investment account. The pooled separate accounts are valued based on net asset value (NAV) per unit of participation in the fund. The NAV is used as a practical expedient to estimate fair values. This practical expedient is not used when it is determined to be probable that the fund will sell the investment for an amount different than that reported at NAV. These accounts have no unfunded commitments or significant redemption restrictions at year-end. The value of these units is determined by the trustee based on the current market values of the underlying assets of the pooled separate accounts. Therefore, the value of the pooled separate accounts is deemed to be at estimated fair value.

The general investment account is not actively traded, and significant other observable inputs are not available. The fair value of the general investment account is calculated by discounting the related cash flows based on current yields of similar instruments with comparable durations.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Plan's management believes the valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain investments could result in a different fair value measurement at the reporting date.

A fair value hierarchy which prioritizes the inputs to valuation methods is used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

The fair value of DB Plan and OPEB Plan assets by levels within the fair value hierarchy used as of December 31, 2017 was as follows:

(in thousands)	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
DB Plan:				
Guaranteed Interest Accounts	\$ 3,215	\$ -	\$ -	\$ 3,215
Total Assets in the Fair Value Hierarchy	3,215	-	-	3,215
Investments measured at net asset value ^(a)	14,551	-	-	-
DB Plan Investments, at Fair Value	17,766	-	-	3,215

(continued)

(continued)

(in thousands)	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
OPEB Plans:				
Common stocks	310	310	-	-
Mutual funds	111	111	-	-
Fixed income funds	180	180	-	-
Money market funds	11	-	11	-
Total Assets in the Fair Value Hierarchy	612	601	11	-
Investments measured at net asset value ^(a)	-	-	-	-
OPEB Plans Investments, at Fair Value	612	601	11	-
Totals	<u>\$ 18,378</u>	<u>\$ 601</u>	<u>\$ 11</u>	<u>\$ 3,215</u>

(a) In accordance with Subtopic 820-10, certain investments that were measured at fair value using the net asset value per share (or its equivalent) practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the statements of assets available for benefits of the Plans.

The fair value of DB Plan and OPEB Plan assets by levels within the fair value hierarchy used as of December 31, 2016 was as follows:

(in thousands)	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
DB Plan:				
Guaranteed Interest Accounts	<u>\$ 2,264</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,264</u>
Total Assets in the Fair Value Hierarchy	2,264	-	-	2,264
Investments measured at net asset value ^(a)	12,625	-	-	-
DB Plan Investments, at Fair Value	<u>14,889</u>	<u>-</u>	<u>-</u>	<u>2,264</u>

(continued)

(continued)

(in thousands)	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
OPEB Plans:				
Common stocks	268	268	-	-
Mutual funds	131	131	-	-
Fixed income funds	173	173	-	-
Money market funds	13	-	13	-
Total Assets in the Fair Value Hierarchy	585	572	13	-
Investments measured at net asset value ^(a)	-	-	-	-
OPEB Plans Investments, at Fair Value	585	572	13	-
Totals	<u>\$ 15,474</u>	<u>\$ 572</u>	<u>\$ 13</u>	<u>\$ 2,264</u>

(a) In accordance with Subtopic 820-10, certain investments that were measured at fair value using the net asset value per share (or its equivalent) practical expedient have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the statements of assets available for benefits of the Plans.

Level 1: Based on quoted prices in active markets for identical assets.

Level 2: Based on significant observable inputs.

Level 3: Based on significant unobservable inputs.

The following table summarizes investments at fair value based on NAV per share as of December 31, 2017 and 2016, respectively:

(in thousands)	<u>Fair Value</u>
December 31, 2017	
Pooled Separate Accounts:	
Equities	\$ 11,117
Fixed Income	3,434
Total Pooled Separate Accounts	<u>\$ 14,551</u>
December 31, 2016	
Pooled Separate Accounts:	
Equities	\$ 9,561
Fixed Income	3,064
Total Pooled Separate Accounts	<u>\$ 12,625</u>

The following table presents a period-end reconciliation of DB Plan assets measured and recorded at fair value on a recurring basis, using significant unobservable inputs (Level 3):

(in thousands)	<u>2017</u>	<u>2016</u>
Balance, beginning of year	\$ 2,264	\$ 2,581
Plan transfers	1,314	493
Contributions	222	196
Benefits paid	(651)	(1,068)
Return on plan assets (net of investment expenses)	<u>66</u>	<u>62</u>
Balance, end of year	<u>\$ 3,215</u>	<u>\$ 2,264</u>

In order to satisfy the minimum funding requirements of the Employee Retirement Income Security Act of 1974, applicable to defined benefit pension plans, the Company anticipates it will contribute approximately \$1.1 million to the DB Plan in 2018.

