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March 4, 2010

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
P. O. Box 3265
Harrisburg, PA 17105-3265

Re: Docket No. R-2009-2117550
Pa. P.U.C. v. The Newtown Artesian Water Company

Dear Secretary McNulty:

Enclosed for filing on behalf of The Newtown Artesian Water Company are an original and nine (9) copies of its Replies to the Exceptions of the Office of Trial Staff and the Office of Consumer Advocate in the above matter. Copies of the Replies are being served upon the persons and in the manner set forth on the certificate of service attached to it.

Very truly yours,

THOMAS, LONG, NIESEN & KENNARD

By

Thomas T. Niesen

Encl.

cc: Certificate of Service (w/encl.)
Brenden Brett, Esq. (w/encl.)

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**Before The
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Administrative Law Judge
Ky Van Nguyen, Presiding**

Pennsylvania Public Utility Commission	:	Docket No. R-2009-2117550
Office of Consumer Advocate	:	Docket No. C-2009-2122003
	:	
v.	:	
	:	
The Newtown Artesian Water Company	:	

**REPLIES OF THE NEWTOWN ARTESIAN WATER COMPANY
TO THE EXCEPTIONS OF THE OFFICE OF TRIAL STAFF
AND THE OFFICE OF CONSUMER ADVOCATE**

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I. INTRODUCTION

This proceeding concerns The Newtown Artesian Water Company's ("NAWC" or "Company") Supplement No. 68 to Tariff Water-Pa. P.U.C. No. 9 ("Supplement No. 68"). Supplement No. 68 would include a Purchased Water Adjustment Clause in the Company's Tariff as permitted by Section 1307 of the Public Utility Code, 66 Pa. C.S. § 1307. The PWAC would allow the Company to timely recover *increases* in purchased water costs from customers or to timely pass through *decreases* in purchased water costs to customers.

By Recommended Decision dated January 25, 2010, Judge Nguyen recommended that NAWC be allowed to implement a PWAC "capped," however, at 3% of the amount billed to customers, exclusive of amounts recovered under the State Tax Adjustment Surcharge. NAWC filed Exceptions to the Recommended Decision on February 22, 2010 asking the Public Utility Commission ("Commission") to remove the "cap" as part of its final Opinion and Order approving the PWAC.¹ The Office of Trial Staff ("OTS") and the Office of Consumer Advocate ("OCA") also filed Exceptions to the Recommended Decision.

NAWC submits the following Replies to the Exceptions of the OCA and the OTS to the Recommended Decision.² The Commission should reject the Exceptions of the OTS and the OCA in opposition to NAWC's PWAC. Their arguments are inconsistent with prior Commission and Court decisions³ and statutory criteria⁴ and only serve to

¹ NAWC's Exceptions also addressed the Recommended Decision's provision for one-way directional interest on overcollections.

² Consistent with Section 5.535 of the Commission's Rules of Practice and Procedure, 52 Pa. Code § 5.535, NAWC, as appropriate, refers to and incorporates by reference relevant passages from its previously filed Main and Reply Briefs.

³ See NAWC's Main Brief at 21-24 and the case law and regulatory precedent cited therein.

⁴ See NAWC's Main Brief at 19-21 and 24-27.

complicate an otherwise simple and straightforward matter. Consistent with the clear language of Section 1307, NAWC's PWAC would do no more than allow the Company the opportunity for a just and reasonable return on rate base.

In the Introduction Section of its Exceptions, pages 2 and 3, the OCA expresses concern that approval of NAWC's PWAC would open the door to the recovery of any expense through an automatic adjustment clause. This concern is not rational and not supported by the evidence of record. NAWC's circumstances concerning purchased water expense are atypical. The Company's percentage of purchased water expense to revenue falls in the upper 96th percentile of the PA Water Industry. Further, the Company's percentage of purchased water expense to operations and maintenance expense falls in the upper 94th percentile of the PA Water Industry. NAWC has an average percentage of purchased water expense compared to revenue or operations and maintenance expense that is eight to ten times *greater* than the PA Water Industry.⁵

The Commission's authority to implement an automatic adjustment clause for recovery of a specific, identifiable expense, such as purchased water expense increases, is clear and obvious. The Exceptions of the OTS and OCA should be denied. The Commission should modify the Recommended Decision to eliminate the 3% "cap" and approve NAWC's PWAC.

⁵ NAWC St. No. 1R at 8. NAWC purchases 57% of its present water supply from the Bucks County Water and Sewer Authority and has annual purchased water expense of \$1,104,000 or approximately \$92,000 on a monthly basis. The Company's purchased water expense for 2008 represented 34% of the Company's total operation and maintenance expenses and equaled 24% of the Company's revenues. Rec. Dec., Finding of Fact 6.

II. REPLIES TO OTS EXCEPTIONS

REPLY TO OTS EXCEPTION NO. 1 - NAWC's PWAC Does Not Constitute Impermissible Single Issue Ratemaking.

