



# State of New Jersey

## DIVISION OF RATE COUNSEL

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December 30, 2010

### **VIA HAND DELIVERY**

Kristi Izzo, Secretary  
State of New Jersey, Board of Public Utilities  
Two Gateway Center  
Newark, New Jersey 07102

**Re: I/M/O The Possible Implementation of a  
Distribution System Improvement Charge (DSIC)  
For Water and Wastewater Utilities  
BPU Docket No. WO10090655**

Dear Secretary Izzo:

Please accept for filing an original and eleven copies of the Division of Rate Counsel's ("Rate Counsel") comments regarding the above referenced matter. Please date stamp the additional copy as "filed" and return it in the enclosed, self-addressed, stamped envelope. In addition to the paper copies of our comments, we are also providing our comments via e-mail in Microsoft Word format at [rule.comments@bpu.state.nj.us](mailto:rule.comments@bpu.state.nj.us) per the instructions in the Notice requesting comments on this issue. Thank you for your consideration and attention to this matter.

### **I. Background**

On August 4, 2010 the Board of Public Utilities (the "Board" or "BPU") issued an Order in the Matter of the Petition of New Jersey American Water Company for

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Authorization to Implement a Distribution System Improvement Charge (“DSIC”) denying the Petitioner’s request and Instituting a Stakeholder Process. The Board in its Order concluded that a broader examination of whether it is appropriate to adopt a DSIC type mechanism as part of the rate structure of water and wastewater public utilities in New Jersey is warranted. Further, the Board ordered an initiation of an open stakeholders process to provide the necessary foundation for the Board to determine if and how to implement a global DSIC program. A DSIC is a possible surcharge that would allow water and wastewater utilities to recover the costs of certain non-revenue producing infrastructure improvements outside of the context of a base rate case.

Pursuant to this August 4, 2010 Order, the Board issued a Notice on October 25, 2010 in which it sought comments on several topics. Specifically, these topics included:

- Whether there is or is not a demonstrated need for a DSIC mechanism in New Jersey at this time;
- The applicability of a DSIC mechanism to both water and wastewater utilities;
- The type of infrastructure to be included in the DSIC;
- The methodology to be used in computing the DSIC surcharge;
- The appropriate level and timing of the DSIC mechanism;
- The need for an earnings test in the context of a DSIC; and
- The applicability of interest charges on DSIC rate over/under recoveries.

Rate Counsel provided oral comments at a Public Stakeholder Meeting attended by the Board’s Commissioners on December 7, 2010. These written comments are being

submitted to supplement and amplify the oral comments provided by Rate Counsel at the Public Stakeholder Meeting.

The Division of Rate Counsel represents and protects the interests of all utility consumers—residential customers, small business customers, small and large industrial customers, schools, libraries and other institutions in our communities. Rate Counsel is a party in cases where New Jersey utilities seek changes in their rates or services. Rate Counsel also gives consumers a voice in setting energy, water and telecommunications policy that will affect the rendering of utility services well into the future.

Prior to the initiation of the Stakeholder Process, DSIC proposals have been made in the context of regularly filed base rate cases by three of the four largest regulated water utilities in New Jersey: New Jersey American Water Company, United Water New Jersey and Aqua New Jersey. In addition, New Jersey American Water Company filed a separate DSIC Petition with the Board and in that proceeding a group of water utilities (United Water New Jersey, United Water Toms River, Aqua New Jersey and Middlesex Water Company) intervened under the banner of the National Association of Water Companies (“NAWC”) in support of the concept of a DSIC. At the December 7, 2010 Public Stakeholder Meeting, a group of utilities (New Jersey American Water Company, United Water New Jersey, United Water Toms River, Aqua New Jersey, Middlesex Water Company, Shorelands Water Company and Gordons Corner Water Company) appeared collectively as the New Jersey Utilities Association (“NJUA”) and offered comments favorable to the implementation of a DSIC. Some of these NJUA utilities own and operate both water and wastewater systems regulated by the Board.

