

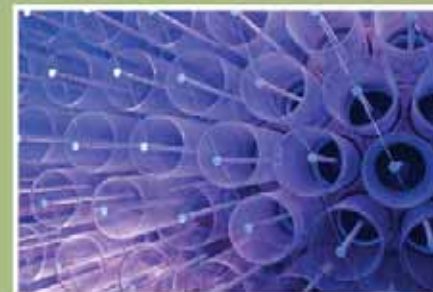


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The Benefits of Infrastructure Replacement Surcharges

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Purpose of Today's Discussion

- American Water overview
- What are infrastructure surcharges?
- What is the need?
- The Pennsylvania example
- Other AW Utility Programs
- Rate impacts
- Benefits



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American Water



- Heritage dates back to 1886
- Largest water services provider in U.S.
- Serves approximately 15 million people in more than 1,600 communities
- Operations in 32 states and Ontario, Canada
- More than 7,000 employees



Facts & Figures *(owned Assets)*

- 372 individual service areas
- 46,000 miles of distribution mains
- 80 surface water treatment plants
- 600 groundwater treatment plants
- 1,000 groundwater wells
- 45 wastewater treatment plants



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What Are Infrastructure Surcharges?

- Mechanisms to pass through to customers the **return on** (rate of return) and **return of** (depreciation expense) the capital needed to **replace** water or wastewater company infrastructure on a periodic basis without filing a full rate case



The Need for Infrastructure Replacement Programs

Infrastructure Replacement and Compliance with increasing SDWA & CWA Quality Requirements.

- 2002 USEPA Clean Water and Drinking Water GAP analysis
 - Drinking Water: **\$154 billion** - \$446 billion through 2019 (pt.est. = \$274 billion).
 - Clean Water: \$331 Billion - \$450 billion through 2019 (pt.est. \$662 billion).
 - Total: \$485 billion – \$896 billion through 2019 (pt. est = \$662 billion)
- June 2005 USEPA Drinking Water Infrastructure Needs Survey and Assessment
 - ◆ **\$276 billion** over 20 years* (former estimate: \$154 Billion)
 - ◆ \$263.7 billion (50 states)
- 20 year water/wastewater infrastructure costs could exceed \$1 trillion



The Need for Infrastructure Replacement Programs (cont'd)

- **Cost of \$1 to install 1 foot of main in 1900 can exceed \$100 / foot today**
- **Regulatory Lag acts as a disincentive to necessary infrastructure replacement investment**
 - Non-recognition of infrastructure replacement investment between and during the pendency of general rate proceedings can delay earning a return of or on infrastructure investment for years, permanently impairing the ability to earn fair or allowed returns.

