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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION  
DOCKET CONTROL

Arizona Corporation Commission  
**DOCKETED**

JAN 18 2011

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IN THE MATTER OF THE  
COMMISSION'S GENERIC  
EVALUATION OF THE REGULATORY  
IMPACTS FROM THE USE OF NON-  
TRADITIONAL FINANCING  
ARRANGEMENTS BY WATER  
UTILITIES AND THEIR AFFILIATES.

DOCKET NO. W-00000C-06-0149

**NOTICE OF FILING  
PRESENTATION MATERIALS**

Attached are copies of the slides from the presentation delivered by Paul Townsley at the Workshop on January 14, 2011, as well as a copy of the NARUC Resolution dated February 24, 1999.

Dated this 18th day of January, 2011.

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ORIGINAL and thirteen (13) copies of the foregoing filed this 18th day of January, 2011, with

1 The Arizona Corporation Commission  
2 Utilities Division — Docket Control  
3 1200 W. Washington  
4 Phoenix, AZ 815007

5 Copy of the foregoing hand-delivered  
6 this 18th day of January, 2011, to:

7 Lyn Farmer, Chief Administrative Law Judge  
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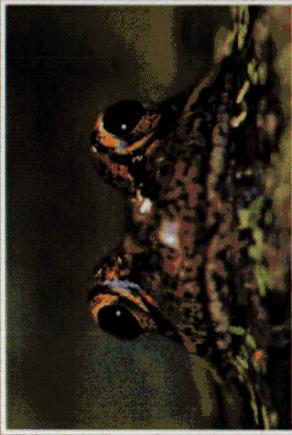
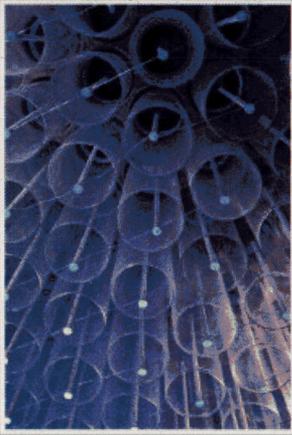


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AMERICAN WATER

D.S.I.C.

An Important Tool for Water Utilities  
and Their Regulators

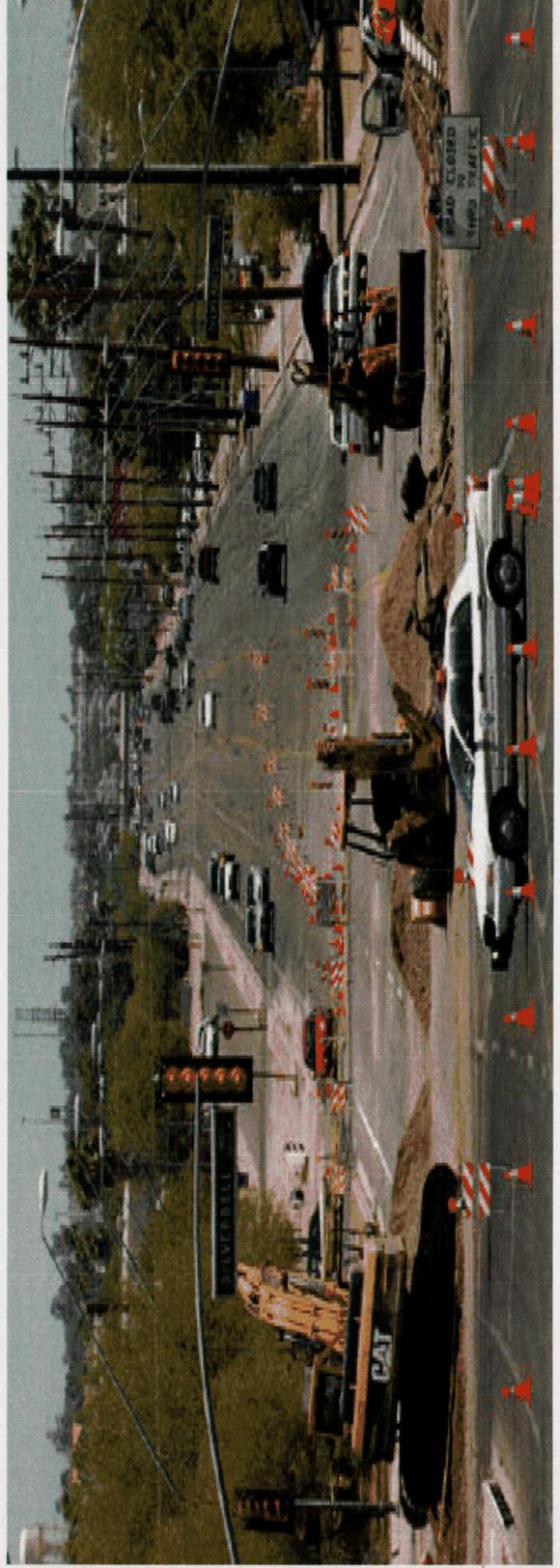
Paul Townsley, President  
Arizona American Water  
January 14, 2011