Citing *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, 653 A.2d 1336 (Pa. Cmwlth. 1995), the Recommended Decision concluded that the "doctrine of single-issue ratemaking or piecemeal ratemaking is inapplicable here."⁶ In its Exception No. 1 the OTS argues that the Recommended Decision is incorrect.

As explained by the Commonwealth Court and reproduced at page 9 of the Recommended Decision:

Single-issue ratemaking is similar to retroactive ratemaking and, in general, is prohibited if it impacts on a matter that is normally considered in a base rate case. This is, however, not a base rate case. No party has asked for specific recovery of a line item that traditionally would be requested in a rate-making procedure. The PUC applied Section 1307's authorization to specifically allow an automatic adjustment of rates outside of the rate-making procedures. ***Because the surcharge is permitted under the Code, with procedures to determine the reasonableness of the charges outside of a base rate case, the doctrine of single-issue ratemaking is inapplicable.***⁷

OTS argues that the Commission could apply the doctrine of "single-issue ratemaking" if it would choose to do so. OTS, however, cites no Commission decision in which the Commission has relied on the doctrine to deny the implementation of a Section 1307 automatic adjustment clause⁸ and NAWC submits that the Commission has never viewed the doctrine of "single issue ratemaking" as an impediment to the implementation of a clause under Section 1307. The Commission's formal regulation at 52 Pa. Code § 53.54(c), clearly demonstrates that the Commission recognizes that

⁶ Recommended Decision at 9.

⁷ *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, at 1349-50 (emphasis added).

⁸ In its discussion of *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, OTS refers, in fact, to the "cost recovery methods approved by the Commission" in that proceeding. OTS Exception No. 1 at 3.

it has the statutory authority to implement a purchased water adjustment clause. Nowhere does the Regulation cite single issue ratemaking as an impediment to the implementation of a purchased water adjustment clause.⁹ The General Assembly, moreover, has not enacted "single issue ratemaking" as an impediment to the exercise of Section 1307.¹⁰

OTS Exception No. 1 should be denied. The Recommended Decision correctly interprets and applies the clear language of the Commonwealth Court decision, reproduced and emphasized above, to the matter at hand. An automatic adjustment clause "is permitted under the [Public Utility] Code, with procedures to determine the reasonableness of the charges outside of a base rate case." The doctrine of single issue ratemaking is, thus, inapplicable here.

REPLY TO OTS EXCEPTION NO. 2 - *Increases in Purchased Water Costs Between General Rate Filings Are Forever Lost to the Utility and Not Recovered in a General Rate Filing.*

In its Exception No. 2, the OTS argues that purchased water cost is normally considered in a base rate case and that NAWC's PWAC is contrary to OTS's reading of *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*.

NAWC's PWAC would allow the Company to timely recover *increases* in purchased water costs and to timely pass through *decreases* in purchased water costs. These *increases* (and *decreases*) that occur between general rate filings are never

⁹ The Commission, by formal regulation at 52 Pa. Code § 53.54(c), with specific citation to its statutory authority under Section 1307, has provided for the implementation of a purchased water adjustment clause - - a sliding scale of rates - - for small water utilities with less than \$250,000 annual revenue. What the Commission can accomplish by Regulation for small water companies, it can accomplish by Order for NAWC.

¹⁰ The only statutory requirement of Section 1307(a) is that the automatic adjustment clause provide a just and reasonable return on the rate base of the public utility to be determined upon such equitable or reasonable basis as shall provide such fair return. 66 Pa. C.S. § 1307(a).

considered or recovered as part of the traditional Section 1308(d) general rate filing. The *increases*, in the form of Lost Purchased Water Expense, are never recovered from customers and are forever borne by Company shareholders. Lost Purchased Water Expenses are significant. They approximate \$400,000 just as a result of the prior two BCWSA rate *increases* that occurred in 2005 and 2008.

OTS suggests that simultaneous decreases in other line item expense could offset BCWSA purchased water rate increases. The last increase in BCWSA purchased water expense was approximately \$23,000 per month; \$276,000 on an annual basis. Realistically, there is no offsetting expense decrease or combination of offsetting expense decreases that could have offset this significant expense as suggested by OTS.

OTS Exception No. 2 should be denied. Although the baseline, annualized cost of purchased water at the most recent price is considered as part of the traditional Section 1308(d) general rate filing, the *increases* (and *decreases*) that occur subsequently between general rate filings are not considered and are appropriately recovered through NAWC's PWAC.¹¹

REPLY TO OTS EXCEPTION NO. 3 - The Recommended Decision Appropriately Describes *Bethel* as a Commission Decision Cited by NAWC as Supportive of NAWC's Proposed PWAC.

In its Exception No. 3, the OTS argues that the Recommended Decision misinterpreted *Pa. P.U.C. v. United Water Bethel, Inc.*, Docket No. R-00963804 (Order entered December 19, 1996). The reference to *Bethel* appears in the paragraph at the top of page 12 of the Recommended Decision where Judge Nguyen states that "the

¹¹ See 52 Pa. Code § 53.54 (c).

Commission has approved an automatic adjustment clause for recovery of purchased water expense for United Water Bethel, a water utility, like Newtown Artesian, with annual revenue greater than \$250,000.

