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April 16, 2009

VIA ELECTRONIC FILING AND HAND DELIVERY

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor North
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Harrisburg, PA 17105-3265

RE: Pennsylvania Public Utility Commission *et al.* v. Aqua Pennsylvania, Inc.; Docket Nos. R-2008-2079310, *et al.*; **MAIN BRIEF OF AQUA PENNSYLVANIA, INC.**

Dear Secretary McNulty:

Enclosed for filing with the Commission on behalf of Aqua Pennsylvania, Inc. are the original and nine (9) copies of Aqua Pennsylvania, Inc.'s Main Brief in the above-referenced proceeding. Copies of this document have been served in accordance with the attached Certificate of Service.

If you have any questions regarding this filing, please direct them to me. Please date-stamp the extra copy and return it with our messenger. Thank you for your attention to this matter.

Sincerely,

David P. Zambito

Counsel for *Aqua Pennsylvania, Inc.*

DPZ/kmg

Enclosures

c: Honorable Cynthia Williams Fordham
Per Certificate of Service

CERTIFICATE OF SERVICE
Docket No. R-2008-2079310 et al.

I hereby certify that I have this day served a true copy of the foregoing Main Brief, upon the parties, listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a party).

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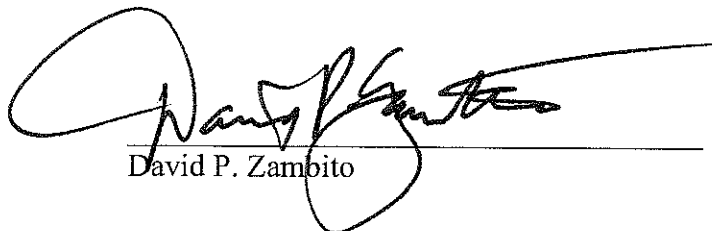
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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Administrative Law Judge
Cynthia W. Fordham

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Office of Small Business Advocate,	:	
Office of Consumer Advocate,	:	Docket Nos. R-2008-2079310
Kevin Tracey,	:	C-2008-2080943
Michael E. Waitlevertch,	:	C-2008-2082586
Daniel & Elizabeth Palumbo,	:	C-2009-2086699
Borough of Athens,	:	C-2009-2087277
Borough of Sayre,	:	C-2009-2090937
Borough of South Waverly,	:	C-2009-2090542
	:	C-2009-2090707
v.	:	C-2009-2090725
	:	
Aqua Pennsylvania, Inc.	:	

**MAIN BRIEF OF
AQUA PENNSYLVANIA, INC.**

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Dated: April 16, 2009

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I. INTRODUCTION

Aqua Pennsylvania, Inc., (“Aqua” or the “Company”) requests approval to implement Supplement No. 88 to Tariff Water-PA.P.U.C. No. 1 (“Supplement No. 88”), pursuant to Section 1307(g) of the Public Utility Code, 66 Pa. C.S. § 1307(g). Through Supplement No. 88, Aqua seeks to increase its Distribution System Improvement Charge (“DSIC”) surcharge cap from 5% to 7.5% in order to support its needed water main renewal program and accomplish necessary improvements to the infrastructure of its water distribution systems, without increasing the frequency of base rate filings and possibly extending the time between future base rate filings. The requested increase in the DSIC surcharge cap is intended to accommodate increased capital investment targeted toward, *inter alia*, 1,500 miles of main requiring near-term renewal. Aqua’s DSIC surcharge calculation and safeguards, which were approved by the Pennsylvania Public Utility Commission (“Commission”) and which otherwise remain unchanged in Supplement No. 88, ensure that Aqua’s DSIC is reflecting only DSIC-eligible projects in the DSIC formula and that Aqua is not over-earning compared to the authorized return on common equity reflected in the DSIC. For the reasons that follow, approval of the proposed tariff supplement is proper and in the public interest.

II. STATEMENT OF THE CASE

A. DESCRIPTION OF THE COMPANY

Aqua, formerly Pennsylvania Suburban Water Company,¹ is a public utility regulated by the Commission. Aqua is a wholly-owned subsidiary of Aqua America, Inc. Aqua’s principal executive offices are located in Bryn Mawr, Pennsylvania. (Aqua St. No. 1, at p. 1.)

¹ Pennsylvania Suburban Water Company changed its name to Aqua Pennsylvania, Inc., effective the close of business on January 16, 2004.

Aqua provides drinking water to approximately 420,000 customers, serving about 1.3 million people, throughout Pennsylvania. (Aqua St. No. 2, at p. 2.) Aqua currently has a Commission-approved DSIC surcharge with a maximum cap of 5% of billed revenues, which is set forth in Supplement No. 44 to Tariff Water-PA.P.U.C. No.1, Second Revised Page No. 20B. *See Petition of Philadelphia Suburban Water Company*, Docket No. P-00961036 (August 22, 1996). (Aqua St. No. 2, at p. 4.) The rates from Aqua's most recent base rate case went into effect on August 1, 2008, following a fully litigated proceeding. *See Pa. Pub. Util. Comm'n v. Aqua Pa., Inc.*, Docket Nos. R-00072711, R-00072711C0001 (Order entered July 31, 2008).

B. PROCEDURAL HISTORY

On December 8, 2008, Aqua filed Supplement No. 88, requesting an increase in the maximum allowable DSIC surcharge from 5% to 7.5%. The filing was made in accordance with the provisions of Sections 1307(g) and 1308(b) of the Public Utility Code, 66 Pa. C.S. §§ 1307(g), 1308(b). Included as part of the data in support of Supplement No. 88 was a study undertaken by Aqua that identified 1,500 miles of main requiring replacement in the near term.

The Office of Small Business Advocate ("OSBA") filed a Complaint and Public Statement on December 24, 2008, which was docketed at Docket No. C-2009-2080943. The Office of Consumer Advocate ("OCA") filed a Complaint and Public Statement on January 6, 2009, which was docketed at Docket No. C-2008-2082586. In addition, formal complaints were filed by the following: Kevin Tracey, at Docket No. C-2009-2086699; Michael Waitlevertch, at Docket No. C-2009-2087277; Daniel and Elizabeth Palumbo, at Docket No. C-2009-2090937; the Borough of Athens, at Docket Number C-2009-2090542; the Borough of Sayre, at C-2009-2090707; and the Borough of South Waverly, at Docket No. C-2009-2090725.

On February 6, 2009, the Commission instituted an investigation into the lawfulness,

justness, and reasonableness of the rates, rules, and regulations contained in the proposed Supplement No. 88. Pursuant to Section 1308(b), the proposed Supplement No. 88 was suspended until August 6, 2009, unless otherwise permitted by Commission order to become effective at an earlier date. On February 17, 2009, Aqua filed Supplement No. 91 to Tariff Water-PA.P.U.C. No. 1, suspending Supplement No. 88 until August 6, 2009.

On February 17, 2009, the Office of Trial Staff (“OTS”) entered a notice of appearance.

On February 19, 2009, Administrative Law Judge (“ALJ”) Cynthia Williams Fordham issued a Prehearing Order. On February 24, 2009, Prehearing Memoranda were submitted by Aqua, OCA, OTS, and OSBA. A prehearing conference was held on February 25, 2009, at which time a procedural schedule was established.

On March 3, 2009, Aqua served the direct testimony of William C. Packer (“Aqua St. No. 1”), and the direct testimony of Dennis J. Mahoney (“Aqua St. No. 2”).

On March 6, 2009, ALJ Fordham issued a second Pre-hearing Order, which set forth the procedural schedule and modifications to the Commission’s discovery rules.

On March 20, 2009, Aqua served the supplemental direct testimony of William C. Packer (“Aqua St. No. 1 (Supp.)”). On March 20, 2009, the following direct testimony was served: Brian Kalic on behalf of OSBA (“OSBA St. No. 1”); Robert Plonski on behalf of OTS (“OTS St. No. 1”); and Marilyn J. Kraus on behalf of OCA (“OCA St. No. 1”).

A public input hearing was held before ALJ Fordham on March 23, 2009, in Kingston Township, Pennsylvania. At the public hearing, the Borough of Athens, the Borough of Sayre, and the Borough of South Waverly were all granted inactive party status.

The parties engaged in extensive discovery in support of their respective positions. The evidentiary record was scheduled to close on April 1, 2009.

Evidentiary hearings were held before ALJ Fordham on March 31, 2009. During the hearing, counsel for OCA made certain on-the-record data requests. As a result, the record was held open until April 8, 2009, to allow the responses to the on-the-record data requests to be admitted into the record if necessary. On April 8, 2009, OCA requested that two responses to on-the-record data requests be admitted into the record as OCA Cross-Examination Exhibits 7 and 8. The two exhibits were admitted to the record. The record was closed on April 9, 2009.

