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April 27, 2009

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor North
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RE: Pennsylvania Public Utility Commission *et al.* v. Aqua Pennsylvania, Inc.; Docket Nos. R-2008-2079310, *et al.*; **REPLY 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 Reply 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 Reply 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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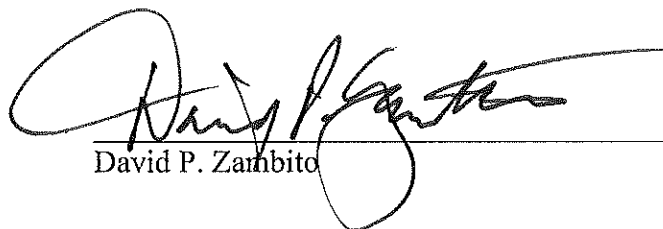
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DATED: April 27, 2009



David P. Zambito

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Administrative Law Judge
Cynthia W. Fordham

Pennsylvania Public Utility Commission,	:	
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.	:	

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

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I. INTRODUCTION

On April 16, 2009, pursuant to the schedule established by Administrative Law Judge Cynthia W. Fordham (“ALJ”), Aqua Pennsylvania, Inc. (“Aqua” or the “Company”), the Office of Consumer Advocate (“OCA”), the Office of Small Business Advocate (“OSBA”), and the Office of Trial Staff (“OTS”) filed main briefs in the above-captioned matter. In its Main Brief, Aqua explained its positions on the issues pending before the Pennsylvania Public Utility Commission (“Commission”) in this proceeding. In so doing, Aqua anticipated and, as a practical matter, responded to many of the arguments raised by the other parties in their main briefs. Nevertheless, it is appropriate for Aqua to respond to certain contentions advanced by other parties in their main briefs.

Aqua 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%. The parties that opposed the requested increase contend that Aqua failed to meet its burden to establish that the increase in the DSIC surcharge cap from 5% to 7.5% is just, reasonable, and in the public interest. However, a review of the evidence of record reveals that Aqua has established by a clear preponderance of the evidence that it should be permitted to increase its DSIC surcharge cap to 7.5%.

It is unrefuted that the requested increase in the DSIC surcharge will support Aqua’s needed water main renewal program and accomplish necessary improvements to the infrastructure of its water distribution systems, including increased capital investment targeted toward, *inter alia*, 1,500 miles of main requiring near-term renewal, without increasing the frequency of base rate filings. It is also uncontested that Aqua has been reaching the current surcharge cap in approximately 18 months and that a moderate increase to the surcharge cap will

support the purpose of the DSIC. Further, Aqua's DSIC surcharge calculation and safeguards, which were approved by the 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, as well as those more fully explained in Aqua's Main Brief, approval of the proposed tariff supplement is proper and in the public interest.

II. ARGUMENT

A. The Evidence of Record Establishes that Aqua has Demonstrated a Need to Increase its DSIC Surcharge Cap.

In their Main Briefs, OCA and OSBA assert that Aqua failed to introduce evidence to support its request to increase the DSIC surcharge cap from 5% to 7.5%. (OCA Main Brief, at p. 6; OSBA Main Brief, at p. 3.) However, such assertions ignore two critical, undisputed facts. First, Aqua has submitted unrefuted record evidence establishing that there is a current need to rehabilitate over 25% of Aqua's distribution system. Second, Aqua has for a number of years been reaching the current 5% DSIC surcharge cap in a short period of time following the surcharge being reset to 0% in a base rate case and, thus, the pace of needed rehabilitation cannot be attained within the limits of the current cap. As explained below, and more fully in Section VI.A of Aqua's Main Brief, OCA's and OSBA's argument that Aqua has failed to meet its burden is without merit and should be rejected.

1. The evidence of record demonstrates that Aqua has a current need to accelerate rehabilitation of its distribution system.

As explained at length in Section VI.A.2 of Aqua's Main Brief, Aqua has a current need to accelerate and expand its infrastructure improvement plan. In a study of its existing

infrastructure, Aqua identified over 1,500 miles of main in need of near-term renewal. (Aqua St. No. 2, pp. 2, 10; Aqua Ex. DJM-1.) The study identified replacement needs due to age, inadequate size, and experienced breaks. OCA and OSBA have barely acknowledged the results of this study throughout this proceeding or in their briefs. Clearly, 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.

The benefits of replacing these old, inadequate, or otherwise decaying mains has been conclusively demonstrated. The DSIC directly benefits customers through infrastructure remediation, resulting in improved service and reliability, and increased fire protection.¹ (OTS St. No. 1, at p. 7; OSBA St. No. 1, at p. 4; Aqua St. No. 2, at pp. 4-5; *see also* OCA Main Brief, at p. 17.) 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; Tr. at 218.) As explained at length in Section VI.A.1 of Aqua's Main Brief, it cannot reasonably be disputed that the increased funding for infrastructure improvements through an increase in the DSIC surcharge cap will provide Aqua's customers a number of benefits, including further reductions in main breaks and the service interruptions that they cause. (Aqua St. No. 2, at P. 5.) Indeed, no party in this proceeding has introduced evidence or even asserted otherwise.