The paragraph at the top of page 12 of the Recommended Decision and the discussion therein of *Bethel* is part of Section III.B.3 of the Recommended Decision titled "Newtown Artesian's Position." The paragraph is not part of the "ALJ's Recommendation," which is presented in Section III.B.4 and the paragraphs immediately following the paragraph presenting the discussion of *Bethel*.

The "ALJ's Recommendation," presented in Section III.B.4, page 12, is based on *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*. The "ALJ's Recommendation" presents an appropriate summation of the Commonwealth Court decision in *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, and an appropriate conclusion that an "automatic adjustment clause that enables a utility to recover applicable increased water costs on a dollar-for-dollar basis fits a Section 1307(a) surcharge. See Rate Case Handbook (1983) B2."

OTS Exception No. 3 should be denied. The "ALJ's Recommendation" is based on a proper reading of *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*. Concerning *Bethel*, the Recommended Decision appropriately describes *Bethel* as a Commission decision cited by NAWC as supportive of NAWC's proposed PWAC.

REPLY TO OTS EXCEPTION NO. 4 - NAWC's PWAC Is Consistent with the Applicable Statutory Criteria and Decisional Law.

In its Exception No. 4, the OTS argues that NAWC's PWAC is not in the public interest and that the Recommended Decision failed to address this issue. In presenting this argument, the OTS appropriately acknowledges that the Commission has authority

to grant an automatic adjustment clause for a non-capital expense, such as purchased water, an expense which is easily determined and beyond a utility's control, or required by a government entity.¹² The OTS acknowledges, further, that NAWC's PWAC "fits the criteria."

Although OTS argues that the Recommended Decision does not provide a discussion of the balancing of Company and ratepayer interests, the OTS fails to recognize the analysis of competing interests presented in the discussion of *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, at page 12 of the Recommended Decision. That discussion explains that the Court limited the use of Section 1307(a) to the recovery of non-capital expenses and allowed a Section 1307(a) surcharge that flows through only expenses and *changes* to those expenses *without* including any profit or other recovery. The discussion concludes that an "automatic adjustment clause that enables a utility to recover applicable increased water costs on a dollar-for-dollar basis fits a Section 1307(a) surcharge. See Rate Case Handbook (1983) B2." Dollar-for-dollar recovery (without profit or other recovery) appropriately reflects a balancing of Company and ratepayer interests.

OTS argues further that there is no check upon expenses to be recovered through the automatic adjustment clause.¹³ Once, again, however, the "check" is the

¹² OTS Exception No. 4 at 10-11. As stated by the OTS more fully at pages 9 and 10 of its Main Brief:

"... purchased water is a non-capital expense that is beyond the utility's control and easily determined. NAWC's purchased water expenses are not required by a government entity. Although NAWC has demonstrated that it has some degree of influence over its purchased water expenses, it has no control over the price of purchased water. Finally, NAWC's purchased water costs are easily identifiable as the Company only purchases water from a single supplier. Under the standards identified in *Popowsky v. PUC*, the Commission is not precluded from granting a PWAC under Section 1307. This position is evidenced by the Commission's adoption of 52 Pa. Code 53.54, which permits water and wastewater utilities with gross revenues of less than \$250,000 to implement a PWAC"

¹³ OTS Exception No. 4 at 12-13.

dollar-for-dollar recovery of a specific, identifiable expense utilizing a statutory procedure for rapid cost recovery, with a more comprehensive analysis upon reconciliation of actual costs with previously projected costs used to establish the effective rate. This statutory procedure reflects an appropriate weighing of Company and ratepayer interests. A purchased water pass-through, which OTS suggests as an alternative remedy to a PWAC, is nothing more than a Section 1308(d) general rate filing. It does not solve the problem of dealing with the significant financial deficiencies of a short notice BCWSA rate filing.¹⁴

NAWC also contends that NAWC has overstated the adverse financial effects it has suffered in the absence of a PWAC.¹⁵ NAWC vigorously disagrees with this contention. It has, in no way, overstated the significant, adverse financial effects suffered as a result of BCWSA increases in the absence of a PWAC. The Lost Purchase Water Expense was approximately \$400,000 as a result of the last two BCWSA purchased water rate increases in 2005 and 2008. The lack of a PWAC has denied NAWC the opportunity to recover significant and material *increases* in purchased water costs over the baseline level reflected in its base rates and resulted in the denial of NAWC's constitutional right to an opportunity to earn a fair rate of return on the value

¹⁴ When United Water Bethel attempted a "surcharge" tariff filing "solely caused by the cost of purchased water" that would have affected all customers and increased revenue by 3.67%, OTS notified the company that the filing would be treated as a general rate increase under Section 1308(d) and Bethel petitioned to withdraw the filing. See OCA Exception No. 2 at 9-10. Thus, when the "pass-through" is significant the OTS apparently would insist on treating the filing as a Section 1308(d) general rate filing. NAWC's most recent purchased water increase from BCWSA was 5.2% of billed revenue.

¹⁵ OTS Exception No. 4 at 13.

of its property which is dedicated to public service.¹⁶ The obvious solution to this difficult circumstance is a Section 1307 automatic adjustment clause.

