

**BEFORE THE STATE OF NEW JERSEY  
BOARD OF PUBLIC UTILITIES**

**IN THE MATTER OF THE PETITION :  
OF NEW JERSEY AMERICAN WATER :  
COMPANY FOR AUTHORIZATION : BPU Docket No. WO08050358  
TO IMPLEMENT A DISTRIBUTION :  
SYSTEM IMPROVEMENT CHARGE :  
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**REPLY BRIEF OF THE  
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE,  
DIVISION OF RATE COUNSEL**

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**TABLE OF CONTENTS**

**INTRODUCTION**..... 1

**SUMMARY OF RATE COUNSEL’S POSITION** ..... 2

**ARGUMENT**..... 6

**POINT I**..... 6

New Jersey American’s Assertion That An Infrastructure Crisis Exists Is Not Supported By The Record..... 6

**POINT II**..... 10

Sound Public Policy Does Not Support Giving New Jersey American An Incentive To Maintain Its Distribution System When Maintenance Is Part Of The Company’s Obligation As A Utility..... 10

**POINT III** ..... 13

New Jersey American Adequately Maintains Its Infrastructure Through The Traditional Ratemaking Process and Does Not Require The Extraordinary Remedy Of A DSIC..... 13

**POINT IV** ..... 19

Board Staff’s DSIC Pilot Program Is More Equitable To Ratepayers Than New Jersey American’s Proposal. However, Rate Counsel Has Concerns With Staff’s Pilot Program..... 19

A. Outline of the Pilot Program..... 19

B. Staff’s Recommended Pilot Program is Not Supported By The Evidentiary Record..... 21

C. Although Staff’s DSIC Proposal Supports the Adoption of An Earnings Test, Staff Did Not Specify a Particular Test. Until an Earnings Test is Determined, the Board Should Not Adopt the DSIC Pilot Study..... 24

D. The Cost to Ratepayers and Administrative Burden to the Company, Rate Counsel, and Board Staff of Implementing The Pilot Program Outweighs any Limited Benefit..... 25

**POINT V** ..... 28

If the Board Wishes to Explore the Broad Policy Issues Raised by a DSIC, The Board Should Initiate A Generic Proceeding And/Or A Rulemaking. Thus, A Pilot Program Is Not Needed ..... 28

**CONCLUSION** ..... 30

**TABLE OF AUTHORITIES**

**Cases**

*I/M/O Alleged Violations of Law By Valley Road Sewerage Co.*, 154 N.J. 224, 240 (1998)  
..... 11  
*In Re Industrial Sand Rates*, 66 N.J. 12, 19-20 (1974)..... 18

**Administrative Decisions**

*In Re Pub. Serv. Elec. & Gas Co.*, BPU Docket No. EO96010028, 170 PUR4th 334, 347  
(June 21, 1996)..... 1

**Statutes**

N.J.S.A. 48:2-21.1..... 18  
N.J.S.A. 48:2-21.2..... 18  
N.J.S.A. 48:3-49 et seq ..... 16  
N.J.S.A. 48:3-51..... 16

## INTRODUCTION

The Division of Rate Counsel (“Rate Counsel”) submits this Reply Brief in response to the Initial Briefs filed in this matter on April 17, 2009 by the petitioner New Jersey American Water Company (“New Jersey American” or the “Company”), the Staff of the Board of Public Utilities (“Staff”) and intervenors Bulk Purchaser Coalition and the New Jersey Chapter of the National Association of Water Companies (“NAWC”).<sup>1</sup> In its Initial Brief, Rate Counsel discussed in great detail the fact that New Jersey American has not met its burden of proof that a Distribution System Improvement Charge (“DSIC”) is needed to maintain its infrastructure and continue to provide safe, adequate and proper service to its ratepayers.

New Jersey American’s Initial Brief fails to refute Rate Counsel’s position that proper investment in its infrastructure can be accomplished through traditional rate base, rate of return regulation. New Jersey American has thus failed to meet its burden of proof that the Company needs a DSIC. *See In Re Pub. Serv. Elec. & Gas Co.*, BPU Docket No. EO96010028, 170 PUR4th 334, 347 (June 21, 1996) (noting that the burden of proof in BPU proceedings is on the petitioner).

Board Staff’s Initial Brief recommends that the Board initiate a rulemaking to explore the possibility of implementing a DSIC for the water and wastewater industry. SIB at 31. Staff also proposes to allow a DSIC pilot program through which New Jersey American will recover main replacement expenditures between rate cases, up to 3% of

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<sup>1</sup> Board Staff’s Initial Brief will be referred to as SIB. Rate Counsel’s Initial Brief will be referred to as RCIB, New Jersey American’s Initial Brief will be referred as NJAWIB, and the brief of the National Association of Water Companies will be referred to as NAWCIB.

the Company's annual gross revenues. *Id.* at 30. Rate Counsel has several concerns regarding Staff's proposed DSIC pilot program for New Jersey American. These concerns will be discussed in greater detail in this Reply Brief.

### **SUMMARY OF RATE COUNSEL'S POSITION**

The issue before the Board is whether New Jersey American needs the extraordinary remedy of a DSIC to properly maintain its distribution system. The Company's argument in favor of a DSIC consists of two parts: (1) A national infrastructure crisis is looming, and (2) New Jersey American needs an incentive to invest additional amounts of money. NJAWIB at 14, 26. While the Company speaks generally about an alleged national infrastructure crisis, the Company never asserts or proves that its own distribution system is in crisis. This a huge gap in the Company's case, since New Jersey American is seeking a DSIC for itself, not for other companies nationwide that may have declining infrastructure.