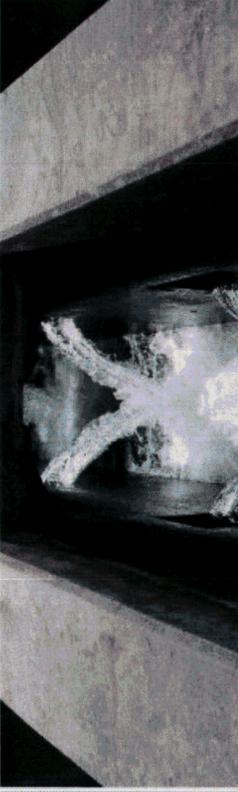




## What is DSIC?

- DSIC stands for Distribution System Improvement Charge
- DSIC is in place in a number of states and goes by a variety of names – DSIC, ISRS, ISS, etc – but the underlying concepts are similar
- Simply put, DSIC provides for the systematic replacement of aged infrastructure in a manner that mitigates rate shock that would be otherwise encountered under traditional ratemaking





## Why Use DSIC?

- Water utility infrastructure is aging across our country.
- The reason for this is that investments in replacing infrastructure are not occurring at a rapid enough pace.
  - For example, if water mains are expected to last 40 years, then 2½ % of all water mains should be replaced each year.
  - The reality is that reinvestment in these facilities is often less than half that amount.
- Often, competing demands for capital cause companies to direct investment away from replacing infrastructure.
- DSIC creates a dedicated reinvestment pool that can only be used for replacing aging infrastructure.

## How Do Customers Benefit from DSIC?

- In many areas infrastructure is reaching the end of its useful life, requiring higher levels of capital investment.
- This, coupled with the lag associated with historic test years, will result in larger step rate increases – sometimes called “rate shock”.
- Using DSIC, once qualifying reinvestments are made, rates would be raised gradually and in smaller steps – concept of “gradualism”.
- A DSIC program would help ensure that that needed reinvestment is not deferred and that facilities are continuing to work properly.
- This regular reinvestment could also mitigate future rate increases due to catastrophic asset failures or overly deferred replacement.
- Over time DSIC can improve service quality, reliability, and help prevent some of the infrastructure crises being experienced elsewhere in the U.S.

## How Can DSIC Mitigate Rate Increases?

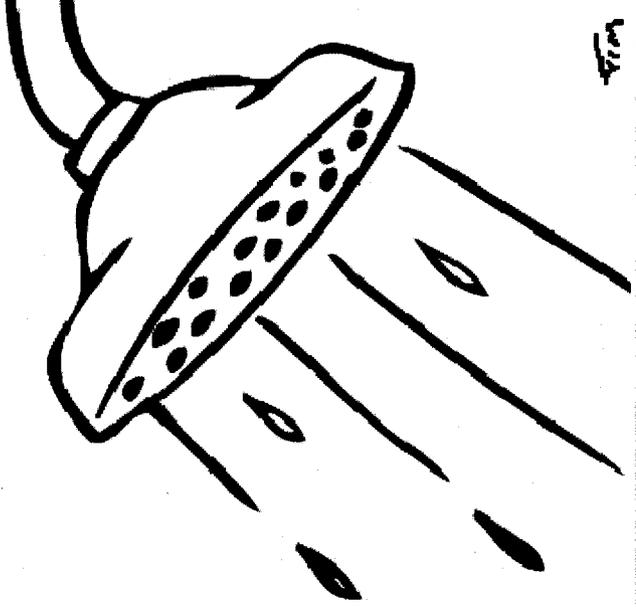
- **DSIC can mitigate customer rate increases two ways:**
  1. **Allowing a water company to delay a rate case filing –**
    - Many rate cases are driven by the need to recover new capital
    - If this capital is recovered via DSIC, and if operating expenses are not increasing significantly, the need to file a rate case can be pushed off
  2. **Providing smaller rate increases than traditional rate making –**
    - DSIC provides for semiannual increases based on completed qualifying projects, rather than single larger increases 2-3 years later.
    - Example: 10,000 cust system; avg bill \$45/mnth; net capex \$2 mill/yr; 3 yr rate case cycle
    - Using DSIC, customers have a semi-annual increase of 2.7%.
    - Without DSIC, customers have an increase in next rate case of 16.3%.

