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**MAINE PUBLIC UTILITIES
COMMISSION**

**REPORT REGARDING ADDITIONAL
FLEXIBILITY FOR FUNDING
INFRASTRUCTURE IMPROVEMENTS
BY CONSUMER-OWNED WATER
UTILITIES**

**SUBMITTED TO THE JOINT STANDING
COMMITTEE ON ENERGY, UTILITIES AND
TECHNOLOGY**

January 15, 2012

I. BACKGROUND

On May 11, 2011, the Legislature enacted P.L. 2011, ch. 106 (An Act To Provide Additional Flexibility for the Funding of Infrastructure Improvements by Consumer-owned Water Utilities). The law made amendments to 35-A M.R.S.A. § 6104-A regarding alternative rate making provisions for consumer-owned water utilities (COUs). Additionally, the law directed the Commission to convene a work group, that included representatives of small COUs and the Office of the Public Advocate (OPA) to examine ways of ensuring the capital requirements of these water utilities were provided for in an adequate and appropriate manner. The law further required the Commission to report on the progress of the work group and any recommendations for changes to laws to the Energy, Utilities, and Technology Committee by January 15, 2012.

In response to this direction from the Legislature, the Commission assembled a work group consisting of representatives from the OPA, Maine Rural Water Utilities Association, Maine Water Utilities Association, The Maine Water Company (formerly known as Aqua Maine, Inc.), Portland Water District, Winthrop Utilities District, Caribou Utilities District, Kennebunk, Kennebunkport and Wells Water District and the Houlton Water Company (collectively, the Work Group). The Work Group met on September 22, 2011, October 21, 2011, November 16, 2011, and November 30, 2011 to propose and discuss alternative mechanisms to fund replacement of water system infrastructure.

II. FUNDING OF INFRASTRUCTURE REPLACEMENT

Current ratemaking practice, as authorized by 35-A M.R.S.A §§ 301 and 6105, assures water utilities have an opportunity to recover the costs of providing utility service. The Commission limits the revenues collected through rates charged to customers to the amount necessary to provide that utility's public service and, if the utility is investor-owned, to attract necessary capital. Historically, the Commission has determined the amount of revenue that is required for the utility to reasonably provide water service through a review of expenses and investments within a recent 12-month operating period called a "test-year." As a practical matter, this means that a water utility must complete a capital project and then complete a rate case before it may actually begin to recover the costs of the capital expenditure through rates paid by customers.

In general, therefore, COUs are forced to obtain financing for any improvements and then recover the costs of borrowing, including interest, after the project is complete or nears completion.¹ Although a water utility may recover depreciation for capital improvements over the usable life of the facility, water utilities are unable to fund the replacement of infrastructure solely through depreciation because construction costs

¹ Investor-owned water utilities must also fund construction projects prior to recovery in rates but the recovery afforded them for any debt incurred is different than for COUs.

invariably increase during the usable life of water system infrastructure. The usable life of water infrastructure can extend to 100 years and a standpipe installed for \$15,000 in 1915 will have to be replaced in 2015 at a cost of over \$1 million. Consequently, COUs are dependent upon financing and grants to fund necessary improvements. The availability of grants is not assured and financing results in increased recoverable costs to the water utilities in the form of interest. As the funding of an infrastructure replacement project often leads to a need for rate increases for customers and given the institutional reluctance of COUs (governed by elected trustees) to increase rates, necessary replacement of aging infrastructure is often deferred longer than is cost effective or efficient in terms of prudent, long-range planning.²

III. WORK GROUP PROPOSALS

The Work Group proposed two mechanisms to encourage water utilities to plan for infrastructure replacement in a more flexible method than currently exists. These two proposals, Surcharges for Capital Improvement and Capital Reserve Accounts, are discussed in turn below.

A. Surcharge for Capital Improvements

Maine Water Company proposed a surcharge to allow for immediate recovery of capital expenditures. As proposed by Maine Water Company, water utilities seeking to recover for expenditures to replace aging infrastructure using this method would submit to the Commission an initial assessment of its water system infrastructure along with a plan that prioritizes replacement projects. As the utility completes each of these projects approved by the Commission, it would submit a request to recover the costs through a surcharge. The surcharge would be set by the Commission at six-month intervals, subject to a limitation that the surcharge not be greater than 5% of total rates in any calendar year and that it not exceed a cumulative amount of more than 7% between general rates cases. These limitations ensure that rate increases through an automatic mechanism do not result in rate shock or provide an opportunity for utilities to avoid general rate cases through continued application of surcharges. The surcharge would appear as a separate item on customer bills that identifies it as related to construction projects.

