

PENNSYLVANIA PUBLIC UTILITY COMMISSION
Uniform Cover and Calendar Sheet

95

1. REPORT DATE:
August 12, 1996

2. BUREAU AGENDA NO.:
AUG-96-L-62*

3. BUREAU:
LAW

4. SECTION(S):

5. PUBLIC MEETING DATE:
August 22, 1996

6. APPROVED BY:

Director: J. Povilaitis 7-5000
Supervisor: B. R. Pankiw 7-3190

7. PERSONS IN CHARGE:
S. Povilaitis 7-2871

8. DOCKET NO.:
P-00961036

DOCKETED
AUG 29 1996

JLS

9. (a) CAPTION (abbreviate if more than 4 lines)
(b) Short summary of history & facts, documents & briefs
(c) Recommendation

(a) Petition of Philadelphia Suburban Water Company for Approval to Implement a Tariff Supplement Establishing a Distribution System Improvement Charge.

(b) On March 20, 1996, the Philadelphia Suburban Water Company (PSWC) filed a petition requesting regulatory approval to file and implement an automatic adjustment clause tariff that would establish a Distribution System Improvement charge (DSIC) pursuant to Section 1307(a). Answers, comments and protests were filed by the Office of Trial Staff (OTS), the Office of Small Business Advocate (OSBA), the Office of Consumer Advocate (OCA), and individual customers.

(c) The Law Bureau recommends, with the concurrence of the Bureaus of Fixed Utility Services and Audits, that the Commission adopt the draft order which grants in part and denies in part the company's petition and which sets forth parameters for a sample DISC surcharge tariff supplement.

10. MOTION BY: Commissioner Chm. Quain Commissioner Hanger - Yes
SECONDED: Commissioner Crutchfield Commissioner Bloom - Yes

CONTENT OF MOTION: Staff recommendation adopted.

DOCUMENT
FOLDER



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

August 26, 1996

IN REPLY PLEASE
REFER TO OUR FILE

P-00961036

DOCKETED
SEP 04 1996

■
THOMAS P GADSDEN ESQUIRE
MORGAN LEWIS & BOCKIUS
2000 ONE LOGAN SQUARE
PHILADELPHIA PA 19103-6993
■

JAF

Petition of Philadelphia Suburban Water Company

To Whom It May Concern:

This is to advise you that an Opinion and Order has been adopted by the Commission in Public Meeting on August 22, 1996 in the above entitled proceeding.

An Opinion and Order has been enclosed for your records.

Very truly yours,

John G. Alford
Secretary

Enclosure
Certified Mail
JEP

**DOCUMENT
FOI DEF**

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held August 22, 1996

Commissioners Present:

John M. Quain, Chairman
Lisa Crutchfield, Vice Chairman
John Hanger
Robert K. Bloom

DOCKETED
SEP 04 1996

Petition of Philadelphia Suburban Water
Company for Approval to Implement a
Tariff Supplement Establishing a
Distribution System Improvement Charge

Docket No. P-00961036

OPINION AND ORDER

**DOCUMENT
FOLDER**

BY THE COMMISSION:

I. Background

On March 20, 1996, the Philadelphia Suburban Water Company (PSWC or company) filed the above-referenced petition with this Commission requesting regulatory approval to file and implement an automatic adjustment clause tariff that would establish a Distribution System Improvement Charge (DSIC or surcharge) pursuant to Section 1307(a) of the Public Utility Code. 66 Pa.C.S. §1307(a). Section 1307(a) provides statutory authority for a utility to establish, subject to Commission review and approval, a tariffed automatic adjustment clause mechanism designed to provide "a just and reasonable return on the rate base" of the public utility.

As proposed by PSWC, the DSIC would operate to recover the fixed costs (depreciation and pre-tax return) of certain non-revenue producing, non-expense reducing infrastructure rehabilitation projects completed and placed in service between Section 1308 base rate cases. The company maintains that the property additions eligible for the DSIC will be limited to revenue neutral infrastructure projects, consisting principally of replacement investments in so-called "mass property" accounts. The DSIC is designed to provide the company with the resources it needs to accelerate its investment in new utility plant to replace aging water distribution infrastructure, facilitating compliance with evolving regulatory requirements imposed by the Safe Drinking Water Act (SDWA) and the implementation of solutions to regional water supply problems.