## **II. Rate Counsel Analysis**

Rate Counsel generally supports the concept of utilities investing in their aging infrastructure, particularly in ways that extend the useful life of the pipelines that make up existing water distribution and wastewater collection systems. Rate Counsel believes that any incentive provided by a DSIC mechanism to accelerate the maintenance and renewal of these existing systems should encourage activities that extend the life of existing assets where appropriate, rather than provide an incentive to choose costlier asset replacement. Capital expenses associated with large-scale asset replacements are best addressed in the context of a base rate proceeding where all cost implications can be addressed at one time. It is also Rate Counsel's firm belief that any mechanism adopted by the Board must recognize the potentially cumulative impact of surcharges on base rates. An innovative mechanism like a DSIC should only be adopted if it meets the objective of renewing the life of existing infrastructure in a way that does not exceed customers' ability to pay or remain in business in New Jersey.

Many utilities have raised an alarm that underground infrastructure is aging and that a crisis of runaway system failure will result. Rate Counsel believes that assets that are not periodically evaluated and properly maintained are consigned to failure at some point. Unfortunately, buried infrastructure cannot be seen and inspected with ease and there are few objective tests that can be done to completely assess the condition of this important infrastructure. It has been out of sight since its installation and generally out of mind unless it failed to perform adequately.

However, although Rate Counsel agrees that aging infrastructure should be

addressed, we believe that any mechanism designed to finance such improvements should encourage the most cost-effective response, not simply the response that brings greatest revenues to the utility. A good illustration of this concept is the case of cast iron water mains. These mains represent some of the oldest water mains in service in New Jersey. Unlike more modern mains installed today, these older cast iron mains were not manufactured with a factory installed cement lining. The water transmitted through the mains was in direct contact with the metallic surface of the pipe and in many cases, this contributed to the development of tuberculation or scale within the pipe. Tuberculation robs the pipeline of its carrying capacity by restricting the diameter of the line or increasing the roughness of the pipe. This inhibits the free flow of water through the pipe. In extreme cases, this causes diminished or substandard fire flows, low pressure complaints from customers and discoloration of the water. Tuberculation also creates sites in which colonies of bacteria can grow, leading to other significant water quality problems.

Based on recent Annual Reports to the Board of Public Utilities filed by several water utilities the amount of cast iron pipe in service in New Jersey is shown in Table 1.

<b>Table 1: Cast Iron Pipe in Service for Selected Utilities</b>	<b>Estimated cast iron pipe in Service</b>	
	<b>Feet</b>	<b>Miles</b>
United Water New Jersey	5,089,234	963.87
Middlesex Water Company	617,760	117.00
United Water Toms River	10,735	2.03
Aqua New Jersey	714,087	135.24
Shorelands Water Company	9,005	1.71
Gordons Corner Water Company	-	-

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New Jersey American Water Co	14,888,181	2,819.73
Shore Water Company	16,158	3.06

For some companies, the amount of cast iron pipe in service is significant. Approximately 30% of New Jersey American's water distribution networks are cast iron pipe. For United Water New Jersey, cast iron pipe represents 45% of the system. Other systems like Gordons Corner Water Company have no cast iron pipe in service.

At the present time, it appears that much of this pipe is structurally sound based on the low break frequencies reported by the various utilities for this material. For example, in Aqua New Jersey's Phillipsburg system, where cast iron pipe accounts for 48% of the mains in service, the break rate per mile of main averaged a low 0.12 breaks per mile between 2007 and 2009. This performance is significantly better than the goal range recommended by the American Water Works Association in its 1995 Research Foundation study entitled Distribution System Performance Evaluation. In this study AWWA concluded that a reasonable goal for North American water utilities was to limit breaks to a rate of 0.25 to 0.30 breaks per mile of main. Thus, for the Aqua New Jersey Phillipsburg system, and potentially other major utilities in New Jersey, the data do not suggest a need for an accelerated main replacement program. Rather, the data suggest the condition of cast iron pipe would be better addressed through a cleaning and lining effort designed to extend the life of these mains.

Most of New Jersey's water utilities have reported costs to clean and line mains that are between one half and one third the cost of replacement. Because cleaning and lining structurally sound water mains can extend the service life of these mains

indefinitely, Rate Counsel believes that any DSIC mechanism adopted by the Board should incentivize the most cost-effective method of renewal. This means that while some mains will need to be replaced rather than cleaned and lined, the DSIC should be structured to encourage utilities to conduct appropriate testing (e.g. metallurgic analyses of pipe samples, ring tests, hardness tests, etc.) to verify the condition of the mains that are candidates for cleaning and lining.