A briefing schedule has been established by ALJ Fordham. Aqua's Supplement No. 88, requesting an increase in the maximum allowable DSIC surcharge cap from 5% to 7.5%, is ripe for disposition.

III. STATEMENT OF THE ISSUES

- A. Should Aqua, as a matter of both policy and fact, be permitted to increase its DSIC surcharge cap from 5% to 7.5%?

Suggested answer: *Yes.*

- B. Are Aqua's DSIC rates, rules, and regulations lawful, just, and reasonable?

Suggested answer: *Yes.*

IV. BURDEN OF PROOF AND STANDARD OF REVIEW

Aqua has the burden of proving that its tariff revision should be adopted by the Commission. *See* 66 Pa. C.S. § 332(a). It must establish by a preponderance of the evidence that it should be permitted to increase its DSIC surcharge cap to 7.5%. *See Re: Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement...Revising the Distribution System Improvement Charge*, Docket Nos. P-00062241,

et al., at p. 5 (July 11, 2007) (“*Petition of PAWC*”) (citing *Samuel J. Lansberry, Inc. v. Pa. Pub. Util. Comm’n*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990)).

The preponderance of evidence standard requires proof by a greater weight of the evidence. *Cmwlth. v. Williams*, 557 Pa. 207, 732 A.2d 1167 (1999). This standard is satisfied by presenting evidence more convincing, by even the smallest amount, than that presented by another party. *Brown v. Cmwlth.*, 940 A.2d 610, 614 n.14 (Pa. Cmwlth. 2008).

Additionally, any finding of fact necessary to support an adjudication of the Commission must be based upon substantial evidence. *Met-Ed Indus. Users Group v. Pa. Pub. Util. Comm’n*, 960 A.2d 189, 193 n.2 (Pa. Cmwlth. 2008) (citing 2 Pa. C.S. § 704). Substantial evidence is such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. *Borough of E. McKeesport v. Special/Temporary Civil Serv. Comm’n*, 942 A.2d 274, 281 (Pa. Cmwlth. 2008). Although substantial evidence must be “more than a scintilla and must do more than create a suspicion of the existence of the fact to be established,” *Kyu Son Yi v. State Bd. of Vet. Med.*, 960 A.2d 864, 874 (Pa. Cmwlth. 2008) (citation omitted), the “presence of conflicting evidence in the record does not mean that substantial evidence is lacking.” *Allied Mechanical and Elec., Inc. v. Pa. Prevailing Wage Appeals Bd.*, 923 A.2d 1220, 1228 (Pa. Cmwlth. 2007) (citation omitted).

V. SUMMARY OF ARGUMENT

Aqua’s request to increase its DSIC surcharge cap to 7.5% is proper and in the public interest, and is supported by the record evidence presented in this case. First, Aqua’s request to increase its DSIC surcharge cap to 7.5% will continue to facilitate improvements to the infrastructure of Aqua’s distribution system, thereby decreasing water main breaks that cause customer service interruptions and damage to municipal streets, mitigating local fire protection

risks, improving low pressure problems, and limiting discolored water. Second, the increase will further facilitate Aqua's continued acquisition of and improvements to small and non-viable water systems, consistent with Commission policy. Third, the requested increase in the maximum DSIC surcharge will afford Aqua the opportunity to undertake specific main remediation projects that might otherwise be deferred due to their cost, including increased water main and service line renewals targeted toward 1,500 miles of pipe requiring near-term replacement. Finally, the requested increase in Aqua's DSIC surcharge cap from 5% to 7.5% will help to limit increases in rate case expenses that would result if Aqua would have to file more frequent base rate cases to recover costs associated with increasing investment in main replacements and renewals.

Aqua's DSIC rates, rules, and regulations are lawful, just, and reasonable under the Commission-approved safeguards and Aqua's DSIC surcharge calculation. Aqua's DSIC reflects only DSIC-eligible projects in the DSIC formula and the earnings safeguard ensures that Aqua is not over-earning compared to its authorized return on common equity. In addition to a DSIC surcharge cap, Aqua's existing tariff contains the following Commission-approved safeguards: (a) there is an annual reconciliation; (b) Aqua is subject to a DSIC audit performed by the Commission; and (c) there is an earnings cap which provides that, if Aqua's achieved rate of return on common equity as shown in its Quarterly Earnings Reports filed with the Commission exceeds Aqua's authorized return on equity, the DSIC surcharge is set at 0%. Further, although Aqua has and expects to continue to be able to access certain funds to undertake capital projects, in the forms of deferred income taxes, low-interest financing, and depreciation, the benefits of such funds are accounted for in Aqua's quarterly DSIC surcharge calculation, are updated and reflected in each Quarterly Earnings Report filed with the

Commission, and were taken into consideration by Aqua in developing its Water Main Renewal Program. As such, Aqua's access to these incentives does not diminish Aqua's need for an increase in its DSIC surcharge cap to 7.5%.

VI. ARGUMENT

A. **AQUA SHOULD, AS A MATTER OF BOTH POLICY AND FACT, BE PERMITTED TO INCREASE ITS DSIC SURCHARGE CAP FROM 5% TO 7.5%.**

In response to the problem of the Commonwealth's aging water infrastructure, on December 18, 1996, the General Assembly adopted Section 1307(g) of the Public Utility Code. Section 1307(g) expressly authorizes a DSIC for water utilities, and provides as follows:

(g) RECOVERY OF COSTS RELATED TO DISTRIBUTION SYSTEM IMPROVEMENT PROJECTS DESIGNED TO ENHANCE WATER QUALITY, FIRE PROTECTION RELIABILITY AND LONG-TERM SYSTEM VIABILITY.-- Water utilities may file tariffs establishing a sliding scale of rates or other method for the automatic adjustment of the rates of the water utility as shall provide for recovery of the fixed costs (depreciation and pretax return) of certain distribution system improvement projects, as approved by the commission, that are completed and placed in service between base rate proceedings. The commission, by regulation or order, shall prescribe the specific procedures to be followed in establishing the sliding scale or other automatic adjustment method.

66 Pa.C.S. § 1307(g). The statutory authorization for the DSIC does not mandate a particular surcharge cap; instead, such restrictions were left by the General Assembly to the expert discretion of the Commission.

The DSIC was recently described by the Commission as follows:

The DSIC is a regulatory tool created in Pennsylvania that has since been adopted, in similar versions, in seven states.² The

² Indiana, Illinois, Ohio, Delaware, Missouri, New York, and Connecticut. (Footnote in original.)

purpose of the DSIC is to provide the Company with the resources to accelerate the rate of aging water distribution system infrastructure replacement in a timely, cost-effective manner. Water utilities with an approved DSIC tariff may charge a sliding scale of rates collected through a quarterly surcharge that enables the recovery of the fixed costs (depreciation and pre-tax return) of certain non-revenue producing, non-expense reducing distribution system improvement projects completed and placed in service between base rate cases. DSIC approved projects include main and valve replacement, main cleaning and relining, fire hydrant replacement, main extensions to eliminate dead ends, solutions to regionalization projects and meter change outs.

Petition of PAWC, at p. 5.

In authorizing water companies to establish DSICs, the Commission adopted a number of critical customer safeguards. Two of the more important safeguards were to establish a maximum DSIC surcharge cap, to ensure that companies could not indefinitely postpone filing of base rate cases, and to establish an earnings test that would set the DSIC at zero if the utility's quarterly-filed earning report demonstrated that the utility was exceeding its authorized return.³ The DSIC includes other safeguards, such as resetting the DSIC to zero at the time of the next base rate case; limiting the application of the DSIC to replacement of mains, services, meters and hydrants; providing notice to customers of any change in the DSIC rate; conducting audits of actual DSIC-eligible expenditures; and requiring an annual reconciliation audit to ascertain any over or under-collections, with any over-collections being refunded with interest at the time of the next DSIC calculation. *See Petition of Pennsylvania-American Water Company for Approval*

³ If a water company has a Commission-established return on common equity that was set less than two years prior to the DSIC filing, that authorized return is to be used. If not, then the authorized return to be used is that established by the Commission's staff in its quarterly reports on utility earnings. *See Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-00961031, Attachment A, "Sample Tariff Language," at p. 4. (August 16, 1996); *compare* Aqua St. No. 1, p. 4; Aqua Ex. No. WCP-1, Appx. D.

to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge, Docket No. P-00961031, Attachment A, “Sample Tariff Language,” at p. 4. (August 16, 1996); compare Aqua Tariff, Aqua Ex. No. WCP-1, Appx. D.