Utilities using a surcharge would file an annual reconciliation report with the Commission that would detail the eligible projects that were completed and the

² Pursuant to 35-A M.R.S.A. § 6107, water utilities may also assess a System Development Charge to new customers that are added to the water system. However, these charges are limited to costs resulting from increased demand on the system caused by new customers and do not provide a mechanism for the funding the replacement of infrastructure used to serve existing customers. In addition, in the majority of systems that have enacted a System Development Charge, expenditures for capital projects necessary to accommodate increased demand exceed amounts recovered through the charge.

amount of funds recovered through the surcharge during the previous year. This reconciliation report would allow the Commission to determine if the surcharge had generated revenues in excess of the amount associated with eligible projects.

Given that reasonable rates are determined by the overall revenue picture of a utility, the Commission has historically declined to consider rate changes based on an increase in cost for a single item, such as a capital expenditure. The surcharge, however, allows a utility to begin recovery for specific expenditures related to infrastructure replacement prior to the initiation of a general rate proceeding, thus reducing the traditional regulatory lag that occurs in between rate cases. The limitation on cumulative surcharge increases between rate cases will encourage utilities engaged in the replacement of infrastructure to conduct general rate proceedings on a regular basis to allow rates to keep pace with costs. At the conclusion of any general rate case, the surcharge amounts would return to zero as the costs associated with eligible projects were included in the utility's revenue requirement.³

B. Capital Reserve Accounts

Capital Reserve Accounts (CRAs) would allow a water utility to collect an additional amount of revenue from customers on top of rates paid by customers that would be deposited in a reserve account dedicated to future capital infrastructure replacement in a manner similar to municipal reserve accounts authorized by 30-A M.R.S.A. § 5801.

Under traditional rate making, future costs of providing utility service are allocated to customers who are receiving service from the utility at the time the cost occurs. To require existing customers to pay for service to be provided to future customers is viewed as creating intergenerational inequities and would violate the general principle that rates be based on the cost of providing the utility's current service. See 35-A M.R.S.A. §§ 301 and 6105. Furthermore, 35-A M.R.S.A. § 6105 which describes what costs a COU may recover through rates, does not permit the accumulation of revenue unrelated to current costs or reserves.⁴

As discussed above, the Commission has historically required water utilities to meet the mandate of 35-A M.R.S.A §§ 301 and 6105 that rates be just and reasonable by showing that any amount proposed to be recovered in rates is associated with a specific cost or expense that could be demonstrated with a high degree of certainty. The adoption of CRAs would be inconsistent with this requirement. To allow

³ This mechanism was modeled on a current surcharge statute for investor-owned water utilities in Connecticut attached to this report. Similar provisions have also been enacted in Pennsylvania, California, West Virginia, and Illinois.

⁴ Although 35-A M.R.S.A. § 6105 authorizes the creation of sinking funds to pay debts, the creation of a contingency allowance, and rate adjustments as a result of new facilities necessary to meet the requirements of the Safe Drinking Water Act, it does not authorize the collection of funds for future infrastructure replacement.

COUs to collect revenues in excess of the amount justified by the costs of providing utility service leaves open the possibility that utilities will use these amounts to offset increases in operating costs rather than file for an increase in rates, thus defeating the purpose of the CRA and preventing the Commission and customers from being assured that rates are related to the costs of prudently operating the water system. These concerns could be addressed by combining the adoption of CRAs with limitations on the permissible uses of collected revenues, prescribing limitations for the amount of revenue to be collected, adopting planning requirements and rigorous reporting requirements.

In order to assure that CRA funds are part of an overall replacement program, the Work Group agreed that a water utility seeking to set aside funds for future replacement of infrastructure must complete an assessment of its system and prioritize infrastructure projects similarly to the surcharge discussed above. This assessment would be submitted to the Commission for approval and would establish which projects are eligible for funding through the CRA. The Work Group did not reach agreement on a specific proposal for the contents of the assessment. Representatives from COUs urged for the simplest possible mechanism, such as an inventory of current infrastructure potentially needing replacement in the set period of time. Likewise, the Work Group did not reach agreement on a specific proposal defining what types of projects should be eligible for funding with CRA reserves. Representatives of COUs advocated for flexibility so that a wider range of construction costs could be flowed through a CRA reserve. The OPA, on the other hand, advocated for a more rigorous definition that would more clearly delineate appropriate uses for these funds. In the view of the OPA, actions must be taken to ensure that CRA reserves would not be used to cover increases in operations and maintenance costs. Furthermore, although the Work Group discussed setting levels of revenue to be recovered through rates to fund CRAs, it did not reach a specific proposal for how to determine this level. Finally, the Work Group proposed limiting the use of CRAs to COUs.⁵

We suggest the following conditions for the creation and funding of Capital Reserve Accounts:

- Water utilities seeking to create a CRA should submit to the Commission for approval an infrastructure assessment that lists, at a minimum, the age, material, and technical details of its infrastructure. This assessment should be combined with a prioritized list of projects.