The following maximum benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

(in thousands)	<u>DB Plan</u>	<u>OPEB Plans</u>
2018	\$ 818	\$ 70
2019	974	87
2020	980	90
2021	1,115	108
2022	1,248	123
2023 - 2027	<u>7,663</u>	<u>745</u>
Total	<u>\$ 12,798</u>	<u>\$ 1,223</u>

Because the Company is subject to regulation in the state in which it operates, we are required to maintain our accounts in accordance with the regulatory authority's rules and regulations. In those instances, we follow the guidance of ASC 980 ("Regulated Operations"). Based on prior regulatory practice, we recorded underfunded DB Plan and OPEB Plan obligations as a regulatory asset, and we expect to recover those costs in rates charged to customers.

Defined Contribution Plan

In addition to the defined benefit plan, the Company provides and maintains a defined contribution plan covering substantially all employees. Under this plan, the Company matches 100% of the first 3% of each participating employee's salary contributed to the plan. The matching employer's contributions, recorded as operating expenses, were approximately \$239,000 and \$215,000 for the years ended December 31, 2017 and 2016, respectively.

Note 6 - Commitments and Contingencies

Operating Leases

The Company's corporate office space, as well as certain office equipment, is leased under operating lease agreements. Total rent expense was approximately \$309,800 and \$344,800 for the years ended December 31, 2017 and 2016, respectively.

The remaining non-cancelable lease commitments for the corporate office space and leased equipment as of December 31, 2017 were as follows:

(in thousands)	<u>Amount</u>
2018	\$ 348
2019	343
2020	333
2021	338
2022	<u>199</u>
Total	<u>\$ 1,561</u>

Note 7 – Financial Measurement and Fair Value of Financial Instruments

Management uses its best judgment in estimating the fair value of its financial instruments. However, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts that we could realize in a sales transaction for these instruments. The estimated fair value amounts have been measured as of the period end and have not been reevaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates.

A fair value hierarchy is used, which prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of fair value hierarchy are as follows:

Level 1: Based on quoted prices in active markets for identical assets.

Level 2: Based on significant observable inputs.

Level 3: Based on significant unobservable inputs.

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For assets and liabilities measured at fair value on a recurring basis, the fair value measurement by levels within the fair value hierarchy used as of December 31, 2017 and 2016 were as follows:

		December 31, 2017			
(in thousands)		<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Liabilities:					
Interest rate swap		\$ <u>(374)</u>	\$ <u>-</u>	\$ <u>(374)</u>	\$ <u>-</u>

		December 31, 2016			
(in thousands)		<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Liabilities:					
Interest rate swap		\$ <u>(453)</u>	\$ <u>-</u>	\$ <u>(453)</u>	\$ <u>-</u>

The carrying value of certain financial instruments included in the accompanying Consolidated Balance Sheets, along with the related fair value, as of December 31, 2017 and 2016 was as follows:

		2017		2016	
(in thousands)		<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Liabilities:					
Long-term debt	\$	(207,709)	\$ (234,509)	\$ (210,443)	\$ (264,700)
Interest rate swap liability	\$	(374)	\$ (374)	\$ (453)	\$ (453)

The fair value of long-term debt has been determined by discounting the future cash flows using current market interest rates for similar financial instruments of the same duration. The fair value for long-term debt shown above does not purport to represent the amounts at which those debt obligations would be settled. The fair market value of the interest rate swap represents the estimated cost to terminate this agreement as of December 31, 2017 and 2016 based upon the then-current interest rates and the related credit risk.

The carrying values of our Cash and Cash Equivalents, Accounts Receivable and Accounts Payable approximate their fair values because of their short maturity dates. The carrying value of our CIAC approximates its fair value because it is expected that this is the amount that will be recovered in future rates.