In recent years, New Jersey utilities have treated cleaning and lining of water mains as a capital expense. This forces cleaning and lining projects to compete for capital dollars against other asset improvement needs of the utility. Unfortunately, given the capital allocation strategies employed by most utilities, other projects often win this contest for capital dollars. With few exceptions, this has left an important need unattended or insufficiently attended. Rate Counsel proposes that cleaning and lining should again be treated as an expense but one that can be recovered concurrently through the DSIC mechanism. There are three reasons for this. First, by approaching this work on a pay as you go basis through the DSIC mechanism, funds will be available as the work is being done. There will be no reason to defer the effort and expense in a year when sales may be depressed by weather or economic conditions or when other meaningful capital project needs take precedence. Second, cleaning and lining is an effort undertaken to extend the service life of an existing asset. With the exceptions of valve and service line replacements done during the normal course of a typical cleaning and lining project, no new units of property are created. Thus, expensing these costs is appropriate. Third, by expensing this work as it is done, the pyramiding effects of

continuing to recover the cost of capital and depreciation for many projects over an extended period of time are avoided. Most utility companies have a significant amount of cleaning and lining work and the magnitude of this effort could take a long time. The cost to ratepayers of expensing ongoing cleaning and lining programs will be exceeded by the cumulative impact of the cost of capital and depreciation in about six to nine years. That is, if large scale cleaning and lining programs are capitalized, ratepayers will shortly be asked to pay more for the same work than if they paid for it as the work is done.

Table 2, appended at the end of this letter, shows a hypothetical example of this issue. In this case, a utility intends to undertake a long-term cleaning and lining program in which an annual expense of \$1,000,000 is incurred. These expenses are inflated at a rate of 3% per year. In this example, the revenue requirement for the capitalized program exceeds the revenue requirement for the expensed program in year nine. By the 15<sup>th</sup> year of the program, ratepayers would be paying 50% more for the same level of cleaning and lining activity and by the 24<sup>th</sup> year of the program, ratepayers would be charged double the amount compared to what they would be charged if the program were expensed.

While cleaning and lining has been capitalized in recent years, Rate Counsel believes that the magnitude of the programs needed to clean and line cast iron pipe water mains is so significant that an alternative rate making strategy is needed. Prior to the early 1980's it was common practice to treat cleaning and lining of existing water mains as an expense item. This approach recognized that the activity of cleaning and cement lining an existing cast iron water main was intended to extend the life of the asset that was already providing useful service. Cleaning and lining was not thought to add new



units of property to the utility system. Cleaning and lining projects represent a significant operating expense when compared to what a typical water utility would spend on items like chemicals or power. In years when water sales were depressed by weather or economic conditions, it would be easy for a utility to defer planned cleaning and lining work to reduce overall expenses. As a result, to the extent that cleaning and lining was done, it was accomplished only when other financial performance goals were being met.

In the early 1980's utilities began treating cleaning and lining work as a capital expense and most often recorded the cost in its books to a Transmission & Distribution account. This eliminated the problem of having to support this work with general revenues that could fluctuate with the weather, but it placed cleaning and lining work in competition with capital projects for the utilities limited capital dollars. The prioritization of cleaning and lining existing water mains often took a back seat to capital requirements for treatment renovation projects. So, while allowing cleaning and lining to be treated as a capital expense solved its vulnerability to year-to-year financial performance, this work was often seen as a low priority item compared to funding work needed to maintain compliance with drinking water quality rules, and thus spending on cleaning and relining remained insufficient.

We are now at a point where a dedicated source of funds should be provided to get this work done. Rate Counsel's proposal would do this by once again expensing cleaning and lining work as it is done, while insuring that funds would be available through the DSIC mechanism. By returning to the old practice of expensing this work, rate payers will benefit by avoiding the pyramiding impact of paying for the utilities' rate

of return and depreciation as the result of year after year of capitalizing this work to rates. At the same time, if the cost of this necessary work is recovered through the DSIC mechanism, utilities will have a dedicated source of funding provided concurrently with execution of the work on spending will not fluctuate based on performance.

Accordingly, Rate Counsel recommends that this work be expensed while it is being recovered in the DSIC.