On August 26, 1996, the Commission issued an order authorizing Aqua (then Philadelphia Suburban Water Company) to establish a DSIC surcharge. *Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-00961036 (August 22, 1996). See Aqua Ex. WCP-1, Appx. C. Included as part of that Order was a form of a DSIC surcharge acceptable to the Commission. Subsequently, Aqua filed a tariff supplement containing a DSIC surcharge in accordance with the form authorized by the Commission, which the Commission later approved. *Id.* Pursuant to the Commission’s form of DSIC surcharge, Aqua’s DSIC currently includes a maximum cap of 5% of billed revenues. (Aqua St. No. 2, p.3; Aqua Ex. WCP-1, Appx. D.)

Aqua proposes in this proceeding to increase the maximum surcharge cap to 7.5% of billed revenues. As explained next, that increase is justified by the need to undertake additional infrastructure improvements in a timely manner, and by the fact that Aqua’s current pace of DSIC eligible improvements results in Aqua reaching the current cap in less than 18 months. (Aqua St. No. 1, pp. 6-7.)

1. The Success Of Aqua’s DSIC Cannot Be Reasonably Disputed.

a. DSIC Benefits Customers Through Improved Service and Reliability.

The DSIC directly benefits customers through infrastructure remediation and improved service and reliability. (OTS St. No. 1, at p. 7; OSBA St. No. 1, a p. 4; Aqua St. No. 2, at pp. 4-

5; *see also* *Petition of PAWC*, at p. 13.) Upgrades of deteriorated mains are essential to: reduce main breaks, service interruptions, and unaccounted for water; improve water quality and pressure; enhance fire protection; and achieve rate stability. (Aqua St. No. 2, at pp. 4-5; *see also* *Petition of PAWC*, at p. 13.)

Recognizing the need to continue to renew the distribution system in order to improve the infrastructure and provide reliable service to customers, Aqua has been replacing the water mains in its system for many years. The DSIC has been an integral tool in enabling Aqua to replace pipe at an average rate of 28 miles per year since the DSIC was first authorized.⁴ (Aqua St. No. 2, p. 7.) In 2008, over 90 miles of replacement main was installed. (Aqua St. No. 2, p. 8.) However, Aqua's DSIC recovery is limited to the 5% surcharge cap between rate cases, and as explained in Section VI.A.2.b of this Brief, Aqua has been reaching that cap in less than 18 months.

One example of the benefit provided by Aqua's DSIC eligible capital investments is the enhanced fire protection as evidenced by the numerous representatives of local fire companies that testified at the public input hearing regarding the importance and success of DSIC remediation. (Tr. at 127-139.) Other examples of substantial improvements in service and reliability from Aqua's DSIC eligible infrastructure remediation are illustrated by the comments at the public input hearings regarding Exeter Township, Shickshinny Lake Development, and Honesdale Consolidated Water Company. (Tr. at 89, 114, 119.) Another example of the benefit provided by Aqua's DSIC eligible capital investments is the economic development and job creation/security as explained by several individuals at the public input hearings. (Tr. at 92-93,

⁴ In addition to pipe replacement, 200 miles of pipe in Aqua's system have been cleaned and relined since the DSIC was implemented. The DSIC surcharge also has facilitated replacement of substantial numbers of meters, services and hydrants. (Aqua St. No. 2, p. 7.)

120, 123.)

The increased funding for infrastructure improvements through the DSIC provides Aqua's customers a number of benefits, including the reduction of main breaks and service interruptions they cause. (Aqua St. No. 2, at. P. 5.) Since the DSIC was implemented in 1998, Aqua has experienced a decline in the number of main breaks. (Tr. at 218.) Customer water quality is also improved through replacement, cleaning, lining, and tie-ins. (Aqua St. No. 2, at. P. 5.) Indeed, the number of customer complaints regarding discolored water has decreased from 190 in July 1998, to approximately 65 in November, 2008. (Tr. at 218.) Increased funding for infrastructure improvements further provides improved water flow and pressure as Aqua up-sizes its mains from 4" and 6" to 8" and 12". (Aqua St. No. 2, at. P. 5.) These benefits will be enhanced by increasing the cap to 7.5%, which will facilitate further needed infrastructure rehabilitation.

b. DSIC promotes the acquisition of small and non-viable water systems.

The DSIC also facilitates the achievement of the Commission's policy at 52 Pa. Code §§ 69.701, 69.711 of promoting the acquisition of small and non-viable water systems. Similarly, the DSIC promotes the Commission's policy at 52 Pa. Code § 69.721 of regionalization of water systems. In furtherance of the Commission's policies, Aqua has, since 2001, been acquiring various small water systems throughout Pennsylvania.⁵ (Aqua St. No. 2, p. 3.) Many of these distribution systems are in poor condition, have a high unaccounted water loss, and some are

⁵ See, e.g., Tr. at 63 (discussing Aqua's acquisition of Midway Manor water system); Tr. at 119 (discussing Aqua's acquisition of Honesdale Consolidated Water Company); Tr. at 114 (discussing Aqua's acquisition of water system at Shickshinny Lake Development).

considered “troubled” under the Commission’s definition of small non-viable systems at 52 Pa. Code § 69.711(a)(3). (Aqua St. No. 2, p. 3.)

Aqua has taken over 48 such small and often “troubled” systems, most of which are located in Aqua’s Waymart and White Haven operating divisions in Northeast Pennsylvania. (Aqua St. No. 2, p. 4.) These systems account for approximately 208 miles of main, or about 4% of Aqua’s total miles of main. (Aqua St. No. 2, p. 4.) Corrective water quality measures, including water main replacement, are needed for many of these troubled systems well in advance of filing for rate cases. (Aqua St. No. 2, p. 3.)

The need for additional DSIC-eligible infrastructure investment was illustrated by customer testimony at the public input hearing regarding water quality issues at the Midway Manor water system. (Tr. at 63, 65-66, 97, 100-101.) Similar to other small systems within Aqua’s distribution system, these problems originated with prior owners, and the cost to fix the system is exacerbated by, *inter alia*, cost prohibitive permitting requirements, including: moving the mains from the back of the property to the road in front of the properties and repaving the entire road. (Tr. at 123-124, 199.) Increasing Aqua’s maximum DSIC surcharge cap from 5% to 7.5% will facilitate the needed remediation of these smaller troubled systems in a timely manner and further promote the Commission’s policy to encourage large, well-run water companies to acquire small, nonviable water systems.⁶

⁶ It is to be noted that some of the problems of small water systems relate to the quantity and quality of the source of supply. Those repairs are not permitted to be recovered through the DSIC, and the burden of those capital costs must be borne by Aqua between rate cases. However, the DSIC does enable distribution system replacements to be undertaken promptly.

c. ***Federal and State Policy Favor Infrastructure Investment.***

Both federal and state policy encourage water infrastructure investment. Notably, the Pennsylvania Governor's Sustainable Infrastructure Task Force Report, entitled "Creating a Sustainable Solution for Pennsylvania," issued November 1, 2008, notes the need for increased water system infrastructure improvements:

Pennsylvania's drinking water and wastewater systems are critical to protecting public health, the environment and the continuing economic vitality of the Commonwealth; yet, many of these systems have been allowed to deteriorate, resulting in an urgent need for repairs and replacements. Leaking collection and distribution systems, poorly maintained treatment facilities and combined sewer overflows are common throughout the state.

Governor's Task Force Report, p. ii; Aqua St. No. 1, p. 10. Likewise, the federal 2008 Stimulus Act and the 2009 Stimulus Legislation referenced by OCA, (OCA St. No. 1, pp. 5, 7-8), are indeed recognitions by the United States Congress that improvements to the nation's water distribution systems are necessary and will help to stimulate the nation's economy through job retention and creation. As demonstrated by the testimony of various witnesses at the public input hearing, the DSIC helps to further the goals of water infrastructure investment and job retention and creation. (*See, e.g.*, Tr. at pp. 89-96, 121-127.)

2. **There is a Demonstrated Need to Build Upon the Success of the DSIC by Increasing the Cap from 5% to a Reasonable 7.5%.**

a. ***Aqua has Identified Four Categories of Pipe in Need of Near-Term Renewal.***

In determining whether to propose an increase to its DSIC surcharge cap, Aqua undertook a Water Main Renewal Program Study (the "Study"). (Aqua Ex. DJM-1.) The purpose of that Study was to identify pipe in Aqua's system of 5,476 miles of pipe that requires near-term renewal, principally through replacement, due to factors such as age, composition,

size, and leak rates. (Aqua St. No. 2, pp. 2, 10.) The study identified over 1,500 miles of four categories of pipe in need of near-term renewal.⁷ (Aqua Ex. DJM-1.)

The first category of pipe in need of renewal consists of “cement stovepipe.” This pipe is unique to the Southeast PA system. Aqua has 195 miles of “cement stovepipe” that remain in service. This type of pipe was installed in the 1890’s through the mid-1920’s and is particularly problematic due to the high frequency and severity of main breaks attributable to such pipes. (Aqua St. No. 2, p. 12; Aqua Ex. DJM-1.)