Note 8 – Income Taxes

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the TCJA). The TCJA makes broad and complex changes to the U.S. tax code, including, but not limited to, (1) reducing the U.S. federal corporate tax rate from 35 percent to 21 percent; (2) elimination of the corporate alternative minimum tax (AMT) and changing how existing AMT credits can be realized; (3) changing rules related to usage and limitation of net operating loss carryforwards created in

tax years beginning after December 31, 2017; and (4) changing rules related to limitation of interest expense deductions. Certain of TCJA's provisions require interpretation, which may be clarified through issuances of guidance by the U.S. Treasury Department, regulations, or future technical corrections.

FASB ASC 740 requires companies to recognize the effects of tax law changes in the period of enactment, which for the Company is for the year ended December 31, 2017, even though the effective date of most provisions of TCJA is January 1, 2018.

The Company's revaluation of federal deferred tax balances to reflect the 21% corporate income tax rate resulted in a one-time, non-cash expense of approximately \$2,500,000, included in the Company's provision for income taxes, offset by an increase in deferred income tax liabilities.

The components of the federal and state income tax provision (benefit) as of December 31, 2017 and 2016 were as follows:

(in thousands)	<u>2017</u>	<u>2016</u>
Federal	\$ 1,057	\$ 284
State	84	(116)
Amortization of investment tax credits	<u>(33)</u>	<u>(33)</u>
Total	<u>\$ 1,108</u>	<u>\$ 135</u>
Current	\$ -	\$ -
Deferred	<u>1,108</u>	<u>135</u>
Total	<u>\$ 1,108</u>	<u>\$ 135</u>

The following is a reconciliation between the statutory federal income tax rate and the effective income tax rate for 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Statutory federal rate	34.0%	34.0%
State tax rate, net of federal benefits	6.2%	5.4%
Permanent differences	-15.8%	-54.8%
Tax rate change	-45.8%	0.0%
Amortization of investment tax credits	<u>0.6%</u>	<u>3.0%</u>
Effective tax rate	<u>-20.8%</u>	<u>-12.4%</u>

The temporary items that give rise to the net deferred tax liability as of December 31, 2017 and 2016 were as follows:

(in thousands)	<u>2017</u>	<u>2016</u>
Liabilities:		
Property-related, net	\$ 19,967	\$ 27,599
Other	<u>373</u>	<u>563</u>
Total liabilities	<u>20,340</u>	<u>28,162</u>
Assets:		
Pension accrued liability	1,186	1,555
Net operating loss carryforward	5,042	4,480
Alternative minimum tax credit	476	476
NH Business Enterprise Tax credits	853	727
Other	<u>789</u>	<u>782</u>
	8,346	8,020
Less valuation allowance	<u>(853)</u>	<u>(727)</u>
Total assets	<u>7,493</u>	<u>7,293</u>
Net non-current deferred income tax liability	<u>\$ 12,847</u>	<u>\$ 20,869</u>

The Company had a federal net operating loss in 2017 and 2016 in the amounts of approximately \$6.7 million and \$1.6 million, respectively. The federal tax benefit of the cumulative net operating loss is approximately \$3.8 million which begins to expire in 2032, and is included in deferred income taxes in the Consolidated Balance Sheet as of December 31, 2017.

The Company also had a New Hampshire net operating loss in 2017 and 2016 in the amounts of approximately \$7.3 million and \$2.5 million, respectively. The New Hampshire tax benefit of the cumulative net operating loss is approximately \$1.2 million which begins to expire in 2022, and is included in deferred income taxes in the Consolidated Balance Sheet as of December 31, 2017.

As of December 31, 2017 and 2016, it is estimated that approximately \$476,000 and \$476,000, respectively, of cumulative federal alternative minimum tax credits may be carried forward indefinitely as a credit against our regular tax liability.

As of December 31, 2017 and 2016, the Company had New Hampshire Business Enterprise Tax ("NHBET") credits of approximately \$853,000 and \$727,000, respectively. NHBET credits begin to expire in 2018. It is anticipated that these NHBET credits will not be fully utilized before they expire; therefore, a valuation allowance has been recorded related to these credits. The valuation allowance increased by \$126,000 and \$358,000 in the years ended December 31, 2017 and 2016, respectively.

Investment tax credits resulting from utility plant additions are deferred and amortized. The unamortized investment tax credits are being amortized through the year 2033.

The Company had a regulatory liability related to income taxes of approximately \$9,955,000 and \$760,000 as of December 31, 2017 and 2016, respectively. This represents the estimated future reduction in revenues associated with deferred taxes which were collected at rates higher than the currently enacted rates and the amortization of deferred investment tax credits.