Additionally, approximately 208 miles of main, or about 4% of Aqua's total miles of

¹ OCA states that at "Aqua's request" representatives from local fire departments testified that Aqua's DSIC eligible capital investments have provided enhanced fire protection. (OCA Main Brief, at p. 17.) Aqua objects to this characterization to the extent it implies that Aqua advised, instructed, prepared, or otherwise directed the testimony of the numerous representatives of local fire companies. The witnesses testimony was their own. (*See, e.g.*, Tr. at 131, 134-135.)

main, are in small and often troubled systems acquired by Aqua since 2001. (Aqua St. No. 2, p. 4.) It is undisputed that corrective water quality measures, including water main replacement, are needed for many of these troubled systems well in advance of filing rate cases, which include these systems, as illustrated by the testimony at the public input hearings. (Aqua St. No. 2, p. 3; Tr. at 63, 65-66, 97, 100-101, 123-124, 199.) It cannot reasonably be disputed that an increase in the DSIC surcharge cap will facilitate the needed remediation of these smaller systems, such as the Waymart and Midway Manor water systems.

In asserting that Aqua has failed to meet its burden to establish by a preponderance of the evidence that it should be permitted to increase its DSIC surcharge cap to 7.5%, OCA and OSBA disregard the substantial evidence of record that demonstrates Aqua has an immediate need to increase the pace at which it remediates its distribution system. Indeed, no party has introduced any evidence to the contrary. Accordingly, Aqua has presented substantial, unrefuted evidence that it has a need to increase the DSIC surcharge cap from 5% to 7.5% and, therefore, Aqua has met its burden of proof. *See Brown v. Cmwlth.*, 940 A.2d 610, 614 n.14 (Pa. Cmwlth. 2008).

2. The evidence of record demonstrates that Aqua has historically exceeded the current 5% DSIC surcharge cap.

As explained in Section VI.A.2.b of Aqua's Main Brief, the unrefuted evidence of record further establishes that for a number of years Aqua's investment in DSIC-eligible expenditures under its infrastructure improvement program has resulted in Aqua reaching the current 5% DSIC surcharge cap in 18 months or less after the rate has been reset to 0% following the 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, *i.e.*, 13 months since the rate was reset to 0%. (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.)

The evidence of record establishes that 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.² Indeed, in approving the request of Pennsylvania American Water Company ("PAWC") to increase its DSIC surcharge cap from 5% to 7.5%, the Commission noted the importance of the DSIC in reflecting ongoing improvements to infrastructure, stating in relevant part as follows:

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.

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. 18 (July 11, 2007) ("Petition of PAWC") (See also OTS Main Brief, at p. 6.)

In asserting that Aqua has failed to meet its burden to establish by a preponderance of the evidence that it should be permitted to increase its DSIC surcharge cap to 7.5%, OCA and OSBA disregard the unrefuted fact that Aqua has historically exceeded the current 5% DSIC cap in 18

² See *Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-000961036, at p. 5 (August 22, 1996) ("the DSIC amount will be capped at a relatively low level to prevent any long-term evasion of a base rate review of these plant costs").

months or less. Accordingly, Aqua has presented evidence more convincing than that presented by another party that it has a need to increase the DSIC surcharge cap from 5% to 7.5%. Aqua has met its burden of proof. *See Brown v. Cmwlth.*, 940 A.2d 610, 614 n.14 (Pa. Cmwlth, 2008).

3. OCA's and OSBA's arguments that Aqua has failed to satisfy its burden of proof are without merit and should be rejected.

(a) OCA errs in contending that the needed accelerated rehabilitation of mains can be undertaken within the current 5% DSIC surcharge cap.

OCA asserts that the increase in the DSIC surcharge cap is not necessary because Aqua was able to replace and rehabilitate 122 miles of main in 2008. Based upon this single year experience, OCA contends that Aqua could rehabilitate the 1,500 miles identified in the study without an increase to the current 5% DSIC surcharge cap. OCA's contentions overlook critical facts.

Initially, it must be emphasized that the 1,500 miles of main identified in Aqua's study are in need of near-term replacement. A majority of these mains are approaching, or have already exceeded, 100-year lives. (Aqua Ex. DJM-1.) A substantial portion of these 1,500 miles of pipe are substandard in design, particularly including the above-mentioned 208 miles of main located in small and often troubled water systems recently acquired by Aqua. There are also nearly 100 miles of transmission mains in need of near-term renewal. These transmission mains are critical to the operation of Aqua's system, and a failure of any of these mains can disrupt service to tens of thousands of customers. (Aqua Ex. DJM-1.) These critically important replacement projects should not be delayed for decades, as could occur under OCA's proposal that the DSIC surcharge cap not be increased.