Rate Counsel and Staff have both examined the capital planning program of the Company, and Rate Counsel's expert Howard Woods maintains that the Company places inordinate emphasis on pipe replacement rather than cleaning and relining. The Company disputes this, while Staff is silent on the issue. Given the testimony in the record on this issue, the Board should not adopt a DSIC before the Company's capital planning process is further investigated. Rate Counsel believes that the Company may not need to accelerate spending if it applies a capital planning philosophy that allows for more cost-effective pipe repair and maintenance where appropriate, rather than replacement.

The second part of the Company's argument – that it needs an incentive to invest additional funds – is seriously flawed. First, the Company has not proven that it needs to invest additional funds, and Rate Counsel questions whether such additional investment is necessary. Secondly, the Company's request for an incentive is not appropriate. New Jersey American is required to maintain its distribution system and should not need an "incentive" beyond the opportunity to earn a reasonable return to do so. New Jersey American has further failed to prove that the extraordinary remedy of single-issue ratemaking is warranted. Rate Counsel thus urges the Board to deny New Jersey American's request for a rate recovery clause to do what it is already legally bound to do.

Board Staff recommends a limited DSIC pilot program for New Jersey American. Board Staff also recommends that the Board initiate a DSIC rulemaking. SIB at 31. Under Staff's proposal, mains replaced using DSIC monies must be at least fifty years old. *Id.* The DSIC would not be self-implementing, but would require Board approval following an annual DSIC filing. *Id.* DSIC rates would change annually. The Company would be required to reconcile the DSIC-eligible plant along with the associated depreciation reserve. *Id.* New Jersey American would also be required under Staff's proposal to file a base rate petition within three years. The base rate case would involve a prudence review of all DSIC-eligible projects, and the DSIC clause would reset to zero. *Id.* at 31. Any over recoveries would be refunded to ratepayers with interest. Staff also supports the adoption of an earnings test, although Staff does not propose a specific test. *Id.* The DSIC pilot program proposed by Staff would involve DSIC-eligible plant placed in service between December 31, 2008 and December 31, 2010. *Id.* at 1. The pilot would end in two to three years.

Rate Counsel appreciates the extensive consideration Staff gives to the numerous objections to DSIC raised by Rate Counsel. Rate Counsel acknowledges that Staff's recommended pilot study offers some ratepayer protection that the Company's proposal does not. Still, Rate Counsel has several concerns with Staff's proposal. One chief concern is the fact that Staff's proposal is not supported by the evidentiary record. Second, Staff's proposal will allow New Jersey American to collect a return of and on investment without examining the other components of the Company's revenue requirement. In addition, the Board must consider the cost to ratepayers to implement Staff's proposal.

Accordingly, Rate Counsel recommends that the Board refrain from adopting the pilot program. However, if the Board chooses to adopt the pilot program, the Board must develop a proper earnings test and earnings cap to protect ratepayer interests. If the pilot program is adopted, Rate Counsel recommends that the Board decrease New Jersey American's current Board authorized equity return to reflect the reduced risk to the Company.

Rate Counsel agrees with Staff's position that the topic of DSIC is most appropriately considered in a rulemaking proceeding. DSIC is a novel concept in New Jersey, implicating broad policy issues of first impression. Numerous stakeholders will be affected by the Board's position on DSIC, including small and large water and sewer utilities, gas and electric utilities, public interest groups, senior citizens' groups, and government agencies. Given the precedent that is at stake, DSIC is most appropriately decided in a rulemaking where all interested stakeholders can participate in the process.

Rate Counsel's Initial Brief also raises numerous legal and policy objections to DSIC. Rate Counsel asserts that the Board does not have the statutory authority to implement a DSIC. While the Company and Staff point to the extensive powers delegated to the Board by the Legislature, these powers are tempered by the statutory limitations on increasing rates outside of a base rate case. Furthermore, the proposed DSIC differs from other adjustment clauses previously authorized by the Board. This Board has never authorized an adjustment clause that allows a utility to automatically increase rates to earn a return of and on its capital investment at its Board authorized equity return. Such a clause would violate traditional ratemaking principles, represent poor public policy, and exceed the ratemaking powers of the Board. For all these reasons, the Board should deny New Jersey American's DSIC petition.

## **ARGUMENT**

### **POINT I**

#### **New Jersey American's Assertion That An Infrastructure Crisis Exists Is Not Supported By The Record.**

In its Initial Brief, New Jersey American claims that “[t]he fundamental policy reason inherent in NJAWC’s DSIC proposal is that an infrastructure crisis looms in the water/wastewater industry....” NJAWIB at 14. New Jersey American argues that water utilities across the United States face major infrastructure challenges, and the most effective way to address those challenges is by implementing a DSIC. *Id.* at 3. Although New Jersey American makes broad allegations about a looming infrastructure crisis, the Company never introduced anything in the record to support these claims.

The Company never proves that it is faced with extraordinary infrastructure challenges that mandate the implementation of a DSIC. Although New Jersey American speaks in general terms about an alleged national infrastructure crisis, it never alleges that its own distribution system is in a critical state. Vague, unsupported assertions of a looming national infrastructure crisis do not satisfy New Jersey American’s burden of proving that New Jersey American needs a DSIC. There is no proof in the record that New Jersey American’s distribution system is in such a condition that requires the extraordinary ratemaking remedy of DSIC.

To the contrary, New Jersey American currently has an aggressive capital spending program designed to continue the provision of safe, adequate and proper service to its ratepayers. New Jersey American’s annual investment budget of \$147 million is so

massive that it would duplicate the entire rate base of Aqua New Jersey every eight months or Middlesex Water's rate base every fourteen months. There is no evidence that New Jersey American's distribution system is in a state of crisis, or even that New Jersey American must accelerate its capital spending. Indeed, Rate Counsel expert witness Howard Woods, a Professional Engineer, testified that he does not agree that New Jersey American needs to accelerate its infrastructure maintenance and repair program. 104T:L24 – 105T:L2 (3/6/09).