A second category of pipe in need of replacement is cast iron pipe installed between 1936 and 1948. Aqua has about 250 miles of this “wartime type” pipe in service in its system. As explained in the Study, due to manufacturing techniques then in use, this cast iron pipe experiences substantial breakage rates. (Aqua St. No. 2, pp. 12-13; Aqua Ex. DJM-1.)

The third category of pipe that is a candidate for near-term renewal is comprised of pipes with a diameter of four inches or less. Aqua has approximately 275 miles of main in its system that are four inches or less in diameter. (Aqua St. No. 2, p. 13.) This is particularly of concern in acquired water systems. Indeed, over 25% of the pipes in Aqua’s systems outside of Southeast PA are a diameter of four inches or less. This small diameter pipe is problematic because it breaks frequently and has severe hydraulic restrictions. In the Southeast Pennsylvania portion of its system, where Aqua has implemented a GIS system to track the location and frequency of main breaks, small water mains account for 15% of main breaks, even though they

⁷ At the historical average rate of 28 miles per year, it would take over 55 years to replace all of this pipe. This does not take into account that additional pipe would need to be replaced due to age or failure. This also does not take into account ongoing increases in materials and increased cost due to governmental requirements, which result in cost increases well in excess of the rate of inflation, nor the ongoing costs of meter, services and hydrant replacements. (Aqua St. No. 2, p. 9.)

represent only 3% of the system. (Aqua. St. No. 2, p. 13.) Aqua believes that similar leakage rates exist in its other service areas, and are a major contributor, along with age, to the substantially higher leakage rates experienced in these other, smaller systems. Many of these smaller systems were acquired relatively recently by Aqua after years of neglect and poor management by prior owners. Not only are the small diameter water pipes problematic, such pipe is inconsistent with the Commission's regulations on standards of design for water systems, which generally prohibit the use of pipe with a diameter less than six inches for distribution mains. *See* 52 Pa. Code § 65.17(b). In addition, larger pipes are needed for adequate fire protection. (Aqua St. No. 2, p. 13; Aqua Ex. DJM-1.)

The fourth category of pipe in need of near-term renewal is pipe that was installed prior to 1926. Aqua has over 800 miles of pipe throughout its system of that vintage, exclusive of pipe reflected in the other three categories. Much of this pipe is already over 100 years old and is a candidate for near-term renewal to proactively minimize main breaks and resulting service disruptions. (Aqua St. No. 2, p. 14; Aqua Ex. DJM-1.)

No party has disputed the conclusions of Aqua's Study that there is substantial pipe in Aqua's system that is in need of replacement in the near term future. The results of the Study support a need to increase the DSIC cap to 7.5% to facilitate these needed infrastructure replacements in the near term.

b. Aqua has been Reaching the Current Surcharge Cap in Approximately 18 Months, and a Moderate Increase to the Surcharge Cap will Support the Purpose of the DSIC.

Although the replacement of these inadequate water mains is recoverable under the DSIC surcharge, for a number of years Aqua's pipe replacement program under the DSIC program has resulted in DSIC-eligible expenditures reaching the current 5% DSIC surcharge cap in 18

months or less after the rate has been reset to 0% following conclusion of a base rate case. (Aqua St. No. 1, p. 6; Aqua Ex. WCP-1, Appx. F.) Indeed, the rates from Aqua's most recent base rate case went into effect on August 1, 2008, and Aqua anticipates reaching the current 5% DSIC surcharge cap by September 1, 2009. (Aqua St. No. 1, p. 6.) Under Aqua's current pattern of filing base rate cases approximately every two years, the 5% DSIC surcharge cap is reached well prior to the surcharge being reset to 0% in conjunction with new base rates. (Aqua St. No. 1, p. 6.) For example:

In the fourth quarter of 2005, Aqua's DSIC eligible expenditures could have supported \$3,264,260 in DSIC return and depreciation, which, based on applicable total quarterly revenue of \$62,000,469, would have yielded a DSIC rate of approximately 5.26%.

In the second quarter of 2006, Aqua's DSIC eligible expenditures could have supported \$4,742,228 in DSIC return and depreciation, which, based on applicable total quarterly revenue of \$65,751,860, would have yielded a DSIC rate of approximately 7.21%.

In the second quarter of 2008, Aqua's DSIC eligible expenditures could have supported \$4,551,782 in DSIC return and depreciation, which, based on applicable total quarterly revenue of \$75,543,940, would have yielded a DSIC rate of approximately 6.03%.

(Aqua Ex. WCP-1, p. 7.) Further, Aqua has experienced an approximate 10% to 13% increase in material, fuel, municipal permitting, and other related replacement costs for DSIC eligible projects over the last three (3) to five (5) years.⁸ (Tr. at 201.) Thus, the 2.5% increase in the DSIC surcharge cap would more accurately reflect the pace of ongoing improvements that are made to Aqua's distribution system, while maintaining the purpose of the surcharge cap, which is to ensure that water companies do not indefinitely avoid rate cases through an unlimited DSIC surcharge.

⁸ Indeed, the witness at the public input hearing that testified on behalf of South Waverly Borough, Sayre Borough, and Athens Borough acknowledged that the municipalities have experienced a similar increase in the cost of materials. (Tr. at 86-87.)

Although Aqua has not ceased construction of DSIC-eligible expenditures upon reaching the cap in prior instances, the need for additional expenditures to replace more mains may necessitate more frequent base rate filings or limitations on other needed capital expenditures in the absence of an increase in the DSIC surcharge. (Aqua St. No. 1, p. 7.) Aqua's resources for capital improvements are not unlimited, but an increase to the DSIC surcharge cap will, over time, provide additional revenue to support further construction. (Aqua St. No. 1, pp. 6-7.) Increasing the maximum cap incrementally by 2.5% would support approximately 50 to 70 additional miles of main replacements before reaching the proposed 7.5% DSIC cap, at the current replacement cost of approximately \$150 to \$200 per linear foot. (Aqua St. No. 2, p. 15.)

Increasing the maximum DSIC rate to 7.5% will help to mitigate the potential for increased rate case expenses resulting from more frequent base rate proceedings. As noted above, Aqua's current pace of DSIC-eligible additions results in Aqua reaching the DSIC cap in 18 months or less, substantially less than Aqua's recent general schedule of submitting base rate filings every two years. (Aqua St. No. 1, p. 6; Aqua Ex. WCP-1, Appx. F.)

It is important to recognize that Aqua is investing approximately \$200M annually in capital improvements including DSIC eligible projects, and the amount relating to DSIC is about half of that total. (Aqua St. No. 1, p. 8.) Thus, Aqua invests a significant amount in addition to just DSIC eligible projects. In the absence of a DSIC surcharge mechanism, the Company would be absorbing the effects of regulatory lag at greater levels than currently experienced with a DSIC surcharge. (Aqua St. No. 1, p. 8.) Although, as OCA points out, reaching the DSIC cap is only one of many factors that Aqua must consider in determining the frequency for filing base rate cases, it cannot reasonably be disputed that Aqua would find it necessary to file rate cases at shorter intervals than usual if the DSIC surcharge cap is not increased by 2.5%, which in turn

would drive greater rate case expenses over time.⁹ (OCA St. No. 1, p. 4; OSBA St. No. 1, p. 3; OTS St. No. 1, p. 8; Aqua St. No. 1, pp. 7-8.)

c. The Proposed DSIC Surcharge Increase Represents a Reasonable Incremental Increase.

The increased cost to customers under the proposed 7.5% surcharge cap is very reasonable when compared to the noticeable benefits. The current approximate monthly cost of the DSIC at the maximum surcharge rate of 5% for an average residential customer is \$2.57 per month. Increasing the maximum DSIC rate to 7.5% is expected to result in an estimated increased average residential customer cost of approximately \$1.28 per month at the 7.5% cap. (Aqua St. No. 1, p. 8.) However, even this small increase would not be experienced immediately. Because the DSIC rate rises gradually each quarter based upon DSIC-eligible construction previously completed, the average increase will take some time between rate cases to build up to this \$1.28 per month additional amount. Furthermore, as explained below, the Commission has established adequate safeguards in the DSIC process to ensure that the DSIC is appropriately monitored and that ratepayers are adequately protected.¹⁰

d. Conclusion.

Based on the foregoing, Aqua's request to increase its DSIC surcharge cap to 7.5% will improve the infrastructure of Aqua's distribution system by, *inter alia*, decreasing water main breaks that cause customer service interruptions and damage to municipal streets, mitigating

⁹ Aqua's most-recent rate case expense totaled \$925,000. (Aqua St. No. 1, p. 8.)