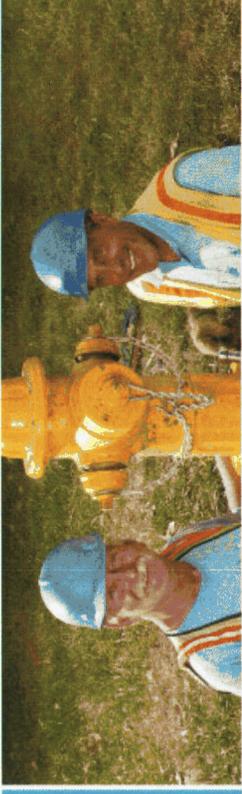


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## How Does DSIC Work?

- **DSIC should be simple for a company to administer, the Commission to review and customers to understand.**
- **DSIC is a surcharge on customer bills and is updated twice per year.**
- **Components of the DSIC program include:**
  - Defining which assets qualify for the DSIC
  - Calculating and filing the surcharge with the Commission
  - Educating and billing customers
  - Implementing appropriate controls





## Which Assets Qualify for DSIC?

- DSIC is an asset replacement surcharge, so the qualifying assets would be limited to replacements of existing assets.
- The most common types of assets covered by other DSIC programs include:
  - Replacement Water Mains
  - Replacement Fire Hydrants
  - Replacement Water Meters
  - Replacement Service Lines
  - Replacement of Tanks and Pumps





## Calculating DSIC

- Twice per year, a company would analyze the qualifying assets placed in service.
- Calculations are based on factors from the most recently completed rate case including depreciation rates, allowed ROE, cost of debt, capital structure and revenue gross-up factors.
- Based on the estimated service life and depreciation rates from the last case, the company would calculate the depreciation expense attributable to these assets.
- Additionally, the company would calculate the appropriate return on these assets based on the authorized return approved in the last case.
- The total amount of the surcharge would be the return “on” and “of” these qualifying assets.

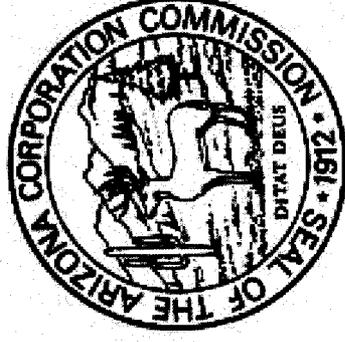
## Illustration of DSIC Calculation

### Illustrative DSIC Calculation

	Investment Amount (a)	Rate of Return (b)	Gross Up Amount (c)	Depreciation Amount (d)	Revenue Requirement (e) + (d)	Surcharge Percent (f)
		(a) * ROR	(b) * 1.667	(a) * Depr Rate		$\frac{(e)}{10M}$
Qualifying Asset 1	\$ 200,000	\$ 14,660	\$ 24,433	\$ 5,000	\$ 29,433	0.55%
Qualifying Asset 2	\$ 250,000	\$ 18,325	\$ 30,542	\$ 6,750	\$ 37,292	0.69%
Qualifying Asset 3	\$ 500,000	\$ 36,650	\$ 61,083	\$ 11,500	\$ 72,583	1.34%
Qualifying Asset 4	\$ 150,000	\$ 10,995	\$ 18,325	\$ 3,750	\$ 22,075	0.41%
Qualifying Asset 5	\$ 750,000	\$ 54,975	\$ 91,625	\$ 18,000	\$ 109,625	2.03%
Qualifying Asset 6	\$ 800,000	\$ 58,640	\$ 97,733	\$ 20,800	\$ 118,533	2.20%
<u>Qualifying Asset 7</u>	<u>\$ 100,000</u>	<u>\$ 7,330</u>	<u>\$ 12,217</u>	<u>\$ 2,000</u>	<u>\$ 14,217</u>	<u>0.26%</u>
Total Qualifying Assets	\$ 2,750,000	\$ 201,575	\$ 335,958	\$ 67,800	\$ 403,758	7.48%

Approved ROR: 7.33% [Amount approved by Commission in company's most recent rate order]  
 Range of Depreciation Rates: 2.0% - 2.7% [Commission approved depreciation rate based on life expectancy of asset]  
 Gross Up Factor: 1.6667 [Tax gross up amount at tax rate of 40%]  
 District Revenue Requirement: \$ 5,400,000 [Amount approved by Commission in company's most recent rate order]

## Filing DSIC with Commission



- A company would file a DSIC application with the Commission no more than twice per year.
- The filing would limit DSIC to no more than 10% in additional revenue generated from the charge.
  - Example: if company granted an annual revenue requirement of \$10 million in its previous rate case, the amount of the DSIC could never be greater than \$1 million or 10%.
- For recovery of amounts greater than 10%, the company would need to file a general rate case.
- At the conclusion of a company's next general rate case, qualifying assets would be placed in base rates and DSIC would be reset to zero.