To illustrate its point, the company states that it has 3,180 miles of mains, that it is currently rehabilitating approximately 15 miles of main each year, and that, at that pace, it would require approximately 212 years to make all of the needed improvements to existing facilities. The company also states that water service, more than any other utility service, is critical to maintaining public health as water is "a necessity of life and vital for public fire protection services." Petition at 3.

The company alleges that the DSIC may enable it to break out of a cycle, imposed on it by its capital investment needs, of filing base rate relief every 15 months. Any reduction in rate case filing frequency would generate costs savings which would inure to the benefit of customers and the Commission. In its petition, the company proposes certain accounts

for recovery, time-frames and other procedures to be followed in implementing the DSIC. The details of those procedures will be discussed below.

To begin with, the company proposes that the DSIC become effective for service rendered on and after July 1, 1996. The company also proposes that the initial charge to be calculated would recover the fixed costs of eligible plant additions that have not previously been reflected in the company's rate base and will have been placed in service between January 1, 1996 and May 31, 1996. Thereafter, the company proposes to update the DSIC on a quarterly basis to reflect eligible plant additions placed in service during the three-month periods ending one month prior to the effective date of each DSIC update. Petition at 3-4.

The company also proposes that the DSIC be capped at 5% of the amount billed to customers under otherwise applicable rates and charges, exclusive of amounts recovered under the State Tax Adjustment Surcharge (STAS). If the cap is reached, the company would not seek any additional increases. Petition at 4.

As with any Section 1307 automatic adjustment clause, the DSIC will be subject to an annual reconciliation, whereby the revenue received under the DSIC for the reconciliation period will be compared to the Company's eligible costs for that period. The difference between such revenues and costs will be recouped or refunded to customers, as appropriate, in accordance with Section 1307(e). Petition at 5.

Lastly, in terms of procedures, the company proposes that the DSIC will be reset to zero as of the effective date of new Section 1308 base rates that provide for prospective

recovery of the annual costs that had previously been recovered under the DSIC. Petition at 5. And to avoid over recovery of costs in the absence of a base rate case, the company also proposed that the DSIC will be reset to zero if, in any quarter, data filed with the Commission in the company's then most recent Annual or Quarterly Earnings Report shows that the company will earn a rate of return that would exceed the rate of return used to calculate its fixed costs under the DSIC. Petition at 5.

In terms of the legal issues raised by its petition, the company also states that its proposed automatic adjustment clause and procedures are lawful for a number of reasons found in statutory and case law. With regard to statutory law, PSWC states that Section 1307(a) of the Public Utility Code, 66 Pa. C.S. §1307(a), provides that a company may establish a sliding scale of rates or such other method for the automatic adjustment of the rates to recover a variety of costs. Petition at 19. Moreover, the company has cited circumstances in which the Commission has authorized the use of Section 1307 (a) automatic adjustment clauses to recover a wide array of expenses, depreciation and capital costs. See Pennsylvania Industrial Energy Coalition v. Pa. P.U.C., 653 A.2d 1336 (Pa. Cmwlth. 1995) (PIEC) (recovery of electric utilities' demand-side management costs); 52 Pa. Code §69.181 (recovery of gas utilities' take or pay liabilities to pipeline suppliers); 52 Pa. Code §69.341(b) (recovery of gas utilities' gas supply realignment costs and stranded costs resulting from Federal Energy Regulatory Commission Order 636); and 52 Pa. Code §69.353 (recovery of water utilities' principal and interest due on PennVEST obligations). Petition at 20-21.

Answers were filed by the Office of Trial Staff (OTS) (Answer filed April 9, 1996), the Office of Small Business Advocate (OSBA) (Answer filed May 3, 1996) and the Office of Consumer Advocate (OCA) (Comments and testimony filed May 6, 1996). Protests to the petition were also filed by many individual customers.

In its answer, the OTS requests that the Commission deny the company's petition based on legal and technical grounds. With regard to the legal objections, the OTS argues that, since the facilities are "new" facilities, the company is attempting to circumvent a base rate review through the use of a surcharge, in violation of the Court's decision in PIEC.