¹⁰ See Aqua Ex. WCP-1, App. D (setting forth the safeguards in the current DSIC); see also Aqua Ex. WCP-1, App. A (setting forth the safeguards in the proposed DSIC).

local fire protection risks, improving low pressure problems, and limiting discolored water. The increase will further facilitate Aqua's continued acquisition of small and non-viable water systems, consistent with Commission policy, and will afford Aqua the opportunity to undertake specific main remediation projects that might otherwise need to be deferred due to their cost. These projects include increased water main and service line renewals targeted toward 1,500 miles of main requiring near-term renewal. Further, the requested increase in the DSIC surcharge will help to avoid an increase in rate case expenses that would result if Aqua were to find it necessary to file more frequent base rate cases to recover costs associated with the need to accelerate its main replacements. Accordingly, Aqua should, as a matter of both policy and fact, be permitted to increase its DSIC surcharge cap from 5% to 7.5%.

B. OCA'S AND OSBA'S OBJECTIONS TO THE PROPOSED INCREASE TO THE DSIC CAP ARE WITHOUT MERIT AND SHOULD BE REJECTED.

OCA and OSBA have not challenged Aqua's identified need to undertake substantial main renewals in the near term, as demonstrated by its Study. They also have not disputed that Aqua's current pace of DSIC eligible replacements has resulted in Aqua reaching the current surcharge cap in less than 18 months. In addition, neither party has denied that main breaks and customer complaints have declined since adoption of the DSIC, or that repairs of troubled water systems are facilitated by the DSIC. Nevertheless, both parties object to the proposed increase to the surcharge cap. As explained next, the contentions of OCA and OSBA are either not relevant to the proposed increase to the surcharge cap or are incorrect. In essence, OCA and OSBA are attempting to relitigate the merits of the DSIC itself -- an issue that the Commission has long ago resolved in favor of the DSIC.

In stark contrast to the position of its fellow public advocates, OTS recognizes that an

increase in Aqua's DSIC surcharge cap will allow Aqua "to address its infrastructure remediation while mitigating the regulatory lag associated with recovery of expenditures." (OTS St. No. 1, p. 7.) OTS, therefore, recommends that the Commission approve the proposed increase in Aqua's DISC surcharge cap from 5% to 7.5%. (OTS St. No. 1, p. 6.)

1. The DSIC Does Not Represent Impermissible Single-Issue Ratemaking.

In an attack on the DSIC mechanism itself, rather than Aqua's requested increase in its DSIC surcharge cap, OSBA asserts that automatic adjustment clauses like the DSIC that postpone a general base rate proceeding are not beneficial to the public because they allegedly equate to a form of single-issue ratemaking without the comprehensive review of a base rate case. (OSBA St. No. 1, p. 3.) However, as noted by the Commission in granting Pennsylvania American's request for an increase in its DSIC surcharge cap from 5% to 7.5%:

The DSIC more accurately reflects the ongoing investments and improvements that are made in the water distribution system versus the less frequent but larger step increases that would result from base rate increases without an appropriately funded DSIC. The timely recovery of the fixed costs of infrastructure replacement through the DSIC provides an incentive for increased and continued levels of capital infusion. This results in a stronger and more reliable water distribution system for both current and future customers.

Petition of PAWC, at p. 18. Further, as discussed below in Section VI.B.2, *infra*, Aqua's DSIC surcharge calculation and Commission-approved safeguards ensure that the DSIC reflects only DSIC-eligible projects and is not over-earning as compared to Aqua's most current authorized return on common equity.

The DSIC mechanism has been authorized by both the General Assembly and the Commission. Accordingly, it does not represent impermissible single-ratemaking. *See*

generally, Pa. Indus. Energy Coalition v. Pa. Pub. Util. Comm'n, 653 A.2d 1336, 1350 (Pa. Cmwlth. 1995), *aff'd per curiam*, 543 Pa. 307, 670 A.2d 1152 (1996) (explaining that there is permissible and impermissible single-ratemaking). OSBA's objections to the DSIC on the grounds of "single issue ratemaking" should be rejected.

2. The DISC Safeguards Remain Effective.

In what is arguably an attempt to attack collaterally the DSIC mechanism itself, as well as Aqua's last base rate case, OCA and OSBA argue that the DSIC surcharge provides Aqua with an opportunity to recovery costs without the comprehensive review of base rates, including the rate of return, cost of common equity, depreciation reserve, and deferred taxes. (OSBA St. No. 1, p. 3; OCA St. No. 1, p. 5.) However, as explained below, Aqua's DSIC tariff, like Pennsylvania American Water Company's tariff, contains several Commission-approved safeguards to ensure that the DSIC is appropriately monitored and that ratepayers are adequately protected. These safeguards will remain in place under Aqua's instant proposal.

OCA and OSBA contend that increasing the DSIC surcharge cap would compromise the Commission-approved safeguards. (OCA St. No. 1, p. 5; OSBA St. No. 1, p. 3.) OCA asserts that the DSIC surcharge effectively allows increases in rate base and depreciation expense without any adjustment for offsetting revenue increases or expense decreases. (OCA St. No. 1, pp. 11-12.) Similarly, OSBA argues that an increase in the DSIC surcharge may cause Aqua to file base rate cases less frequently and, therefore, ratepayers would see none of the benefits inherent in any potential cost offsets. (OSBA St. No. 1, p. 4.) OCA further contends that the Commission-approved safeguard of requiring water companies to submit quarterly earnings is not an effective way of determining whether a utility is over-earning from a ratemaking standpoint. (OCA St. No. 1, p. 13.) Despite the assertions of OSBA and OCA to the contrary,

Aqua's DSIC ensures that it is reflecting only DSIC-eligible projects in the DSIC formula and is not over-earning compared to its most current authorized return on common equity.

First, there is an annual reconciliation based on a reconciliation period consisting of the twelve months ending December 31 of each year. (Aqua St. No. 1, at pp. 3-4; Aqua Ex. WCP-1, Appx. B, D.) The actual revenue received under the DSIC for the reconciliation period is then compared to Aqua's eligible DSIC revenues for that same period. (*Id.*) The difference between actual and eligible revenue is recouped or refunded, as appropriate, in accordance with Section 1307(e) of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 1307(e), over a one-year period commencing on April 1 of each year. (*Id.*) Therefore, this true up difference effectively acts as either a credit or extra surcharge to the tariff during each subsequent year, ensuring that Aqua does not recover an amount that is different from what the surcharge calculation allows. (Aqua St. No. 1, p. 3-4.)

Second, Aqua is subject to regular DSIC audit performed by the Commission's Bureau of Audits. (Aqua St. No. 1, at p. 4; Aqua Ex. WCP-1, Appx. B, D.) Aqua's most recent audit was performed in 2008. During these audits, a comprehensive review of the calculations, eligible projects, and revenues is performed by Commission Staff auditors. At the conclusion, a report is filed with the Commission that includes findings and recommendations. (Aqua St. No. 1, p. 4.)

Third, Aqua is required to file Quarterly Earnings Reports with the Commission. (Aqua St. No. 1, at pp. 4-5; Aqua Ex. WCP-1, Appx. B, D; *see also* Aqua Ex. WCP-2A (copy of Aqua's most-recent Quarterly Earnings Report).) These Quarterly Earnings Reports summarize Aqua's results and report on the return on rate base and return on common equity. In compliance with requirements for filing earnings reports, the Quarterly Earnings Reports filed by Aqua reflect normal ratemaking adjustments to present earned returns on a *pro forma* basis. (Aqua St. No. 1

(Supp.), pp. 2-3; *see, e.g.*, Aqua Ex. WCP-2.) If the return on common equity, shown on Schedule D-2 of Aqua's most recent report, exceeds the return on common equity used to calculate the DSIC surcharge, the DSIC surcharge must be reset to zero for that quarter. (Aqua St. No. 1, at p. 4.) The return on common equity utilized for DSIC is the same return on common equity determined by the Commission in Aqua's most recent base rate case concluded within the past two years.¹¹ (*Id.*) Importantly, if it has been more than two years since Aqua's last litigated case, the allowable rate of return is that calculated by the Commission staff in the last quarterly earning report. (Aqua St. No. 1, pp. 4-5.)

For the reasons explained above, OCA's and OSBA's contentions that the DSIC surcharge will allow the Company to overearn its allowed return are without merit. The existing DSIC safeguards remain effective.

3. Aqua's Need for a DSIC Cap Increase is Unrelated to its Approved Rate of Return.

OCA opposes the increase in Aqua's DSIC surcharge cap from 5% to 7.5% because of the rate of return on common equity Aqua received in its last base rate case. Specifically, OCA asserts that Aqua is seeking an increase in the DSIC surcharge cap because the 11% return on equity the Commission authorized Aqua to earn in its last base rate case allegedly causes Aqua to reach the current DSIC 5% surcharge cap in a shorter period of time. (Tr. at 230-231.) OCA's assertion is incorrect and must be rejected.