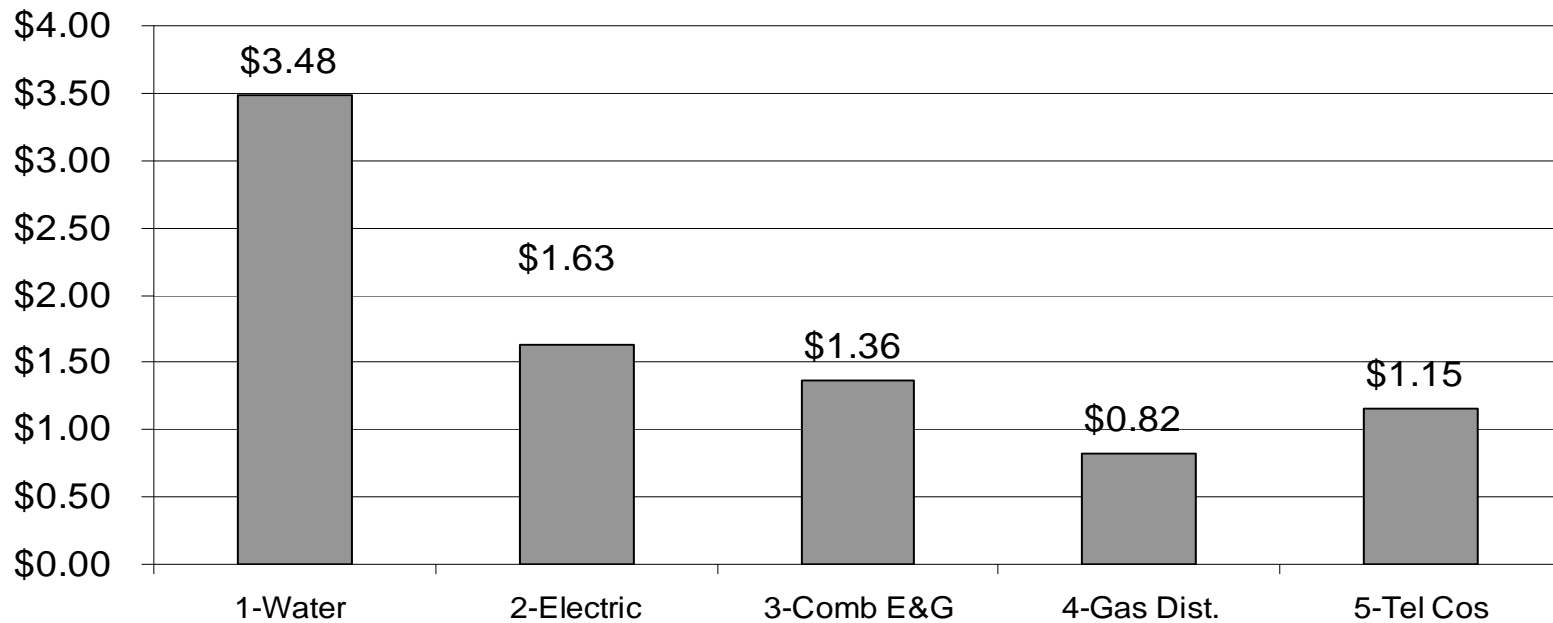


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Capital Intensity: Utility Plant / Operating Revenue

2006 Capital Intensity



Source: AUS Utility Reports



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Analyst Perspectives

Negative Impact of Regulatory Lag and Potential Impact on Cost of Capital for Capital Intensive Regulated Industries

“Primarily because of regulatory lag and increased financing expenses that cause balance sheet strain and execution risks, utilities suffer sub par returns during periods of heavy capital investment.”

(Source: Lehman Brothers; Power and Utilities: Regulated Utilities; Global Equity Research, North America, May 22, 2007)

Infrastructure Replacement Surcharge Programs Permit Utilities to Better Manage Cash Flows and Capital Programs in Times of Extreme Financial /Market Volatility

“Firms can also reallocate capital to projects with more timely return periods and take advantage of regulatory mechanisms that recover investment more quickly. Pennsylvania’s distribution system infrastructure charge (DSIC), which allows a monthly customer surcharge for pipe repair costs, is an example of this.”

(Source: Janney Montgomery Scott, LLC; Water Industry Report; October 30, 2008)



State Utility Commissions that have approved infrastructure replacement surcharges*

Pennsylvania	Delaware
Indiana	New York
Illinois	Missouri (St Louis County)
Ohio	Connecticut

*California PUC recently approved a pilot DSIC program for one of California American Water Co Districts



Examples of AW Utilities Infrastructure Replacement Programs

State/Program	Applicability	Timing/Frequency	Recovery Cap	Included Plant
Indiana Distribution System Improvement Charge (DSIC)	Water	Not > once every 12 month period; not in year of rate case being filed prior to DSIC filing.	5% of revenue between rate cases	Replacement & reinforcement mains, hydrants, services and meters and not included in last rate case.
Illinois Qualifying Infrastructure Plant Surcharge (QIPS)	Water & Wastewater	Annually (prospective plant) Quarterly (historic plant)	5% of revenue between rate cases	<u>Water</u> : Mains, services, meters, hydrants, and relocations and looping dead ends. <u>Sewer</u> : Force and gravity collection, mains, services, and manholes
Missouri (St Louis Cnty) Infrastructure System Replacement Surcharge (ISRS)	Water	Semi-annually Depreciation and property tax, all others have pre-tax ROR	Not in excess of 10% of previously approved revenue	Mains, valves, hydrants, main cleaning and re-lining and facility relocations

