Advisory
UTILITIES AND REGULATED INDUSTRIES DEPARTMENT | DECEMBER 2007

WIGGIN AND DANA
Counsellors at Law

Summary of Aquarion Rate Case Decision DPUC Docket No. 07-05-19

On December 12, 2007, the Connecticut Department of Public Utility Control ("Department" or "DPUC") issued a final decision on the rate application filed earlier in the year by Aquarion Water Company of Connecticut ("Aquarion" or the "Company"). The final decision approved an overall revenue increase of $19.3 million, or about 16.7% overall. The following is a summary of the key facts and issues from the decision.

I. Background

As required by Department regulations, Aquarion filed a notice on May 15, 2007 stating its intent to file a rate application. The Company subsequently filed its application (the "Application") on June 15, 2007. The Application proposed a revenue increase of approximately $31.95 million, or 27.86% overall. The historical test year for the case was the 12 months ending December 31, 2006.[1] The new rates were proposed to go into effect on or about December 1, 2007.

The Company's prior rate case was in 2004 ("2004 Rate Case").[2] Aquarion stated that the increase proposed in its Application was necessary "to sustain necessary new and replacement infrastructure investment to maintain water quality and service at a high level while also providing a fair and reasonable rate of return on equity." Decision at 1.

II. Proceedings

A. Public Comment. The Department received extensive public input with respect to this case. It conducted eight evening hearing sessions from August to October for the purpose of taking public comment in municipalities throughout Aquarion's service territory. The Department also received over 300 letters objecting to the rate increase.

B. Hearings. Evidentiary hearings commenced on August 29, 2007 and concluded on October 11, 2007. There were a total of 14 hearing days.

---

[1] The applicant's test year is the most recent twelve month period available ending on a calendar quarter. The DPUC typically establishes rates prospectively on the basis of a historical test year, adjusted for pro forma purposes. The DPUC may make "prospective adjustments deemed necessary to ensure that a regulated utility has a reasonable opportunity to achieve a fair rate of return." Decision at 5.

[2] The 2004 Rate Case resulted in an overall decrease of $1.9 million, or 1.6%. See DPUC Docket No. 04-02-14RE01, *Application of Aquarion Water Company of Connecticut to Amend Rates – Recalculation of Revenue Adjustments for Weather Normalization and Customer Growth in the Litchfield Division*, decision dated Nov. 18, 2004.

C. Parties. Aquarion, the Office of Consumer Counsel ("OCC"), the Prosecutorial Unit of the Department,[3] the City of Stamford, and the Town of Simsbury.

D. Intervenors. The Office of the Attorney General ("AG"), the New York State Department of Public Service, United Water Westchester Inc., the City of Rye and the Village of Rye Brook.

E. Decision Process. Prior to issuing its final decision in this case, the Department issued a draft decision on November 19, 2007, and a revised draft decision on December 10, 2007. The final decision ("Decision") was approved on December 12, 2007.

III. Engineering Issues

A. Capital Improvement Projects. The Application included approximately $129.5 million of equipment and plant additions from the time of the 2004 Rate Case decision through November 30, 2007. The Company updated its number during the case to $132 million. The Department excluded approximately $3.3 million of rate base additions, but provided the Company with the opportunity address the excluded projects in a 2008 reopener of the case.

B. Aquarion's Regional Project. The Department evaluated investments (including the application of land sale proceeds) by the Company in its regional project, which consists of an upgrade to the Stamford Water Treatment Plant (comprising approximately one-third of capital expenditures since 2004) and other distribution system improvements.

C. Non-Revenue Water. The Department stated that it requires, at a minimum, 85% of the water produced by a water system to be used to supply water to its customers. Decision at 16. The Department recognized that Aquarion had made some improvements with respect to non-revenue water, but determined that it was above the 15% acceptable range, and therefore disallowed approximately $100,000 in production expense.

D. Periodic Meter Testing. In three of the Company's four divisions, tested meters complied with the Department's accuracy standards (96% - 102%). The Department stated that it expects Aquarion to improve the accuracy of tested meters and increase the number of meters to be tested.

E. Five-Year Capital Improvement Program. The Company proposed a five-year capital improvement program of $191.2 million for 2007 - 2011, with annual expenditures between approximately $37 - $39.6 million. The Department expressed some concern about the level of expenditures and ordered periodic reports.

[3] Under Connecticut law, the Department shall designate a portion of its staff to be made a party to rate proceedings, with limited exceptions. Conn. Gen. Stat. §16-19j.

IV. Rate Base Issues

The Company's pro forma rate base was $464 million. The Department reduced the pro forma by $6 million, resulting in an allowed rate base of $458 million.

The Department made downward adjustments to the Reserve for Accumulated Depreciation ($1.3 million), Working Capital Allowance ($451,000), the Company's SAP system ($1.6 million) and office complex ($607,000), among others, and deferred making an adjustment for Deferred Taxes and Prepayments (with minor exceptions).

V. Revenues

Aquarion filed revised pro forma revenues of approximately $115 million at current rates, and $146 million at proposed rates ($32 million proposed revenue increase, or about 27.74%). The Department adjusted total pro forma revenues to $115.6 million at current rates and $148.7 million at proposed rates.

The Department made its revenue adjustments based on changes to weather normalization calculations, customer growth and late payment fees.

