DSIC COMMENTS – Docket No. WO10090655

A CAPITAL MARKETS PERSPECTIVE ON NEW JERSEY'S REGULATORY CLIMATE & THE IMPLIMENTATION OF A DISTRIBUTION SYSTEM IMPROVEMENT CHARGE (DSIC)

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INVESTOR SENTIMENT ON WATER UTILITIES:

The U.S. investor-owned water utility industry is a small sector with only 10 publicly-traded stocks currently, with a combined market capitalization of less than $5 billion. Perhaps more so than other regulated utilities, water utilities are subject to a high degree of both environmental and economic regulation, given the importance of the availability and quality of their product for human survival, as well as their monopoly status within their given regions.

Investors like:

- Water is an irreplaceable commodity with stable demand;
- High capital expenditure requirements fuel investment and technology development & rate base growth;
- The industry is highly fragmented, with over 50,000 community water systems; consolidation drives rate base and earnings growth.

Investors don't like:

- Government controls limit investor returns – customers feel entitled that water should be free;
- Rate increases don't keep up with capital spending; regulatory lag causes negative cash flow and risk to returns;
- Merger and acquisition activity is at risk of regulatory and political interference.

INVESTORS PERCEPTION ON REGULATION:

Maintenance of the "Regulatory Compact" is essential for utilities to have continued access to capital markets. The Commission's responsibility is not to ensure that customer rates are kept low, but that rates are fair to both investors and customers. Commissions that work with their utilities to minimize rate shock to customers, while stimulating infrastructure investments in their jurisdictions, are viewed most favorably by the investment community. There is no formulaic equation to gauge a fair regulatory environment, and commissions have utilized a variety of methods to strike the right balance of supporting infrastructure while balancing the needs of consumers. In some states, allowed returns may be somewhat lower, but investors deem the regulatory climate constructive, if regulatory matters are resolved in a timely fashion and mechanisms to minimize regulatory lag are in place. Utilities with good operating discipline and solid customer service records should be provided a certain degree of regulatory consistency and the ability to earn their states rate of return.

Criteria investors utilize to evaluate regulatory environments:

- ***Recent Allowed ROEs granted***
- Consistent Regulatory Treatment
- Timely Decision Making
- Efforts to Minimize Regulatory Lag

THE IMPORTANCE OF ROEs:

We believe that the single most important feature in a rate case is the allowed return on equity, since it sets the framework for what investors can expect to earn on their equity investment in a utility. ***Most water utilities struggle to earn their Commission-allowed ROEs, given their ongoing capital investment requirements and regulatory lag.*** Allowed ROEs range from 8.5% - 12%, with the national average for the water utility sector currently at about 10.25%. We view 10.0% as floor, and take a negative view on allowed returns below that level, as we believe it is more difficult for utilities earning sub-par returns to attract investment and generate earnings growth. Conversely, we believe ROEs of 10.5% or higher provide a more attractive incentive for utilities to allocate capital expenditure dollars, and for investors to provide equity capital.

The following excerpt is taken from our report, "Aqua America: Positive Development in Pennsylvania Rate Case," published by Janney Montgomery Scott for investor clients in July 2008.

> **"Favorable Allowed ROE Granted in Pennsylvania Rate Case.** Pennsylvania is Aqua's largest operating territory, comprising 44% of the company's customers and 56% of its total PPE (property, plant and equipment). The company filed for a $41.7 million rate increase last November with a requested allowed ROE of 11.75%. Yesterday, the Pennsylvania PUC issued a press release regarding Aqua's rate case. The Commission conducted a "binding poll", which is used by the PUC Staff to draft the Order, and indicated that the rate increase to be granted by the Commission would be approximately $34.4 million. At yesterday's hearing, the four Commissioners unanimously supported an allowed ROE of 11%. ***We are encouraged by this ROE announcement as it indicates that the Pennsylvania Commission is aware of the increased risks faced by water utility companies and supports allowing them to earn a commensurate return for this risk.***

COMPARING WATER UTILITY REGULATORY ENVIRONMENTS:

New Jersey is one of the three most important regulatory climates, as it relates to water utilities, along with Pennsylvania and California. Each of these states is an operating jurisdiction of multiple, large investor-owned water utilities. In New Jersey, investor-owned and private water utilities serve almost half of the state's population. This is considerably more than the 15% of the national population served by such entities. We view the regulatory climate in Pennsylvania and California to be more constructive than that of New Jersey.