OCA's contention is based upon a simplified assumption that a higher authorized rate of return produces a higher DSIC revenue requirement. However, OCA fails to consider the

¹¹ Aqua's most-recent base rate case was fully litigated, and was concluded by Order entered July 31, 2008, at Docket No. R-00072711.

dynamic nature of the DSIC calculation. This is because the allowed return on equity affects the revenue base used to calculate the allowed surcharge. OCA's witness conceded that at an 11% allowed return on equity, the base rate revenue is higher and, thereby, increases the dollars that may be recovered under a 5% DSIC surcharge cap. (Tr. at 239-240.) As a result, to reach the DSIC surcharge cap under a higher cost of equity, Aqua would have to invest more money in DSIC eligible projects than compared to a lower cost of equity. (Tr. at 174.) Thus, despite OCA's assertion to the contrary, Aqua's 11% return on equity received in its last base rate case does not cause Aqua to reach its current DSIC 5% cap in a shorter period of time and, therefore, is not the reason for Aqua's requested increase in the DSIC surcharge cap. The reason, as explained previously, is that substantial additional main replacements are needed. Further, as explained above, the safeguards of Aqua's DSIC ensure that Aqua is reflecting only DSIC-eligible projects in the DSIC formula and is not over-earning compared to its most current authorized return on common equity.

4. Aqua's Need for a DSIC Cap Increase is Not Affected by Stimulus Incentives.

OCA further opposes Aqua's requested increase in the DSIC surcharge cap from 5% to 7.5% because of the possibility of low-interest financing and allowable tax depreciation deductions made available to water utilities by the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment of 2009. (OCA St. No. 1, p. 5.) Although Aqua expects to receive some benefits from these recent economic stimulus plans, these benefits will be accounted for in Aqua's Quarterly Earnings Reports and DSIC surcharge calculation. Further, the availability of these incentives does not diminish Aqua's need to enhance the renewal of its distribution system through an increase in its DSIC surcharge cap to 7.5%.

a. PennVEST Loans do Not Lessen Aqua's Need for a DSIC Cap Increase.

Low-interest financing from the stimulus plans is anticipated to be made available through PennVEST. Such low interest financing currently is available as an option for an overall main renewal or capital investment plan, including both DSIC and non-DSIC eligible projects. (Tr. at 161.) However, these programs are prioritized and the funding is not guaranteed. (Tr. at 161.) For example, Aqua currently has applications pending for \$33 million, \$4.7 of which pertains to projects that would otherwise be eligible for DSIC, such as replacement of mains. (Tr. at 162.) Therefore, there is no basis to conclude that low interest financing will obviate the demonstrated need to increase the DSIC surcharge cap.

Alternatively, OCA has suggested that low interest financing provides a benefit to Aqua that is not recognized in the DSIC formula. (Aqua. St. No. 1, p. 5.) Such contention is incorrect. PennVEST projects are not eligible for recovery under the DSIC surcharge. (OCA St. No. 1, p. 6; Tr. at 162.) Therefore, any main replacement project financed with PennVEST funds will not increase the DSIC. Further, any such low-interest financing obtained between rate cases is reflected both in Aqua's Quarterly Earnings Reports filed with the Commission, as well as in the quarterly DSIC surcharge calculation as part of both the debt ratio and Aqua's current weighted average cost of debt. (Tr. at 168, 192.) Indeed, OCA's witness conceded that the DSIC surcharge reflects new debt issuance, including PennVEST loans. (Tr. at 242.) Thus, any low interest rate debt that Aqua obtains will be considered both in establishing the quarterly DSIC surcharge and in determining whether Aqua is overearning its authorized equity return.

b. Deferred Taxes Are Factored into the DSIC Mechanism.

Similarly, the tax depreciation deductions made available to water utilities by the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment of 2009 are accounted for in both the Quarterly Earnings Reports filed with the Commission and Aqua's DSIC surcharge earnings safeguard calculations. The first-year depreciation deductions and allowance of bonus depreciation permit a water utility to take bonus depreciation over and above the normal tax depreciation rates prescribed by the tax code in the first year an asset is placed into service. (Tr. at 160.) The accelerated depreciation produces deferred income taxes, which must be paid in the future. The deferred taxes can be viewed as a source of additional capital for improvements. (Tr. at 177, 180.)

OCA incorrectly asserts that these deferred taxes are not taken into account by the DSIC surcharge. (OCA St. No. 1, p. 8.) However, as explained by Aqua's witness Mr. Packer, current deferred tax balances are accounted for as a reduction to rate base in Aqua's Quarterly Earnings Reports. (Tr. at 167.) Thus, the experienced return on equity reflected in the Earnings Reports is greater than would be the case if deferred taxes were not deducted from rate base. As explained above, if the return on common equity exceeds the return on common equity used to calculate the DSIC surcharge, the DSIC surcharge must be reset to zero for that quarter. This is a safeguard that has worked with a 5% DSIC cap and will continue to work with a 7.5% DSIC cap. Thus, any additional deferred taxes are accounted for in the operation of the DSIC. OCA's contention that deferred taxes offset any need to increase the surcharge cap is incorrect and must be rejected.

5. Depreciation is Accounted for in the DSIC Formula.

OCA also contends that Aqua's DSIC surcharge cap should not be increased from 5% to 7.5% because the depreciation reserve deduction is not considered in the DSIC surcharge calculation. (OCA St. No. 1, pp. 8, 10.) However, such assertion is not correct. The accumulated depreciation reserve associated with property reflected in the DSIC is specifically included in Aqua's DSIC surcharge calculation as acknowledged by OCA's witness. (Tr. at 243-244.) Furthermore, Aqua's overall accumulated depreciation reserve is updated with each Quarterly Earnings Report filed with the Commission, and that reserve, like deferred taxes, is a deduction from rate base. (Tr. at 163-166; Aqua Exs. WCP-4, WCP-5, WCP-6, WCP-7 (examples of Aqua's quarterly filings, each of which reflect the calculation of an applicable accumulated depreciation reserve).) Therefore, any increase in the depreciation reserve is reflected in determining Aqua's earned return, and whether that return exceeds the earnings cap. OCA's contention is erroneous and should be rejected.

6. Retirements Do Not Affect the DSIC Calculation.

OCA also contends that the DSIC formula fails to account for changes in depreciation resulting from retirements of property replaced by property reflected in the DSIC calculation. (OCA St. 1, p. 8.) Such contention fails to consider how retirements are reflected in the remaining life method of depreciation.

As OCA's witness acknowledged, Pennsylvania has adopted the remaining life method. (Tr. at 242.) That method provides for recovery of the undepreciated portion of the original cost of an asset by dividing that undepreciated portion by the anticipated remaining life. Moreover, under accepted accounting procedures, when an asset is retired, both the plant in service balance and the depreciation reserve are reduced by the original cost of the retired asset. (Tr. at 242-

243.) Therefore, a retirement does not affect rate base and, thus, does not affect the remaining undepreciated balance. (Tr. at 243.) As a result, retirements have no effect upon depreciation expense. OCA's contention that retirements are not reflected in the DSIC fails to consider that retirements do not affect net rate base or depreciation, and should be rejected.

7. Conclusion.

In summary, OCA and OSBA contend that Aqua's DSIC surcharge calculation fails to consider certain adjustments and, thus, assert that no increase to the DSIC surcharge cap is necessary. However, as explained above, these claimed adjustments are accounted for in Aqua's DSIC surcharge calculation, and/or through the operation of the Commission-approved safeguards, and these calculations are updated with each Quarterly Earnings Report filed with the Commission. Further, as most witnesses agreed, issues pertaining to return on rate base, return on common equity, low-interest financing, accelerated depreciation, deferred taxes, and depreciation reserve will be considered in Aqua's future base rate cases. (Tr. at 236-237; OTS St. No. 1, pp. 9-10; OSBA St. No. 1, p. 6.) Indeed, Aqua agrees that these issues should be thoroughly evaluated in Aqua's future base rate cases in accordance with the Public Utility Code and the Commission's regulations.

Based on the foregoing, Aqua's DSIC surcharge calculation and the Commission-approved safeguards ensure that Aqua's DSIC is reflecting only DSIC-eligible projects in the DSIC formula, and that Aqua is not over-earning compared to its most current authorized return on common equity. Accordingly, Aqua's DSIC rates, rules, and regulations are lawful, just, and reasonable under these safeguards and protections

C. OTS AGREES WITH THE PROPOSED INCREASE IN AQUA'S DSIC SURCHARGE CAP.

OTS concludes that an increase in Aqua's DSIC surcharge cap will allow Aqua "to address its infrastructure remediation while mitigating the regulatory lag associated with recovery of expenditures." (OTS St. No. 1, p. 7.) OTS, therefore, recommends that the Commission approve the proposed increase in Aqua's DISC surcharge cap from 5% to 7.5%. (OTS St. No. 1, p. 6.) OTS further asserts that the Commission should consider the DSIC in setting the cost of common equity in future base rate cases. (OTS St. No. 1, pp. 9-10.)