NAWC's Exception No. 4 should be denied. The PWAC, which would allow for no more than a dollar-for-dollar recovery of increases in purchased water expense, presents no potential harm to ratepayers and reflects an appropriate balancing of the interests of the Company and ratepayers.

¹⁶ For the five years ended 2008, NAWC has only averaged a 6.9% return on common equity despite filing two rate cases during this period; whereas, the Commission generally authorized water utilities the opportunity to earn returns on common equity in excess of 10% during this same period. NAWC St. No. 1 at 4-5. The Lost Purchased Water Expense represents a 4% return on common equity. That is, NAWC's return on common equity would have been about 400-basis points higher had it been able to recover the LPWE in rates. NAWC St. No. 1 at 5-6; NAWC St. No. 1R at 14 (i.e., NAWC's return on common equity would have been about 400-basis points higher had it been able to recover the LPWE in rates). NAWC St. No. 1 at 6; NAWC St. No. 1R at 10-11 and 14-15.

III. REPLIES TO OCA EXCEPTIONS

REPLY TO OCA EXCEPTION NO. 1 - NAWC's PWAC Does Not Constitute Impermissible Single Issue Ratemaking

In its Exception No. 1, the OCA asserts, similar to OTS, that NAWC's PWAC constitutes impermissible single issue ratemaking. The OCA begins its argument by repeating its claim that NAWC's PWAC would open the door to wide ranging recovery of expenses through an automatic adjustment clause. This claim is simply not supported by the evidence of record. At issue in this proceeding is purchased water expense that constitutes approximately 34% of the Company's total operations and maintenance expenses and approximately 24% of revenue. The idea that a decision in this case involving an expense of this magnitude and significance to NAWC would open the door to recovery of every other kind of expense for every other kind of utility is not credible.

As set forth above in reply to the OTS, the Commission has never viewed the principle of "single issue ratemaking" as an impediment to the implementation of an automatic adjustment clause under Section 1307. The General Assembly, moreover, has not enacted "single issue ratemaking" as a prohibition to the exercise of Section 1307.¹⁷ In *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra* at 1349-50, the Commonwealth Court explained that the doctrine of single issue ratemaking is inapplicable where, as here, a surcharge is permitted under the Code, with procedures to determine the reasonableness of the charges outside of a base rate case.¹⁸

¹⁷ The only statutory requirement of Section 1307(a) is that the automatic adjustment clause provide a just and reasonable return on the rate base of the public utility to be determined upon such equitable or reasonable basis as shall provide such fair return. 66 Pa. C.S. § 1307(a).

¹⁸ Also see Reply to OTS Exception No 1, *supra*.

Although the baseline, annualized cost of purchased water at the most recent price is considered as part of the traditional Section 1308(d) general rate filing, the *increases* that occur subsequently between general rate filings are not considered. Those *increases*, in the form of Lost Purchased Water Expense, are never recovered from customers and are forever borne by Company shareholders. These Lost Purchased Water Expenses are significant. They approximate \$400,000 just as a result of the immediately prior two BCWSA rate increases in 2005 and 2008. Contrary to the argument of the OCA, these *increases* are never considered or recovered under the Section 1308 cost recovery mechanism.

As part of its Exception No. 1, the OCA criticizes automatic adjustment clause recovery of purchased water expense increases without reflecting elements of base rates that *might* be changing in the Company's favor, such as additional revenue due to customer growth and lower capital costs. The last increase in BCWSA purchased water expense was approximately \$23,000 per month; \$276,000 on an annual basis. Realistically, there is no other NAWC expense or combination of expenses that could have offset this significant expense increase. OCA witness Kraus had no idea of the number of customers that would have to be added to offset increases in purchased water expense. Ms. Kraus also did not know which expenses might be decreased to offset an increase although she acknowledged that probably no one expense would have offset a \$200,000 annual increase in purchased water expense. N.T. 155.¹⁹

¹⁹ There are, likewise, no potential offsetting decreases in capital costs as a result of NAWC's PWAC. NAWC has incurred approximately \$400,000 in Lost Purchased Water Expenses as a result of the last two BCWSA rate increases. There was no risk adjustment made or proposed to NAWC's equity return in its general rate proceedings that could have or would have compensated NAWC in any way for this significant lost expense. On an annual basis, the adjustment, if it existed or had been proposed, would have had to approach 4 percentage points to compensate the Company for the lost \$400,000. If an equity adjustment had been made in the general rate proceedings, NAWC's experienced return would not have suffered as a result of the Lost Purchased Water Expense. The facts show, however, that return did suffer, and suffer significantly. Return fell to 6.9% for the five years ended 2008 when opportunity equity returns allowed by the Commission were 10% or higher.

