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June 22, 2009

James J. McNulty, Secretary
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RE: Pennsylvania Public Utility Commission *et al.* v. Aqua Pennsylvania, Inc.; Docket Nos. R-2008-2079310, *et al.*; REPLIES OF AQUA PENNSYLVANIA, INC. TO EXCEPTIONS OF OTHER PARTIES

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 Replies to Exceptions 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.

Very truly yours,

Michael W. Hassell

MWH/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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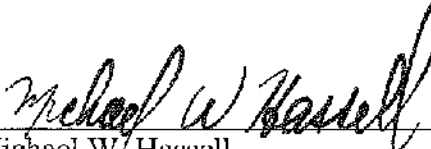
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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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.	:	

**REPLIES OF AQUA PENNSYLVANIA, INC.
TO EXCEPTIONS OF OTHER PARTIES**

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I. PROCEDURAL HISTORY

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.

A public input hearing was held in Shavertown, Pennsylvania on March 23, 2009. Evidentiary hearings were held at the Philadelphia State Office Building before Administrative Law Judge Cynthia W. Fordham on March 31, 2009. Pursuant to the schedule established by ALJ Fordham, Aqua, the Office of Consumer Advocate (“OCA”), the Office of Small Business Advocate (“OSBA”), and the Office of Trial Staff (“OTS”) filed main briefs on April 16, 2009, and reply briefs on April 27, 2009, in the above-captioned matter.

On May 22, 2009, ALJ Fordham issued a Recommended Decision (“RD”) concluding that Aqua satisfied its burden of establishing by a preponderance of the evidence that its DSIC rates, rules, and regulations are lawful, just, and reasonable. (*See* RD at p. 50.) The ALJ also

concluded that Aqua demonstrated that the requested increase in its DSIC surcharge cap from 5% to 7.5% is proper and in the public interest. (*See* RD at p. 50.)

On June 12, 2009, OCA and OSBA filed exceptions to the Recommended Decision of ALJ Fordham. Therein, OCA and OSBA assert that ALJ Fordham erred in concluding that Aqua met its burden to demonstrate the need to increase its DSIC surcharge cap. OCA further contends that approval of the requested increase in Aqua's DSIC surcharge cap will erode the consumer safeguards approved by this Commission. OSBA also asserts that, if approved, the increase in Aqua's DSIC surcharge cap should not be implemented until Aqua's next base rate case, and that such an increase cannot be used to remedy water systems acquired by Aqua.

Aqua herein files these Replies to the Exceptions of OCA and OSBA. For the reasons stated herein, as well as those more fully explained in Aqua's Main Brief and Reply Brief, the Exceptions are without merit and the Recommended Decision of ALJ Fordham should be adopted.

II. SUMMARY OF AQUA'S REPLIES TO EXCEPTIONS

OCA and OSBA, in essence, assert 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. 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 has been demonstrated 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. The record is also clear that a moderate increase to the surcharge cap will support the purpose of the DSIC.

OCA's claim that increasing the surcharge cap will erode important consumer safeguards is without merit. 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. Accordingly, the Commission should permit Supplement No. 88 to go into effect upon one-day's notice. Contrary to OCA's inferences, the increase to the surcharge cap will not result in Aqua avoiding rate filings for extended periods of time.

OSBA's contentions that an increase in the DSIC is contrary to provisions in the Public Utility Code prohibiting "unreasonable" increases to customers after a system acquisition similarly are without merit. The Commission would not authorize an acquisition if it concluded that rates to existing customers would be increased "unreasonably." Further, there is nothing "unreasonable" about recovery of DSIC-eligible expenditures, whether incurred to improve service to existing customers or newly acquired systems. Finally there is no basis in fact or law to justify postponing the effective date of the DSIC until after a future rate case.

III. AQUA'S REPLIES TO EXCEPTIONS

A. THE EVIDENCE OF RECORD ESTABLISHES THAT AQUA HAS MET ITS BURDEN TO DEMONSTRATE THAT THE DSIC CAP SHOULD BE INCREASED FROM 5% TO 7.5%.

