NEW ENGLAND CHAPETR—NAWC
Recap of November 2009 Annual Meeting
Newport, Rhode Island

Investor Owned Water Companies – The Next Five Years

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No one disputed the fact that the water utility industry is one of the most capital intensive of all utilities; it takes $4 of new plant to generate $1 of revenue. The industry is over 200 years old and water utilities are now competing for significant investment dollars to replace their aging infrastructure. Investors typically expect a 4% dividend payout from the water sector, which does not compare favorably with electric utilities at 4.8%, gas utilities at 4.4%, gas and oil distributors at 6.2%. Water utility payout ratios are expected to average about 75% in 2010. Thus, the water group will find it more and more difficult to increase dividends to competitive levels without increased earnings (rate cases) due to its already high average payout ratio. It is important that regulators be educated that greater business risks from EPA mandates and increased maintenance expenses will need to be counteracted with decreased financial risks. On the flip side of things, more stringent EPA requirements are forcing more municipal water departments to seek relief by selling or leasing to investor-owned water utilities. They have the same problem as the investor-owned sector – the need for huge amounts of capital with limited sources. The investor-owned water utilities do, however, have access to the unlimited source of funds in the equity market. A harder look needs to be given to increasing common equity ratios and decreasing debt ratios. There are most certainly challenging times ahead on both the regulatory and utility fronts.

George Logan discussed in depth the capital planning process at Aquarion Water and the various financing options available to support major construction projects.

Paul Roberti made an interesting presentation which follows in his own words. "All regulated industries face unprecedented times -- that similar to 1991 when three major low pressure systems converged off the coast of northeast New England to create the "Perfect Storm", we, as a nation, are confronted with three converging socio-economic and environmental problems that appear to be on a collision course: (1) national security issues associated with terrorism and our dependence on foreign oil; (2) climate change issues that are heavily driven from electric industry emissions; and (3) a deep economic recession that arguably impedes our financial capability (and willingness) to address the first two items.

Climate change issues are indeed controversial, but perhaps the message of those that support significant efforts to curb greenhouse gas emissions has not been properly adjusted to reflect reality. Energy use is not only expected to increase significantly over the course of the next two decades, but will undoubtedly do so both domestically and around the world. Dependence on any natural resource, most particularly petroleum based fuels, will perhaps inevitably produce greater demand against an overall shrinking resource, and thus produce even greater price volatility over the next decade.

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Diversification with renewable sources of energy, energy efficiency, etc. could probably best be defended not just by the security it brings, along with mitigation of climate change, but also for many other important environmental benefits. It's not just about greenhouse gas emissions -- but also about SOx, NOx, mercury and other pollutants. The fact that a pregnant mother or small child can't eat the fish from our lakes, ponds and oceans should be just as alarming as the rise of CO2 emissions. So, you could argue that the challenging issues we face and the corresponding message for solving these problems, require a public message that includes a much broader context as described above.

All of these issues have a direct correlation to the water industry in terms of rising costs to consumers and their financial capability to pay for necessary infrastructure improvements. Water pollution, rising electricity costs, and the consumers' ability to pay, along with the increasing demand for water will force the water industry and policy makers to make tough choices. Of all utility services, water is arguably in a class of its own -- it is the most essential commodity that we can never live without.

My perspective is that as you assess what direction your company needs to go, in terms of delivering safe and reliable service, scrutinize your options carefully about what investments should be made. Be careful not to place too much emphasis on "new and exciting" technologies that are not really proven and may not have sustained value over the life of the investment. Like the federal government's unprecedented investment in "smart meters" -- it gives me pause to hear from high level executives today that their companies are glad to receive the grants and make the necessary matching investment, but are still troubled by the fact that the technology being employed is ten years old. I would embrace a more strategic and sensible approach to any investment decision, and then bring the regulators to the table to educate them as to why you've made a particular decision. Bring the regulator into that pump house, or out into the watershed to see why the utility believes land acquisitions may be necessary to prevent future development that will degrade the water resources which you are entrusted to protect."

Prudent Capital Expenses – Concept to Rate Base- A Panel Discussion

Moderator:	Judy Kelley, President, Aqua Maine
Panelist:	Don Ware, President, Pennichuck W.W.
Panelist:	Don Tata, President, Tata & Howard Engineers
Panelist:	Rich Sobolewski, Office of Consumer Counsel, CT
Panelist:	Mark Naylor, Director of Finance, Gas & Water, NH PUC

Don Ware opened the panel discussion by presenting key questions and objectives to prudent capital investment. In addition to evaluating investment alternatives using life cycle analysis, companies should ask if the investment will add value to the customer, determine what the impact on rates will be, and determine how best to finance the expense.