⁵ While the Work Group recommended this limitation and Maine Water Company, the only investor owned utility represented in the group, did not express interest in this mechanism, the Commission sees no principled reason why CRAs should not be available to all water utilities, especially the smaller investor-owned water utilities that are more similarly situated to the COUs, provided that there are rigorous reporting requirements and reasonable limitations on the use and levels of revenue collected.

- During analysis and approval of the assessment, the Commission should determine, using criteria contained in Commission rule, the appropriate amount of revenue to be collected on a yearly basis to fund the CRA.
- CRA funds should be held in a separate account from the normal operating funds of the utility in order to allow their collection and use to be accurately tracked and reported. Revenue collected to fund the CRA should be deposited quarterly in a manner consistent with the utility's billing cycle.
- Water utilities electing to fund a CRA should file a report with the Commission annually providing a detailed accounting of all funds deposited into the CRA, all funds withdrawn, and a detailed list of projects funded with CRA revenues.
- If the balance continually increases over a period of three years and the utility does not complete projects listed in its initial filing, the utility should be required to explain why it has not used the funds.

These provisions provide a structure to ensure that CRAs are used to fund capital expenditures for the replacement of utility infrastructure without creating excessive burdens for water utilities. Thus, the creation of CRAs would both encourage and assist water utilities in the replacement of infrastructure necessary to perform their public service without removing regulatory safeguards for utility customers.

IV. CONCLUSION

The Work Group proposes two mechanisms, a Surcharge for Capital Improvement and Capital Reserve Accounts, intended to provide at least consumer owned water utilities with additional flexibility in funding infrastructure improvements. The Commission believes that either of these mechanisms could provide reasonable access to capital without risking harm to customers, provided certain safeguards, described in this report, are in place.

Public Act No. 07-139

AN ACT CONCERNING WATER COMPANY INFRASTRUCTURE PROJECTS.

Be it enacted by the Senate and House of Representatives in General Assembly convened:

Section 1. (NEW) (*Effective from passage*) For purposes of this section:

(1) "Eligible projects" means those water company plant projects not previously included in the water company's rate base in its most recent general rate case and that are intended to improve or protect the quality and reliability of service to customers, including (A) renewal or replacement of existing infrastructure, including mains, valves, services, meters and hydrants that have either reached the end of their useful life, are worn out, are in deteriorated condition, are or will be contributing to unacceptable levels of unaccounted for water, or are negatively impacting water quality or reliability of service if not replaced; (B) main cleaning and relining projects; (C) relocation of facilities as a result of government actions, the capital costs of which are not otherwise eligible for reimbursement; and (D) purchase of leak detection equipment or installation of production meters, and pressure reducing valves.

(2) "Department" means the Department of Public Utility Control.

(3) "Infrastructure assessment report" means a report filed by a water company with the department that identifies water system infrastructure needs and the company's criteria for determining the priority for eligible projects related to infrastructure.

(4) "Pretax return" means the revenue necessary, after deduction of depreciation and property taxes, to produce net operating income equal to the water company's weighted cost of capital as approved by the department in the company's most recent general rate case multiplied by the new original cost of eligible projects.

(5) "Reconciliation adjustment" means the difference between revenues actually collected through the water infrastructure and conservation adjustment and the amount allowed under the WICA for that period for the eligible projects. The amount of revenues overcollected or undercollected through the adjustment will be recovered or refunded, as appropriate, as a reconciliation adjustment over a one-year period commencing on April first.

(6) "Water company" means a water company, as defined in section 16-1 of the general statutes, that has filed for approval an individual infrastructure assessment report to support a request for a WICA adjustment.

(7) "Water Infrastructure and Conservation Adjustment (WICA)" means an adjustment applied as a charge or credit to a water company customers' rates to recover the WICA costs of eligible projects.

(8) "WICA costs" means the depreciation and property tax expenses and associated return on completed eligible projects.

(9) "WICA revenues" means the revenues provided through a water infrastructure and conservation adjustment for eligible projects.

Sec. 2. (NEW) (*Effective from passage*) (a) The Department of Public Utility Control may authorize a water company to use a rate adjustment mechanism, such as a water infrastructure and conservation adjustment (WICA), for eligible projects completed and in service for the benefit of the customers. A water company may only charge customers such an adjustment to the extent allowed by the department based on a water company's infrastructure assessment report, as approved by the department and upon semiannual filings by the company which reflect plant additions consistent with such report. The department, in consultation with the Office of Consumer Counsel, shall conduct the proceeding in accordance with the provisions of section 16-18a of the general statutes.