The OSBA's answer did not submit legal arguments opposing the implementation of the DSIC. Rather, the OSBA has requested that the Commission conduct a thorough investigation regarding the reasonableness and lawfulness of the proposed tariff supplement as they affect the company's various customer classes.

In its comments, the OCA argues against the implementation of the DSIC alleging that the company does not need the DSIC mechanism and that implementation of a DSIC mechanism would provide in excess of a fair return to the company. With regard to legal arguments, OCA challenges the legality of the surcharge based upon the same arguments outlined in OTS' answer based on its interpretation of Section 1307(a) and the PIEC decision.

On May 30, 1996, the company filed a reply with the Commission addressing the comments raised in the answers filed by OTS, OSBA and OCA. The OCA then filed a response to this reply on June 19, 1996. In PSWC's reply to the various parties concerning the legality of the DSIC, the company continued to support the legality of a surcharge under

Section 1307(a) of the Public Utility Code and the Commonwealth Court decision in PIEC, and supplied rebuttal arguments in support of its need for the DSIC and the legality of its proposal.

II. Discussion

At the outset of this discussion regarding the PSWC petition, we believe it necessary to clarify the Commission's view of the scope of this proceeding and the nature of the PSWC proposal. Because the PSWC petition requests regulatory approval to file and implement a certain type of automatic adjustment clause, we will not address, in this order, the specific factual issues that may be raised by the proposed tariff supplement submitted as Exhibit A to the petition. The Commission views the tariff supplement in Exhibit A as no more than the company's proposal as to how such an automatic adjustment clause should be structured. Indeed, as explained below, the specific tariff supplement proposed by PSWC will not be approved by this order.

Therefore, to the extent that parties have objections and/or complaints to the rates to be charged by means of an automatic adjustment clause that provides for the recovery of a water company's infrastructure improvement costs, those objections and/or complaints would be appropriately addressed to an actual PSWC tariff filing that contains specific rates to be charged to consumers based on specific distribution system improvement expenditures. A Section 701 complaint would be the appropriate procedural vehicle to challenge such a tariff filing and, provided that factual issues are raised, the filing of such a complaint will

entitle the complainant to a hearing before an administrative law judge and an adjudication of the complaint.

Thus, the key issues raised by the PSWC petition, and to be resolved in this order, are generic threshold issues regarding (1) the legality of the type of automatic adjustment clause proposed by the company and (2) the appropriate general structure of such an automatic adjustment clause that conforms to the requirement of the statute and Pennsylvania case law. In other words, this proceeding will address the legal issue concerning the adoption of the surcharge pursuant to Section 1307(a) of the Code. In addition, the Commission will outline the general parameters of a surcharge mechanism that meets the requirement of the statute, that is consistent with the case law, that has adequate safeguards to protect consumers' interests and, therefore, constitutes a surcharge that is likely to receive regulatory approval when filed.

To begin with, we applaud companies who present this Commission with innovative ideas to address recurring problems for their respective industries. In the water industry, companies are faced with the dual tasks of improving the quality of the water delivered to customers due to the new mandates of the SDWA and other governmental requirements and, at the same time, maintaining an aging water utility infrastructure. We recognize that, in recent years, PSWC and other Pennsylvania water companies have been required to make significant investments in new utility plant for projects such as: the filtration of surface water supplies; the replacement of aging water distribution plant; and, the implementation of meter replacement programs. In addition, water companies face the daunting challenge of

rehabilitating their existing distribution infrastructure before the property reaches the end of its service life to avoid serious public health and safety risks.

In the Commission's judgement, the establishment of a DSIC along the lines proposed by PSWC can substantially aid the water company in meeting these challenges on behalf of the water consuming public. We agree with the company that the establishment of a DSIC would enable the company to address, in an orderly and comprehensive manner, the problems presented by its aging water distribution system, and would have a direct and positive effect upon water quality, water pressure and service reliability. For these reasons, we endorse the concept of using an automatic adjustment clause to address this regulatory problem for the water industry in Pennsylvania and, in particular, the type of DSIC proposed by PSWC.