Despite its massive investment budget, New Jersey American indicates that if granted a DSIC, the Company will increase its spending. The Company intends to focus on pipe replacement in an effort to reduce its replacement interval from 580 years to 100-150 years. NJAWIB at 19.<sup>2</sup> Rate Counsel maintains that the goal of a replacement cycle of 100 – 150 years is inappropriately aggressive. A utility's replacement interval is the period of time that elapses between the initial construction of an asset, and the time it is replaced by a new comparable asset. If a utility's replacement interval is 580 years, this means that if the utility replaces a fixed amount of pipe each year, it would take 580 years to replace its entire system. While a company's replacement interval provides some indication of the condition of its system, it is not dispositive. For example, the cleaning and relining of a pipe does not reduce a utility's replacement interval. Yet, cleaning and relining is an accepted method of pipe maintenance.<sup>3</sup> RC-1 at 22. A utility's

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<sup>2</sup> The Company stated its intention to reduce its replacement interval to 100 – 150 years for the first time in its Initial Brief. NJAWIB at 19. The Company never provided this figure during months of discovery, in its Initial or Rebuttal testimony, or at the evidentiary hearings. The Company's actions precluded Rate Counsel's witnesses from vetting this goal and properly responding to it. The Company's goal should therefore not be used as a basis for granting a DSIC without at the very least providing an opportunity for Rate Counsel to examine the Company's proposal.

<sup>3</sup> The Direct Testimony of Howard Woods was admitted into evidence as RC-1. The Rebuttal testimony of Suzanne Chiavari was admitted into evidence as PRT-2. The Direct Testimony of Robert Henkes was

replacement interval focuses solely on pipe replacement, and does not necessarily determine the appropriate level of spending.

Furthermore, age is only one of many factors to consider in determining whether a pipe should be replaced. New Jersey American's witness Suzanne Chiavari testified to this fact:

Q. Does this mean that you should automatically replace mains when they have reached 100 years of service?

A. No. As indicated in my initial testimony, some thick walled pipelines installed prior to 1900 have reached 100 – 125 years of service while some pipelines installed during more recent decades have needed to be replaced due to structural issues in 50 -75 years. Changes in design standards during the past century and the availability (or lack of availability) of material during war years have a greater impact on expected service lives. The replacement interval is not meant to indicate which pipes should be replaced but rather it indicates overall whether the replacement program will keep pace with projected needs.

PRT-2 at 3.

Thus, the Company acknowledges that age is only one factor that should be considered in determining whether to replace a pipe. New Jersey American's statement that it intends to use the DSIC to reduce its replacement interval drastically to 100 – 150 years confirms Rate Counsel's concern that the Company's capital planning program overemphasizes replacement, which is more costly than cleaning and re-lining or other maintenance strategies. As Rate Counsel expert Howard Woods testified, "[u]nlined cast iron mains that are structurally sound could be cleaned of tuberculation and lined with a cement or epoxy lining. In most cases, this would indefinitely extend the life of these mains....the obvious benefit is that the capital cost of cleaning and relining a structurally sound water main is much less than the cost of a replacement." RC-1 at 22, 24.

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admitted into evidence as RC-25. The Direct Testimony of A. Bruce O'Connor was admitted into evidence as NAWC-2.

New Jersey American's desire to implement a DSIC is based on anticipated capital costs that are only necessary if New Jersey American is permitted to accelerate a costly capital asset replacement program, rather than focus on service life extension. Pipe replacement increases rate base, and therefore the Company's return on rate base, at a faster rate than service life extension. The DSIC is therefore not necessary to solve any demonstrated "infrastructure crisis," but will allow the Company to unnecessarily gold plate its distribution system at ratepayer expense.

Indeed, the Company has not supported its claim that it needs to accelerate its capital spending at all. Mr. Woods testified that "[w]ith regard to main breaks, the Company's break incident rate varies between 0.04 (Mt. Holly) to 0.24 (Raritan – East) breaks per mile and this is better performance than the goal range recommended by the American Water Works Association. These data do not suggest a need for an accelerated main replacement program." RC-1 at 24. While the Company's testimony speaks in generalities about the benefits of replacing small diameter, unlined cast-iron mains (PT-2, p. 16), there is no specific data presented by the Company or any other witness demonstrating current deficiencies regarding water quality complaints, leakage from water mains or service lines, or poor fire protection. To the extent that any such deficiencies may exist within New Jersey American's systems, no one has demonstrated that there is an urgent need to act to correct those deficiencies. Rather, the record demonstrates the effectiveness of the programs the Company has already put in place supported only by revenues generated through traditional rate making procedures.

Increasing the amount of capital investment will cost ratepayers dearly. Rather than increasing such investment, it is possible that the Company's ratepayers may be best

served by a better allocation of New Jersey American's current resources. For example, a philosophical shift away from main replacement towards a more extensive cleaning and relining program and a more comprehensive maintenance program will benefit ratepayers, since infrastructure maintenance will be accomplished at lower cost. A complete assessment of the Company's capital planning process is needed to further evaluate these issues. Rate Counsel witness Mr. Woods recommended that the Board order a focused management audit of the Company's capital planning program. RC-1 at 27-28. Otherwise ratepayers face the risk of paying for unnecessary capital spending during a period of economic crisis.