A review of the portfolio of uncertain tax positions was performed. In this regard, an uncertain tax position represents the expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, it was determined that the Company had no material uncertain tax positions, and tax planning strategies will be used, if required and when possible, to avoid the expiration of any future net operating loss and/or tax credits.

The Company's practice is to recognize interest and/or penalties related to income tax matters in "Other, Net" in the Consolidated Statements of Income. We incurred no interest in 2017 and 2016. We incurred \$0 and \$0 of penalties during the years ended December 31, 2017 and 2016, respectively.

Note 9 – Debt

Long-term debt as of December 31, 2017 and 2016 consisted of the following:

	2017	
(in thousands)	Principal	Unamortized Debt Issuance Costs
Unsecured note payable to City of Nashua, 5.75%, due 12/25/2041	\$ 108,960	\$ -
Unsecured senior note payable due to an insurance company 7.40%, due March 1, 2021	3,600	27
Unsecured Business Finance Authority:		
Revenue Bonds (Series 2015A), interest rates from 4.00% to 5.00%, due January 1, 2046	20,035	1,527
Revenue Bonds (Series 2015B), 5.00%, due January 1, 2046	1,940	251
Revenue Bonds (Series 2014A), interest rates from 3.00% to 4.125%, due January 1, 2045	39,935	1,949
Revenue Bonds (Series 2014B), 4.50%, due January 1, 2045	5,125	118
Unsecured notes payable to bank, floating-rate, due March 1, 2030	3,134	16
Unsecured notes payable to bank, 3.62%, due June 20, 2023	1,438	9
Unsecured notes payable to bank, 4.20%, due December 20, 2041	1,221	7
Unsecured notes payable to bank, 4.83%, due December 20, 2041	930	5
Unsecured notes payable to bank, 4.25%, due June 20, 2033	780	7
Unsecured notes payable to bank, 4.90%, due March 6, 2040	588	36
Unsecured New Hampshire State Revolving Fund (“SRF”) notes (1)	20,023	182
Unamortized debt issuance costs for defeased obligations, allowed by regulation	-	95
Total	207,709	\$ 4,229
Less current portion	(5,575)	
Less unamortized debt issuance costs	(4,229)	
Total long-term debt, less current portion and unamortized debt issuance costs	\$ 197,905	

(1) SRF notes are due through 2048 at interest rates ranging from 1% to 3.8%. These notes are payable in 120 to 240 consecutive monthly installments of principal and interest. The 1% rate applies to construction projects still in process until the earlier of (i) the date of substantial completion of the improvements, or (ii) various dates specified in the note (such earlier date being the interest rate change date). Commencing on the interest rate change date, the interest rate changes to the lower of (i) the rate as stated in the note or (ii) 80% of the established 11 General Obligations Bond Index published during the specified time period before the interest rate change date.

(in thousands)	2016	
	Principal	Unamortized Debt Issuance Costs
Unsecured note payable to City of Nashua, 5.75%, due 12/25/2041	\$ 110,970	\$ -
Unsecured senior note payable due to an insurance company 7.40%, due March 1, 2021	4,000	36
Unsecured Business Finance Authority:		
Revenue Bonds (Series 2015A), interest rates from 4.00% to 5.00%, due January 1, 2046	20,555	1,614
Revenue Bonds (Series 2015B), 5.00%, due January 1, 2046	2,035	272
Revenue Bonds (Series 2014A), interest rates from 3.00% to 4.125%, due January 1, 2045	40,930	2,114
Revenue Bonds (Series 2014B), 4.50%, due January 1, 2045	5,215	123
Unsecured notes payable to bank, floating-rate, due March 1, 2030	3,332	17
Unsecured notes payable to bank, 3.62%, due June 20, 2023	1,505	11
Unsecured notes payable to bank, 4.20%, due December 20, 2041	1,250	7
Unsecured notes payable to bank, 4.83%, due December 20, 2041	950	5
Unsecured notes payable to bank, 4.25%, due June 20, 2033	815	7
Unsecured notes payable to bank, 4.90%, due March 6, 2040	602	38
Unsecured New Hampshire State Revolving Fund ("SRF") notes (1)	18,284	168
Unamortized debt issuance costs for defeased obligations, allowed by regulation	-	111
Total	210,443	\$ 4,523
Less current portion	(5,162)	
Less unamortized debt issuance costs	(4,523)	
Total long-term debt, less current portion and unamortized debt issuance costs	\$ 200,758	