VI. Rate Design and Cost of Service

Aquarion currently uses five separate rate schedules across four divisions, which are legacies of the predecessor companies acquired, merged or combined over the years. The Department stated its belief, previously articulated in the 2004 Rate Case, that "eventual achievement of single-tariff pricing is in the best interest of the company involved and its customers. However, the Department is cognizant that any movement towards that goal must be sensitive to the impact of significant rate charges on customers and the economy." Decision at 46. The Department made incremental changes to the Company's proposed rate schedules to move toward this objective, yet rate disparities will continue to exist across Aquarion's divisions.

The Company has achieved a uniform schedule of miscellaneous service charges, as a result of the 2004 Rate Case. The Department approved its proposed increases, with one modification to the initial hourly rate for service calls.

VII. Expenses

A. Summary. The Department conducted a detailed review of the Company's operating expenses. The Company's pro forma expenses of $105 million were reduced by $2.4 million, for total approved operating expenses of $102.6 million.

B. Employee Bonus Program. The company sought an adjustment of approximately $500,000 for costs associated with its "Employee Bonus Program." In its last case, Aquarion was allowed 25% of these costs to be treated as a customer expense. In this case it sought 100% of the costs to be above the line, explaining that it had changed the program so that the metrics would be "customer based." The decision allowed 25% of the expense in rates (reducing expenses by $394,500). The Company also sought approximately $300,000 for its "Long-term Incentive Plan" 100% above the line. The decision similarly allowed 25% of the expense in rates (reducing expenses by $234,000)

C. Other Adjustments. Other notable adjustments included Organization Dues (50% to be borne by customers consistent with Department precedent), Charitable Contributions (0% to customers), Recruiting Fees (reduced by full amount as a non-recurring expense), Capitalization Ratio for wages, salaries and benefits charged to expense (proposed 81.6%, reduced to 77.9%, for a net adjustment of $167,000), Employee Count (two positions disallowed, equal to $106,000), Land Sale Expenses (reduced 89%, or $168,000, to reflect cost allocable to shareholders), Bad Debts (reduced by $269,000), Rate Case Expenses (fully allowed, but amortized over 4 - 6 years), Corporate Expense associated with a management fee paid to its affiliate (reduced by 75%, or $575,000), Depreciation Expense (net reduction of $800,000), and associated changes to Income Tax (increased by $1.7 million).

VIII. Financial Analysis

A. Capital Structure. Capital structure was a contentious issue in the case. The Company's proposed capital structure, based on its actual capital structure as of December 31, 2006, was approximately 58% Common Equity and 42% Long-term Debt. The OCC and AG recommended a capitalization mix of 48% Common Equity and 52% Long-term Debt. In its initial draft decision, the Department would have approved a rate-making capitalization of 50/50. In its final decision, the Department ultimately approved a mix of 55% Common Equity and 45% Long-term Debt.

WIGGIN AND DANA

Counsellors at Law

Utilities and Regulated Industries Department Contacts

Bethany L. Appleby
203.498.4365
bappleby@wiggin.com

Bruce L. McDermott
203.498.4340
bmcdermott@wiggin.com

Danial P. Venora
203.498.4338
dvenora@wiggin.com

B. Cost of Debt. The Department approved the Company's weighted cost of debt of 6.13% for rate-making purposes.

C. Cost of Common Equity. Approximately one-quarter of the 120-plus page decision is devoted to the Department's consideration and analysis of this issue. Aquarion recommended a return on equity ("ROE") of 11%, and its witness testified at the hearing that 11.87% could be justified. The OCC's recommendation was a 9.4% ROE, which was supported by the AG. The DPUC approved a 10% ROE, with a rate of return on rate base of 8.26%.

D. PA 07-139. The Department considered whether the provisions of P.A. 07-139, *An Act Concerning Water Company Infrastructure Projects,*[4] would affect the Company's risk profile, in that it could allow the Company to maintain a more even and steady cash flow associated with infrastructure projects. The Department made no explicit downward adjustment for this item.

IX. Other Issues

A. Reopener. Section 16-19h allows the Department to reopen proceedings on a proposed rate amendment of a water company to include in rate base the construction costs associated with plant additions that are required by the DPUC, the Department of Public Health or the Department of Environmental Protection. The decision authorizes Aquarion to seek a reopening for three specific projects, and for certain other projects that were completed by November 30, 2007 but disallowed in this proceeding.

B. Customer Service Issues. The Department acknowledged the Company's improvements in customer service, found its bill processing system to be reasonable, congratulated Aquarion for being the first DPUC-regulated water company to offer a low income customer assistance program, and directed some modifications to its water conservation program.

X. Effective Date

The Department-approved schedule of rates and miscellaneous service charges shall apply to service rendered on or after the date of the Decision.

XI. Other Considerations

Under Connecticut law, any appeal of an administrative agency decision in a contested case proceeding must be initiated within 45 days of mailing or personal delivery of the decision.[5] Parties to a contested case proceeding also have an opportunity to ask the agency to reconsider its decision.[6] A request for reconsideration generally is not a prerequisite to filing an appeal, but the agency's response to a request for reconsideration can affect the timing of the appeal.

---

[4] See Wiggin and Dana Advisory, October 2007, for a summary of PA 07-139 and other 2007 Connecticut legislation affecting the energy and utilities sector.

[5] See Conn. Gen. Stat. §4-183.

[6] See Conn. Gen. Stat. §4-181a.