In OCA Exception No. 2 and OSBA Exception No. 1, OCA and OSBA assert that Aqua failed to meet its burden to demonstrate that the cap on its DSIC should be increased from 5% to 7.5%. However, such assertions ignore two critical and largely 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 relatively 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 and Section II.A. of Aqua's Reply Brief, OCA's and OSBA's argument that Aqua has failed to meet its burden is without merit and should be rejected.

1. There is a demonstrated need to build upon the success of the DSIC by increasing the cap from 5% to a reasonable 7.5%.

As explained at length in Section VI.A.2. of Aqua's Main Brief and Section II.A. of Aqua's Reply 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.¹ (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 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.

¹ OCA asserts that Aqua did not have an accurate count of the footage of pipe in its system until after it filed its request to increase the DSIC cap. (See OCA Exceptions at p. 6.) However, this is a mischaracterization of the testimony of Aqua's witness Dennis J. Mahoney. Mr. Mahoney explained that Aqua knew the total amount of pipe on its system in Southeast Pennsylvania and that it extrapolated the study to include those older water systems outside the Southeast Pennsylvania service territory that were later acquired by Aqua. Aqua refined the total mileage of its system as reliable information regarding the amount of pipe on these later acquired systems became available. (See Tr. at pp. 205-207.)

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 water quality, service and reliability, and increased fire protection. (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 more fully 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 credible evidence to the contrary.

OCA contends that at Aqua's current pace of replacement and rehabilitation of 122 miles of pipe per year, Aqua would be able to replace or rehabilitate the 1,500 miles of pipe identified in its study in less than fifteen (15) years under the 5% cap on the DSIC.² (*See* OCA Exceptions at p. 6.) However, as explained below and in Section VI.A.2.b. of Aqua's Main Brief and Section II.A.2. of Aqua's Reply Brief, OCA disregards the unrefuted fact that, for a number of years, Aqua's investment in DSIC-eligible expenditures has caused it to reach the current 5% DSIC surcharge cap within a very short period of time, and that Aqua has experienced an increase in replacement costs associated with DSIC eligible projects. OCA further fails to

² Although OSBA failed to make a request for such information, OSBA similarly asserts that Aqua failed to provide a comparison of how long the backlog identified in the study would take to remediate without the requested DSIC increase as compared to with the requested increase. (*See* OSBA Exceptions at p. 3.)

consider that other mains, as well as meters, services and other DSIC eligible assets, will continue to need to be replaced in the future. Thus, it is unreasonable to contend that the needed near term replacement of pipe identified in Aqua's study can be undertaken under the existing surcharge cap. As such, it cannot be assumed that remediation can occur at a steady pace over a set number of years.

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 credible 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, has met its burden of proof.³

2. The evidence of record demonstrates that the pace of Aqua's investments has caused it to reach the current 5% DSIC surcharge cap.

As explained in Section VI.A.2.b. of Aqua's Main Brief and Section II.A.2. of Aqua's Reply 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

³ See *Brown v. Cmwlth.*, 940 A.2d 610, 614 n.14 (Pa. Cmwlth. 2008) (stating that the preponderance of evidence standard is satisfied by presenting evidence more convincing, by even the smallest amount, than that presented by another party).

September 1, 2009, *i.e.*, 13 months after 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.)

By way of 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.⁴ (See Aqua's Main Brief at p. 16; Tr. at 201.)

Thus, the evidence of record establishes that the incremental increase in the DSIC surcharge cap from 5% to 7.5% 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.⁵ Indeed, in approving the request of Pennsylvania

⁴ In its Exceptions, OCA incorrectly states that Aqua mentioned only two increases in the costs associated with DSIC-eligible expenditures. (See OCA Exceptions at p. 8.)

⁵ See *Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-000961036, (Continued on next page...)

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”).

OCA and OSBA assert that the unrefuted fact that Aqua has historically reached the current 5% DSIC cap in 18 months or less is not sufficient to satisfy Aqua’s burden because Aqua admittedly has continued to replace and rehabilitate its distribution system after reaching the cap.⁶ Although Aqua has not ceased construction of DSIC-eligible expenditures upon reaching the cap in prior instances, as explained more fully in Section VI.A.2.b. of Aqua’s Main Brief, 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

(...continued from previous page.)

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”).