(1) SRF notes are due through 2035 at interest rates ranging from 1% to 4.488%. These notes are payable in 120 to 240 consecutive monthly installments of principal and interest. The 1% rate applies to construction projects still in process until the earlier of (i) the date of substantial completion of the improvements, or (ii) various dates specified in the note (such earlier date being the interest rate change date). Commencing on the interest rate change date, the interest rate changes to the lower of (i) the rate as stated in the note or (ii) 80% of the established 11 General Obligations Bond Index published during the specified time period before the interest rate change date.

The aggregate principal payment requirements subsequent to December 31, 2017 are as follows:

(in thousands)	<u>Amount</u>
2018	\$ 5,576
2019	5,911
2020	6,169
2021	8,450
2022	6,343
2023 and thereafter	<u>175,260</u>
Total	<u>\$ 207,709</u>

Several of Pennichuck Water's loan agreements contain a covenant that prevents Pennichuck Water from declaring dividends if Pennichuck Water does not maintain a minimum net worth of \$4.5 million. As of December 31, 2017 and 2016, Pennichuck Water's net worth was \$118.0 million and \$122.1 million, respectively.

The 2014A, 2014B, 2015A and 2015B bonds were issued under a new bond indenture and loan and trust agreement, established with the issuance of the 2014 Series Bonds, which contains certain covenant obligations upon Pennichuck Water, which are as follows:

Debt to Capital Covenant - Pennichuck Water cannot create, issue, incur, assume or guarantee any short-term debt if (1) the sum of the short-term debt plus its funded debt ("Debt") shall exceed 85% of the sum of its short-term debt, funded debt and capital stock plus surplus accounts ("Capital"), unless the short-term debt issued in excess of the 85% is subordinated to the Series 2014 bonds. Thereby, the ratio of Debt to Capital must be equal to or less than 1.0. As of December 31, 2017 and 2016, Pennichuck Water Works has a Debt to Capital Coverage ratio of 0.5 and 0.5, respectively.

All Bonds Test - Additionally, Pennichuck Water cannot create, issue, incur, assume or guarantee any new funded debt, if the total outstanding funded debt ("Total Funded Debt") will exceed the sum of MARA (as defined in Note 11 of these consolidated financial statements) and 85% of its Net Capital Properties ("MARA and Capital Properties"), and unless net revenues or EBITDA (earnings before interest, taxes, depreciation and amortization) shall equal or exceed for at least 12 consecutive months out of the 15 months preceding the issuance of the new funded debt by 1.1 times the maximum amount for which Pennichuck Water will be obligated to pay in any future year ("Max Amount Due"), as a result of the new funded debt being incurred. Thereby, the ratio of Total Funded Debt to MARA and Capital Properties must be equal to or less than 1.0; as of December 31, 2017 and 2016, this coverage ratio was 0.4 and 0.4, respectively. Also, the ratio of EBITDA to the Max Amount Due must be equal to or greater than 1.1; as of December 31, 2017 and 2016, this ratio was 1.5 and 1.8, respectively.

Rate Covenant Test - If during any fiscal year, the EBITDA of Pennichuck Water shall not equal at least 1.1 times all amounts paid or required to be paid during that year ("Amounts Paid"), then the Company shall undertake reasonable efforts to initiate a rate-making proceeding with the NH Public Utilities Commission, to rectify this coverage requirement in the succeeding fiscal years. Thereby, the ratio of EBITDA to Amounts Paid must be equal to or greater than 1.1; as of December 31, 2017 and 2016, the Rate Covenant coverage ratio was 1.41 and 1.93, respectively.

Pennichuck East's loan agreement for its unsecured notes payable to a bank of \$8.1 million and \$8.5 million at December 31, 2017 and 2016, respectively, contains a minimum debt service coverage ratio requirement of 1.25. At December 31, 2017 and 2016, this ratio was 0.92 and 1.29, respectively. This covenant has not been met, and the Bank has waived such noncompliance. Also, Pennichuck East is required to maintain a maximum ratio of total debt to total capitalization of 65%; at December 31, 2017 and 2016, this ratio was 59% and 56%, respectively.

