Testimony of National Association of Water Companies New Jersey Chapter in New Jersey BPU Stakeholder Proceeding – Docket No. WO10090655
Submitted December 29, 2010

The National Association of Water Companies' New Jersey Chapter (NAWC-NJ) strongly supports the implementation of a Distribution System Improvement Charge (DSIC) in New Jersey. We applaud the Board of Public Utilities (BPU) for its decision to formally investigate the value that an infrastructure investment mechanism could have for New Jersey and its residents.

Background on NAWC New Jersey Chapter

NAWC NJ represents all aspects of the investor-owned water industry in New Jersey. Its mission is to promote the value of the private sector as a provider of quality, sustainable water services and innovative water and wastewater solutions for New Jersey residents and businesses. The New Jersey Chapter of the NAWC has 11 member companies. They are: Aqua New Jersey, Inc.; Fayson Lake Water Company; Gordon's Corner Water Company; Middlesex Water Company; New Jersey American Water Company; Roxiticus Water Company; SB Water Company; Shore Water Company; Shorelands Water Company, Inc.; United Water New Jersey; and United Water Toms River. These companies collectively provide more than 480 million gallons of drinkable water each day to a population of more than 4.3 million people either directly or via bulk sale of water through 12,500 miles of water mains spanning more than 320 New Jersey municipalities. The investor-owned water industry also contributes to New Jersey's economy providing good-paying and stable New Jersey jobs to more than 1600 people.

The Need for a DSIC

Many of the water mains in New Jersey were installed during the first half of the last century. If they have not done so already, they will reach the end of their useful life sometime during the next 25 years. 100% of the cast iron and ductile iron pipe installed by 1965 will reach the end of its estimated life by 2035. Pipe installed in the 1880s is already 120 years old. So we have 25 years to replace or rehabilitate 80 years of pipe installation; this is significant. We are facing a critical problem for which a solution is needed. The rate at which our systems are aging is rapidly accelerating. We cannot effectively address this critical need unless an effective DSIC program is implemented.

DSIC is a Workable Solution to a Growing Problem

A DSIC is a proven regulatory tool that allows for an increase in non-revenue producing investments to be funded through modest interim rate increases in a structured process that includes built-in safeguards. This enables eligible investments to be funded and made on an ongoing basis while maintaining transparency and necessary regulatory oversight. DSIC rates would not become permanent until the next base rate case at which time the DSIC investments would receive the same scrutiny as all other non-DSIC investments. This type of regulation, first implemented in Pennsylvania in 1997, has also been successfully implemented in Connecticut, Delaware, Illinois, Indiana, Missouri, New Hampshire, New York, Ohio and Los Angeles, California.

DSIC Goals and Benefits

NAWC-NJ believes that it is critical for New Jersey to implement an effective DSIC program to meet the following goals:

- Improved water quality and fire protection
- Improved system reliability that will ensure sustainable water service, which is essential to the health and economic vitality of customers and the New Jersey communities we serve
- Support of the State's short-term and long-term goal of economic development
- Job creation/expansion[1]
- Lower long-term capital and maintenance costs due to planned replacements and rehabilitation, instead of costly emergency repairs
- Gradual price changes for customers with long-term lower costs that will help to avoid rate shock
- Transparency of infrastructure investment needs, planning and prioritization
- Continued regulatory oversight and transparent prudency reviews of company investment decisions
- Customer safeguards
- Increased resource conservation through reduced leakage in distribution systems
- Better coordination between water companies and towns, for example:
    - Additional funds for infrastructure replacement would allow water companies to better coordinate their plans with towns that have well-planned street paving programs, creating a cost savings for both.

Industry Efforts to Address Infrastructure Concerns

The NAWC NJ companies take seriously their obligation to provide safe, adequate and proper service to their customers. During the mid-1990s, when the growing need for a mechanism to

[1] Exhibit A of this filing is a draft report prepared by the Bloustein School which estimates that a total of 6.5 to 7.9 jobs will be created for every $1 million of DSIC spending, depending on the specific project. Approximately 80% of those are expected to be direct jobs. We will provide the final Bloustein report which we expect to be largely unchanged from the draft once it is available.

accelerate water infrastructure upgrades first became clear and discussions to implement these mechanisms began across various states, we recognized the need also existed in New Jersey. So, beginning in the mid-1990s we increased the dialogue on this critical issue, recognizing that a significant portion of New Jersey's underground water and wastewater infrastructure was reaching the end of its useful life. We started to focus policy makers on the aging and loss of structural integrity of the water distribution infrastructure that would converge between 2020 and 2035.

Facing the issue head on, NAWC NJ companies began investing more in infrastructure rehabilitation and replacement. At the same time, the industry began discussions with the State about a mechanism to accelerate investment. While the industry has steadily addressed its aging infrastructure under the current regulatory system, we have reached a point where the current regulatory structure is not sufficient to address the acceleration of distribution infrastructure aging and must be modified to address this critical issue. The fact is that, under the current regulatory framework, investments in distribution system upgrades have had to be fit in around other urgent mandates and requirements.