OCA also fails to consider that the costs of replacements are rising at a pace that far

exceeds the rate of inflation.³ (Aqua St. No. 2, p. 9.) OCA also overlooks that major projects that have been deferred due to costs are projected to require an investment of more than \$1 million per mile, which is substantially greater than the average cost per mile that Aqua has incurred in prior years for DSIC-eligible main replacements. (Tr. at 214-215; OCA Cross Ex. 5.) Therefore, it is incorrect to suggest that all of these needed replacements can be undertaken within the current surcharge cap.

Additionally, OCA fails to consider that the DSIC is used for other projects besides simply main replacement. Indeed, in addition to pipe replacement, 200 miles of pipe in Aqua's system have been cleaned and relined since the DSIC was implemented. (Aqua St. No. 2, p. 7.) The DSIC surcharge also has facilitated replacement of substantial numbers of meters, services, and hydrants, all of which will continue to need to be replaced in the near future. (*Id.*) There are also unexpected other main replacements that, due to emergencies, will need to be undertaken on a priority basis before other scheduled replacement projects. (Tr. at 210.) These projects constrain Aqua's ability to undertake all of the 1,500 miles of main replacement identified in the study in a timely manner under the current 5% DSIC surcharge cap. Expansion of the cap to 7.5% will increase Aqua's ability to rehabilitate its system as needed.

Finally, as explained above and more fully in Section VI.A.2.b of Aqua's Main Brief, OCA overlooks the undisputed fact that Aqua has historically exceeded 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.) In fact, in the second quarter of 2008, Aqua's DSIC eligible expenditures could have supported \$4,551,782 in DSIC return

³ Aqua has experienced a 10% to 13% increase in material, fuel, municipal permitting, and other related replacement costs for DSIC eligible projects over the last three to five years. (Tr. at 201.)

and depreciation, which, based on an applicable total quarterly revenue of \$74,543,940, would have yielded a DSIC rate of approximately 6.03%. (Aqua St. No. 1, p. 6; Aqua Ex. WCP-1, p.7.) Increasing the surcharge cap to undertake further projects is needed where Aqua is already reaching the cap in a relatively short period of time.

(b) OSBA's argument that Aqua had a duty to prove, and failed to demonstrate, that the DSIC should be increased to exactly 7.5% is without merit.

OSBA contends that Aqua made no showing that the DSIC surcharge cap should be increase to exactly 7.5% rather than a lesser rate. However, OSBA overlooks the unrefuted fact that Aqua has historically exceeded 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, 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 an applicable total quarterly revenue of \$65,751,860, would have yielded a DSIC rate of approximately 7.21%. (Aqua St. No. 1, p. 6; Aqua Ex. WCP-1, p.7.) OSBA also disregards the unrefuted fact that, as discussed above and in Section VI.A.2 of Aqua's Main Brief, Aqua has an immediate need to expand and accelerate its main remediation program. Given that Aqua is currently exceeding the 5% DSIC surcharge cap and that Aqua needs to accelerate the rate of main remediation, it cannot be reasonably disputed that Aqua's DSIC eligible projects are sufficient to support a 7.5% DSIC surcharge cap.

Moreover, the exact level of the DSIC surcharge cap is an issue of policy for the Commission. As the Commission noted in its order approving an increase to PAWC's surcharge cap:

The [Public Utility] Code ... grants the Commission the legal authority and power to establish the Petitioner's DSIC rate cap at either 5% or 7.5% or, conceivably, at a higher percentage.

Petition of PAWC, at p. 12. It is important to recognize that the change to the surcharge cap is not akin to a base rate increase, where the utility bears the burden to prove the level of its test year plant in service claim. The surcharge cap is a limit, but the actual surcharge rate is determined by actual qualifying additions each quarter. Thus, the issue is not whether Aqua has demonstrated whether 7.5% is the one and only valid surcharge cap but, rather, whether 7.5% is a just and reasonable cap in light of record evidence of necessary plant rehabilitation requirements, the fact that Aqua is consistently exceeding the current cap in less than 18 months, and the intent of the surcharge cap to allow the surcharge to operate for a reasonable, but not excessive, time frame before being reset in a base rate case. The evidence in this case overwhelmingly supports the reasonableness of the proposed surcharge cap. OSBA's contentions must be rejected.

(c) OCA erred in claiming that Aqua failed to demonstrate that an increase in the DSIC would support the continued acquisition of small and non-viable systems.

OCA asserts that Aqua has not demonstrated a need to increase the DSIC surcharge to facilitate Aqua's continued acquisition of small and non-viable water systems. The evidence of record is directly contrary to OCA's assertions.

The Commission has a recognized policy to encourage large, well-run companies to acquire small non-viable water systems. *See* 52 Pa. Code §§ 69.701, 69.711. Such acquisitions often have an adverse impact upon the acquiring company. There are several reasons for this.