- All Programs Reconciled Annually



Examples of AW Utilities Infrastructure Replacement Programs (cont'd)

State/Program	Applicability	Timing/Frequency	Recovery Cap	Included Plant
Ohio System Infrastructure Charge	Water & Wastewater	Once every 12 month period	3% per year for maximum of 3 years; limit of 3 surcharges in effect; can be reduced if it causes the company to earn an excessive rate of return on its valuation	<u>Water</u> : Replacement mains, valves, service lines, hydrants, main extensions, main cleaning or re-lining, unreimbursed relocation expenditures, required by a governmental agency , land or land rights related to qualifying plant. <u>Sewer</u> : Replacement mains and lift stations, main extensions, main cleaning I&I elimination or relining, unreimbursed facilities relocation expenditures, land or land rights needed related to qualifying plant.
Pennsylvania Distribution System Improvement Charge (QIPS)	Water	Quarterly	7.5% of total revenue, applicable for period between base rate cases, at which time total DSIC is folded into base rates, SSIC restarts and is set to -0-. Can be capped at a lower level if Company is earning in excess of authorized.	Replacement mains, valves, service lines, hydrants and meters.

* All Programs Reconciled Annually



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Focus on Pennsylvania American Water

- **Total DSIC capital investment since inception in 1997:**
 - \$557,000,000
- **Frequency of rate case proceedings pre DSIC:**
 - Annually
- **Frequency of rate case proceedings post DSIC:**
 - Every two years on average
- **Infrastructure replacement pre and post DSIC**
 - Pre DSIC average from 1991 to 1996 was approximately \$17 million
 - Post DSIC average from 1997 to 2007 was approximately \$44 million



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Focus on Pennsylvania DSIC - DSIC Impact

Company # 1

Pre-DSIC Rehabilitation Pace:

- 1991 – 3.8 Miles completed; entire system would require 904 years
- 1995 – 14 Miles completed; entire system would require 246 years

Current Pace with DSIC:

- Since 1997 – 23 miles completed annually; entire system can be completed in about 125 years

(Source: Presentation of Carol Kozloff, Water Industry Policy Analyst for Commissioner Robert F. Powelson, PA PUC, to the California Water Association, May 4, 2004)



Focus on Pennsylvania DSIC - DSIC Impact

Company # 2

- ***Pre-DSIC (1995)***
 - DSIC-type projects - \$1.2 million
- ***With DSIC (1998)***
 - DSIC investment \$1.7 million
- ***Projected (2000)***
 - DSIC investment \$2.5 million
- ***Projected DSIC Projects (2001)***
 - DSIC investment - \$2.7 million
 - 117 years to complete entire system

(Source: Presentation of Carol Kozloff, Water Industry Policy Analyst for Commissioner Robert F. Powelson, PA PUC, to the California Water Association, May 4, 2004)