(b) On or before ninety days after the effective date of this section, the department shall initiate a generic docket on what shall be included in a water company's infrastructure assessment report and annual reconciliation reports and the criteria for determining priority of eligible projects. The department shall provide public notice with a deadline for interested parties to submit recommendations on the report contents and criteria. The department may hold a hearing on the generic docket but shall issue a decision on the docket not later than one hundred eighty days after the deadline for interested parties to submit their recommendations on the report contents and criteria.

(c) The water company shall file their individual infrastructure assessment report with the department and such report shall identify the water system infrastructure needs and a water company's criteria for determining priority for eligible projects related to infrastructure. The department shall address such criteria in its docket initiated pursuant to subsection (b) of this section. Criteria may include, but shall not be limited to, (1) age, material or condition of the facilities; (2) extent and frequency of main breaks or interruption of service; (3)

adequacy of pressure; (4) head loss; (5) availability of fire flows; and (6) the potential of such projects to improve system integrity and reliability.

(d) The department shall approve a water company's individual infrastructure assessment report upon determining that the company has demonstrated through generally accepted engineering practices (1) the infrastructure projects considered for renewal or replacement are eligible projects; (2) such projects will benefit customers by improving water quality, system integrity or service reliability; (3) they adhere to the criteria established for determining priority for infrastructure projects; and (4) there is a sufficient level of investment in infrastructure. The department may hold a hearing to solicit input on a water company's individual infrastructure assessment report provided a decision on the assessment is made not later than one hundred eighty days after filing. Any such report not approved, rejected or modified by the department within such one-hundred-eighty-day period shall be deemed to have been approved.

(e) Notwithstanding the provisions of section 16-19 of the general statutes, upon department approval of a water company's individual infrastructure assessment report, the water company may charge the WICA for eligible projects in addition to such water company's existing rate schedule pursuant to subsection (f) of this section and the procedures and customer notification requirements in subsections (g) and (h) of this section.

(f) The WICA adjustment shall be calculated as a percentage, based on the original cost of completed eligible projects multiplied by the applicable rate of return, plus associated depreciation and property tax expenses related to eligible projects and any reconciliation adjustment calculated pursuant to subsection (j) of this section as a percentage of the retail water revenues approved in its most recent rate filing for the regulated activities of said water company.

(g) A water company may impose the WICA adjustment for eligible projects as a charge or credit on customers' bills at intervals of not less than six months, commencing on either January first, April first, July first or October first in any year. No proposed WICA charge or credit shall become effective until the Department of Public Utility Control has approved such charges or credits pursuant to an administrative proceeding. The department may receive and consider comments of interested persons and members of the public at such a proceeding, which shall not be considered a contested case for purposes of title 4 of the general statutes, this section or any regulation adopted thereunder. Such administrative proceeding shall be completed not later than thirty days after the filing of an application by a water company or within a time period as otherwise established in the generic docket conducted pursuant to subsection (b) of this section. Any approval or denial of the department pursuant to this subsection

shall not be deemed an order, authorization or decision of the department for purposes of section 16-35 of the general statutes. Notwithstanding the provisions of this section, if the department has not rendered an approval or denial concerning any such application within the established timeframe, the proposed charges or credits shall become effective at the option of the company pending the department's finding with respect to such charges, provided the company will refund its customers any such amounts collected from them in excess of the charges approved by the department in its finding.

(h) Water companies shall notify customers through a bill insert or other direct communications when the adjustment is first applied and the WICA charge or credit shall appear as a separate item on customers' bills.

(i) The amount of the WICA applied between general rate case filings shall not exceed seven and one-half per cent of the water company's annual retail water revenues approved in its most recent rate filing, and shall not exceed five per cent of such revenues for any twelve-month period. The amount of the adjustment shall be reset to zero as of the effective date of new base rates approved pursuant to section 16-19 of the general statutes and shall be reset to zero if the company exceeds the allowable rate of return by more than one hundred basis points for any calendar year.

(j) On or before February twenty-eighth of each year, a water company shall submit to the department an annual reconciliation report for any WICA charges applied to customers' rates through December thirty-first of the previous calendar year. Such reconciliation report shall identify those projects that have been completed, demonstrate that the WICA charges are limited to eligible projects that are in service and used and useful as of the end of the calendar year, and include any other information required as a result of the generic docket conducted pursuant to subsection (b) of this section. The company shall indicate in its report any significant changes in the extent of infrastructure spending, the priorities for determining eligible projects or the criteria established in the infrastructure assessment report. In addition, the reconciliation report shall compare the WICA revenues actually collected to the allowed amount of the adjustment. If upon completion of the review of the annual reconciliation report the department determines that a water company overcollected or undercollected the WICA adjustment, the difference between the revenue and costs for eligible projects will be recovered or refunded, as appropriate, as a reconciliation adjustment over a one-year period commencing on April first. The company shall refund the customers with interest for any overcollection but shall not be eligible for interest for any undercollection.

Approved June 19, 2007