First, the revenues from the customers may not cover the cost to serve the acquired system.⁴ (Tr. at 191-192.) Thus, until Aqua files a rate case, it bears the operating and capital costs of the acquired facilities. Second, as acknowledged by OCA, many of these acquired small water systems require capital improvements that must be accomplished in advance of filing a base rate case. (OCA Main Brief, at p. 13.) The first negative effect must be borne by the acquiring company because the cost of acquired facilities are not reflected in the DSIC. However, it is by allowing Aqua a return on improvements that the DSIC facilitates the acquisitions of these small non-viable water systems, by providing a mechanism to encourage investment to begin to rehabilitate immediately such systems as necessary. Authorizing an increase to the DSIC surcharge cap will further the needed rehabilitation of such acquired systems by increasing revenues following needed investments.

OCA attempts to criticize Aqua's efforts to rehabilitate small systems by asserting that Aqua has declined to undertake DSIC eligible projects in some of these smaller acquired systems while undertaking projects on other smaller systems. (OCA Main Brief, at p. 14.) Specifically, OCA notes that Aqua declined to undertake main renewal at Aqua's Midway Manor water system due to the Township's requirement that Aqua, and therefore its customers, bear the full cost to repave the entire width of any disturbed roads. OCA contends that this is in direct contrast to assistance that Aqua provided to Exeter Township. (*Id.*) OCA further notes that the lowest bid to complete the remediation of Midway Manor is only a fraction of the amount that

⁴ OCA asserts, without citation to any empirical analysis, that these acquisitions generate additional profits for Aqua. (OCA Main Brief, at p. 13-14.) However, as explained by Aqua's witness, Mr. Packer, the revenues generated from small non-viable acquisitions that require extensive capital improvements and high operating costs do not necessarily result in net income between rate cases. (Tr. at 183, 191-192.) Therefore, an acquisition may actually reduce net return on plant investment.

Aqua spends on DSIC eligible projects. (*Id.*)

There is simply no basis to compare these two projects. Indeed, the circumstances and priority to remediate these two systems are simply not of record. If anything, the Midway Manor situation demonstrates that Aqua undertakes DSIC eligible expenses in a prudent fashion and avoids unreasonable costs that adversely impact ratepayers. As such, the Midway Manor situation directly refutes OCA's suggestion that Aqua may undertake replacements in a way that may not be "efficient."⁵ Further, Aqua's remediation of these two water systems does not refute the fact that Aqua has an immediate need to accelerate rehabilitation of its distribution system or that Aqua has historically exceeded the current 5% DSIC surcharge cap.⁶ OCA's contention that an increase to the DSIC surcharge cap will not further facilitate continued acquisition of small, non-viable systems is in error and must be rejected.

(d) OCA's claim that needed improvements will continue to be made in the absence of an increase to the DSIC surcharge cap fails to consider the limits on funds available for construction.

OCA contends that nothing suggests that Aqua will reduce its main improvement program or defer projects if the requested increase in the DSIC surcharge cap is not granted. (OCA Main Brief, at pp. 7, 11-12.) OCA relies on a statement by Aqua's witness, Mr. Mahoney, that Aqua will continue to provide safe and adequate service if the DSIC increase is denied. (Tr. at 210.) OCA also references four identified projects that Aqua potentially would have to defer

⁵ As the Commission noted in *Petition of PAWC*, contentions that recovery of costs through the DSIC are relatively automatic are "simply not accurate nor reflective of the extensive and thorough DSIC review process." *Petition of PAWC*, at p. 22.

⁶ OCA's attempted comparison of the miles of main in recently acquired systems to the total amount of mains rehabilitated in 2008 is equally without merit. Mains to be replaced in recently acquired systems represent only a fraction of the total amount of mains in need of near-term replacement. (Aqua St. No. 2, p. 4) It is erroneous to suggest that Aqua can focus all its DSIC-eligible expenditures on these systems for several years to the exclusion of other projects.

completing if the requested increase in the DSIC was not granted. OCA asserts that the cost to complete these projects is a fraction of what Aqua actually spends on DSIC eligible projects each quarter and, therefore, concludes that Aqua will not have to defer these projects if the DSIC increase is denied. (OCA Main Brief, at p. 12.)

In making these assertions, OCA overlooks the substantial evidence of record that Aqua has a need to accelerate and expand its main renewal program, as well as the unrefuted fact that Aqua has historically exceeded the 5% DSIC surcharge cap in 18 months or less. Further, OCA selectively disregards the testimony of Mr. Mahoney that, in the absence of an increase in the DSIC, Aqua will be forced to prioritize its remediation projects within its current economic constraints. (Tr. at 210.) OCA's own witness acknowledged that Aqua does not have unlimited access to capital and, thus, must prioritize its capital expenditures to meet funds available. (Tr. at 247.) This means that needed projects may have to be deferred absent an increase to the surcharge cap. As a result, the backlog of needed improvements will continue to grow. OCA also ignores that the purpose of the DSIC mechanism is to be proactive by improving infrastructure, rather than simply maintaining minimal requirements of the Pennsylvania Public Utility Code on an *ad hoc* basis. With 1,500 miles of main awaiting near-term rehabilitation, and Aqua already investing in DSIC eligible plant at a pace that results in it reaching the surcharge cap in 18 months or less, the status quo is not sufficient.