Focus on Pennsylvania DSIC - DSIC Impact

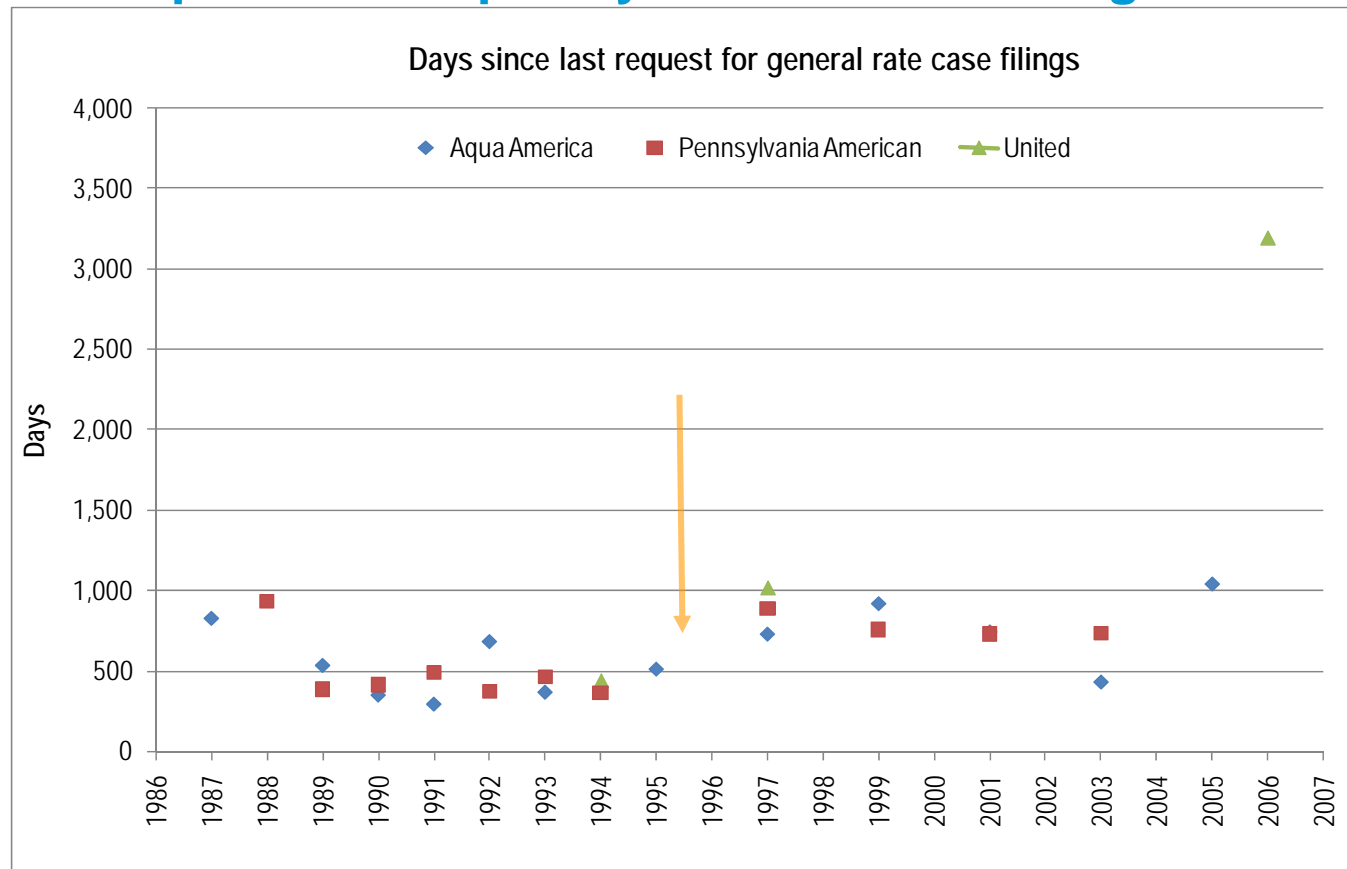
Company # 3

- ***Pre-DSIC***
 - System-wide improvement rate – 27 miles
 - Entire system would require 225 years
- ***First year of DSIC***
 - Replacement rate – 42 miles
 - Entire system would require 178 years
- ***Second year of DSIC***
 - *Replacement rate dropped to 163 years*
 - *Remediated 46.6 miles*

(Source: Presentation of Carol Kozloff, Water Industry Policy Analyst for Commissioner Robert F. Powelson, PA PUC, to the California Water Association, May 4, 2004)



Focus on Pennsylvania: Potential Impact on Frequency of Rate Case Filings



(Source: Presentation of Dr. Jan Beecher, Executive Director, Institute for Public Utilities, Michigan State University, to the 2008 Eastern NARUC Water Committee Rate School)