The Company's revolving credit loan facility with TD Bank contains a covenant that requires the Company to maintain a minimum fixed charge coverage ratio of at least 1.0; at December 31 2017 and 2016, the fixed charge coverage ratio was 0.81 and 1.05, respectively. The Company is also required to maintain an equity capitalization ratio of not less than 35%; at December 31, 2017 and 2016, the equity capitalization ratio was 34% and 36%, respectively. These covenants have not been met, and TD Bank has waived such noncompliance.

Under this agreement, the Company is also precluded from declaring or paying dividends, or making any other payment or distribution of its equity without the bank's prior written consent, except for: (1) its obligations under Rate Order No. 25,292 as it pertains to the Company's specific obligations under the City Bond Fixed Revenue Requirement ("CBFRR") which provides for payments of approximately \$707,000 per month of the note payable to the City of Nashua (the "City"), and quarterly dividends to the City for the remainder of this annual obligation, as defined by the order; and (2) a specific allowance, under Rate Order No. 25,292, whereby the Company is allowed to make distributions to the City from current earnings and profits in excess of the CBFRR, to provide funds to allow the City to reimburse itself for the costs incurred by the City relating to its efforts in pursuing the eminent domain proceedings from January 2002 through August 2009; provided, however, that such amount shall not exceed \$500,000 in any fiscal year, or \$5,000,000 in the aggregate, of all such distributions. No special dividend was declared or paid in 2017 or 2016.

Short-term borrowing activity under this revolving credit loan facility for the years ended December 31, 2017 and 2016 was:

(in thousands)	<u>2017</u>	<u>2016</u>
Established line as of December 31,	\$ 6,000	\$ 10,000
Maximum amount outstanding during period	5,574	1,118
Average amount outstanding during period	228	73
Amount outstanding as of December 31,	5,574	-
Weighted average interest rate during period	3.01%	2.22%
Interest rate as of December 31,	3.10%	2.251%

As of December 31, 2017 and 2016, the Company had a \$3.1 million and \$3.3 million, respectively, interest rate swap which qualifies as a derivative. This financial derivative is designated as a cash flow hedge. This financial instrument is used to mitigate interest rate risk associated with our outstanding \$3.1 million loan which has a floating interest rate based on the three-month London Interbank Offered Rate (“LIBOR”) plus 1.75% as of December 31, 2017. The combined effect of the LIBOR-based borrowing formula and the swap produces an “all-in fixed borrowing cost” equal to 5.95%. The fair value of the financial derivative, as of December 31, 2017 and 2016, included in our Consolidated Balance Sheets under “Other Liabilities and Deferred Credits” as “Derivative instrument” was \$374,000 and \$453,000, respectively. Changes in the fair value of this derivative were deferred in accumulated other comprehensive income (loss).

Swap settlements are recorded in the statement of income (loss) with the hedged item as interest expense. During the years ended December 31, 2017 and 2016, \$76,000 and \$123,000, respectively, was reclassified pre-tax from accumulated other comprehensive income (loss) to interest expense as a result of swap settlements. The Company expects to reclassify approximately \$109,000, pre-tax, from accumulated other comprehensive income (loss) to interest expense as a result of swap settlements, over the next twelve months.

Note 10 – Accumulated Other Comprehensive Income

The following table presents changes in accumulated other comprehensive income by component for the years ended December 31, 2017 and 2016:

(in thousands)	<u>Interest Rate Contract</u>	
	<u>2017</u>	<u>2016</u>
Beginning balance	\$ 258	\$ 201
Other comprehensive income (loss) before reclassifications	1	(17)
Amounts reclassified from accumulated other comprehensive income	46	74
Net current period other comprehensive income	47	57
Ending balance	<u>\$ 305</u>	<u>\$ 258</u>

The following table presents reclassifications out of accumulated other comprehensive income for the years ended December 31, 2017 and 2016:

<u>Details about Accumulated Other Comprehensive Income Components</u> (in thousands)	<u>Amounts Reclassified from Accumulated Other Comprehensive Income</u>		<u>Affected Line Item in the Statement Where Net Income is Presented</u>
	<u>2017</u>	<u>2016</u>	
Gain (loss) on cash flow hedges			
Interest rate contracts	\$ 77	\$ 123	Interest expense
	<u>(31)</u>	<u>(49)</u>	Tax expense
Amounts reclassified from accumulated other comprehensive income	\$ <u>46</u>	\$ <u>74</u>	Net of tax