Finally, OCA disregards the fact that an increase in the DSIC surcharge cap from 5% to 7.5% would 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. OCA's apparent acceptance of the current pace of needed infrastructure replacements is short-sighted and should not be adopted.

- (e) *OCA's argument that Aqua failed to demonstrate that an increase in the DSIC will help avoid increases in rate case expenses is without merit.*

OCA contends that the amount DSIC eligible capital expenditures is only one factor in determining the frequency of Aqua's base rate cases, and that Aqua has filed a base rate case every two years notwithstanding the availability of the DSIC. (OCA Main Brief, at pp. 15-16.) From this, OCA concludes that an increase to the DSIC surcharge cap will have no effect on future rate case expenses. Such conclusion is incorrect.

First, Aqua has an annual capital investment budget of approximately \$200 million, one-half of which is comprised of DSIC eligible projects. (Aqua St. No. 1, at p. 8.) Thus, although DSIC expenditures are only one factor by which Aqua determines the frequency of its base rate cases, they are clearly a significant factor. Without a DSIC, Aqua either could not undertake its increased level of DSIC-eligible expenditures, or would have to increase substantially the frequency of its rate filings. Aqua notes that, prior to adoption of the DSIC, it had a cycle of filing for base rate relief every 15 months. *See Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-000961036, at p. 1 (August 22, 1996).

Second, OCA ignores the fact that Aqua has in recent years exceeded the 5% DSIC surcharge cap in 18 months or less. The evidence presented reveals that Aqua has a choice of either seeking resources adequate to maintain a two-year or more base rate case filing cycle (a 7.5% DSIC cap), or continuing with more limited resources (a 5% DSIC cap), which would encourage a less-than two year base rate case filing cycle. Rather than filing more frequent base rate cases to offset DSIC eligible capital investments that exceed the 5% surcharge cap, Aqua is seeking an increase in the DSIC surcharge cap from 5% to 7.5% to reflect more accurately the pace of the ongoing improvements that are made to Aqua's distribution system, while

maintaining the benefit of reducing rate case expenses by decreasing the projected frequency of base rate case filings.⁷

As the Commission noted, when faced with similar arguments in opposition to the increase to Pennsylvania American Water Company's DSIC surcharge cap:

We agree with the Petitioner that the evidence presented in the instant case reveals a choice between:

- (1) providing the Company with adequate resources (a 7.5% DSIC cap) to support a three-year or more base rate case filing cycle, or
- (2) providing the Company with more limited resources (a 5% DSIC cap) that would encourage a more frequent base rate case cycle – every year or two.

Petition of PAWC, at p. 21. The evidence in this case clearly demonstrates that an increase in the DSIC surcharge cap will permit accelerated replacement of critical infrastructure, while maintaining a reasonable base rate case filing cycle. OCA's claims to the contrary should be rejected.

- (f) *OSBA's argument that Aqua failed to make a showing of facts similar to those in the Pennsylvania American Water Company case is without merit.*

OSBA asserts that Aqua's alleged reliance on *Petition of PAWC* is misplaced because the Commission determined that it was not binding on other water companies. (OSBA Main Brief, at pp. 5-6.) OSBA further asserts that the Commission should deny Aqua's request to increase the DSIC surcharge cap from 5% to 7.5% because Aqua purportedly failed to make a showing of facts similar to those in *Petition of PAWC*. (OSBA Main Brief, at pp. 5-6.) OSBA's arguments lack merit and should be rejected because Aqua has met or exceeded the facts the Commission found critical in granting PAWC's request to increase its DSIC.

⁷ Aqua's most-recent rate case expense totaled \$925,000. (Aqua St. No. 1, p. 8.)

Initially, Aqua emphasizes that it has never claimed that the *Petition of PAWC* is controlling in the present matter, and that it has relied upon the record developed in this proceeding to support the need for an increase in its DSIC surcharge cap. Nevertheless, it is instructive to consider the facts that the Commission found important in *Petition of PAWC*.

In granting PAWC's request to increase its DSIC, the Commission found that in PAWC's most recent quarterly filing its DSIC eligible expenditures could have supported a DSIC rate of 6.36%. *Petition of PAWC*, at p. 13. Similarly, for a number of years Aqua's infrastructure 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.) For example, Aqua's DSIC eligible expenditures in the fourth quarter of 2005 could have supported a DSIC rate of approximately 5.26%; Aqua's DSIC eligible expenditures in the second quarter of 2006 could have supported a DSIC rate of approximately 7.21%; and Aqua's DSIC eligible expenditures in the second quarter of 2008 could have supported a DSIC rate of approximately 6.03%. (Aqua Ex. WCP-1, p. 7.)