⁶ OSBA asserts that under Section 1501 of the Public Utility Code, 66 Pa. C.S. § 1501, Aqua has an obligation to fund system improvements regardless of the presence of a DSIC mechanism. (See OSBA Exceptions at p. 3.) However, Aqua has never represented that it would not continue to meet its statutory obligations, nor has there been any assertion that Aqua has somehow been derelict therein.

in the DSIC surcharge. (Aqua St. No. 1, p. 7.) Aqua's resources for capital improvements are not unlimited, and its access to additional resources is under some stress in the current economic environment, 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% could 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.)

OCA asserts that the "rate of acceleration" in Aqua's investment in remediation of its distribution system is driven by the amount of revenues collected from customers through the DSIC, which OCA asserts is driven by base rate changes and acquisitions rather than by the DSIC cap percentage. (See OCA Exceptions at p. 7.) Such assertion does not make sense. The amount of revenues collected for purposes of DSIC-eligible expenditures is not driven by base rate changes or acquisitions. Rather, it is driven only by the pace of Aqua's DSIC eligible plant investments. Although increased rates may increase the total amount available under the DSIC cap, Aqua must first make the DSIC-eligible investments before it is entitled to recover any amounts it invests through the DSIC surcharge.

In summary, the positions of OCA and OSBA 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% disregards the unrefuted fact that Aqua has historically exceeded the current 5% DSIC cap in 18 months or less. 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%, and that such increase is in the public interest. Aqua has met its burden of proof.⁷

⁷ See *Brown v. Cmwlth.*, 940 A.2d 610, 614 n.14 (Pa. Cmwlth. 2008).

3. The recommended increase in Aqua's DSIC surcharge cap will facilitate the continued acquisition of small and non-viable systems.

In the Recommended Decision, ALJ Fordham concluded that an increase from 5% to 7.5% in Aqua's DSIC surcharge cap will further assist Aqua's need to improve the systems of the small water companies it acquires. (RD at 48.) OCA asserts that an increase in the DSIC is not necessary because Aqua purportedly receives additional revenue every time it acquires another system. (*See* OCA Exceptions, Section II.B.5.) OSBA asserts that increasing the DISC in order to finance repairs to water systems acquired by Aqua allegedly violates Section 529(a)(6) and 1327(a)(8) of the Public Utility Code, 66 Pa. C.S. §§ 529(a)(6), 1327(a)(8). The arguments of OCA and OSBA lack merit and should be summarily rejected.

a. OCA's argument that an increase in the DSIC cap is not necessary for Aqua to continue to acquire small water companies lacks merit and should be rejected.

The Commission has a recognized policy to encourage large, well-run companies, such as Aqua, to acquire small non-viable water systems. *See* 52 Pa. Code §§ 69.701, 69.711. OCA overlooks the fact that an increase in the DSIC surcharge cap will provide Aqua with additional capital to remediate small troubled systems that it might not otherwise acquire due to the major capital needed to make a small troubled system viable. Further, such acquisitions often have an adverse economic 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.⁸ (Tr. at 191-192.) Thus, until Aqua files a rate case, it bears the operating and capital

⁸ OCA asserts, without citation to any empirical analysis, that these acquisitions generate additional profits for Aqua. (OCA Exceptions at p. 12.) 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.

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 initial negative impact must be borne by the acquiring company because the cost of acquired facilities are not reflected in base rates. However, by allowing Aqua a return on remediations, the DSIC facilitates the acquisition of these small non-viable water systems by providing a mechanism to begin to immediately rehabilitate such systems. Authorizing an increase to the DSIC surcharge cap will further the needed rehabilitation of such acquired systems by increasing revenues following needed investments.

Additionally, OCA overlooks the fact that Aqua has already acquired many small water systems that are currently in need of remediation. Approximately 208 miles of main, or about 4% of Aqua's total miles of main, are in small and often troubled systems acquired by Aqua since 2001.⁹ (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 base rate cases, 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. OCA's contention that the Commission disregard the needed rehabilitation of small, acquired water

⁹ OCA suggests that the identified main replacements in small systems is not a problem, comparing the 208 miles of needed replacements to the 122 miles of main rehabilitated under the DSIC last year. This is a false comparison. If Aqua devoted all of its replacements under the DSIC to small system replacements, other needed replacements throughout Aqua's system would be postponed, resulting in adverse affects to service for larger numbers of customers. (Aqua St. No. 1, pp. 7-8; Tr. at 210.)

systems should be rejected.

b. OSBA's argument that increasing the DISC in order to finance repairs to water systems acquired by Aqua violates the Public Utility Code lacks merit and should be rejected.