Note 11 – Transaction with the City of Nashua

On January 25, 2012, in full settlement of an ongoing Eminent Domain lawsuit filed by the City of Nashua (“City”) and with the approval of the New Hampshire Public Utilities Commission (“NHPUC”), the City acquired all of the outstanding shares of Pennichuck Corporation (“Pennichuck”) and, thereby, indirect acquisition of its regulated subsidiaries. The total amount of the acquisition was \$150.6 million (“Acquisition Price”) of which \$138.4 million was for the purchase of the outstanding shares, \$5.0 million for the establishment of a Rate Stabilization Fund, \$2.6 million for legal and due diligence costs, \$2.3 million for severance costs, \$1.3 million for underwriting fees, and \$1.0 million for bond discount and issue costs. The entire purchase of \$150.6 million was funded by General Obligation Bonds (“Bonds”) issued by the City of Nashua. Pennichuck is not a party to the Bonds and has not guaranteed nor is obligated in any manner for the repayment of the Bonds. Pennichuck remains an independent corporation with an independent Board of Directors, with the City of Nashua as its sole shareholder.

Pennichuck Water Works, Inc. (“PWW”), Pennichuck East Utility, Inc. (“PEU”), Pittsfield Aqueduct Company, Inc. (“PAC”), Pennichuck Water Service Corporation, and The Southwood Corporation will continue as subsidiaries of Pennichuck Corporation and PWW, PEU and PAC will continue as regulated companies under the jurisdiction of the New Hampshire Public Utilities Commission. The terms of the merger and the requisite accounting and rate-setting mechanisms were agreed to in the NHPUC Order 25,292 (“PUC Order”) dated November 23, 2011.

Transactions with Related Party – City of Nashua

Pennichuck issued a promissory note to the City of Nashua in the amount of approximately \$120 million to be repaid over a thirty (30) year period with monthly payments of approximately \$707,000, including interest at 5.75%. Pennichuck recorded an additional amount of approximately \$30.6 million as contributed capital. The remaining outstanding balance of the note payable to the City at December 31, 2017 and 2016 was approximately \$109 million and \$111 million, respectively, as disclosed in Note 9 to these consolidated financial statements. During 2017 and 2016, dividends of approximately \$279,000 and

\$280,000, respectively, were declared and paid to the City. The dividends paid to the City during 2017 comprised approximately \$279,000 of regular quarterly dividends declared and paid; and no special dividend was declared or paid in 2017. The dividends paid to the City during 2016 comprised approximately \$280,000 of regular quarterly dividends declared and paid; and no special dividend was declared or paid in 2016.

Additional ongoing transactions occur in the normal course of business, between the Company and the City, related to municipal water usage, fire protection and sewer billing support services, and property taxes related to real property owned by the Company within the City of Nashua. For the years ended December 31, 2017 and 2016, respectively, approximately \$3.2 million and \$3.1 million were paid to the Company by the City for municipal water consumption, fire protection charges, and sewer billing support services. Conversely, the Company paid property taxes to the City of Nashua of approximately \$2.9 million for the year ended December 31, 2017, and approximately \$2.8 million for the year ended December 31, 2016.

Rate Stabilization Fund – Restricted Cash

As a part of the acquisition, Pennichuck agreed to contribute \$5,000,000 of the proceeds from the settlement transaction to PWW, which was used to establish a Rate Stabilization Fund (“RSF”), allowing for the maintenance of stable water utility rates and providing a mechanism to ensure the Company’s continued ability to meet its obligations under the promissory note to the City, in the event of adverse revenue developments. Restricted cash consists of amounts set aside in the RSF account and is adjusted monthly as required in the PUC Order, as discussed in Note 1 of these financial statements.

Municipal Acquisition Regulatory Asset (“MARA”)

Pursuant to the PUC Order, Pennichuck established a new Regulatory asset (MARA) which represents the amount that the Acquisition Price exceeded the net book assets of Pennichuck’s regulated subsidiaries (PWW, PEU, and PAC) at December 31, 2011. The initial amount of the MARA was approximately \$89 million for the regulated companies, offset by a non-regulated amount of approximately \$4.8 million. The MARA is to be amortized over a thirty (30) year period in the same manner as the repayment of debt service for the City’s acquisition bonds. The balance in the MARA at December 31, 2017 was approximately \$77.5 million, reduced by the non-regulated credit of approximately \$4.3 million.