In addition to the expense category, Rate Counsel also proposes a second category of costs to be recovered through the DSIC. This category involves investment on which the utility can earn a return at its long-term debt rate in between rate cases. Under Rate Counsel's proposal, once the utility completes its next base rate case, this investment will be rolled into rate base where it will then start earning a return on investment at the overall rate of return, including an equity return, established by the Board during that rate case. It is important to note that under Rate Counsel's proposal, the return on DSIC investments will be funded by ratepayers contemporaneously to when the investments are being made and will continue until the investments are rolled into base rates in the next base rate case. In other words, there is no regulatory lag associated with the rate recovery of this return. In addition, the DSIC mechanism provides for reconcilable, dollar-for-dollar recovery of the return. A reduction in regulatory lag and guaranteed cost recovery reduces regulatory risk. It is only fair to the ratepayers – the ones who are paying the utility's return on investment – that this reduced regulatory risk be reflected in a lower return on investment.

Rate Counsel believes that this alternative to the capital-only DSIC proposed by

the utilities will accomplish the objective of renewing the life of existing infrastructure in a way that does not exceed customers' ability to pay. Rate Counsel's alternative proposal seeks to provide the utilities with increased funding for system renewal, while minimizing the burden on ratepayers, who must pay for any increased infrastructure spending. Rate Counsel's alternative, set forth in detail below, will also more fairly balance risk and return. Utilities will be able to earn their full return for larger capital projects in rate cases and once DSIC-funded projects are rolled into rate base, but while they are recovering contemporaneously and thus incurring less risk, some of that benefit will be shared with ratepayers through a lower rate of return.

Rate Counsel also proposes that the determination of which projects may be funded through the DSIC should be based on a comprehensive engineering analysis conducted before solutions are chosen and before money is spent. This analysis should prioritize problems and determine what solutions are necessary and most cost-effective. To the extent break history is an indicator that a segment of pipe needs to be replaced, utilities must adopt a practice of investigating the root cause of water main failures, as broad replacement strategies based on localized failure rates may not be the best solution to the apparent problem.

For example, in its most recent base rate filing, United Water New Jersey offered certain engineering evaluations of its system in response to Rate Counsel discovery requests. These evaluations demonstrated that United Water New Jersey had quite properly identified the operational characteristics of certain pump stations as a possible cause of some main failures in its system. The Company set about addressing the

operations of its pumps and defined ways to limit transient pressure surges that were contributing to the failures. Costly pipe replacements would not have corrected this problem. By taking time to understand the nature of the problem and fix the root cause rather than the symptom, United Water chose a solution that provides greater benefits to ratepayers and to their system overall. This type of analysis should be conducted in advance as part of the DSIC process and the costs of the analysis should be recoverable. In order to encourage more complete analyses of the issues causing main failures, Rate Counsel believes that any DSIC mechanism adopted by the Board should also allow for the recovery as an expense of the cost of conducting engineering evaluations of the condition and performance of both water distribution systems and wastewater collection systems.

The Board is also seeking comments on the applicability of any potential DSIC to both water and wastewater utilities. Rate Counsel does not object to an alternative to a DSIC applying to both water and wastewater utilities. Of course Rate Counsel does not believe that a DSIC should provide rate recovery for major capital investments such as water treatment plants, wastewater treatment plants, or pump stations. Due to their size and potential rate impact, these investments are best addressed in the context of a base rate case when all cost adjustments, not only those that would increase rates, can be considered. The primary focus of the DSIC mechanism should be the renewal of existing buried infrastructure.

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### III. Rate Counsel Recommendation

Rate Counsel believes that any DSIC or alternative adopted by the Board should be implemented as a pilot program with a pre-established end date. Rate Counsel recommends the pilot program be three years in length. After three years, the Board will evaluate whether or not there is a continued need for this infrastructure surcharge. Regarding an appropriate funding level, Rate Counsel believes that any surcharge adopted by the Board must include a spending cap, set as a percentage of a company's annual revenues. Table 3 shows the level of spending that would be allowed under various caps that are tied to utility revenues. Rate Counsel believes that a 3% cap on spending would provide sufficient funds to initiate this program on a trial basis and, based on experience gained in the trial period, future adjustments to the cap can be made if necessary.