Citing *Popowsky v. Pa. P.U.C.*, 869 A. 2d 1144 (Pa. Cmwlth. 2005), the OCA contends that NAWC's PWAC is an example of "single-issue" ratemaking. *Popowsky* dealt, however, with recovery of capital costs, not expenses. For expenses, the Court explained that a Section 1307 automatic rate adjustment is appropriate for "easily identifiable expenses that are beyond a utility's control."²⁰ The increased purchased water expense that NAWC would recover through its PWAC is an easily identifiable expense that falls squarely within the Court's definition and which is appropriately recovered through a Section 1307(a) automatic adjustment clause.

In *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, also cited by the OCA in its Exception No. 1, the Court explained that the concept of single issue ratemaking is inapplicable to a Section 1307 surcharge. The Court also addressed the use of an automatic adjustment clause to recover a "specific *identifiable* expense item" as follows:

In *National Fuel Gas Distribution Corp. v. Pennsylvania Public Utility Commission*, 81 Pa.Commonwealth Ct. 148, 171-72, 473 A.2d 1109, 1121 (1984), we held that the purpose of this section was to permit reflection in customer charges of changes in one component of a utility's cost of providing public service without the necessity of the broad, costly and time-consuming inquiry required in general rate cases and the automatic provision does not eliminate the requirement for approval of revisions in the charges by the PUC. To be appropriate for automatic adjustment, the Industrial Coalition argues, the costs must be large in

The experienced return reflects the impact of Lost Purchased Water Expense but it does not reflect any adjustment for the risk of the loss. As a result of the Lost Purchased Water Expense, shareholders are being denied their constitutional opportunity for a fair return. See also NAWC's Main Brief at 10-14.

²⁰ The Court in *Popowsky* explained as follows:

Indeed, the very function of the *typical automatic adjustment clause* is to permit rapid recovery of a *specific, identifiable expense item*, with a more comprehensive analysis upon reconciliation of actual costs with previously projected costs used to establish the effective rate. *The initial process is essentially a mathematical review of the projections provided by the public utility.* Therefore, there is no initial review to determine the appropriateness or necessity of the rate request. (Emphasis in original). *Popowsky supra* at 1156.

magnitude in relation to the utility's rate base, volatile, like fuel costs, specifically identifiable, and beyond the control of the utility, which it argues is unlike DSM program costs. It asserts that the statute is only applicable to fuel costs and certain taxes as it has already been applied by the PUC. It cites *Masthope Rapids Property Owners Council v. Pennsylvania Public Utility Commission*, 135 Pa. Commonwealth Ct. 437, 581 A.2d 994 (1990). In *Masthope*, we held that a water utility could not recover the principal and interest of a loan received under the Water Facilities Restoration Act, 32 Pa.C.S. §§ 7501-7518, through an automatic adjustment of rates because Section 1307 did not provide the necessary review required by the Water Act. We stated:

[T]he automatic adjustment of public utility rates may only occur in certain limited instances.... Section 1307 has been customarily employed, for example, as the statutory predicate for the implementation of electric cost rates by certain electric utilities, ... and is also employed for recovery of natural gas costs by natural gas utilities. Further, in all such proceedings the Commission's review is appropriately characterized as preliminary and cursory. Indeed, the very function of the typical automatic adjustment clause is to permit rapid recovery of a specific *identifiable* expense item, with a more comprehensive analysis upon reconciliation of actual costs with previously projected costs used to establish the effective rate. The initial process is essentially a mathematical review of the projections provided by the public utility. Therefore, there is no initial review to determine the appropriateness or necessity of the rate request.

Id. at 447-48, 581 A.2d at 999-1000 (emphasis in original).

Although we agree that Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process, the General Assembly did not limit the allowance of automatic adjustment to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the PUC or the utilities to initiate the automatic adjustment of costs within specific procedures.²¹

Neither *Popowsky v. Pa. P.U.C.*, *supra*, nor *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, supports OCA's position in opposition to NAWC's PWAC. Each case, to the contrary, supports the recovery of a specific, identifiable expense,

²¹ *Pennsylvania Indus. Energy Coalition*, 653 A.2d at 1348-49 (footnotes omitted).

such as purchased water expense increases, through a Section 1307(a) automatic adjustment clause as proposed by NAWC.

OCA's Exception No. 1 should be denied. The Recommended Decision correctly interprets and applies the clear language of decisional law to the matter at hand. NAWC's PWAC is permitted under the Public Utility Code with applicable statutory procedures to determine the reasonableness of the charges outside of a base rate case. The doctrine of single issue ratemaking is, thus, inapplicable here.

REPLY TO OCA EXCEPTION NO. 2 - NAWC's Purchased Water Adjustment Clause Is A Method of Cost Recovery Authorized by Section 1307(a) of the Public Utility Code.