OSBA asserts that Sections 529(a)(6) and 1327(a)(8) of the Public Utility Code, 66 Pa. C.S. §§ 529(a)(6), 1327(a)(8), prohibit increasing the DSIC to encourage acquisitions of small non-viable water systems or to fund repairs of such acquired systems because it would purportedly result in an “unreasonable” increase in the rates charged to preacquisition customers. (See OSBA Exception No.3, Section II.C.) OSBA’s position lacks merit.¹⁰

Sections 529(a)(6) and 1327(a)(8) of the Public Utility Code referenced by OSBA provide that the rates charged by the acquiring public utility to its preacquisition customers will not increase *unreasonably* because of the acquisition.¹¹ These sections do not provide that *any* increase in the rates charged to preacquisition customers is impermissible but, rather, prohibit only *unreasonable* increases in rates. Further, the determination of whether there is an “unreasonable” increase is made at the time of acquisition. At that time, the Commission can consider the repairs needed to the acquired system and the costs associated therewith, and can balance the interests of customers in safe and adequate service and the needed costs. Additionally, as stated above, the Commission’s policy supporting the use of the DSIC mechanism recognizes the need to correct water problems on these acquired small non-viable

¹⁰ Preliminarily, it should be noted that this argument is being raised for the first time in OSBA’s Exceptions. Neither Aqua nor ALJ Fordham have had an opportunity to address this argument in the proceeding below. Notwithstanding, and without waving objection thereto, Aqua refutes OSBA’s position.

¹¹ See 66 Pa. C.S. § 529(a)(6) (“the rates charged by the acquiring capable public utility to its preacquisition customers will not increase unreasonably because of the acquisition.”); 66 Pa. C.S. § 1327(a)(8) (“the rates charged by the acquiring public utility to its preacquisition customers will not increase unreasonably because of the acquisition.”).

water systems. See 52 Pa. Code §§ 69.701, 69.711. Finally, once these systems are acquired, the customers of such systems become the customers of Aqua and are subject to reasonable charges such as the DSIC surcharge. OSBA's assertion that the DSIC may not be used to recover investments in repairs to acquired systems is not supported by law and must be rejected.

4. The recommended increase in Aqua's DSIC surcharge cap represents a reasonable incremental rate increase.

OCA and OSBA both refer to the Company's proposal as a "50%" increase to the DSIC. (See, e.g., OCA Exceptions, at p. 2; OSBA Exceptions, at p. 2.) Such references exaggerate the effect of Aqua's proposal. 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.) This increase will facilitate millions of dollars in additional investment for the benefit of the economy and improvements to vital infrastructure. However, even this small increase will 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 in Section VI.B.2. of Aqua's Main Brief, the Commission has established adequate safeguards in the DSIC process to ensure that the DSIC is appropriately monitored and that ratepayers are adequately protected.

B. OCA'S OTHER EXCEPTIONS LACK MERIT AND SHOULD BE REJECTED.

1. OCA's argument that the increase in Aqua's DSIC cap will erode consumer safeguards is without merit and should be rejected.

In its Exception No. 1, OCA asserts that an increase in Aqua's DISC will diminish the Commission-approved consumer safeguards. (See OCA Exception No. 1, Section II.A.) More specifically, OCA contends that an increase in Aqua's DSIC will eviscerate the 5% cap safeguard. Apparently, OCA believes that the Commission limited the DSIC surcharge cap to 5%. However, as held in the Recommended Decision, the Commission has the statutory authority to permit a sliding scale of rates or other automatic adjustment methods for water utilities to recover the costs of DSIC projects, as well as the legal authority to approve a DSIC with a cap in excess of 5% of billed revenues. (RD at p. 49.)

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 Commission recently described the DSIC as follows:

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

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 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.

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. 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").¹²

¹² Both OCA and OSBA cite *Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-000961036 (August 22, 1996), for the proposition that Aqua agreed that "[i]f the cap is (Continued on next page...)