Aggregate amortization expense for the years ended December 31, 2017 and 2016 totaled approximately \$1,917,000 and \$1,884,000, respectively.

The following table represents the total estimated amortization of MARA:

(in thousands)	Estimated Amortization Expense
2018	\$ 1,958
2019	2,006
2020	2,061
2021	2,119
2022	2,183
2023 and thereafter	<u>62,900</u>
Total	<u><u>\$ 73,227</u></u>

Note 12 – Rate Cases

Pennichuck Water Works, Inc.

On September 23, 2016, Pennichuck Water Works, Inc. (“PWW”) filed a request with the New Hampshire Public Utilities Commission (“NHPUC”) for a rate increase of 17.21% over its current rates for the test year 2015, for which 7.86% was related to a permanent rate increase, and 9.35% was related to a prospective step increase (associated with capital investments and other allowable expenditures in the twelve months following the test year). The overall rate increase is subject to the normal regulatory filing process with the NHPUC, as followed for all prior rate case filings, and as such, the final permanent rate increase granted will be effective retroactive back to the filing date, once approved by the NHPUC. The step increase, once approved and granted, would be earned on a forward-looking basis, as of the date of the order granting such increase. In addition, PWW requested that a temporary rate increase of 6.21% be granted as a subset of the final permanent rate increase, with the intention that this temporary rate increase would be approved very early in 2017. The Company, NHPUC Staff and the Office of Consumer Advocate agreed to a temporary rate increase at "current rates," and as such, there was no impact on ratepayers for any temporary rate increases.

The request for the overall permanent rate increase was based upon increases in PWW’s operating costs since the last allowed rate increase in 2010/2011 (for the 2009 test year), as well as revenues needed to pay the debt service on over \$40 million of infrastructure replacements made since the last rate case, with those dollars being invested in its real property assets, distribution and treatment systems, and other necessary capital items, to ensure continued compliance with the Safe Drinking Water Act and prudent ongoing replacement of aging infrastructure to properly maintain the company’s operating systems.

On November 7, 2017, the PUC issued Order No. 26,070 approving a permanent rate increase of 3.12% and a 7.69% step increase for its customers. The permanent rate increase was effective on a bills-rendered basis on and after December 7, 2016. The step increase is effective the date of the order, November 7, 2017.

Pennichuck East Utility, Inc.

On October 18, 2017, Pennichuck East Utility, Inc. (“PEU”) filed a request with the New Hampshire Public Utilities Commission (“NHPUC”) for a rate increase of 21.24% over its current rates for the test year 2016, for which 20.08% of this increase is related to a permanent rate increase and 1.16% is related to a prospective step increase (associated with capital investments and other allowable expenditures in the twelve months following the test year). The overall rate increase is subject to the normal regulatory filing process with the NHPUC, as followed for all prior rate case filings, and as such, the final permanent rate increase granted will be effective retroactive back to the filing date, once approved by the NHPUC. The step increase, once approved and granted, would be earned on a forward-looking basis, as of the date of the order granting such increase. In addition, PEU requested that a temporary rate increase of 13.70% be granted as a subset of the final permanent rate increase, with the intention that this temporary rate increase would be approved in early 2018, and with permanent rates being set in the summer or fall of 2018.

The last general rate increase for PEU was in 2014, based upon 2012 as a test year. Since then, PEU’s operating expenses have increased ratably, and for some items like local property taxes, well above the rate of inflation. Additionally, since the beginning of 2013, the Company has borrowed and invested over \$7.5 million in new capital assets to serve its customers through ongoing investments in infrastructure replacements and system improvements. The rate increase being requested will allow PEU to pay the debt service attributable to these new capital investments, pay its necessary operating costs, and continue to meet the needs of its customers now and into the future.

A hearing was held on the Temporary Rate request on February 26, 2018, where the Commissioners were asked to opine on a temporary rate increase of 12.24%, pursuant to a Settlement Agreement entered into between the Company, the PUC Staff and the Office of Consumer Advocate and other intervenors to the case. Upon receiving an order authorizing a temporary rate increase, the new rates resulting from that will begin to be billed to customers in 2018.

Note 13 – Subsequent Events

The Company has evaluated the events and transactions that have occurred through March 21, 2018, the date that these consolidated financial statements were available for issuance, for which no reportable events were discovered.