## **POINT II**

### **Sound Public Policy Does Not Support Giving New Jersey American An Incentive To Maintain Its Distribution System When Maintenance Is Part Of The Company's Obligation As A Utility.**

New Jersey American argues in its Initial Brief that it needs an incentive to adequately maintain its distribution system. The Company specifically asserts that "NJAWC will need an incentive to make such expenditures at the accelerated pace necessary to keep up with the aging infrastructure demands....The DSIC mechanism will create an incentive to invest in aging infrastructure that would not otherwise exist if the Company is required to wait until its next rate base proceeding to recover its costs." NJAWIB at 26. New Jersey American's argument totally disregards the foundation of utility ratemaking. New Jersey American is a monopoly utility with captive ratepayers. In exchange for the privilege of being a permissible monopoly, the Company is obligated to provide safe, adequate, and proper service to its ratepayers. Our State Supreme Court

has found that “[u]nlike other corporations...utilities are subject to a special obligation to serve the public interest. In particular, the primary obligation of a utility is to provide safe, adequate, and proper service at fair and reasonable rates.” *I/M/O Alleged Violations of Law By Valley Road Sewerage Co.*, 154 N.J. 224, 240 (1998). New Jersey American should not need an extra incentive to fulfill its obligations.

In its Initial Brief, New Jersey American claims that Rate Counsel witness Robert Henkes agrees that a DSIC will create an incentive to invest in DSIC-eligible investments. NJAWIB at 5. Rate Counsel acknowledges that a DSIC naturally gives a utility a financial incentive to invest in DSIC-eligible plant because it provides immediate rate relief to the utility. Sound public policy does not support giving a DSIC as an incentive to invest in infrastructure because it gives a utility a financial incentive to do something it is already required to do – maintain its infrastructure. Proper maintenance of its infrastructure is an inherent component of the operation of any utility.

New Jersey American’s request for an incentive is disingenuous. The Company is saying, “give us an incentive or we may not provide safe, adequate and proper service to our ratepayers.” New Jersey American is attempting to create a misimpression that the provision of safe, adequate and proper water/wastewater service may be compromised without a DSIC. New Jersey American received rate increases of 15.19% in 2008, 12.46% in 2007, and approximately 10% in 2004. The Company has annual filings for its Purchased Water Adjustment Clause (“PWAC”) and Purchased Sewage Treatment Adjustment Clause (“PSTAC”). The PWAC and PSTAC eliminate the Company’s financial exposure to fluctuations in its costs for purchased water and purchased sewer

treatment. These ratemaking mechanisms ensure that the Company is both financially able and legally able to provide safe, adequate and proper service to its ratepayers.

When New Jersey American needs rate relief, the Company has the option of filing a traditional base rate case. New Jersey American's obligation to properly prioritize and implement distribution system improvements can be accomplished with normal rate filings. The Company does not dispute this. Rather, the Company complains about the regulatory lag that follows a traditional base rate filing. The Company argues that "[n]ot many people would be willing to put their money in the bank and not receive interest on such for the first 3 years..." NJAWIB at 16. Despite the complaints about regulatory lag, there is no evidence that this lag is negatively affecting the financial integrity of the Company. Furthermore, assuming the average length of time between rate increases is three years (recently it has been less than that), the average regulatory lag is 18 months, not three years. New Jersey American makes its capital improvements over time, not on the first day following a rate increase. Also, there are very few investors that can earn a virtually guaranteed 10.3% return on their investment, even if they had to wait 18 months to begin earning that return. Particularly given the current economic climate, traditional ratemaking more than fairly compensates the Company for any regulatory lag.

Moreover, New Jersey American's argument does not take into account that when the Board authorized a return on equity ("ROE") for New Jersey American in its recently approved base rate case, the potential for regulatory lag was factored into that determination. Regulatory lag is one of many factors considered by the Board in determining a regulated utility's authorized equity return. A DSIC, which would provide immediate rate relief for DSIC-eligible projects, would greatly reduce the Company's

business risk. A DSIC would necessitate a decrease to the Company's currently authorized ROE of 10.3%. Notably, New Jersey American does not propose to decrease its authorized ROE if the Board were to approve a DSIC.

Additionally, Rate Counsel is concerned that an incentive to invest in DSIC-eligible plant will distort New Jersey American's capital planning process. RC-1 at 26. A DSIC will give the Company an incentive to invest in DSIC-eligible plant instead of non DSIC-eligible plant. A DSIC will allow New Jersey American to receive almost immediate rate recognition for DSIC-eligible investments, while waiting until a future base rate case to earn a return on investments that are not eligible under DSIC. The Company's financial resources are not unlimited, and the incentive to invest in DSIC-eligible plant is evident. This is yet another reason for the Board to deny the DSIC requested in this case.

### **POINT III**

#### **New Jersey American Adequately Maintains Its Infrastructure Through The Traditional Ratemaking Process and Does Not Require The Extraordinary Remedy Of A DSIC.**

Single-issue ratemaking is an extraordinary remedy. Regulated utilities such as New Jersey American traditionally receive rate increases by filing base rate cases before the Board. Under a traditional ratemaking process, the Board sets rates on a cost of service basis, by employing an approach that looks at a utility's capital investments, revenues, and expenses, including a fair rate of return, to determine required revenues. The concept of examining all components that compose the revenue requirement is known as the "matching" principle, which, as Mr. Henkes testified, is a very important

part of proper ratemaking. RC-25 at 6. A DSIC is an adjustment clause that would allow New Jersey American to increase rates to collect a return of and on capital additions without examining all components of the revenue requirement. DSIC does not adhere to the matching principle.

If granted a DSIC, New Jersey American's earnings may exceed its authorized return on equity. DSIC effectively increases rate base, by allowing the Company to earn a return of and on its investment, without corresponding offsets to rate base that are recognized in a base rate case. Mr. Henkes provided examples of ratemaking components that have the potential to reduce New Jersey American's revenue requirement between rate cases, which the proposed DSIC ignores. RC-25 at 7. Mr. Henkes testified that while the Company will receive a return of and on eligible plant additions under the DSIC proposal, there will be no recognition of the growth in New Jersey American's accumulated depreciation reserve, accumulated deferred income tax, and customer advances/contributions in aid of construction balances, all of which serve to reduce the Company's revenue requirement. RC-25 at 7-8. Customers will be required to fund capital improvements and the Company's return on investment, without receiving the benefits produced by those improvements.