The assertion that the Commission should consider the DSIC in setting a future allowed return on equity appropriately is not considered in this proceeding, but should be examined in future rate cases along with all factors relevant to establishing the rate of return on equity -- including current market conditions, business and financial risk, and quality of service. Indeed, Aqua agrees that these issues should be evaluated in Aqua's future base rate cases in accordance with the Public Utility Code and the Commission's regulations.

VII. PROPOSED FINDINGS OF FACT

1. Aqua, formerly Pennsylvania Suburban Water Company, is a public utility regulated by the Commission. (Aqua St. No. 1, p. 1.)
2. Aqua provides drinking water to approximately 420,000 customer accounts, serving about 1.3 million people, throughout Pennsylvania. (Aqua St. No. 2, p. 2.)
3. Aqua operates three major regional divisions: Southeastern Pennsylvania, Central and Northern Pennsylvania, and Western Pennsylvania. Aqua's largest operating division includes the former Philadelphia Suburban Water Company territory and surrounding areas, the Southeast PA system. Aqua's other water systems are much smaller and are scattered

throughout the Commonwealth. Aqua's water systems include approximately 5,476 miles of water mains. (Aqua St. No. 2, p. 2)

4. In 1996, the Pennsylvania General Assembly enacted into law Section 1307(g) of the Public Utility Code, 66 Pa. C.S. § 1307(g).

5. The purpose of the DSIC is: (1) to provide water utilities with the resources to accelerate the rate of aging water distribution system infrastructure replacement in a timely, cost-effective manner; (2) to recover, through a sliding scale of rates, the fixed costs (depreciation and pre-tax return) of certain non-revenue producing, non-expense reducing distribution system improvement projects completed and placed in service between base rate cases; (3) facilitate the achievement of the Commission's policy at 52 Pa. Code §§ 69.701, 69.711, of promoting the acquisition of small and non-viable water systems; (4) promotes the Commission's policy at 52 Pa. Code § 69.721, of regionalization of water systems; and (5) reduce the potential need for more frequent base rate proceedings, with their attendant increased rate case expense. *See generally Petition of PAWC.*

6. DSIC approved projects include main and valve replacement, main cleaning and relining, fire hydrant replacement, main extensions to eliminate dead ends, solutions to regionalization projects and meter change outs. The DSIC directly benefits rate-paying customers through infrastructure remediation and improved service and service reliability. (OTS St. No. 1, at p. 7; OSBA St. No. 1, a p. 4; Aqua St. No. 2, at pp. 4-5; see also *Petition of PAWC*, at p. 13.)

7. Aqua currently has a DSIC surcharge with a maximum cap of 5% of billed revenues, which is set forth in Supplement No. 44 to Tariff Water-PA.P.U.C. No.1, Second Revised Page No. 20B. *See Petition of Philadelphia Suburban Water Company for Approval to*

Implement a Tariff Supplement Establishing a Distribution System Improvement Charge, Docket No. P-00961036 (August 22, 1996). (Aqua St. No. 2, p.3; Aqua Ex. WCP-1, Appx. C, D.)

8. On December 8, 2008, Aqua filed Supplement No. 88 to Tariff Water-PA.P.U.C. No. 1, requesting an increase in the maximum allowable DSIC surcharge from 5% to 7.5%. (Aqua Ex. WCP-1, Appx. B.)

9. Since 2001, Aqua has been acquiring various small water systems throughout Pennsylvania. (Aqua St. No. 2, p. 3.) Many of these distribution systems are in poor condition, have a high unaccounted water loss, and some are considered “troubled” under the Commission’s definition of small non-viable systems at 52 Pa. Code § 69.711(a)(3). (Aqua St. No. 2, p. 3.) There are 48 such systems in Aqua’s distribution system, which account for approximately 208 miles or 4% of Aqua’s total distribution system. (Aqua St. No. 2, p. 4.)

10. Aqua has been replacing the water mains in its system for many years. The DSIC has been an integral tool in enabling Aqua to replace pipe at an average rate of 28 miles per year since the DSIC was first authorized. (Aqua St. No. 2, p. 7.)

11. Aqua’s DSIC eligible capital investments have provided enhanced fire protection. (Tr. at 127-139.)

12. Aqua’s DSIC eligible investments have improved the water quality and service on several small systems, including Exeter Township, Shickshinny Lake Development, and Honesdale Consolidated Water Company. (Tr. at 89, 114, 119.)

13. Many of the smaller distribution systems in Aqua’s system, such as Midway Manor, have ongoing water quality problems that would benefit from an increase in the DSIC surcharge cap. (Tr. 63, 65-66, 97, 100-101.)

14. Aqua’s DSIC eligible capital investments promote economic development and job

creation/security. (Tr. at 92-93, 120, 123.)

15. Aqua has experienced an approximate 10% to 13% increase in material, fuel, municipal permitting, and other related replacement costs for DSIC eligible projects over the last three (3) to five (5) years, including municipality requirements of relocating mains and repaving the entire road. (Tr. at 123-124, 199, 201.)

16. In determining whether to propose an increase to its DSIC surcharge cap, Aqua undertook a Water Main Renewal Program Study. (Aqua Ex. DJM-1.) The purpose of that Study was to identify pipe in Aqua's system that requires near-term renewal, principally through replacement, due to factors such as age, composition, size, and leak rates. (Aqua St. No. 2, p. 10.) The study identified over 1,500 miles of four categories of pipe in need of near-term renewal. (Aqua Ex. DJM-1.)

17. Aqua has identified 195 miles of "cement stovepipe" that was installed in the 1890's through the mid-1920's and is particularly problematic due to the high frequency and severity of main breaks attributable to such pipes. (Aqua St. No. 2, p. 12; Aqua Ex. DJM-1.)

18. Aqua has identified 250 miles of cast iron pipe installed between 1936 and 1948, which has substantial breakage rates. (Aqua St. No. 2, pp. 12-13; Aqua Ex. DJM-1.)

19. Aqua has identified approximately 275 miles of main in its system that are four inches or less in diameter. (Aqua St. No. 2 p. 13.) This is particularly of concern in acquired water systems. This small diameter pipe is problematic because it breaks frequently and has severe hydraulic restrictions. Such pipe is inconsistent with the Commission's regulations on standards of design for water systems, which generally prohibit the use of pipe with a diameter less than six inches for distribution mains. *See* 52 Pa. Code § 65.17(b). In addition, larger pipes are needed for adequate fire protection. (Aqua St. No. 2 p. 13; Aqua Ex. DJM-1.)

20. Aqua has over 800 miles of pipe throughout its system that was installed prior to 1926, which Aqua has identified as a candidate for near-term renewal to minimize proactively main breaks and resulting service disruptions. (Aqua St. No. 2, p. 14; Aqua Ex. DJM-1.)

21. For a number of years Aqua's pipe replacement program under the DSIC program has resulted in DSIC-eligible expenditures reaching the current 5% DSIC surcharge cap in 18 months or less after the rate has been reset to 0% following conclusion of a base rate case, which is substantially less than Aqua's recent general schedule of submitting base rate filings every two years. (Aqua St. No. 1, p. 6; Aqua Ex. WCP-1, Appx. F.)

22. Aqua's recent DSIC-eligible additions could have supported DSIC charges in excess of the current 5% maximum DSIC surcharge. (Aqua St. No. 1, p. 6.) In the fourth quarter of 2005, Aqua's DSIC eligible expenditures would have yield a DSIC rate of approximately 5.26%. In the second quarter of 2006, Aqua's DSIC eligible expenditures would have yield a DSIC rate of approximately 7.21%. In the second quarter of 2008, Aqua's DSIC eligible expenditures would have yield a DSIC rate of approximately 6.03%. (Aqua Ex. WCP-1, p. 7.) Aqua's most recent base rate case went into effect on August 1, 2008, and Aqua anticipates reaching the current 5% DSIC surcharge cap by September 1, 2009. (Aqua St. No. 1, p. 6.)

23. Increasing the maximum cap by 2.5% would support approximately 50 to 70 additional miles of main replacements before reaching the proposed 7.5% DSIC cap, at the current replacement cost of approximately \$150 to \$200 per linear foot, as well as other DSIC-eligible projects. (Aqua St. No. 2, p. 15.)

24. Increasing the maximum DSIC rate to 7.5% is expected to result in an estimated increased customer cost of approximately \$1.28 per month at the cap. (Aqua St. No. 1, p. 8.)