**Table 3: Annual Spending Caps**

Company	Annual Operating Revenues	Annual Cap		
		1%	3%	5%
United Water New Jersey	\$176,800,000	\$1,768,000	\$5,304,000	\$8,840,000
Middlesex Water Company	\$65,286,000	\$652,860	\$1,958,580	\$3,264,300
United Water Toms River	\$30,670,000	\$306,700	\$920,100	\$1,533,500
Aqua New Jersey	\$32,673,000	\$326,730	\$980,190	\$1,633,650
Shorelands Water Company	\$9,200,000	\$92,000	\$276,000	\$460,000
Gordons Corner Water Company	\$9,200,000	\$92,000	\$276,000	\$460,000
New Jersey American Water Co	\$575,000,000	\$5,750,000	\$17,250,000	\$28,750,000
Shore Water Company	\$463,849	\$4,638	\$13,915	\$23,192

The 3% DSIC rate cap should also be viewed in the context of balancing the interests of ratepayers and utilities and is particularly appropriate given that the New Jersey water and wastewater ratepayers are already experiencing significant base rate

increase requests, on average every two years or earlier, ranging from a low of approximately 13% to a high of approximately 92%. Table 4 provides this information in more detail.

**Table 4: Summary of Recent Requested and Authorized Rate Increases**

	<u>Filing Date</u>	<u>Rate Increase Request</u>	<u>Rate Increase Granted</u>
<b><u>New Jersey-American</u></b>	4/9/10	13.61%	7.45%
	1/14/08	23.35%	15.19%
	<u>3/31/06</u>	<u>22.30%</u>	<u>12.46%</u>
<b>Approximate Average</b>	<b><u>2 Yrs</u></b>	<b><u>19.75%</u></b>	<b><u>11.70%</u></b>
<b><u>United Water New Jersey</u></b>	12/9/09	21.30%	7.72%
	9/5/08	31.50%	17.50%
	<u>2/23/07</u>	<u>27.99%</u>	<u>15.11%</u>
<b>Approximate Average</b>	<b><u>1.4 Yrs</u></b>	<b><u>26.93%</u></b>	<b><u>13.44%</u></b>
<b><u>Middlesex Water</u></b>	8/17/09	26.02%	13.57%
	4/18/07	16.46%	9.09%
	<u>5/18/05</u>	<u>13.10%</u>	<u>8.68%</u>
<b>Approximate Average</b>	<b><u>2.1 Yrs</u></b>	<b><u>18.53%</u></b>	<b><u>10.45%</u></b>
<b><u>Aqua New Jersey</u></b>	12/18/09	25.77%	13.95%
	12/21/07	28.06%	16.44%
	<u>12/8/05</u>	<u>18.73%</u>	<u>11.22%</u>
<b>Approximate Average</b>	<b><u>2.0 Yrs</u></b>	<b><u>24.19%</u></b>	<b><u>13.87%</u></b>
<b><u>United Water Toms River</u></b>	10/18/09	36.96%	19.01%
	<u>3/6/08</u>	<u>91.92%</u>	<u>62.38%</u>
<b>Approximate Average</b>	<b><u>1.6 Yrs</u></b>	<b><u>64.44%</u></b>	<b><u>40.70%</u></b>

**A. Categories of Infrastructure Improvements**

Rate Counsel's proposal that will allow water and wastewater utilities to renew deteriorating water and sewer infrastructure, while balancing the rate impacts of the DSIC and the rate increases outlined above. The proposal separates utility infrastructure into three distinct categories:

1. The first category encompasses items to be treated as expenses. Examples of items in this category include cleaning and relining of water mains; prudent engineering studies to refine and optimize distribution system operations and renewal strategies;<sup>1</sup> cathodic protection expenses incurred to protect water mains and service lines; efforts undertaken to eliminate private building electrical grounding systems from water services; corrosion monitoring; distribution valve and hydrant maintenance; and leak detection. With respect to wastewater systems, Rate Counsel believes that lining of existing sewer mains or manholes should be treated as an expense item and engineering studies done to identify sources of inflow and infiltration in sewer systems should also be treated as expenses.
2. The second category involves investment that the utility can earn a return on between rate cases at its long-term debt rate. Under Rate Counsel's proposal, the utility will be allowed to roll this investment into rate base in a future rate case. The utility will immediately earn a return on its investment at its long-term debt rate until it receives its next rate case