To the extent that OCA asserts the requested increase in the DSIC surcharge cap should be denied because the DSIC purportedly receives meager regulatory oversight, OCA disregards the Commission's recent forceful response that such contention is "simply not accurate nor reflective of the extensive and thorough DSIC review process." *Petition of PAWC*, at 22.

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.) As a result of the annual reconciliation, there is true up that 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 audits performed by the Commission's Bureau of Audits.¹³ (Aqua St. No. 1, at p. 4; Aqua Ex. WCP-1, Appx. B, D.) Third, Aqua is required to file Quarterly Earnings Reports with the Commission.¹⁴ (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).)

(...continued from previous page.)

reached, the company would not seek any additional increases." However, this statement was an acknowledgment that Aqua would not exceed the cap as approved by the Commission, rather than a concession that the Commission lacks the authority to change or adjust the DSIC surcharge cap at a future time.

¹³ 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.)

¹⁴ 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.)

Based on the foregoing, the Recommended Decision correctly concluded that the Commission has the statutory and legal authority to set a reasonable DSIC rate in excess of Aqua's current 5% cap. Further, as more fully explained in Section VI.B.2. of Aqua's Main Brief, Aqua's DSIC implements the Commission-approved 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. The existing safeguards remain effective and, therefore, OCA's argument should be rejected and the Recommended Decision should be adopted without modification.

2. OCA's argument that an increase in Aqua's DSIC is not needed because of additional sources of funding as a result of recent stimulus packages is without merit.

OCA asserts that an increase in Aqua's DSIC is not needed because of the availability of other funds and bonus depreciation as a result of recent stimulus packages. (*See* OCA Exception No. 2, Section II.B.4.) However, there is no basis to conclude that the low interest financing available as a result of the recent stimulus packages will obviate the demonstrated need to increase the DSIC surcharge cap. Similarly, there is no evidence of record to suggest that bonus depreciation deductions will offset the need to increase the surcharge cap.

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. (*See* OCA Exceptions, Section II.B.4.) The possibility that Aqua might obtain some portion of such low-interest financing does not obviate the need to increase the surcharge cap.

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 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.)

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.¹⁵

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 Exceptions, Section II.B.4.) 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 Aqua's witness 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

¹⁵ Aqua emphasizes that it 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.¹⁶

C. OSBA'S OTHER EXCEPTIONS LACK MERIT AND SHOULD BE REJECTED.

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

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. (See OSBA Exception No. 1, Section II.A.1.) 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.¹⁷ However, for the reasons that follow, as well as those more fully explained in Section VI.B.1. of Aqua's Main Brief, 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

¹⁶ 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. Further, it should be noted that the Commission itself has encouraged its jurisdictional utilities to seek federal stimulus money. See 39 Pa. Bulletin 2179.

¹⁷ 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.

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 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 filings will not be postponed indefinitely by increasing the DSIC surcharge cap.

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. (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. (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" ratemaking.

Based on the foregoing, as held in the Recommended Decision, an increase in the DSIC is not impermissible single-issue rate making. (RD at p. 47.) Accordingly, OSBA's contention must be rejected.

2. OSBA's argument that, if approved, the increase in the DSIC surcharge cap should not be implemented until Aqua's next base rate case is without merit.

In its Exception No. 2, OSBA asserts that, if approved, the increase in Aqua's DSIC surcharge cap should not be implemented until Aqua's next base rate case. (See OSBA

Exception No. 2, Section II.B.) OSBA contends that a delay would provide the Commission with an opportunity to set Aqua's rate of return on equity after consideration of the impact the higher DSIC cap will have on the Company's business risk.¹⁸ OSBA's contention lacks merit and should be rejected for the reasons that follow.