In its Exception No. 2, The OCA presents a direct challenge to the Commission's authority under Section 1307 to implement an automatic adjustment clause for purchased water expense. It states that the "primary issue" is whether the Commission has the authority to approve a "surcharge recovery of purchased water expense increases pursuant to the general Section 1307(a) provision."²²

²² OCA Exception No. 2 at 8. In footnote 5, page 8, of its Exception No. 2, the OCA states that the Commission should reject the PWAC for policy reasons even if it concludes that it has the statutory authority to approve the clause. The OCA contends that the surcharge would reduce the Company's incentive to promote conservation and seek alternative water resources at lower costs. NAWC addressed these contentions in its Reply Brief, pages 15 and 16. As explained there, NAWC does, indeed, exercise good management practices including conservation practices. Those practices will not cease upon the implementation of its PWAC. If anything, NAWC's good practices should assure the Commission that, by approving the PWAC, the Commission will be assisting a well-managed Company in the recovery of the just and reasonable costs of providing water service. Additionally, it must be emphasized that lower cost water supply resources are not being pursued with the thought of eliminating the Agreement with BCWSA and the take-or-pay clause. The Agreement and the clause have 15 years remaining on their forty year life. The effort to locate alternative water sources is because the Agreement has an escalator. If the Company's existing wells fail to produce or produce below current levels and the Company, as a result, must resort to additional purchases, increased charges could occur.

The Commission has never doubted its authority under Section 1307. It has, for example, approved automatic adjustment clauses for Pennsylvania American Water Company for recovery of both water and wastewater system improvements.²³ Although the Commission's decision approving the wastewater system charge was reversed in *Popowsky v. Pa. P.U.C.*, *supra*, the Commonwealth Court, in doing so, made it as clear as it possibly could that an automatic adjustment clause for a specific, identifiable expense was allowed by Section 1307.²⁴

The Commission's authority to implement an automatic adjustment clause for recovery of an identifiable expense, such as purchased water expense increases, is clear and obvious.²⁵ Ultimately, the OCA may seek judicial review of the Commission's decision here approving NAWC's PWAC but that possibility should not deter the Commission from exercising its authority and approving NAWC's just and reasonable Section 1307 cost recovery mechanism.

At pages 8 and 9 of its Exception No. 2, the OCA states that the Recommended Decision, page 11, relied on *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, 86 Pa. PUC 415 (1996) and *Popowsky v. Pa. P.U.C.*, *supra*. The discussion of the cases at page 11 of the Recommended Decision is part of Section III.B.3 of the Recommended Decision titled "Newtown Artesian's Position." The

²³ See NAWC's Main Brief, Section V.A. and Reply Brief, Section II.A.

²⁴ See Reply to OTS Exception No. 4, *supra*, and footnote 21; also see Footnote 25, *infra*.

²⁵ At its base line level, the position of the OCA would appear to be that the Commission has no authority under Section 1307(a) to implement an automatic adjustment clause except where the recovery of the expense is expressly authorized by statute. This position would be inconsistent with *Popowsky v. Pa. P.U.C.*, *supra*, at 1160, where the Court explained that a Section 1307(a) automatic rate adjustment is appropriate not only where expressly authorized *but also* for easily identifiable expenses that are beyond a utility's control. In addition to being inconsistent with *Popowsky*, the position of the OCA would render Section 1307(a) a statutory nullity.

discussion is not part of the "ALJ's Recommendation," which is presented in Section III.B.4 of the Recommended Decision.

As presented in the Reply to OTS Exception No. 3 above, the "ALJ's Recommendation," presented in Section III.B.4, page 12, is based on *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*. The "ALJ's Recommendation" presents an appropriate summation of the Commonwealth Court decision in *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, and an appropriate conclusion that an "automatic adjustment clause that enables a utility to recover applicable increased water costs on a dollar-for-dollar basis fits a Section 1307(a) surcharge. See Rate Case Handbook (1983) B2."

NAWC, nevertheless, submits that the two cited cases support its proposed PWAC. In *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, *supra*, the Commission addressed a petition filed by Pennsylvania-American Water Company to implement a Section 1307(a) automatic adjustment clause tariff establishing a proposed Distribution System Improvement Charge.²⁶ Quoting from *Pennsylvania Indus. Energy Coalition v. Pa. P.U.C.*, *supra*, the Commission explained that "*the General Assembly did not limit the allowance of automatic adjustment to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the*

²⁶ The petition predated Section 1307(g) of the Public Utility Code, 66 Pa. C.S. § 1307(g), which formally recognized the DSIC clause for water utilities as part of the Public Utility Code.

PUC or the utilities to initiate the automatic adjustment of costs within specific procedures."²⁷

In *Pa. P.U.C. v. Pennsylvania American Water Co.*, Docket No. R-00027982 (Order entered November 7, 2003), the Commission, again, relied on its Section 1307 statutory authority to approve a Collection System Improvement Charge for the funding of capital improvements for Pennsylvania American Water Company's wastewater service. Although the Commonwealth Court reversed the Commission in *Popowsky v. Pa. P.U.C.*, *supra*, it did so because the proposed clause was intended to recover capital costs.²⁸ The Court drew a sharp distinction between the recovery of capital costs through an automatic adjustment clause and recovery of identifiable expenses (such as purchased water expense) holding that a Section 1307(a) automatic adjustment clause is appropriate for easily identifiable expenses that are beyond the utility's control.²⁹

The OCA also addresses page 12 of the Recommended Decision and the discussion there of *Pa. P.U.C. v. United Water Bethel, Inc.*, *supra*. As set forth above, in the Reply to OTS Exception No. 3, the reference to *Bethel*, which appears at the top of page 12 of the Recommended Decision and the discussion therein of *Bethel*, is part of Section III.B.3 of the Recommended Decision titled "Newtown Artesian's Position." The paragraph is not part of the "ALJ's Recommendation," which is presented in Section

²⁷ *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, 86 Pa. P.U.C. at 420 (emphasis in original).