New Jersey American proposed an earning test in its petition in an effort to mitigate this problem. In its Initial Brief, New Jersey American argues that because of this proposed earnings test, "there is no danger that a 'single' recovery will result in inappropriate earnings." NJAWIB at 29. This statement begs the question of whether New Jersey American's proposed earnings test is adequate. In fact, the Company's proposed earnings test is completely inadequate. Rate Counsel expanded on this issue in

its Initial Brief. RCIB at 14-16. The Company's proposed earnings test allows the Company to earn a return up to 100 basis points above the return authorized by the Board. The Company's proposed test disregards fundamental risk/reward concepts. Since the Company's business risk would decrease with a DSIC, its authorized earnings cap should be lowered, not increased.

Furthermore, the proposed earnings test includes items that the Board always removes when determining the Company's authorized return on equity. RC-25 at 19. Examples of such items are incentive compensation, donations, lobbying expenses, certain advertising expenses, public and community relations expenses, Construction Work in Progress and associated AFUDC, and non-utility property. *Id.* The exercise of comparing the results of the modified earnings test to the Board's authorized equity return, as Mr. Henkes stated, "is like comparing apples to oranges and can result in very inaccurate conclusions." *Id.* The Company has failed to present a meaningful earnings test that will protect the ratepayers who will be required to pay these DSIC charges. The Board should protect New Jersey American's ratepayers by denying the Company's petition.

New Jersey American also argues that a DSIC is appropriate because the Board "has approved similar mechanisms to the one proposed by the Company in its Petition." NJAWIB at 29. Although it is true that the Board previously authorized single-issue ratemaking in certain limited situations, the fact is that single-issue ratemaking remains an extraordinary remedy. New Jersey American attempts to paint single-issue ratemaking as something that the Board does on a regular basis. This is simply not the case. In over thirty years, the Board has implemented single-issue ratemaking only a

handful of times, several of which were done pursuant to legislation through the Electric Discount and Energy Competition Act (“EDECA”), N.J.S.A. 48:3-49 et seq. For example, the Societal Benefits Charge (“SBC”), Basic Generation Service (“BGS”), and Basic Gas Supply Service (“BGSS”) clauses were all a consequence of deregulation under EDECA. Unlike the partially deregulated gas and electric utilities, New Jersey American remains fully regulated.

In particular, New Jersey American inaccurately attempts to equate its proposed DSIC with the BGSS clause. NJAWIB at 32-33. BGSS is an adjustment clause that was mandated by the EDECA, N.J.S.A. 48:3-51, that applies to any customer that decides not to shop for their own commodity supplier. Through the BGSS, the utility collects its cost of purchasing natural gas from suppliers. BGSS thus allows the utility to pass-through those commodity costs. The utility earns no return on the commodity and makes no profit on BGSS. Because the price of natural gas is unregulated and very volatile, the gas utilities have limited control over fluctuations in price.

New Jersey American’s proposed DSIC is very different from the BGSS. DSIC has not been mandated by the Legislature. Unlike BGSS, the DSIC is an adjustment clause that contains a profit element. Furthermore, although the gas utilities enter into hedging contracts, they have limited control over the cost of gas incorporated into the BGSS. In contrast, New Jersey American controls its capital spending. BGSS adjustments also sometimes involve a rate decrease. Savings are passed on to customers as quickly as price spikes are. The DSIC, however, will always involve a rate increase. Moreover, customers of New Jersey American will be required to pay the DSIC charge.

They have no choice in the matter. BGSS customers can shop for an alternate supplier if they are unhappy with the BGSS rate. BGSS and DSIC are clearly very different.

As Mr. Henkes testified, single-issue ratemaking is an extraordinary remedy that the Board has limited to situations involving very large expenses on which the utility earns no profit, that are outside of the utility's control, and are subject to volatility. RC-25 at 12. Although the Company argues that the Board has never announced such criteria, the precedent established by the Board speaks for itself. An examination of the few adjustment clauses that the Board has previously authorized indicates the Board's intention to contain single-issue ratemaking to these limited circumstances. For example, the PWAC and PSTAC collect a utility's expense of purchasing water or wastewater treatment from other parties. Not only does the water or sewer utility earn no profit on this expense, but the expense is volatile and largely outside of the control of the utility. The PWAC and PSTAC conform to the narrow criteria discussed by Mr. Henkes. In contrast, DSIC does not.

Likewise, New Jersey American's proposed DSIC is distinguishable from the gas and electric infrastructure filings recently approved by the Board. In its Initial Brief, New Jersey American states that "[l]ike the proposed DSIC, these mechanisms will allow the utilities to recover a return of and return on capital expenditures." NJAWIB at 8. This is an incomplete comparison. The infrastructure filings and the DSIC are very different. The infrastructure filings involve a rate increase for specific capital expenditures that will be made during a limited period of time. Unlike the gas and electric utilities, New Jersey American is not petitioning for a one-time infrastructure investment. New Jersey American is seeking a permanent adjustment clause that will

permit automatic rate increases. Based on its automatic nature, the proposed DSIC is more appropriately compared to formula rates.