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Pennsylvania PUC Comments in Support of DSIC Increase from 5% to 7.5%

Citing page 21 of the Decision:

“The current DSIC cap of 5% will not provide the Company with resources adequate to achieve this Commission’s long term objective, accelerating the replacement of aged water distribution systems throughout the Commonwealth. Increasing the DSIC cap to 7.5% would achieve a reasonable balance between supporting the Company’s efforts to improve its distribution system while encouraging it to make reasonably frequent base rate filings. PAWC has used the funds available to it under the current 5% cap consistent with the legislative intent. We believe that the incremental increase in the cap to 7.5% will permit the Company to accelerate its replacement of this critical distribution infrastructure.”



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Approximate Utility Plant Placed in Service Under Infrastructure Surcharge Programs

Illinois QIP (2005 - 2008)*	\$ 34,568,337
Indiana (2003 - 2008)	\$ 68,289,680
Missouri (2003 - 2008)	\$ 143,576,508
Ohio (2005 - 2008)	\$ 3,350,057
New York (2004 - 2008)	\$ 10,080,000
TOTAL (without Pennsylvania)	\$ 259,864,582
Pennsylvania (1997 - 2007)	<u>\$ 557,000,000</u>
TOTAL - AW	\$ 816,864,582

* Dates do not necessarily correspond to authorization of DSIC-like program because of rate case timing



DSIC Charges – Examples of Approximate Impact on Typical Customer Bill

State	DSIC MAX (% of revenues)	Typical Avg. Monthly Residential Bill	MAX DSIC Surcharge Per Month	% Current Surcharge	Current Surcharge Per Month
IL	5%	\$40.33 (Peoria)	\$2.02	0.00%*	\$0.00
IN	5%	\$30.53	\$1.53	2.49%	\$0.76
OH	3%/filing 3 filings between rate cases	\$35.07 (Franklin Co)	\$1.05 (each yr for 3 yrs)	0.00%*	\$0.00
MO (St Louis Co)	10%	\$21.50	\$2.15	2.10%	\$0.45
NY	Capped at \$3 million over routine spend	\$48.99	X	X	\$0.35
PA	7.50%	\$42.64	\$3.20	2.44%	\$1.04

* Surcharges worked into general rates pursuant to general rate cases



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Ratepayers Protections

- Surcharges are limited to a maximum, relatively small, percentage of revenues (5% - 10%), with small impact on customer bills
- Annual reconciliations occur with refund potential to prevent any significant over recovery
- Surcharges are reset to zero at the time of a general rate case
- Surcharges are limited to specific non additional revenue producing infrastructure replacement
- Depending on the state, other provisions may apply, such as customer notice requirements, limitations to plant actually in service, etc.

As a result very few customer complaints or inquiries have been received in any state where an AW subsidiary has utilized such programs. This includes customers who may be confused or simply have questions about the program.



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Potential Benefits of a DSIC Program

- Mitigates rate shock
- Reduces rate case expense
- Reduces frequency of base rate proceedings
- Allows for more infrastructure improvements and far more efficient rates of necessary infrastructure replacement
- Promotes the acquisition of small and non-viable water systems consistent with Commission policy
- Allows for pro-active planning and related cost benefits associated with infrastructure replacement
- Positive impact on capital attraction and cost of capital
- Accelerates the replacement of aging infrastructure



Endorsement of DSIC-Like Infrastructure Replacement Programs

- As early as February, 1999, NARUC, through a resolution, endorsed DSIC as “...an example of an innovative regulatory tool that other Public Utility Commissions may consider to solve infrastructure remediation challenges in their states.”
 - Resolution adopted February 24, 1999
- NARUC recognized DSIC-like programs as a “Best Practice.”
 - Resolution adopted July 27, 2005
- DSIC-like programs included as model legislation by Council of State Governments in 1999, Publications of Suggested State Legislation