In determining the overall value of the investment to the customer, companies should evaluate whether the investment will improve pressure, fire protection, or water quality. Investments may also be necessary to improve field operations or efficiency, such as equipment or vehicle replacements. Investment may be required to ensure regulatory compliance, lower operating costs, or may be

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prudent to ensure that the company can absorb customer growth without increasing headcount.

Replacing aging infrastructure is a top priority for water companies to preserve reliability and water quality. Planned replacements should be prioritized to coordinate with existing municipal plans and community projects. In addition, companies need to determine what projects are a priority based on life cycle cost and benefit analyses.

Sufficient investment to keep up with replacement needs is key.

Don Tata discussed the current challenge being faced by New England utilities to replace deteriorating infrastructure during a period of significant economic downturn. He noted there are opportunities, however, to make prudent capital expenditures with appropriate asset management. Construction costs are currently reasonable and the new CT WICA program provides an enhanced regulatory environment.

Asset management to prioritize capital expenditures is not always the oldest pipe. The typical asset management process requires that the condition of each asset be evaluated, that the risk of service disruption be evaluated, that a cost benefit analysis for replacement vs. rehabilitation or no action be evaluated; and that a plan be developed for ongoing implementation.

There are key considerations for developing asset management plans that create greater efficiency. A Master Plan needs to be developed with a hydraulic evaluation to assess the adequacy of pipes, supply and storage; evaluation of critical system components such as hospitals, schools, wells, tanks, etc. while working with the Company operations, engineering and administration to establish a score for each pipe segment based on age, diameter, material, soils, wetlands, water quality, breaks and stray currents.

Asset management is tailored to each system and designed to be in line with WICA requirements with consideration given to cost sharing with roadway projects, other utility projects and construction development. The value of a prudent capital expenditure program addresses the most urgent or critical system needs, increases customer satisfaction and reduces O&M costs including labor and energy.

Rich Sobolewski from the Connecticut Office of Consumer Counsel presented on how ratepayer advocates review utility plant additions. How his office reviews capital expenditures is wholly dependent upon when the review is done; pre-approval, pre-construction or post-construction. Pre-approval is recommended if not required for major pipeline or interconnection projects, system acquisitions, a WICA application, new office/campus, new technology or program and SDWA mandated treatment plants. These reviews take into account a five year capital budget and rate case plan, a water supply plan and a clear proposal of all WICA projects. On the other side of the coin, post-construction capital additions are reviewed when they are going into rates, once they are used and useful. The same judging criteria prevails in both cases:

- What alternatives were looked at?
- Least cost capital vs. least cost O&M
- Was a cost-benefit analysis done? What does it show?
- Are there cost savings?

Mr. Sobolewski noted that during these tough economic times, emphasis should be placed on projects that are WICA eligible. Regulators worked hard with the water utility industry and the Legislature in Connecticut to establish a fair and reasonable Water Infrastructure and Conservation Adjustment mechanism, and

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they want to see WICA used to its full advantage in lieu of some other rate mechanism.

Mark Naylor, who serves as Director of the Gas & Water Division at the NHPUC provided insight into his state's specific requirements for dealing with proposed large capital expenditures requiring extended financings. The PUC has the power to reject management decisions for use of borrowed funds if they deem them to be counter to the public interest, and will not allow them in rates if they have not first been found to be prudent, used and useful.

Mr. Naylor noted the NHPUC recently adopted a Pilot WICA program in its last rate filing for Aquarion Water of NH modeled after Connecticut's. This must be specifically reauthorized in the next rate case. The PUC plans to evaluate the WICA program based on the following criteria:

- Did it provide incentive for the company to speed up infrastructure replacement?
- Did it help to reduce rate shock?
- Did it help extend time between rate cases while helping the company maintain its authorized ROR between cases?

During the extensive Q&A session following the presentations, it was made apparent that having a WICA or similar mechanism such as a DISC in place does indeed accelerate the amount of infrastructure replacement taking place. It is a most useful rate making tool that provides gradual incremental rate increases without the need of a full blown rate filing and helps the customers as well by helping to prevent "rate shock".

During the Chapter Business portion of the meeting, the following were elected to serve as directors of the chapter for the coming year:

Danny Allen - Aqua Maine
Peter Bancroft - Connecticut Water
Sheryl Fairchild – Valley Water Systems
Laurie Felleman - Connecticut Water
Pam Gorman - Pennichuck Water
Bonnie Hartley - Pennichuck Water
Rick Marchesani - Hazardville Water
D J Smiarowski - Aquarion Water
Madeleine Storer - Aqua Maine
Susan Suhanovsky - Torrington Water
Don Vaughan - Valley Water Systems
Alan Weland - United Water, CT
Maureen Westbrook - Connecticut Water
Jean Zanella-Dyer - Aquarion Water

Chapter officers for the year are:

Laurie Felleman, Chair
Rick Marchesani, Vice-Chair
Danny Allen, Treasurer
Madeleine Storer, Secretary
Sheryl Fairchild, Assistant Secretary

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