Furthermore, the stipulations in the infrastructure filings require the utilities to file base rate cases, satisfying the “legal umbilical cord” to a base rate case required under N.J.S.A. 48:2-21.1, the negotiation statute. *In Re Industrial Sand Rates*, 66 N.J. 12, 19-20 (1974). In contrast, New Jersey American’s DSIC does not require the Company to file a base rate case. The Company and Staff both invoke the broad discretion of the Board in asserting the Board’s authority to implement a DSIC. SIB at 33; NJAWIB at 6. That discretion, however, is tempered by the limitations imposed by the Legislature. One of these limitations is that the Board may increase rates outside of a base rate case only pursuant to two limited statutes. All parties to this case appear to agree that one of those two statutes, N.J.S.A. 48:2-21.2, does not apply. The second statute that permits rate increases outside of a full rate case is N.J.S.A. 48:2-21.1, the negotiation statute. Rate increases granted under this statute are regarded as temporary, and require a “legal umbilical cord” to a future rate case. *In Re Industrial Sand Rates, supra*, 66 N.J. at 19-20. Since New Jersey American’s proposed DSIC does not require the Company to file a base rate case, a sufficient nexus to a base rate case does not exist.

The Company is not experiencing an infrastructure crisis or a financial emergency. New Jersey American is a regulated utility that is largely insulated from the financial crisis that is afflicting the majority of its ratepayers. The Company has not offered a sufficient reason for the Board to deviate from the traditional ratemaking process.

## POINT IV

### **Board Staff's DSIC Pilot Program Is More Equitable To Ratepayers Than New Jersey American's Proposal. However, Rate Counsel Has Concerns With Staff's Pilot Program.**

#### **A. Outline of the Pilot Program.**

Citing its belief that “a DSIC would allow the Company to accelerate its pace of infrastructure replacements at a reasonable cost,” Board Staff recommends that the Board adopt a two to three year DSIC pilot program for New Jersey American. SIB at 32. Staff concludes that “the DSIC will permit the Company to address its aging infrastructure on a more timely basis and that a DSIC, when properly implemented, can accelerate the replacement of older mains.” *Id.* Staff’s proposed pilot program limits DSIC-eligible plant to replacement of mains that are fifty years old or older. *Id.* at 39-40. Staff also recommends a DSIC rate cap of 3% of a customer’s bill. *Id.* at 40. Staff proposes DSIC rates to change annually. *Id.* at 43. To avoid unacceptable automatic rate increases, DSIC rates under the Staff proposal would not be self-implementing, but would require Board review and approval by Board order. *Id.* at 43-44. The Staff also supports an earnings test for New Jersey American but does not propose a specific test.

Staff’s proposal calls for an initial filing to occur in October 2009. This initial filing would outline the DSIC-eligible plant that was or will be placed in service between December 31, 2008 and December 31, 2009. *Id.* at 30. Since the filing will occur in October, the data will include three quarters of actual data, and estimated data for the fourth quarter of 2009. *Id.* at 42. The filing must include the required information proposed by Staff, such as a list of specific projects, documentation of costs, revenue

calculation, etc. *Id.* at 44. There would be a public notice and public hearing. The DSIC rate increase would be provisional, subject to refund with interest on any over-recoveries. *Id.* at 43.

Staff also recommends that New Jersey American file quarterly DSIC filings beginning in 2010. These filings would document the DSIC-eligible plant that was placed in service the previous quarter. No rate increase would accompany these quarterly filings. *Id.* at 44. In October 2010, the Company would file its annual petition for plant placed in service between December 31, 2009 and December 31, 2010. *Id.* at 30. That petition must also be accompanied by a “true up” petition that would reconcile the DSIC-eligible plant placed in service in 2009, and associated depreciation reserve. *Id.* Staff recommends that the Company be required to file a base rate case no later than three years, with rates effective no sooner than two years, after the Board order in the present case. *Id.* at 30. The prudence of DSIC projects would be reviewed in the Company’s next base rate case. Prudent projects would be rolled into base rates, and the DSIC would reset to zero. *Id.* at 2. Staff recommends the pilot program terminate in two to three years. Staff also recommends that the Board initiate a rulemaking for DSIC that will run concurrently with the proposed pilot program for New Jersey American. *Id.* at 36.

Rate Counsel appreciates Staff’s efforts to protect ratepayers and the obvious thought given by the Staff to the numerous objections raised by Rate Counsel. Rate Counsel acknowledges that Staff’s recommended pilot study offers some ratepayer protection that the Company’s proposed DSIC does not. One ratepayer protection introduced by the Staff is that DSIC rate increases will be annual, not quarterly, and will

not be automatic. Despite these changes, Rate Counsel has several concerns with Staff's proposed pilot program.

**B. Staff's Recommended Pilot Program is Not Supported By The Evidentiary Record.**

Rate Counsel's first concern with Staff's DSIC pilot program is that it lacks support in the evidentiary record. Although Staff argues "[t]he Board should adopt a DSIC, because the need for one is necessary to address New Jersey's aging water and wastewater infrastructure," Staff never concludes that the specific petitioner in this case, New Jersey American, has demonstrated that it needs a DSIC. SIB at 31. Rather, Staff bases its pilot program recommendation on the belief:

that a DSIC would allow the Company to accelerate its pace of infrastructure replacements at a reasonable cost, resulting in improved water quality, improved pressure and service reliability that will benefit customers. Staff also believes that the replacement and upgrade of deteriorating water and wastewater mains could reduce the number of main breaks, service interruptions, unaccounted for water; improve water quality; and enhance fire protection. Staff agrees with the Company that the DSIC will permit the Company to address its aging infrastructure on a more timely basis and that a DSIC, when properly implemented, can accelerate the replacement of older mains.  
SIB at 32.

Staff recommends a DSIC based on the idea that a DSIC will allow acceleration of main replacement. The problem is that the record does not support a finding that New Jersey American needs to accelerate its infrastructure investment, or that main replacement is the proper course of action. Staff also bases its recommendation on its belief that a DSIC "could reduce the number of main breaks, service interruptions, unaccounted for water; improve water quality; and enhance fire protection." SIB at 32. Yet, there is no evidence in the record that New Jersey American has experienced an inordinate amount of problems in any of those areas, or that the DSIC would correct these problems if they did

exist. Even though Staff labels its recommendation a pilot program, the record must support a finding that New Jersey American's DSIC is necessary and proper. That conclusion cannot be reached on this record.