²⁸ As phrased by the Court, the issue before it in *Popowsky*, was whether Section 1307(a) allows a utility to recover its costs for repairing infrastructure by automatic rate adjustment.

²⁹ *Id.* at 1160. In *Pa. P.U.C. v. East McKeesport Water Co.*, 56 Pa. PUC 570 (1982), the Commission recognized that purchased water expense is beyond the control of the utility. Ms. Kraus, testifying on behalf of the OCA, does not disagree with the Commission's characterization of purchased water in *East McKeesport* as totally outside the control of the utility. N.T. 147.

III.B.4 and the paragraphs immediately following the paragraph presenting the discussion of *Bethel*.

Bethel was discussed during the evidentiary hearing. OCA witness Kraus was asked if she was aware of any purchased water adjustment clauses in place for a water company. She responded, without hesitation, that she believes “that the only one in place is United Water Bethel.”³⁰ In its Exception No. 2, pages 9-11, the OCA contends that Bethel has a “surcharge” but not a purchased water adjustment clause.³¹

The OCA’s attempt to distinguish Bethel is not convincing. A surcharge exists in the tariff of United Water Bethel. The fact that no one complained against it does not mean that the surcharge is contrary to the Public Utility Code. On the contrary, the only reasonable conclusion is that the Commission favors the surcharge recovery of purchased water expense.³²

Perhaps most noteworthy about the OCA’s discussion of *Bethel* is the statement on page 11 of its Exception No. 2 that Bethel’s history illustrates that certain rate mechanisms, other than Section 1307(a) automatic adjustment clauses - - short form rate filings, for example - - are available to water utilities that purchase water. From the perspective of the statutory public advocates, short form filings are **not** available to water utilities when the purchased water increase is significant. As explained at page 10 of OCA Exception No. 2, when Bethel, in 2002, submitted a tariff change “solely

³⁰ N.T. 148. See also N.T. 149.

³¹ In its Reply Brief, the OCA stated at page 8, footnote 3, that Ms. Kraus was in error when she stated that United Water Bethel has a “purchased water adjustment clause” in its tariff.

³² The OCA suggests that “short-form” base rate filings are a possible way to recover BCWSA purchased water expense increases. “Short-form” base rate filings do not provide the opportunity for expedited resolution as do Section 1307 automatic adjustment clauses. A “short-form” filing would still be subject to a statutory six or seven month suspension period. If the filing were submitted by Petition, it might not have any statutory deadline. The reasonable and appropriate resolution for dealing with purchased water expense increases is a Section 1307 automatic adjustment clause.

caused by the cost of purchased water” that would have affected all customers and increased revenue by 3.67%, OTS took the position that the filing would be treated under Section 1308(d) and Bethel, rather than become involved in a general rate filing, withdrew its request for needed rate relief. NAWC would expect the same response to any request it might make for short form recovery of significant BCWSA increases, the last of which was 5.2% of NAWC's billed revenue.³³

The OCA also criticizes the Recommended Decision for allegedly not discussing the OCA's position that Section 1307(a) automatic adjustment clauses are only available for abnormal, nonrecurring and extraordinary expenses outside the control of utility management. *The increases and decreases to purchased water expense that would be reflected through the application of the PWAC, as well as the baseline purchased water expense itself, are highly abnormal, extremely extraordinary and non-recurring.*³⁴

In *Popowsky v. Pa. P.U.C.*, *supra*, the Commonwealth Court explained that extraordinary expenses are “not merely unanticipated but also a substantial, one-time expense or a substantial item that will not appear as a continuing expense and could otherwise never be recovered in rates because, like the weather-related expenses, it would be normalized out of the test year as abnormal.”³⁵ *The increases in BCWSA*

³³ See NAWC Exception No. 1, Section B.

³⁴ NAWC St. No. 1REJ at 7. Additionally, in regard to the abnormal, extraordinary and non-recurring nature of the purchased water expense increases we would point out that, in comparison to the first eighteen years of the Agreement, the rate, or dollar amount, of the BCWSA increases have been accelerating at an increasing rate and the percentage change varies from rate hike to rate hike. NAWC St. No. 1REJ at 8.

³⁵ *Popowsky*, 869 A.2d at 1153, n.24 (quoting *Popowsky v. Pa. P.U.C.*, 164 Pa. Commw. 338, 642 A.2d 648, 652 (1994)).

purchased water expense experienced by NAWC fall squarely within the *Popowsky* definition.³⁶

While purchased water *increases* are highly abnormal, extremely extraordinary and non-recurring, the Commission and the Commonwealth Court have noted different criteria in their discussions of automatic adjustment clauses. In *Pa. P.U.C. v. East McKeesport Water Co.*, 56 Pa. PUC 570 (1982), the critical component in the Commission's thinking in support of a purchased water surcharge was the water utility's lack of control over the purchased water expense. In *Petition of Pennsylvania-American Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge*, *supra*, and *Pa. P.U.C. v. Pennsylvania American Water Company*, *supra*, the Commission, citing *Allegheny Ludlum Steel Corp.*, explained in a clear and concise manner that the purpose of a Section 1307 automatic adjustment clause, simply, is to provide an automatic mechanism enabling utilities to recover specific costs not covered by general rates.