A. Legal Issues

In Pennsylvania, utility costs are recovered from customers through Section 1308 base rates and through Section 1307 automatic adjustment clauses. The purpose of a Section 1307 automatic adjustment clause is to provide an automatic mechanism enabling utilities to recover specific costs not covered by general rates. Allegheny Ludlum Steel Corporation v. Pa. P.U.C., 501 Pa. 71, 75 n.3, 459 A.2d 1218, 1220 n.3 (1983). Moreover, Section 1307(e), 66 Pa. C.S. §1307(e), provides that the automatic adjustment clause procedures shall include an annual report detailing the revenues collected and the expenses incurred under the automatic adjustment clause, followed by a public hearing to reconcile the amounts and to determine any refunds owed to customers or additional recovery due from customers.

Until recently, an automatic adjustment clause has usually been applied only to gas and electric companies. However, the Commission has provided for the recovery of capital costs in at least one instance to date, i.e., for PECO Energy's costs to convert oil-fired units to units which burn natural gas. Philadelphia Electric Co. ECR No.3, Docket No. M-00920312 (Order adopted April 1, 1993). The Commission has also adopted a policy statement which encourages water companies to seek Section 1307(a) cost recovery for their PENNVEST debt costs, 52 Pa. Code §69.361, and policy statements approving Section 1307 cost recovery for certain FERC Order 636 stranded costs, 52 Pa. Code §69.341(b)(4), and electric utility coal uprating costs, 52 Pa. Code §57.124(a). Moreover, since 1970, the Commission has authorized all utilities to use an automatic adjustment clause mechanism to recover certain incremental changes in state tax rates. 52 Pa. Code §69.44.

Pennsylvania case law regarding the permissible scope of Section 1307 cost recovery, while not extensive, supports a broad interpretation of that section. In National Fuel Gas Distribution Corp. v. Pa. P.U.C., 473 A.2d 1109, 1121 (Pa. Cmwlth. 1984), the Commonwealth Court held that the purpose of Section 1307 of the Code is 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 a Section 1308 base rate case. Moreover, under the 1995 PIEC decision, the Commonwealth Court adopted the Commission's legal position that its use of Section 1307 was not limited to fuel and purchased power costs. At the same time, the Commonwealth Court cautioned that Section 1307 should have limited application and should not override

the traditional ratemaking process. PIEC at 1349. In determining whether DSM costs could be recovered through the Section 1307 mechanism, the Court wrote:

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... In this case, Section 1319 of the Code specifically states that all prudent and reasonable costs should be recovered and sets forth requirements that the proposed programs be determined to be "prudent and cost-effective" by the PUC (or the Bureau of Conservation, Economics and Energy Planning as designated by the PUC), before any costs may be recovered through the surcharge mechanism.

PIEC at 1349 (emphasis added). The Court then concluded that the recovery of DSM costs under Section 1307 was lawful because the language of Section 1307 gives the Commission discretion to establish automatic adjustment clauses for the recovery of prudently incurred costs, and because in Section 1319 the legislature specifically identified and provided for the recovery of prudent and reasonable costs for developing DSM programs.

Clearly, the Court in PIEC recognized the importance of the statute (Section 1319) in providing for the recovery of development costs of the DSM programs via Section 1307. However, the Court also recognized that the language of Section 1307 is not limited to a narrow set of costs (as advocated by the industrials), that whether the costs at issue should be recovered via an automatic adjustment clause is a matter of Commission discretion, and

that the court “is not free to substitute its discretion for the discretion properly exercised by the PUC in establishing the surcharge method.” PIEC at 1349.

Turning to the PSWC proposal to file and implement an automatic adjustment clause to recover its distribution system improvement costs, we find that the proposal is appropriately limited and narrowly tailored to recover a specific category of utility costs - the incremental fixed costs (depreciation and pre-tax return) associated with non-revenue producing, non-expense reducing distribution system improvement projects completed and placed in service between base rate cases. Recovery of this narrow set of costs is clearly permitted under Section 1307 (a) (which has no cost category limitation in its language) and Pennsylvania case law; and, in the Commission’s judgment, this proposal is in no way a mechanism to “disassemble” the traditional ratemaking process for several reasons: first, the DSIC is designed to identify and recover the distribution system improvement costs incurred between rate cases; second, the costs to be recovered represent a narrow subset of the company’s total cost of service; and third, 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. Indeed, the company’s proposal recognizes that there will be a full review of these costs in a subsequent Section 1308 base rate proceeding. We also note that the DSIC is designed to reflect only the costs of the eligible plant additions that are actually placed in service during the 3-month periods ending one month prior to the effective date of each surcharge update; this key provision serves to avoid any potential violation of Section 1315 and this state’s long-standing “used and useful” rule.