In granting PAWC's request to increase its DSIC, the Commission also found that the requested increase to the surcharge cap was needed to upgrade existing, aging infrastructure. *Petition of PAWC*, at p. 16. Similarly, Aqua's requested increase in the DSIC surcharge cap is intended to accelerate and expand its main renewal program, including increased capital investment to accommodate, *inter alia*, 1,500 miles of main requiring near-term renewal.⁸

⁸ In this regard, it is to be noted that there were certain criticisms of PAWC's failure to submit a study of its infrastructure needs. *Petition of PAWC*, at p. 15. Aqua, as explained previously, undertook a detailed and unchallenged study identifying the need for increase main replacements in the near-term future.

The Commission also considered relevant evidence in PAWC's case that the increase in the surcharge cap would average about \$1 per month for customers. Similarly, the proposed increase to Aqua's DSIC surcharge cap amounts to an average increase of \$1.28 per month for customers at the maximum DSIC surcharge of 7.5%. (Aqua St. No. 1, p. 8.)

Finally, in granting PAWC's request to increase its DSIC, the Commission also found that PAWC's DSIC implemented the Commission-approved customer safeguards, including: resetting the DSIC to zero at the time of the next base rate case or if the utility is over-earning; providing notice to customers of any change in the DSIC rate; and conducting audits of actual expenditures and 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. *Petition of PAWC*, at p. 14. As explained more fully in Section VI.B.2 of Aqua's Main Brief, Aqua's DSIC tariff, like PAWC's tariff, contains all of these Commission-approved safeguards to ensure that the DSIC is appropriately monitored and that ratepayers are adequately protected. (Aqua St. No. 1, at pp. 3-5; Aqua Ex. WCP-1, Appx. B, D.) These safeguards will remain in place under Aqua's instant proposal.

Therefore, as the record demonstrates, Aqua's facts are equally or more compelling than those considered relevant by the Commission in *Petition of PAWC*. OSBA's contentions are without merit and should be rejected.

(g) *Summary.*

OCA and OSBA presented various arguments to support their assertion that Aqua has not met its burden of proving that it should be permitted to increase its DSIC surcharge cap from 5% to 7.5%. However, OCA and OSBA disregard the substantial evidence of record that establishes both an immediate need to accelerate rehabilitation of Aqua's distribution system and that Aqua

has historically exceeded the current 5% DSIC surcharge cap. Further, there is no evidence of record to the contrary. As explained more fully in Section VI.A of Aqua's Main Brief, OCA's and OSBA's argument that Aqua has failed to meet its burden is without merit and should be rejected.

B. Other Parties' Contentions Ignore the Operation of the Commission-Approved Safeguards.

1. OSBA's argument that the DSIC constitutes impermissible single-issue ratemaking is without merit and should be rejected.

Rather than challenging the evidence of record that establishes both an immediate need to accelerate rehabilitation of Aqua's distribution system and that Aqua has historically exceeded the current 5% 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 Main Brief, at pp. 6-7.) OSBA even goes so far as to assert, without any support, that the DISC mechanism is a violation of the prohibition against single-issue ratemaking.⁹ However, for the reasons that follow, as well as those more fully explained in Section VI.B.1, OSBA's arguments are without merit.

With respect to OSBA's assertion that an increase in a DSIC surcharge cap will permit companies to evade the detailed review of base rate proceedings, OSBA overlooks the fact that the modest increase to the surcharge cap will not enable Aqua to avoid rate case filings for an extended period. Under Aqua's current pattern of filing base rate cases approximately every two years, the 5% DSIC surcharge cap is reached in about 18 months. The requested increase in the

⁹ OSBA has failed to provide any explanation of how a Commission-approved surcharge mechanism, which was explicitly authorized by the General Assembly in Section 1307(g) of the Public Utility Code, 66 Pa.C.S. § 1307(g), is somehow a prohibited act.

DSIC surcharge cap from 5% to 7.5% clearly will not unduly lengthen the time between base rate cases. Furthermore, because the DSIC does not permit companies to reflect various types of plant additions, such as treatment plants or standpipes, rate case filing will not be postponed indefinitely by increasing the DSIC surcharge cap.¹⁰

Further, OSBA overlooks the Commission-approved customer safeguards that ensure 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, as discussed in Section VI.B.2 of Aqua's Main Brief. Indeed, OSBA disregards that 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.) OSBA also ignores that Aqua is subject to a DSIC audit performed by the Commission's Bureau of Audits, at intervals determined by the Commission.¹¹ (Aqua St. No. 1, at p. 4; Aqua Ex. WCP-1, Appx. B, D.) Finally, OSBA fails to account for the fact that Aqua is required to file Quarterly Earnings Reports with the Commission.¹² (Aqua St. No. 1, at pp. 4-5; Aqua Ex. WCP-1, Appx. B, D.) These safeguards protect customers from the claimed harms of any "single-issue"

¹⁰ About one-half of Aqua's annual capital investment is spent on non-DSIC eligible plant, and that plant in service is growing. (Tr. at 245-246.)

¹¹ 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, 4.)