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<sup>1</sup> This could include the development and maintenance of hydraulic models and GIS/programmed and preventative maintenance systems that would allow the utility to monitor and assess the condition of a water distribution system on an ongoing basis.

order, at which time the utility will earn its full rate of return on the investment. The capital items should consist of plant investment net of associated depreciation reserve and accumulated deferred income taxes. No depreciation expenses associated with completed capital items will be recovered in the DSIC. Capital projects funded through the DSIC will not accumulate AFUDC. Examples of items in this category include valve replacements; fire hydrant replacements; service replacements;<sup>2</sup> and replacement of water mains less than six inches in diameter if the company has an engineering evaluation showing the main is not properly sized to meet current service requirements. With respect to wastewater collection systems, investments in replacing manholes and building service laterals should be included in the wastewater charge.

3. The third category involves investment that must continue to be recovered only through traditional rate case filings. This includes replacement of mains six inches or greater; all other capital investment not listed in category 1 or category 2. For wastewater collection systems, the replacement of sewer lines for any reason should be addressed in rate case filings.

**B. Procedural Framework**

A DISC filing should have foundational elements which include among other things:

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<sup>2</sup> Valve replacements and service replacements done as a matter of course in a cleaning and relining project would be recorded as replacement utility plant in service and capitalized through this mechanism and ultimately included in base rates.



**1. Initial Filing**

The program must have an initial filing which includes the submittal of an engineering evaluation defining the elements of the distribution or collection system maintenance and renewal program. This evaluation should identify mains that can benefit from service life extension programs (e.g. cleaning and relining, cathodic protection, etc.) and mains that are no longer structurally sound and should be replaced. This filing could include elements of the utility's comprehensive engineering studies applicable to water distribution system or wastewater collection system assets or a specific evaluation conducted solely for the purpose of supporting a DSIC filing.

As part of the foundational filing, Board Staff and Rate Counsel will be given the opportunity to review the projects planned for the initial DSIC year. Board Staff and/or Rate Counsel will be given the opportunity to disagree with a particular planned project, which could then be discussed among the parties. Determination of prudence will be reserved for the utility's next base rate case. Once an initial agreement is reached on the scope of work to be done in the initial DSIC year, an initial DSIC rate will be set. This rate will allow for the concurrent recovery of both expenses and capital items planned for the coming year.

**2. Annual Filing**

The program will include an annual filing to review the scope of work planned for the coming year and the estimated cost of the elements of the work planned. The filing will also summarize the work completed in the previous twelve months along with the

actual cost for the elements of the work completed. If, during the annual review, it is determined that the utility over-recovered the costs associated with the DSIC program during the previous year, the amount of over-recovery will be refunded to ratepayers with interest in the following year. Any under-recoveries of the costs associated with the DSIC in the previous year will be charged without interest to ratepayers in the following year. This is consistent with the “one-way interest” provision currently applicable to the PWAC and PSTAC clauses in place for New Jersey’s water and wastewater utilities. The interest rate to be used is the 7-year constant maturity rate plus 60 basis points.

**C. Earnings Test**

The range of capital items that could be recovered through the DSIC is purposely limited in Rate Counsel’s proposal and if the Board adopts these limitations, Rate Counsel does not feel that an earnings test is necessary. However, should the Board adopt a DSIC mechanism that significantly expands the list of qualified capital projects beyond what has been proposed by Rate Counsel, an earnings test should be included in the mechanism. Such an earnings test should not be limited to the abbreviated test that has been proposed by New Jersey American Water Company (“NJAWC”) in its most recent DSIC proceeding.<sup>3</sup> This abbreviated test merely consists of determining a utility’s actual return on equity by dividing two numbers into each other: the utility’s per books net income available for common equity in the numerator; and the utility’s per books common equity balance in the denominator. The many deficiencies inherent in this type of simplified earnings test render it meaningless from a regulatory viewpoint. For

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<sup>3</sup> BPU Docket No. WO08050358.

example, the net income available for common equity number (numerator) and the common equity balance (denominator) used in this earnings test include items that represent “below-the-line” non-regulated and non-operating items which are always removed for purposes of determining the Company’s regulated authorized return on equity. Therefore, comparing the return on equity number derived in this abbreviated earnings test to the Company’s BPU-regulated authorized return on equity is like comparing apples to oranges and can result in very inaccurate conclusions.