Additionally, we find that Sections 1307(d) and (e) provide broad auditing powers to the Commission and a formal reconciliation mechanism to carefully monitor the operation of such a surcharge. While admittedly Section 1307(d) is addressed to fuel cost adjustment audits, we do not view the Commission's auditing power over automatic adjustment clauses as limited to only fuel costs, given the broad auditing and investigative powers granted to the Commission via Sections 504, 505, 506, and 516 of the Public Utility Code. 66 Pa. C. S. §§504, 505, 506, 516. Nor would we be likely to approve a utility's request for approval of an automatic adjustment clause in the absence of its complete agreement that the Commission has such auditing powers. Moreover, Section 1307(e) provides for a mandatory annual reconciliation report regarding the revenues and expenses recovered via an automatic adjustment clause and a "public hearing on the substance of the report and any matters pertaining to the use by such public utility" of the automatic adjustment clause. As such, the costs to be recovered via the company's DSIC proposal will be subject to the Commission's auditing powers, an annual reconciliation report and public hearings.

B. General Tariff Parameters

The basic elements of a tariff supplement to implement a lawful DSIC mechanism include a statement of purpose and description of eligible property, a specification of its effective date and the dates of its subsequent quarterly updates, details regarding the computation methodology, and appropriate consumer safeguards. The proposed tariff supplement included with the PSWC petition, as Exhibit A, includes most of these elements but, in the Commission's judgment, certain elements should be modified in order to

adequately protect consumer interests and to comply with Section 1307. In order to provide guidance to PSWC and any other water utility that may need to implement a DSIC, the Commission has developed sample tariff language that, if used in a water utility's Section 1307 proposed tariff supplement, is likely to receive the Commission's approval. The sample tariff language is contained in Attachment A to this order.

The major differences between the tariff supplement proposed by PSWC and the sample tariff language in Attachment A can be summarized as follows:

- specification of the eligible plant accounts by type and account number;
- provision to include recovery of main extensions installed to implement solutions to regional water supply problems that have been documented as presenting a significant public health and safety concern to existing customers;
- specification that the costs of projects funded by PENNVEST loans are not eligible;
- provision of a prospective January 1, 1997 effective date for the tariff supplement and the property eligible for the initial filing;
- if more than 2 years have elapsed since the utility's last base rate case, use of the equity return rate determined by staff and specified in the latest Quarterly Earnings Report released by the Commission;
- greater specification of the depreciation and pretax return elements in the formula to calculate the DSIC;

- added provision to provide interest to consumers for any over recoveries during operation of the DSIC; and
- provision for customer notice of any DSIC changes.

Thus, use of the sample tariff language will fully explain the DSIC computation, including a listing of DSIC eligible property and related account numbers, so that in future years the purpose and intent of the DSIC surcharge will be apparent from reading only the tariff supplement. Additionally, the inclusion of plant account numbers and descriptions of property eligible for DSIC cost recovery parallels the format used for other Section 1307 surcharges, such as the ECR for electric utilities, the GCR for gas distribution utilities and the SCR for steam heat companies.

With these changes to PSWC's proposal, the eligible property, filing dates, parameters, and consumer safeguards have been significantly strengthened. In particular, we note here that the provisions (1) for resetting the DSIC to zero if the company's rate of return exceeds its allowable rate of return, and (2) for resetting the DSIC to zero as of the effective date of new Section 1308 base rates that provide for prospective recovery of the eligible plant costs both serve as effective and reliable rate mechanisms to insure that the DSIC automatic adjustment clause will not produce rates in excess of a fair return to the utility, as required by Section 1307(a). We also note that the provision of a 5% of billed revenues cap on the maximum amount of any DSIC insures that the surcharge mechanism will not evade the Section 1308 base rate process and its intensive top-to-bottom review of all company revenue, expense, rate base and return claims. See Attachment A, p.4. In other words, the

5% cap will insure that the surcharge will not allow the company to avoid a base rate review of the eligible property in perpetuity.