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## **Educating and Billing Customers for DSIC**

- **A company would provide an overview of the program to affected customers annually via a bill insert.**
- **Additionally, a company would notify its customers using a bill text message of any change in the DSIC and the additional investment made during the preceding period.**
- **The total amount of the DSIC would be calculated as a percentage of the base revenue requirement from the last general rate case for a particular district.**
- **This amount would be disclosed on a separate line of the bill as an “Distribution System Improvement Charge” with the percentage clearly visible.**



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## Implementing DSIC Controls

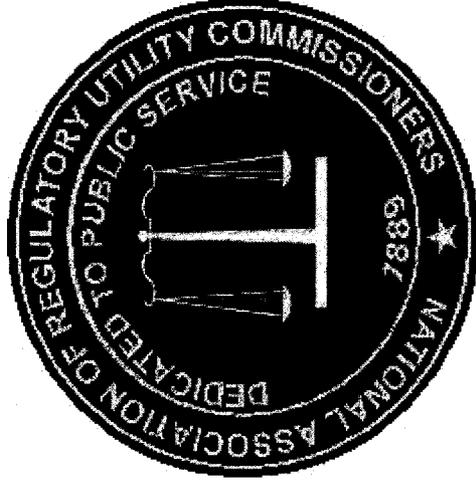
- **Several controls employed in other jurisdictions could be implemented here in Arizona if DSIC was approved.**

- 1. All DSIC assets placed in service would be subject to the normal prudence review in a company's next rate case.**
- 2. A limit of 10% in additional revenue generated from DSIC would be eligible for customer bills.**
- 3. A company could be required to file annual earnings test and only be allowed DSIC increases up to its approved return on rate base.**



## In Summary

- NARUC has identified DSIC as a “Best Regulatory Practice” for water utilities.
- Significant customer benefits can result with DSIC including smaller step rate increases, and deferred rate case filings.
- DSIC creates a dedicated investment pool that can only be used for replacing aging infrastructure.
- Regular reinvestment could mitigate future rate increases due to sudden asset failures and will improve service quality and reliability.



***Resolution Endorsing and Co-Sponsoring "The Distribution System Improvement Charge"***

**WHEREAS**, The Pennsylvania Public Utility Commission and the Pennsylvania Legislature have adopted a promising and unique regulatory approach that encourages the acceleration of the needed remediation of aging water utility infrastructures; *and*

**WHEREAS**, The Distribution System Improvement Charge is an automatic adjustment charge that enables recovery of infrastructure improvement costs on a quarterly basis in between rate cases for projects that are non-revenue producing and non-expense reducing such as main cleaning and relining, fire hydrant replacement and main extensions to eliminate dead ends; *and*

**WHEREAS**, A videotape which explains this unique approach is being prepared by the National Association of Water Companies to help educate and inform other regulatory agencies and legislatures about the benefits of this unique approach; *and*

**WHEREAS**, The U.S. EPA within its Drinking Water Infrastructure Needs Survey has identified a magnitude of national infrastructure needs of \$77.2 billion in pending expenditures; *and*

**WHEREAS**, As the magnitude of need may be too great to be accomplished under traditional ratemaking methodologies; *and*

**WHEREAS**, The Distribution System Improvement Charge provides benefits to ratepayers such as improved water quality, increased pressure, fewer main breaks, fewer service interruptions, lower levels of unaccounted for water, and more time between rate cases which leads to greater rate stability; *and*

**WHEREAS**, Ratepayer protections are incorporated in the Pennsylvania approach: the surcharge is limited to a maximum of 5% of the water bill, annual reconciliation audits are conducted where overcollections will be refunded with interest and undercollections will be billed into future rates without interest recovery, the surcharge is reset to zero at the time of the next rate case, the charge is reset to zero if the company is over-earning, customer notice is provided, and all charges reflect used and useful plant; *now, therefore, be it*

**RESOLVED**, That the Board of Directors of the National Association of Regulatory Utility Commissioners (NARUC), convened at its 1999 Winter Meetings in Washington, D.C, agrees to endorse the mechanism as an example of an innovative regulatory tool that other Public Utility Commissions may consider to solve infrastructure remediation challenges in their States; *now be it further*

**RESOLVED**, That NARUC agrees to co-sponsor with the National Association of Water Companies the videotape of the Distribution System Improvement Charge as an educational tool to inform other regulatory agencies and legislatures about this promising new mechanism.

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*Sponsored by the Committee on Water  
Adopted February 24, 1999*