To the contrary, Rate Counsel witness Mr. Woods testified that he does not agree that New Jersey American needs to accelerate its infrastructure maintenance program. 104T:L24 – 105T:L2 (3/6/09). Mr. Woods testified that “[w]ith regard to main breaks, the Company's break incident rate varies between 0.04 (Mt. Holly) to 0.24 (Raritan – East) breaks per mile and this is better performance than the goal range recommended by the American Water Works Association. These data do not suggest a need for an accelerated main replacement program.” RC-1 at 24. While the Company's testimony speaks in generalities about the benefits of replacing small diameter, unlined cast-iron mains (PT-2, p. 16), there is no specific data presented by the Company or any other witness demonstrating current deficiencies regarding water quality complaints, leakage from water mains or service lines, or poor fire protection. The record in this matter has not shown that New Jersey American is deficient in any of these areas.

Staff's recommendation to limit the scope of the pilot program to replacement of mains more than fifty years old is also not supported by the record. The Staff offers no justification for establishing a DSIC pilot program that would only address replacement of pipes that are more than fifty years old. Rate Counsel believes that the Company's capital planning program should focus on cleaning and relining rather than replacement when possible, as main repair is more cost-effective. According to Mr. Woods, “[u]nlined cast iron mains that are structurally sound could be cleaned of tuberculation and lined with a cement or epoxy lining. In most cases, this would indefinitely extend the

life of these mains....the obvious benefit is that the capital cost of cleaning and relining a structurally sound water main is much less than the cost of a replacement.” RC-1 at 22, 24.

Staff appears to base its pilot program recommendation on its desire to lower New Jersey American’s replacement interval. SIB at 40 (“Staff believes that one of the benefits of a DSIC is to reduce the Company’s time interval of its distribution system.”) New Jersey American stated for the first time in its Initial Brief that it wants to move toward a 100-150 year replacement interval. NJAWIB at 19. The Company has not demonstrated that this is an appropriate replacement interval. As noted above, Rate Counsel believes that such a replacement interval is too aggressive. The Company should focus on the cost-effective approach of cleaning and relining when possible, rather than on drastically reducing its replacement interval. The reality is that a utility’s replacement interval is constantly fluctuating. There is nothing in the record to support a concern over New Jersey American’s current replacement interval, or to support accelerated replacement as a solution rather than alternative strategies that would be more cost-effective.

Staff’s emphasis on the age of pipe being replaced is also not supported by the record. Staff’s choice of a fifty year age requirement for DSIC-eligible plant appears to be arbitrary. Both Rate Counsel and the Company agree that the age of a pipe is not a primary factor in determining whether a pipe should be replaced. Both Mr. Woods and Ms. Chiavari agree that the AWWA Manual of Standard Practice M-28 provides appropriate guidance in making the decision whether to repair or replace a pipe. PRT-2 at 7. Manual M-28 provides six “key elements” to consider in making such decisions.

*Id.* at 8. The age of a pipe is not one of the six key elements. Staff's arbitrary selection of a fifty year age requirement is not supported by the evidentiary record. Accordingly, Rate Counsel maintains that the proposed DSIC pilot program should not be implemented. However, if the Board adopts the pilot program, at a minimum it should be modified to require New Jersey American to justify that every replacement done pursuant to the pilot program is a prudent strategy consistent with the guidance of AWWA Manual M-28.

**C. Although Staff's DSIC Proposal Supports the Adoption of An Earnings Test, Staff Did Not Specify a Particular Test. Until an Earnings Test is Determined, the Board Should Not Adopt the DSIC Pilot Study.**

Although the DSIC pilot study will only last for two to three years, New Jersey American should not be allowed to over-earn during that period of time. The DSIC will allow the Company to collect a return of and on investment without examining the other components of the Company's revenue requirement. The return on investment that the Company will receive makes the Company's proposal unprecedented, and is of great concern to Rate Counsel. The Board should ensure that ratepayers are not funding a return to the Company that exceeds its Board authorized return.

Until a proper earnings test is developed, the Board should not adopt the DSIC pilot study. The Company's proposed earnings test does not offer adequate protection to ratepayers. Rate Counsel presented extensive evidence that the Company's proposed test is seriously flawed. RCIB at 13-17. If the Board wishes to implement the pilot study, the Board needs to develop an adequate earnings test prior to its implementation. Part of this test will be determining an appropriate earnings cap. New

Jersey American recommends an earnings cap of 100 basis points over its authorized return, which is lower than its initial proposal of 200 basis points. Still, New Jersey American's position cannot be adopted. A mechanism that allows near instant rate recovery, as proposed by the Company, or only a slightly delayed recovery as proposed by Staff, should recognize that the Company is less risky financially. Even intervenor NAWC admits that a DSIC may allow a utility to access capital more easily and on better terms. NAWC-2 at 5. If a DSIC pilot program is adopted, the earnings test should not allow a cushion above the Company's authorized rate of return. In fact, if the Board wishes to adopt the pilot program, Rate Counsel recommends that the Board lower New Jersey American's authorized return on equity to reflect the decreased risk to the Company. New Jersey American's current return was set without the consideration of a DSIC. Accordingly, a reduced equity return is appropriate.