Accordingly, although we are denying the PSWC petition to the extent that it requests permission to file and implement a Section 1307(a) tariff supplement to implement a surcharge as set forth in its Exhibit A, we invite the company to file a new tariff supplement consistent with the parameters outlined in the sample tariff language set forth in Attachment A to this order. The sample tariff language in Attachment A is identical to that recommended for the Pennsylvania-American Water Company at Docket No. P-00961031 which has also requested permission to file a DSIC surcharge..

As with other Section 1307 tariff filings, the new tariff supplement should provide for a notice period of no less than 60 days to allow sufficient time for staff review of the proposed tariff supplement and its initial rates for consistency with the sample tariff language and for accuracy of the plant account, depreciation, pre-tax return and other elements of the DSIC calculation. If recommended for approval by staff and formally approved by the Commission, the tariff supplement and initial rates to implement the DSIC will be permitted to go into effect, subject to the outcome of any timely filed complaints. Subsequent quarterly updates, however, may be filed on 10 days notice as originally proposed by the company.

THEREFORE,

IT IS ORDERED:

1. That the petition filed by the Philadelphia Suburban Water Company (PSWC) to file and implement a Section 1307(a) automatic adjustment clause tariff that would establish a Distribution System Improvement Charge (DSIC) is hereby approved in part and denied in part consistent with this order.

2. That all protests, answers and other objections filed with respect to the PSWC petition are hereby granted in part and denied in part consistent with this order.

3. That any complaints regarding the rates to be charged pursuant to a DSIC tariff supplement may be filed if and when PSWC files a tariff supplement with specific rates in accordance with the tariff parameters outlined by this order.

4. That the parameters set forth in the Appendix A are hereby adopted to serve as sample tariff language to be implemented for tariff supplements to establish a DSIC.

5. That the normal auditing, reconciliation, reporting and public hearing procedures applicable to all 1307(e) filings will likewise apply to all DSIC tariff supplements.

6. That this order be published in the Pennsylvania Bulletin.

7. That this order be served upon Philadelphia Suburban Water Company, the Office of Consumer Advocate, the Office of Small Business Advocate, the Office of Trial Staff and the National Association of Water Companies.

BY THE COMMISSION,



John G. Alford
Secretary

(SEAL)

ORDER ADOPTED: August 22, 1996

ORDER ENTERED: AUG 26 1996

Sample Tariff Language

DISTRIBUTION SYSTEM IMPROVEMENT CHARGE (DSIC)

I. General Description

Purpose: To recover 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 and to be recorded in the individual accounts, as noted below, between base rate cases and to provide the Company with the resources to accelerate the replacement of aging water distribution infrastructure, to comply with evolving regulatory requirements imposed by the Safe Drinking Water Act and to develop and implement solutions to regional water supply problems. The costs of extending facilities to serve new customers are not recoverable through the DSIC. Also, Company projects receiving PENNVEST funding are not DSIC-eligible property.

Eligible Property: The DSIC-eligible property will consist of the following:

- services (account 323), meters (account 324) and hydrants (account 325) installed as in-kind replacements for customers;
- mains and valves (account 322) installed as replacements for existing facilities that have worn out, are in deteriorated condition, or upgraded to meet Chapter 65 regulations of Title 52;
- main extensions (account 322) installed to eliminate dead ends and to implement solutions to regional water supply problems that have been documented as presenting a significant health and safety concern for customers currently receiving service from the Company or the acquired Company;
- main cleaning and relining (account 322) projects; and
- unreimbursed funds related to capital projects to relocate Company facilities due to highway relocations.

Effective Date: The DSIC will become effective for bills rendered on and after January 1, 1997.