During this same time period, NAWC NJ companies have been required to make significant investments in other more pressing construction projects, to address emerging water quality issues and to meet new or tightened NJ DEP safe drinking water standards. NAWC NJ companies have also made significant investments to develop necessary new sources of drinking water to meet demands in many parts of the State and to remove contaminants from existing sources.

The industry has done a good job of updating its infrastructure under the current regulatory framework. However, the current framework causes a significant lag in earning on investments and contributes to rate shock. As more and more miles of main, valves and other facilities reach the end of their useful life, the industry will not be able to keep up with the investment demand under the regulatory system as currently implemented.

<u>Consequences of Inaction</u>

The stakeholder meeting record demonstrated a universal understanding of the need to invest in water infrastructure rehabilitation and replacement. There was some limited testimony highlighting the concerns with how the DISC would be implemented. The Board's final judgment of the value of DISC should consider the very real consequences of not implementing a properly functioning DSIC.

If New Jersey does not implement an effective DSIC program to meet the critical need to accelerate investment in infrastructure renewal, water companies will continue to invest as they have been. Because those investments will not meet the need, we will all face the consequences of less reliable water systems, including:

- More prolonged main breaks and service interruptions
- Increased water quality concerns (due to discoloration) resulting in increased customer complaints

- Unreliable supply of safe drinking water
- Economic impact on business and individuals from more frequent and prolonged service interruptions (lost revenue and wages)
- Insufficient water flow and pressure for fire protection
- Insufficient water flow and pressure for personal and industrial/commercial use
- Long-term higher costs as emergencies occur – with up to a 10 times higher cost to fix the problems on an emergency basis.

Importantly, the consequences of inaction will also negatively impact businesses in New Jersey and its ability to attract new business to the Garden State:

- Businesses impacted by a prolonged water outage would face a loss of revenue because of closure, and a loss of customers due to road closure involved with repairing emergencies.

- Businesses with higher than average water demands may look to other states to establish themselves - selecting states that have established policies that foster accelerated investment in sound water infrastructure.

Conversely, demonstrating the State's commitment to address this issue with solid planning and a reasonable funding mechanism could be a key selling point and fits well with the Governor's agenda to attract new business to the state.

<u>Critical Issues to be Addressed by a DSIC</u>

The NAWC-NJ recommends that the investment under a DSIC be directed to the most critical areas of the distribution systems, including:

- Structurally deficient mains

- Unaccounted for Water – (to enhance water conservation)

- Undersized Mains

- Cleaning and Relining

Each of the larger NAWC NJ companies have solid planning processes and capital prioritization models to ensure that the most critical areas are given the highest priority when determining projects that would be completed under a DSIC program. We would be willing to review these processes and models with the BPU Staff and Rate Counsel as part of the discussions regarding the foundational filing that would be part of the DSIC process. Exhibit B is an outline for the foundational filing process that the NAWC NJ proposes and would like to review with BPU Staff and Rate Counsel.

Transparency and Oversight

NAWC NJ supports a fully transparent DSIC program process with appropriate oversight to meet the goals set out above. We believe that this is an important goal for BPU Staff and Rate Counsel as well. The governance of the program must provide sufficient customer protections that allow continued confidence in the rate setting process while maintaining sufficient flexibility to address this critical need in a timely fashion.

As the Board considers the direction it wants to pursue on this issue, we suggest that to ensure adequate customer safeguards, any well-structured DSIC developed for New Jersey should include: a foundational filing at the beginning of the DSIC process; a cap limiting rate increases between rate cases; an earnings cap to ensure that no company can earn more than its authorized return on equity (ROE) due to participation in a DSIC; and the filing of regular compliance and informational reports on the status of the DSIC-eligible projects and spending. Additionally, we would recommend that the interim rate increases granted during the DSIC period would not be made permanent until the next formal rate case at which time the DSIC investments would receive the same scrutiny as all other non-DSIC investments.

The intent of the foundational filing would be to provide the Board and Rate Counsel with a transparent view of the types of investments to be made under a DSIC; the opportunity to discuss those investments; the supporting planning and engineering process utilized; and the decision criteria used to prioritize each type of project.

We believe that it is important that the foundational filing and review process be efficient, effective and provide the necessary flexibility to meet the DSIC program goals. Accordingly, the review process should be completed promptly - within ninety days of filing. The process should also provide flexibility to address changing circumstances that impact planning, design and completion of capital investment in the communities we serve. These include relocation requirements, road restoration projects and specific emergent circumstances which must be addressed with urgency. We reiterate, as we propose it and as outlined in Exhibit B, each completed DSIC project would be detailed in a quarterly DSIC filing and all projects would undergo the regular scrutiny during the following rate case by Rate Counsel and Board Staff. Only after that review would the interim DSIC increase be made permanent.