¹² These Quarterly Earnings Reports summarize 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 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. (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.)

ratemaking. OSBA's contention must be rejected.

2. OTS's proposal erroneously suggests that Commission staff fails to consider the DSIC in setting a range for the allowable rate of return.

Although OTS supports Aqua's request to increase the DSIC surcharge cap from 5% to 7.5%, OTS indirectly suggests that Commission staff fails to consider the DSIC in setting a range for the allowable rate of return. (OTS Main Brief, at p. 9.) As a preliminary matter, it cannot be fairly contended that in a rate base proceeding the Commission does not thoroughly evaluate all of the information presented by parties with respect to rate of return, relevant to both the company in question and the appropriate barometer groups in setting a rate of return. OTS's own witness acknowledges that for companies with a DSIC, he would recommend the bottom end of his range of cost of equity recommendation to account for what he considers to be the effects of a DISC, and that his chosen barometer group does include at least some companies that charge a DSIC. (OTS St. No. 1, pp. 15-16.) Thus, there is no basis to contend that the Commission has ignored the existence of DISCs for water companies over the past decade in determining an appropriate cost of common equity. Issues concerning what the Commission does or does not do or should consider in setting Aqua's cost of common equity are not appropriately considered in this proceeding, but should be examined in future rate cases along with all factors relevant to establishing the rate of return, -- including current market conditions, business and financial risk, and quality of service.

Recognizing that rate of return is properly addressed in a base rate proceeding, OTS nevertheless recommends that the Commission's Bureau of Fixed Utilities Services ("FUS") be directed to prepare a separate calculation recognizing the reduction in risk associated with the DSIC rider if a utility's DSIC filing occurs more than two years after its last base rate filing. (OTS Main Brief, at p. 9.) However, there is nothing in the record to suggest that FUS fails to

consider relevant data in setting an appropriate quarterly DSIC rate of return if it has been more than two years since any water company's last litigated case. There is no basis for OTS to contend that FUS is failing to provide the Commission with an appropriate recommendation with respect to the allowed DSIC rate, and no Commission directive to FUS is necessary or appropriate. To require FUS to perform a special analysis at the end of a two-year period following implementation of new rates is unnecessary.

3. OCA's arguments that an increase in Aqua's DSIC is not needed because of the availability of other funds and accelerated depreciation are without merit and should be rejected.

(a) Low interest financing does not lessen Aqua's need for an increase in the DSIC cap.

OCA opposes Aqua's requested increase in the DSIC surcharge cap from 5% to 7.5% because of the possibility that Aqua may receive some amount of low-interest financing, such as PennVEST and other low interest loans, which may be made available to water utilities by the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment of 2009. (OCA Main Brief, at pp. 8-11.) The possibility that Aqua might obtain some portion of such low-interest financing does not obviate the need to increase the surcharge cap.¹³

Initially, it must be emphasized that 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. However, as explained more fully in Section VI.B.4.a of Aqua's Main Brief, any such low-interest financing obtained

¹³ OCA also challenges Aqua's testimony that a tightening credit market raised the interest rate on debt. (OCA Main Brief, at pp. 10-11.) Such challenge ignores the unrefuted testimony of Mr. Packer that Aqua's recent tax free debt issue was at a higher cost rate than its embedded cost of debt, and that Aqua could only secure about \$22 million of a planned \$80 million debt issue. (Tr. at 170.)

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.)

Although 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, OCA disregards the substantial evidence of record that establishes both an immediate need to accelerate rehabilitation of Aqua's distribution system and that Aqua has historically exceeded the current 5% DSIC surcharge cap, notwithstanding the availability of such low interest financing in the past. Further, these programs are prioritized and the funding is not guaranteed. (Tr. at 161.) Although Aqua's witness stated that he was not aware of PennVEST denying an Aqua loan application (Tr. at 183), the evidence of record establishes that Aqua does not apply for such loans unless it is certain to meet the qualifying criteria. (Tr. at 203.) Aqua currently has applications pending for \$33 million, \$4.7 million of which pertains to projects that would otherwise be eligible for DSIC, such as replacement of mains. (Tr. at 162.) However, Aqua has an annual capital investment budget of approximately \$200 million, one-half of which is comprised of DSIC eligible projects. (Aqua St. No. 1, at p. 8.) Thus, even assuming Aqua is granted the PennVEST loan, the amount of the loan that pertains to DSIC eligible projects is not a significant amount when compared to the amount required for Aqua's DSIC eligible projects and, therefore, will not offset Aqua's need to increase its DSIC surcharge cap to facilitate needed improvements to the infrastructure of its water distribution system. There is no basis to conclude

that low interest financing will obviate the demonstrated need to increase the DSIC surcharge cap.¹⁴

(b) Accelerated tax depreciation does not lessen Aqua's need for an increase in the DSIC cap.

