

**STATEMENT OF SPECIFIC REASONS  
FOR PROPOSED INCREASE IN RATES**

PENNSYLVANIA AMERICAN WATER  
Coatesville Wastewater Operations

Statement of Specific Reasons  
for Proposed Increase in Rates

The Coatesville Wastewater operations ("CWW" or "Company") of Pennsylvania American Water ("PAW") is filing herewith Supplement No. 2 to Tariff Wastewater PA P.U.C. No. 8. This tariff, which bears a proposed effective date of June 22, 2010, would increase the Company's total annual operating revenues by \$8,156,652 or approximately 197%, above the level of pro forma revenues for the future test year ending December 31, 2010. The reasons for the proposed increase in rates are summarized below.

RATE INCREASE

The primary factor accounting for the need for rate relief is the Company's substantial investment in utility plant. By the end of the future year, CWW will have invested approximately \$57.7 million in new utility plant since its last increase which took effect on November 14, 2008. Return on and of capital investments comprises almost \$7 million of the requested increase.

Absent rate relief, the overall rate of return for the Company for the future test year is negative. This result is obviously far less than required, by any standard, to permit a reasonable return on common equity and to provide a reasonable opportunity for the Company to attract the additional capital

required to finance needed plant additions.

Mr. Paul R. Moul, Managing Consultant of P. Moul and Associates and an expert on the subject of rate of return on common equity ("ROE"), has recommended an ROE of 11.75%. Mr. Rod Nevirauskas, Director of Rates and Regulation of PAWC, has calculated an overall rate of return of 7.30% for the Company incorporating an ROE of 11.5% on a reduced equity ratio of approximately 20% in recognition of the specific circumstances of this case. Mr. Moul's rate of return on common equity recommendations are being filed herewith as PAWC Statement No. 9 and Exhibit No. 9-A and Mr. Nevirauskas' rate of return recommendation is being filed as PAWC Statement No. 3. The requested rate of return may be summarized as follows:

TYPE OF CAPITAL	RATIO	COST RATE	WEIGHTED COST RATE
Long Term Debt	19.42%	6.16%	1.20%
PEDFA	60.55%	6.30%	3.81%
Preferred Stock	00.28%	8.11%	0.02%
Common Equity	19.75%	11.50%	2.27%
Overall Rate of Return			7.30%

The Company is filing herewith all of the supporting data required by the Commission's regulations, both for the historic

test year ended December 31, 2009 and the future test year ending December 31, 2010. The Company is basing its claim principally on future test year data and, therefore, the discussion that follows will essentially address such data.

The revenue and expense data for the year ending December 31, 2010 have been prepared in a manner consistent with the accepted practices of the Commission. To establish anticipated operating revenues under the proposed rates, operating revenues for the historic test year ended December 31, 2009 were adjusted (1) for required annualization adjustments (2) to reflect changes in the number of customers and usage by specific customers during the historic and future test years.

After extensive and careful review of the Company's accounts, actual operating expenses for the historic test year ended December 31, 2009 were adjusted to reflect currently effective and anticipated changes in expense levels, as summarized at page 24 of Exhibit No. 3-A. Such adjustments capture, among other things, increases in labor (salaries and wages) and labor-related expense; production costs and general inflation.

Operating revenue deductions other than expenses have also been adjusted to reflect increases and changes in taxes other than income taxes, including the General Assessments for the Commission, the Office of Consumer Advocate and the Office of Small Business Advocate. Federal and State income taxes have been

calculated on a pro forma basis to reflect the effect on the Company's taxable income of the proposed rates, the various expense adjustments made for ratemaking purposes and the use of currently effective state and federal income tax rates.

Annual depreciation charges included for ratemaking have been calculated using the straight line remaining life method for most plant accounts. Provision has also been made for the deferred federal income taxes resulting from the use of the Modified Accelerated Cost Recovery System for qualifying property additions in accordance with the Tax Reform Act of 1986.

After making the proper allowances for all necessary adjustments to determine the appropriate levels of revenue and expense for ratemaking purposes, the Company's anticipated operating income under the proposed rates will be:

Operating Revenues	\$12,289,409
Operating Revenue Deductions	<u>6,621,636</u>
Operating Income	\$5,667,773

The rate base elements which are submitted as part of this filing reflect the original cost of the Company's utility plant, as taken from its continuing property records, together with anticipated additions and retirements. The Company's claim for accrued depreciation applicable to original cost has been determined on the basis of the ratemaking book reserve, consistent with the procedures approved by the Commission in the past. The

resulting claim for depreciated utility plant in service encompasses the Company's planned investment of approximately \$18.6 million in new utility plant, in addition to the \$39 million placed in service in 2009 associated with Phase I of the new treatment plant.

From the depreciated utility plant in service figures, the Company has deducted contributions-in-aid-of-construction and customer advances for construction. Also deducted is the net cash working capital amount of long-term debt interest and preferred stock dividends accrued prior to payment, and the balance of deferred taxes attributable to 2010 accelerated depreciation. In addition, allowances for materials and supplies, cash working capital, and prepaid taxes net of accrued taxes, are reflected in the Company's rate base claim. As so developed, the estimated original cost measure of value at December 31, 2010 is \$77,627,439.

It is evident from the above and from the voluminous supporting data filed herewith that the proposed rate increase is just and reasonable and represents the minimum rate increase necessary to enable the Company to earn a reasonable return on the fair value of its property used and useful in the public service and to maintain the integrity of its existing capital.

### RATE STRUCTURE

As part of its supporting data, the Company has submitted, as Exhibit No. 7-A, a Cost of Service Study performed by the engineering firm of Gannett Fleming Valuation and Rate Consultants, Inc. The results of the Cost of Service Study were one of the factors considered by the Company in developing its rate structure proposal.

The principal elements of that proposal consist of the following:

- An increase of monthly service charges to be consistent with customer costs;
- The allocation of the requested rate increase in such a manner as to realign revenues by major customer class to be more commensurate with the indicated cost of service.

### CONCLUSION

In summary, the proposed increase in revenues is the minimum increase necessary to permit the Company to preserve public health and safety and to maintain the integrity of its existing capital, attract additional necessary capital at reasonable costs and have an opportunity to actually achieve a fair rate of return, particularly on its common equity capital. For these and the other reasons set forth above, the proposed rates should be permitted to become effective as filed.