Furthermore, the net income number and common equity balance used in this earnings test have not been adjusted to reflect all of the pro forma ratemaking adjustments adopted by the Board in establishing the utility’s current rates. For example, the actual per books net income number included in this earnings test includes operating expenses such as incentive compensation, donations, lobbying expenses, institutional advertising expenses, community and public relations expenses, etc. which are disallowed by the Board for ratemaking purposes.

By contrast, a much more reliable, complete and relevant earnings test is the earnings test used in the Pennsylvania DSIC and endorsed by United Water New Jersey, Middlesex, and Aqua New Jersey in the most recent NJAWC DSIC proceeding. This expanded earnings test determines an above-the-line average rate base, net utility operating income and return on average rate base for the DSIC year using financial data adjusted for BPU ratemaking principles. This calculated return on rate base would then be translated in an achieved return on equity using the utility’s actual capital structure and debt cost rates for the DSIC year.

**D. Other Provisions**

1. In order for investment to qualify for recovery under the DSIC, the investment must be determined to be incremental to the utility's current capital investment, as determined by the Board, and must not generate new revenues.
2. As stated previously, the amount recovered in the DSIC surcharge will be limited to 3% percent of annual revenues.
3. During normal utility base rate case proceedings, any capital items reflected in the DSIC rate will be transferred to plant in service if deemed to be prudently incurred expenditures and this portion of the DSIC rate will be reset to zero.
4. A nexus to a base rate proceeding is required. Once a DSIC rate is approved, the utility should be required to file a base rate proceeding no later than three years after the initial DSIC rate approval order;
5. Expenses included in the DSIC rate would be recovered on a per customer basis using a graduated scale of rates similar to the fixed service charges that vary according to meter size and not recovered on the basis of volumetric sales. This is necessary to avoid placing an undue burden on large volume users that most likely receive service from larger diameter transmission mains, not the more prevalent mains typically found in local water distribution networks. The table of fixed rates approved for each utility would be adjusted annually. The program costs would be divided by the total number of accounts (e.g. the sum of the number of metered service accounts, flat rate accounts, private fire accounts, public fire hydrants) and the resulting amount would be recovered on the utility's periodic bills over the course of the year. For flat rate accounts and unmetered

services (e.g. fire hydrants), the size of the service line would be substituted for the meter size. For wastewater systems, the basis of the unit rate should be the size of the service lateral;

6. In order to avoid cross-subsidization of water and wastewater services, separate surcharges should be implemented for water (the DSIC) and wastewater operations. This way, customers who only receive water service would not be charged with the costs of wastewater improvements and customers who only receive wastewater services would not be charged with the costs of water improvements. This separate surcharge concept is consistent with the separate PWAC and PSTAC clauses for water and wastewater operations that are currently in place;

#### IV. Conclusion

Rate Counsel's proposal fulfills the regulatory mandate that there should be a correlation between the risk a utility assumes, and the reward it receives. Since an infrastructure surcharge will decrease a utility's risk by reducing regulatory lag and providing reconcilable, dollar-for-dollar recovery of the infrastructure costs eligible for DSIC inclusion, the utility's reward should be a lower return on investment in between rate case proceedings. Rate Counsel's proposal provides for expensing of certain items, particularly cleaning and relining of mains. Other limited capital investment, such as valve, hydrant, and service replacements should be allowed to earn a return on investment at the utility's long term debt rate until its next base rate case. At that point, the utility will be able to roll this investment into rate base and earn its full rate of return,

assuming the investment was made prudently. We feel that this proposal best balances the utilities' stated need to accelerate maintenance and renewal of aging infrastructure, with ratepayers' interest in minimizing water and sewer rate increases in both the short and long term. The Division of Rate Counsel looks forward to discussing this proposal further with all interested Parties.

Respectfully submitted,

***Stefanie A. Brand, Esquire***

STEFANIE A. BRAND

Director, Division of Rate Counsel

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- c: Service List (*Via E-Mail, Hand Delivery & Regular Mail*)  
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