OCA opposes Aqua's requested increase in the DSIC surcharge cap from 5% to 7.5% because of the allowable bonus or accelerated depreciation tax deductions made available to water utilities by the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment of 2009. (OCA Main Brief, at pp. 8-9.) Although Aqua expects to receive some benefits from the availability of accelerated depreciation, including bonus depreciation, these deductions will not avoid the need for an increase to the DSIC surcharge cap. As explained by Mr. Packer, accelerated and bonus depreciation deductions were available in 2008 and, yet, Aqua's level of investment still justifies a higher DSIC surcharge cap. (Tr. at 161.) The bonus depreciation provides a first year benefit of about 17 cents for every dollar invested. Thus, the bonus depreciation will not eliminate increasing investment needed for infrastructure.

Furthermore, as explained more fully in Sections VI.B.4 through VI.B.6 of Aqua's Main Brief, these benefits will be accounted for in Aqua's Quarterly Earnings Reports and DSIC surcharge calculation. 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.) Therefore, any benefit to earnings is accounted for under the earnings cap safeguard.

In asserting that deferred taxes lessen Aqua's need to increase the DSIC surcharge cap from 5% to 7.5%, OCA disregards the unrefuted evidence of record. Indeed, OCA overlooks the

¹⁴ Aqua emphasizes that its will continue to seek low interest financing for the benefit of its customers. However, whether Aqua receives such financing is outside its control, and should not serve as a basis for denying an increase to the surcharge cap.

fact that 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%. Moreover, OCA ignores the fact that the availability of these incentives does not refute the fact that Aqua has exceeded the current 5% DSIC surcharge cap in recent years, including 2008 when bonus depreciation was available. There is no evidence of record to suggest that bonus depreciation deductions will offset the need to increase the surcharge cap.¹⁵

(c) The rate of return determined in Aqua's last base rate case does not lessen Aqua's need for an increase in the DSIC cap.

OCA further opposes Aqua's requested increase in the DSIC surcharge cap from 5% to 7.5% because Aqua received the opportunity to earn an 11% rate of return on common equity in its last base rate case.¹⁶ (OCA Main Brief, at p. 10.) OCA essentially seeks to re-examine the components of Aqua's most recent rate base case, upon which Aqua's DSIC surcharge calculation is based. However, as explained in Section VI.B of Aqua's Main Brief, these issues are accounted for in Aqua's DSIC surcharge calculation, which is updated with each DSIC Quarterly Earnings Report filed with the Commission, as well as the Commission-approved safeguards. 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 must 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.) Aqua agrees that these issues should be evaluated in

¹⁵ OCA's position also ignores the intent of the stimulus plan, *i.e.*, to stimulate the economy. The availability of this money was intended to encourage construction of additional projects.

¹⁶ OSBA also notes the rate of return authorized for Aqua, and seeks to contrast that authorized rate of return to the 10.0% rate of return previously authorized for PAWC. OSBA fails to note, however, that there was a three and one-half year interval between these two decisions. Thus, OSBA's attempted comparison is invalid.

Aqua's future base rate cases in accordance with the Public Utility Code and the Commission's regulations.

OCA appears particularly bothered by the fact that the Commission considered management efficiency in setting Aqua's allowed rate of return. This is a red herring. The facts considered by the Commission in setting an allowed rate of return are not relevant in this proceeding; only the overall allowance matters. OCA's fixation on a management efficiency "bonus" of 22 basis points is no different from criticizing the Commission's rate of return allowance for allowing 22 basis points more on dividend yield, than was recommended by other parties, or complaining that the Commission considered results other than a DCF analysis in determining the allowed return. The fact is that, after consideration of all evidence, the Commission authorized an 11% return on equity, which was less than Aqua's claim and less than the ALJ's recommendation.

The fact that the Commission set Aqua's rate of return on common equity at 11% 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%. Similarly, the 11% rate of return does not refute the fact that Aqua has exceeded the current 5% DSIC surcharge cap in recent years, nor does it refute the fact Aqua anticipates reaching the current 5% DSIC surcharge cap by September 1, 2009, *i.e.*, 13 months since the rate was reset to 0%. (Aqua St. No. 1, p. 6.)

III. CONCLUSION

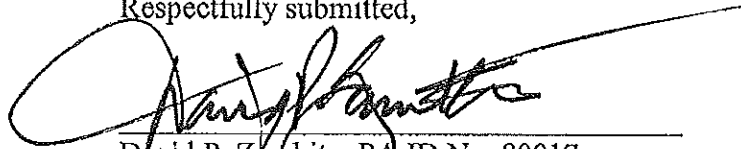
OCA and OSBA disregard the largely undisputed substantial evidence of record that establishes both a current need to accelerate rehabilitation of Aqua's distribution system and that Aqua has historically exceeded the current 5% DSIC surcharge cap.

The evidence of record demonstrates that 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. Further, the unrefuted evidence of record establishes that the increase in the DSIC surcharge cap would more accurately reflect the ongoing improvements that are made to Aqua's distribution system, which in recent years has exceeded the current 5% DSIC cap in 18 months or less. Additionally, 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 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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