Delaying the implementation of the increase in the DISC surcharge cap, if approved, is not appropriate.¹⁹ OSBA's contention is not about delaying the implementation of the DSIC; the DSIC has been in place for a decade, and throughout the decade that the DSIC has been in operation the Commission has presumably considered what, if any, effect the DSIC has in setting allowed rates of return in rate cases and in setting the quarterly DSIC authorized rate of return. Rather, OSBA seeks to delay 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. OSBA contends that the delay in implementing the increase in Aqua's DISC will provide the Commission an opportunity to set Aqua's authorized rate of return on equity after consideration of the impact the higher DSIC cap will have on the Company's

¹⁸ As a preliminary matter, although OSBA's witness asserted that the Commission should account for an increase in the DSIC when setting a rate of return on equity, it should be noted that this proposal to delay implementation of the increase in the DSIC until Aqua's next base rate case was raised for the first time in OSBA's Reply Brief. As a result, Aqua has had no meaningful opportunity to introduce evidence on this issue, let alone address the merits of this proposal. Thus, it is not surprising that the ALJ did not address this proposal. Notwithstanding, and without waiving objection thereto, OSBA's contention lacks merit and should be rejected for the reasons discussed herein.

¹⁹ In granting the increase in the DSIC requested by PAWC, the Commission did not order that the increase could not be implemented until PAWC's next base rate case, nor did it order any other delay. Similarly, when DSIC's were first authorized, the surcharges became effective outside of a base rate proceeding. See, e.g., *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, Docket No. P-00961031 (August 16, 1996); *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).

business risk. (See OSBA Exceptions, at p. 6.) However, OSBA has offered no basis to conclude that Aqua's current authorized return is excessive or that the DSIC should be postponed indefinitely.

OSBA's citation to the Joint Testimony of Chairman Cawley and Commissioner Gardner in hearings concerning proposed gas DSIC legislation does not support OSBA's position. (See OSBA Exceptions, at p. 7.) In that testimony, the Commissioners stated:

Companies using DSIC must complete a general rate case prior to implementing DSIC, *unless they have completed one within the prior three years*, which addresses single-issue ratemaking concerns.

Joint Testimony of Chairman James H. Cawley And Commissioner Wayne E. Gardner Pennsylvania Public Utility Commission, Hearing before the PA House Consumer Affairs Committee Regarding House Bill 744, P.N. 830, at p. 5 (emphasis added). Aqua's last fully litigated rate case was completed in July 31, 2008, well within the three-year period referenced in the Joint Testimony. Thus, the Commissioners' testimony does not support OSBA's proposal for a delay in implementation.

OSBA's citation to a recent Columbia Water Company decision setting a 10.5% allowed rate of return also does not support OSBA's proposal for a delay in the effective date of the increase to the DSIC surcharge cap. Columbia Water Company has an unusually high common equity ratio of 64.2%, well in excess of Aqua's common equity ratio of less than 50%. See *Pennsylvania Public Utility Commission v. Aqua Pennsylvania, Inc.*, Docket Nos. R-000727111, *et al.*, at p. 31 (Order entered July 31, 2008). In its Order, the Commission took particular note of this high equity ratio in setting Columbia Water Company's allowed rate of return at a low 10.5%. *Pennsylvania Public Utility Commission v. The Columbia Water Company*, Docket No. R-2008-2045157, at pp. 78-79 (Order entered June 10, 2009).

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 that 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.) Aqua has repeatedly stated that the issue of what effect, if any, an increase in its DSIC may have on equity return will be considered in future rate cases.²⁰ Accordingly, OSBA's argument should be rejected and the Recommended Decision should be adopted without modification.

IV. CONCLUSION

In their exceptions, 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 reached 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.

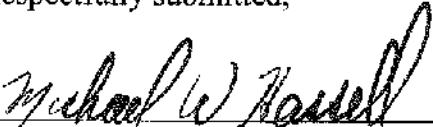
As found in the Recommended Decision, the evidence of record demonstrates that the requested increase in Aqua's maximum DSIC surcharge cap from 5% to 7.5% will assist Aqua in implementing its water main renewal program, which will accommodate increased water main and service line renewals targeted toward 1,500 miles of main requiring near-term renewal, and improve the infrastructure of its water distribution systems, service reliability, and water quality

²⁰ It should be noted that other states have DSIC mechanisms and, thus, barometer groups may be affected. Further, as most witnesses agreed, including OSBA's witness, 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.)

to its customers. (RD at pp. 47-48.) 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. (RD at p. 48.) 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.

WHEREFORE, Aqua respectfully requests that the Commission adopt the Recommended Decision of Administrative Law Judge Fordham and 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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