The Commonwealth Court, moreover, has focused on the use of the clause to recover a "specific *identifiable* expense item" explaining in *Pennsylvania Indus. Energy Coalition*, *supra* , as follows:

In *National Fuel Gas Distribution Corp. v. Pennsylvania Public Utility Commission*, 81 Pa.Commonwealth Ct. 148, 171-72, 473 A.2d 1109, 1121 (1984), we held that the purpose of this section was to permit reflection in customer charges of changes in one component of a utility's cost of providing public service without the necessity of the broad, costly and time-consuming inquiry required in general rate cases and the automatic provision does not eliminate the requirement for approval of revisions in the charges by the PUC. To be appropriate for automatic adjustment, the Industrial Coalition argues, the costs must be large in magnitude in relation to the utility's rate base, volatile, like fuel costs, specifically identifiable, and beyond the control of the utility, which it argues is unlike DSM program costs. It asserts that the statute is only

³⁶ NAWC St. No. 1REJ at 8-9.

applicable to fuel costs and certain taxes as it has already been applied by the PUC. It cites *Masthope Rapids Property Owners Council v. Pennsylvania Public Utility Commission*, 135 Pa.Commonwealth Ct. 437, 581 A.2d 994 (1990). In *Masthope*, we held that a water utility could not recover the principal and interest of a loan received under the Water Facilities Restoration Act, 32 Pa.C.S. §§ 7501-7518, through an automatic adjustment of rates because Section 1307 did not provide the necessary review required by the Water Act. We stated:

[T]he automatic adjustment of public utility rates may only occur in certain limited instances.... Section 1307 has been customarily employed, for example, as the statutory predicate for the implementation of electric cost rates by certain electric utilities, ... and is also employed for recovery of natural gas costs by natural gas utilities. Further, in all such proceedings the Commission's review is appropriately characterized as preliminary and cursory. Indeed, the very function of the typical automatic adjustment clause is to permit rapid recovery of a specific *identifiable* expense item, with a more comprehensive analysis upon reconciliation of actual costs with previously projected costs used to establish the effective rate. The initial process is essentially a mathematical review of the projections provided by the public utility. Therefore, there is no initial review to determine the appropriateness or necessity of the rate request.

Id. at 447-48, 581 A.2d at 999-1000 (emphasis in original).

Although we agree that Section 1307 should have limited application and the PUC should not use it to disassemble the traditional rate-making process, the General Assembly did not limit the allowance of automatic adjustment to only fuel costs and taxes which are generally beyond the control of the utility. Instead, the General Assembly specifically allowed the recovery of fuel costs and also allowed the PUC or the utilities to initiate the automatic adjustment of costs within specific procedures.³⁷

Irrespective of whether purchased water increases are abnormal, extraordinary or non-recurring, NAWC's proposed PWAC would allow rapid recovery of a "specific

³⁷ *Pennsylvania Indus. Energy Coalition*, 653 A.2d at 1348-49 (footnotes omitted).

identifiable expense item” in a manner entirely consistent with the Public Utility Code and Commission and Court precedent.³⁸

OCA’s Exception No. 2 should be denied. NAWC’s purchased water adjustment clause is a method of cost recovery authorized by Section 1307(a) of the Public Utility Code.

³⁸ The OCA’s further contention at page 13 of its Exception No. 2 that the Company failed to support its claim that purchased water expense increases have had a detrimental financial impact on it is addressed in NAWC’s Reply to OTS Exception No. 4. As stated there, the Lost Purchase Water Expense was approximately \$400,000 as a result of the last two BCWSA purchased water rate increases in 2005 and 2008. The lack of a PWAC has denied NAWC the opportunity to recover significant and material *increases* in purchased water costs over the baseline level reflected in its base rates and resulted in the denial of NAWC’s constitutional right to an opportunity to earn a fair rate of return on the value of its property which is dedicated to public service. The obvious solution to this difficult circumstance is a Section 1307 automatic adjustment clause. NAWC need not show that it is in need of extraordinary rate relief to implement a purchased water adjustment clause.

IV. CONCLUSION

NAWC's Supplement No. 68 and proposed automatic adjustment clause for recovery of purchased water expense is a method of cost recovery specifically allowed under Section 1307 of the Public Utility Code, 66 Pa. C.S. § 1307, and consistent with Court and Commission precedent. Supplement No. 68 and the proposed Purchased Water Adjustment Clause should be approved.

Respectfully submitted,

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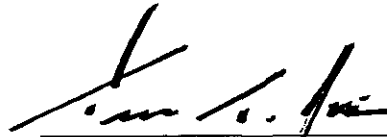
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