Financial Impact to Customers

When examining the many factors involved in the decision to implement a DSIC, the economic impacts to customers must be considered.

Although the Board will ultimately decide how the DSIC is structured, under a scenario with a 5% cap on rate increases related to DSIC projects between rate cases, the maximum increase in a typical monthly residential water bill would be on the order of +/- $2.00. That estimated maximum increase would likely occur in the last month between rate cases. The increases would be incremental over time based on the rate of investment in replacing or rehabilitating infrastructure until they reached the maximum allowed under a cap.

This estimate is based on the following assumptions:

- The DSIC cap is 5% between rate cases
- The 5% DSIC cap is not attained until the last month of the rate cycle
- DSIC investment is relatively uniform each month
- The average monthly bills of the four larger NAWC-NJ companies range from $37.66 to $46.57 per month.

<u>DSIC in Pennsylvania and Delaware</u>

Other states have had great success with water and wastewater DSIC-type programs. Locally, Pennsylvania and Delaware have both implemented successful DSICs, with Pennsylvania being the first in 1997.

Prior to 1997, one of the major Pennsylvania companies estimated it would take over 900 years to make all of the necessary replacements at their current rate of replacement. In 2006, this same company had reduced this replacement cycle to approximately 100 years, a significant and necessary improvement. In 10 years, they reduced the cycle by approximately 800 years. (See the presentation at Exhibit C entitled "DSIC Then, Now, Tomorrow" authored by Steve

Klick, Executive Policy Manager to Pennsylvania PUC Commissioner Robert Powelson and Advisor to Pennsylvania PUC Chairman Butch Howard which was presented at the 2010 NAWC Staff Water Policy Forum.

Other examples of the effectiveness of a DSIC can be found in Pennsylvania and the other states that have embraced the DSIC. The success of the DSIC in Pennsylvania has led the Public Utilities Commission to increase the cap set between rate cases from 5% to 7.5%.

Both Pennsylvania and Delaware have uncomplicated, effective tariffs regulating their DSIC mechanisms that cover the necessary components of an effective DSIC program, including: eligible assets, calculation of the DSIC, frequency of DSIC filings, and customer safeguards. NAWC-NJ recommends that the Board look to those states as a starting point for drafting a DSIC mechanism for New Jersey. Exhibit D includes copies of DSIC tariffs from Pennsylvania and Delaware for the Board's review.

<u>Level of Return Sufficient to Achieve DSIC Goals</u>

There was some discussion during the December 7, 2010 stakeholder meeting about whether the investment in DSIC-qualified projects should receive a lower return on equity (ROE).

NAWC-NJ firmly believes that a lower ROE on investments in DSIC-eligible projects would defeat the goals of an effective DSIC program as it does not reflect the reality of the market. Investors will provide capital only when they believe they have the opportunity to earn a fair return on their investment. A decision to reduce investor return on DSIC investments will make investing in New Jersey less favorable than investing in other states – including neighboring states that do not reduce the ROE on DSIC investments.

In recent rate cases the New Jersey BPU has established 10.3% as the authorized return on equity for water companies. History shows that the ROE authorized for water companies in New Jersey has not been achievable because of a number of inhibitors in the current regulatory process, one of the most significant being regulatory lag.

Exhibit E shows the ranges of actual ROE realized by the four largest NAWC-NJ water companies over the four year period 2006 to 2009. In no instance did any company attain the BPU-authorized ROE in any year. The range spans a negative actual ROE to a maximum actual ROE that was 87% of the ROE authorized by BPU.

As the Board considers the appropriate level of ROE for DSIC investments, it will be important to recognize that there is competition for capital and no other state with a DSIC in place has a reduced ROE for DSIC-eligible projects. Exhibit F is a matrix that provides information related to other states that have implemented a DSIC showing that none of those states' programs have included a reduced ROE for DSIC asset investments. We would urge New Jersey not to implement any policy, such as a reduced ROE, that would frustrate the goal of accelerating water infrastructure investment.

Conclusion

In conclusion, when deciding if and how a DSIC should be implemented in New Jersey, we encourage the Board to take a step back from the debate and examine the true risk and reward of a DSIC. While a DSIC would inherently involve slightly higher costs today for more than half of New Jersey, the end result of this increased investment would be a reliable, sustainable water distribution system that will allow future generations to enjoy the same high level of water service we have enjoyed and a lower cost in the long run.

We all want our children and grandchildren to have a better life than we did; leaving them a decaying and underfunded water distribution system not only ignores this core value, but leaves future generations with the burden of the higher costs associated with once again delaying important policy decisions to be made by others at some point in the future. To wait any longer to implement an effective DSIC program will only put New Jersey further behind. The time to act is now. We will have collectively failed to address this important policy issue if a decision on DSIC for New Jersey is deferred or delayed.

We appreciate the opportunity to provide our thoughts and suggestions on this important issue.