25. In the absence of a DSIC surcharge mechanism, the Company would be absorbing the effects of regulatory lag at greater levels than currently experienced with a DSIC surcharge, which would adversely affect Aqua's ability to undertake infrastructure improvements. (Aqua St. No. 1, pp. 7-8.)

26. Aqua's DSIC includes the Commission-approved safeguard of an annual reconciliation based on a reconciliation period consisting of the twelve months ending December 31 of each year. The actual revenue received under the DSIC for the reconciliation period is then compared to Aqua's eligible DSIC revenues for that same period. The difference between actual and eligible revenue is recouped or refunded, as appropriate, in accordance with Section 1307(e) of the Code, over a one-year period commencing on April 1 of each year. (Aqua St. No. 1, p. 3-4.)

27. Aqua's DSIC includes the Commission-approved safeguard of a DSIC audit performed by the Commission, at intervals determined by the Commission. During these audits, a comprehensive review of the calculations, eligible projects, and revenues is performed by Commission Staff auditors. At the conclusion, a report is filed with the Commission that includes findings and recommendations. (Aqua St. No. 1, p. 4.)

28. Aqua's DSIC includes the Commission-approved requirement to file Quarterly Earnings Reports with the Commission. These Quarterly Earnings Reports summarize the Aqua's results and reports on the return on rate base and return on common equity. If the return on common equity, shown on Schedule D-2 of Aqua's most recent report, exceeds the return on common equity used to calculate the DSIC surcharge, the DSIC surcharge must be reset to zero for the quarter. (Aqua St. No. 1, pp. 4-5.)

29. The return on common equity utilized for DSIC is the same return on common

equity determined by the Commission in Aqua's most recent base rate case concluded within the past two years. If it has been more than two years since Aqua's last litigated case, the allowable rate of return is that calculated by the Commission staff in the last quarterly earnings report. (Aqua St. No. 1, pp. 4-5.)

30. Aqua's 11% return on equity received in its last base rate case does not cause Aqua to reach its current DSIC 5% cap in a shorter period of time and, therefore, is not a cause of Aqua's requested increase in the DSIC surcharge cap. (Tr. at 174, 239-240.)

31. Low-interest financing through PennVEST is available as an option for an overall main renewal or capital investment plan, including both DSIC and non-DSIC eligible projects. (Tr. at 161.) These programs are prioritized and the funding is not guaranteed. (Tr. at 161.)

32. Low-interest financing is reflected in Aqua's Quarterly Earnings Reports filed with the Commission, as well as in the DSIC surcharge calculation in the form of Aqua's cost rate of debt, which includes PennVEST loans. (Tr. at 168, 192, 242.)

33. Deferred taxes are accounted for in Aqua's Quarterly Earnings Reports as a reduction to rate base. (Tr. at 167.)

34. The accumulated depreciation reserve is included in Aqua's DSIC surcharge calculation and is updated with each Quarterly Earnings Report filed with the Commission. (Tr. at 163-166, 243-244; Aqua Exs. WCP-4, WCP-5, WCP-6, WCP-7 (examples of Aqua's quarterly filings, each of which reflect the calculation of an applicable accumulated depreciation reserve).)

35. The parties agree that issues pertaining to return on rate base, return on common equity, low-interest financing, accelerated depreciation, deferred taxes, and depreciation reserve must be considered in Aqua's future base rate cases. (Tr. at 236-237; OTS St. No. 1, pp. 9-10;

VIII. PROPOSED CONCLUSIONS OF LAW

1. The Commission has jurisdiction over the subject matter of, and the parties to, this proceeding.

2. Aqua bears the burden to establish by a preponderance of the evidence that the requested increase its DSIC surcharge cap to 7.5% is just and reasonable. *See Petition of PAWC*, at p. 5 (citing *Samuel J. Lansberry, Inc. v. Pa. Pub. Util. Comm'n*, 578 A.2d 600, 602 (Pa. Cmwlth. 1990)).

3. An appropriately funded DSIC provides Aqua with resources to address the problems presented by its aging water distribution system in an orderly and comprehensive manner.

4. The Commission has statutory authority to permit a sliding scale of rates or other automatic adjustment method for water utilities to recover the cost of distribution system improvement projects completed and placed in service between base rate proceedings. *Petition of PAWC*, at p. 12.

5. The Commission has the legal authority to approve a DSIC with a cap that exceeds 5% of billed revenues. 66 Pa. C.S. § 1307(g); *see also Petition of PAWC*, at pp. 12-13.

6. Aqua's request to increase its DSIC surcharge cap to 7.5% will improve the infrastructure of Aqua's distribution system by, *inter alia*, decreasing water main breaks that cause customer service interruptions and damage to municipal streets, mitigating local fire protection risks, improving low pressure problems, and limiting discolored water.

7. Aqua's request to increase its DSIC surcharge cap to 7.5% will further facilitate Aqua's continued acquisition of small and non-viable water systems, consistent with

Commission policy. 52 Pa. Code §§ 69.701, 69.711.

8. Aqua's request to increase its DSIC surcharge cap to 7.5% will afford Aqua the opportunity to undertake specific main remediation projects that might otherwise be deferred due to their cost, including increased water main and service line renewals targeted toward 1,500 miles of main requiring near-term renewal.

9. Aqua's request to increase its DSIC surcharge cap to 7.5% will help to avoid an increase in rate case expenses that would result if Aqua were required to file more frequent base rate cases in order to recover costs associated with the need to accelerate its main replacements.

10. The Commission-approved safeguards implemented by Aqua's DSIC ensure that Aqua's DSIC is reflecting only DSIC-eligible projects in the DSIC formula, and that Aqua is not over-earning compared to its most current authorized return on common equity.

11. Aqua's DSIC surcharge calculation and updated Quarterly Earnings Reports account for deferred taxes, the possibility of securing low-interest financing, and the accumulated depreciation reserve.

12. Aqua has met its burden to establish by a preponderance of the evidence that its DSIC rates, rules, and regulations are lawful, just, and reasonable.

13. Aqua has demonstrated that, as a matter of both policy and fact, the requested increase its DSIC surcharge cap from 5% to 7.5% is proper and in the public interest.

IX. PROPOSED ORDERING PARAGRAPHS

1. The request of Aqua Pennsylvania, Inc. to implement Supplement No. 88 to Tariff Water-PA.P.U.C. No. 1, filed December 8, 2008, is granted.

2. Supplement No. 88 to Tariff Water-PA.P.U.C. No. 1 shall become effective on one day's notice.

3. The Complaint of the Office of Small Business Advocate, docketed at Docket No. C-2009-2080943, is dismissed.

4. The Complaint of the Office of Consumer Advocate, docketed at Docket No. C-2008-2082586, is dismissed.

5. The formal Complaints filed by Kevin Tracey at Docket No. C-2009-2086699, Michael Waitlevertch at Docket No. C-2009-2087277, Daniel and Elizabeth Palumbo at Docket No. C-2009-2090937, the Borough of Athens at Docket Number C-2009-2090542, the Borough of Sayre at C-2009-2090707, and the Borough of South Waverly, at Docket No. C-2009-2090725 are dismissed.

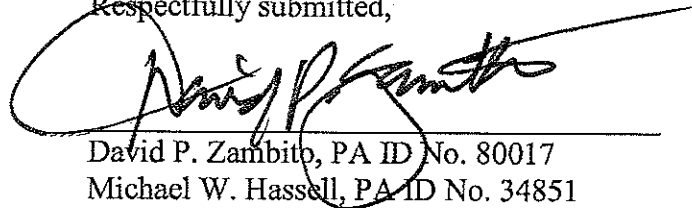
6. The Commission's Secretary shall mark Docket No. R-2008-2079310 as closed.

X. CONCLUSION

The requested increase in Aqua's maximum DSIC surcharge cap from 5% to 7.5% will assist Aqua in implementing its water main renewal program, which will accommodate increased water main and service line renewals targeted toward 1,500 miles of main requiring near-term renewal, and improve the infrastructure of its water distribution systems, service reliability, and water quality to its customers. The increase in the DSIC surcharge cap would more accurately reflect the ongoing improvements that are made to Aqua's distribution system. Further, Aqua's surcharge calculation and the Commission-approved safeguards ensure that Aqua's DSIC is reflecting only DSIC-eligible projects in the DSIC formula, and that Aqua is not over-earning compared to its most current authorized return on common equity. Accordingly, the increase in Aqua's maximum DSIC surcharge cap from 5% to 7.5% is proper and in the public interest, and should be permitted to go into effect on one day's notice.

WHEREFORE, Aqua respectfully requests that the Commission approve Supplement No. 88 to Tariff Water-PA.P.U.C. No. 1, increasing Aqua's DSIC cap from 5% to 7.5% of billed revenues, and permit it to go into effect on one day's notice.

Respectfully submitted,



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