**D. The Cost to Ratepayers and Administrative Burden to the Company, Rate Counsel, and Board Staff of Implementing The Pilot Program Outweighs any Limited Benefit.**

Board Staff's proposed DSIC pilot program is limited to main replacement for mains at least fifty years old. The pilot will last for two to three years, and will likely overlap with a base rate case filing. Pilot studies are normally undertaken to generate data and information that could be used to reexamine components of the studies to shape future policy. Staff's Initial Brief did not discuss the information that Staff hopes to glean from its proposed pilot program. Given the very limited scope and duration of the pilot program, it is questionable whether the results of the pilot will be instructive. Furthermore, New Jersey American is by far the largest regulated water utility in the

State. A pilot for New Jersey American is unlikely to illuminate any of the issues faced by the typical Board regulated water or sewer company. Given the uncertain benefit that will come from this proposed pilot study, Rate Counsel recommends that the Board not adopt the recommended pilot program for New Jersey American.

Moreover, Staff's proposed pilot study will likely have little value given New Jersey American's schedule of rate case filings. The Stipulation of Settlement in New Jersey American's last base rate case includes a provision that new rates will not go into effect prior to January 1, 2011. If the Company intends to seek rate relief on this schedule, they will file a petition in January or February 2010 with a Test Year ending June or July 2010. If the Board adopts the proposed pilot study, the DSIC schedule will overlap with the base rate case schedule. Concurrent with the filing of the base rate petition, the Board will be issuing an order for the initial DSIC filing made in October 2009. The very same projects that are the subject of the initial DSIC order will also be included in the Company's base rate petition. The base rate filing will also include the Company's forecast from January through July 2010, which will be the same projects that will be included in the first two quarterly DSIC reports required under Staff's proposal. Assuming that the base rate case proceeds in a timely fashion, and that these projects are deemed prudent, there would be no need to include these projects in the second DSIC order issued in early 2011. Thus, the pilot will only add contemporaneous and duplicative proceedings that will add to the administrative burden of the Board, the Company and Rate Counsel, all to be paid for by New Jersey American's ratepayers.

Staff's proposal also contains a quarterly reporting requirement that creates an additional administrative burden with little discernable value. The number of regulatory

filings, and overlap with the future base rate case, will create a heavy burden on Staff and Rate Counsel to review and scrutinize all of these filings. It will be very difficult for Rate Counsel's and Staff's accountants to keep track of the same projects in different filings, especially considering the zeroing out of the DSIC charge in the base rate case, the true-ups that will occur, and refunds with interest that may have to be made. In short, the DSIC accounting will be a nightmare.

Also, Rate Counsel's concern with the pilot study is heightened by the unknown costs of conducting this study. Staff's Initial Brief contains no cost/benefit analysis of performing this study, and lacks any general discussion of the program's costs and/or who will pay those costs. Complying with the program will involve both internal and external costs, including legal fees, internal labor for producing the quarterly reports, the cost of publishing the public hearing notices, conducting the public hearings, etc. These costs will not be nominal. For example, Company witness Edward Rex testified that the cost of publishing the public hearing notice in the Company's last base rate case was thirty-five or forty thousand dollars. 20T:L23 – 21T:L2 (3/4/09). There needs to be a more extensive examination of the pilot program's costs and benefits in order to determine if the pilot is a worthwhile endeavor. This is another reason that Rate Counsel suggests that the Board not implement the pilot.

## POINT V

### **If the Board Wishes to Explore the Broad Policy Issues Raised by a DSIC, The Board Should Initiate A Generic Proceeding And/Or A Rulemaking. Thus, A Pilot Program Is Not Needed.**

Board Staff and Rate Counsel both agree that the proper venue for exploring the DSIC is in a generic proceeding and/or a rulemaking. Staff appears to recommend that the Board institute a rulemaking very quickly: “the Board, while evaluating this pilot program, should concomitantly institute a rulemaking procedure.” SIB at 35. If the Board initiates a rulemaking, Board Staff’s proposed pilot study will be unnecessary. Pilot studies are normally undertaken to generate data and information that could be used to enlighten a future decision. If the Staff’s pilot is adopted as proposed, the DSIC will not impact customer bills until early 2010. If the Board begins a rulemaking quickly, the rulemaking will gain no benefit from the DSIC pilot. Little information will be gained from the pilot if the pilot runs concurrently with a DSIC rulemaking.

Although the New Jersey Chapter of the NAWC is an intervenor in this proceeding and has filed generic DSIC testimony in an attempt to secure a generic DSIC order to the benefit of the NAWC’s member utilities, the record in this case cannot support generic relief. While the Board may eventually initiate a generic proceeding on DSIC, it cannot do so within this docket. The only party who could potentially receive relief in this matter is petitioner New Jersey American. This proceeding involves a petition and evidence in the record by New Jersey American only, and the question before the Board is limited to whether or not the Company has met its burden of proof.

To institute a generic proceeding, the Board would have to create a record to address the generic policy issues implicated by the DSIC.

During the evidentiary hearings, Rate Counsel voiced an objection that the NAWC's testimony was irrelevant to the current proceeding. 106T:L22 – 107T:L15 (3/4/09). The NAWC submitted testimony from executives of three regulated water utilities – Aqua New Jersey, United Water New Jersey, and Middlesex Water. This testimony addressed the executives' experiences with DSIC in other states, and generally what the NAWC would like to see in a DSIC. Rate Counsel's position is that the NAWC's testimony would be relevant in a generic proceeding or rulemaking, if one were to occur. The NAWC's testimony is not relevant to the present case, which involves only petitioner New Jersey American. The NAWC cannot, through its testimony, transform this matter into a generic proceeding, or modify New Jersey American's petition. Despite the arguments made in the NAWC's brief, an intervenor cannot redefine the relief requested by a petitioner. The NAWC's arguments are better suited for a generic proceeding.

**CONCLUSION**

For the reasons discussed above, the Division of Rate Counsel recommends that the Board issue an order denying New Jersey American's request for a DSIC. Rate Counsel also believes Staff's proposed pilot program should not be implemented. In the event the Board decides to adopt Staff's pilot program, Rate Counsel requests that the pilot be modified to address Rate Counsel's concerns.

Respectfully submitted,

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