II. Computation of the DSIC

Calculation: The initial charge, effective January 1, 1997, shall be calculated to recover the fixed costs of eligible plant additions that have not previously been reflected in the Company's rate base and will have been placed in service between September 1, 1996, and November 30, 1996. Thereafter, the DSIC will be updated on a quarterly basis to reflect eligible plant additions placed in service during the three-month periods ending one month prior to the effective date of each DSIC update. Thus, changes in the DSIC rate will occur as follows:

<u>Effective Date of Change</u>	<u>Date To Which DSIC-Eligible Plant Addition Reflected</u>
April 1	February 28
July 1	May 30
October 1	August 31
January 1	November 30

The fixed costs of eligible distribution system improvement projects will consist of depreciation and pre-tax return, calculated as follows:

Depreciation: The depreciation expense will be calculated by applying to the original cost of DSIC-eligible property the annual accrual rates employed in the Company's last base rate case for the plant accounts in which each retirement unit of DSIC-eligible property is recorded.

Pre-tax return: The pre-tax return will be calculated using the state and federal income tax rates, the Company's actual capital structure and actual cost rates for long-term debt and preferred stock as of the last day of the three-month period ending one month prior to the effective date of the DSIC and subsequent updates. The cost of equity will be the equity return rate approved in the Company's last fully-litigated base rate proceeding for which a final order was entered not more than two years prior to the effective date of the DSIC. If more than two years shall have elapsed between the entry of such a final order and the effective date of the DSIC, then the equity return rate used in the calculation will be the equity return rate calculated by the Commission Staff in the latest Quarterly Report on the Earnings of Jurisdictional Utilities released by the Commission.

DISC Surcharge Amount: The charge will be expressed as a percentage carried to two decimal places and will be applied to the total amount billed to each customer under the Company's otherwise applicable rates and charges, excluding amounts billed for public fire protection service and the State Tax Adjustment Surcharge (STAS). To calculate the DSIC, one-fourth of the annual fixed costs associated with all property eligible for cost recovery under the DSIC will be divided by the Company's projected revenue for sales of water for the quarterly period during which the charge will be collected, exclusive of revenues from public fire protection service and the STAS.

Formula: The formula for calculation of the DISC surcharge is as follows:

$$\text{DSIC} = \frac{(\text{DSI} \times \text{PTRR}) + \text{Dep} + e}{\text{PQR}}$$

Where:

DSI = the original cost of eligible distribution system improvement projects.

PTRR = the pre-tax return rate applicable to eligible distribution system improvement projects.

Dep = Depreciation expense related to eligible distribution system improvement projects.

e = the amount calculated under the annual reconciliation feature as described below.

PQR = Projected quarterly revenue including any revenue from acquired companies that are now being charged the rates of the acquiring company.

Quarterly updates: Supporting data for each quarterly update will be filed with the Commission and served upon the Office of Trial Staff, the Office of Consumer Advocate and the Office of Small Business Advocate at least ten (10) days prior to the effective date of the update.

III. Safeguards

Cap: The DSIC will be capped at 5% of the amount billed to customers under otherwise applicable rates and charges.

Audit/Reconciliation: The DSIC will be subject to audit at intervals determined by the Commission. It will also be subject to annual reconciliation based on a reconciliation period consisting of the 12 months ending December 31 of each year. The revenue received under the DSIC for the reconciliation period will be compared to the Company's eligible costs for that period. The difference between revenue and costs will be recouped or refunded, as appropriate, in accordance with Section 1307(e), over a one year period commencing on April 1 of each year. If DSIC revenues exceed DSIC-eligible costs, such overcollections will be refunded with interest. Interest on the overcollections will be calculated at the residential mortgage lending specified by the Secretary of Banking in accordance with the Loan Interest and Protection Law (41 P. S. sec.101, et seq.) and will be refunded in the same manner as an overcollection.

New Base Rates: The charge will be reset at zero as of the effective date of new base rates that provide for prospective recovery of the annual costs that had theretofore been recovered under the DSIC. Thereafter, only the fixed costs of new eligible plant additions, that have not previously been reflected in the Company's rate base, would be reflected in the quarterly updates of the DSIC.

Earning Reports: The charge will also be reset at zero if, in any quarter, data filed with the Commission in the Company's then most recent Annual or Quarterly Earnings reports show that the Company will earn a rate of return that would exceed the allowable rate of return used to calculate its fixed costs under the DSIC as described in the Pre-tax return section.

Customer Notice: Customers shall be notified of changes in the DSIC by including appropriate information on the first bill they receive following any change. An explanatory bill insert shall also be included with the first billing.