Pennsylvania has long been a trail-blazing Commission creating favorable regulatory mechanisms that encourage infrastructure investment to be made within the state. The Commission is credited with creating and implementing the first Distribution System Improvement Charge (DSIC) mechanism in 1997. Pennsylvania utilizes a single-tariff rate jurisdiction, which encourages the water utilities to consolidate smaller, troubled systems and make the necessary infrastructure upgrades to improve water quality minimizing the risk that the company will not earn a fair return on this capital outlay. Additionally, the Commission has taken the initiative to meet with the chief financial officers of each of its regulated utilities, outside of formal rate proceedings, so it may stay attuned to the changing financial and operating landscape the utility is experiencing. Lastly, the commission awards return on equity allowances between 10.5% - 11.0%, above the national average. ***We believe this ROE indicates that the Pennsylvania Commission is aware of the increased risks faced by water utility companies and supports allowing them to earn a commensurate return for this risk.***

Regulation is California has come a long way since the late 1990s, when regulation was inconsistent, rate cases were taking as long at 24 months to complete, and water utilities were exposed to supply cost fluctuations. The commission is now recognized as one of the most proactive regulatory environments, due in large part to the publication and implementation of a Water Action Plan, which provides clear goals for regulators and utilities to follow. The commission uses a forward test year and is in the process of consolidating and streamlining its rate case process. The current allowed ROE in the state for most investor-owned water utilities is 10.2%, which is slightly lower than the national average.

The following comments on Pennsylvania and California regulation are excerpts from our research report "Regulation Cheat Sheet: Everything You Need to Know That Will Impact the Stocks in 2009" published on February 24, 2009.

> ***Pennsylvania*** continues to deserve its status as the most constructive regulatory environment in the water sector. In 2008, the Commission raised the allowed return on equity to 11% from 10.5% for both Aqua Pennsylvania and York Water. The Commission also expanded its DSIC (Distribution System Improvement Charge) mechanism, which the PA PUC is credited with creating, allowing interim surcharges of up to 7.5% of customer bills for American Water, versus 5% previously. We would expect other Pennsylvania water utilities to file for increased DSIC mechanisms with their next rate cases. Both of these efforts reinforce the Commission's commitment to encouraging capital investment in the state. This position is strongly backed by Governor Ed Rendell, who has been a vocal supporter for infrastructure investment in Pennsylvania and nationally.
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> ***California*** has managed some notable improvement in recent years, after having been one of the most trying regulatory environments as recently as 2003. California was a combative place, to say the least, back in 2000, when the state's failed attempt at electric deregulation erupted in blackouts and bankruptcy for the state's largest electric company. Though it wasn't directly involved in the electricity crisis, water companies were also harmed by the negative environment, and rate cases averaged 24 months for completion. In December 2005, California became the first state to issue a long-term sector strategy in its Water Action Plan. Under the plan, the state commission has been working to streamline rate cases and improve companies' ability to earn their allowed returns. In the second half of the year, the Commission completed "conservation proceedings" for Golden State Water (American States' California subsidiary) and Cal Water. This new mechanism should have the effect of smoothing out volatility caused by weather, conservation, and water production costs.
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> *Please refer to the research report "Regulation Cheat Sheet: Everything You Need to Know That Will Impact the Stocks in 2009" published on February 24, 2009 and the slides "Financing Infrastructure Replacement: The Importance of Return on Equity" from a speech given on April 27, 2009 for additional details.*

INVESTOR SENTIMENT OF NEW JERSEY REGULATION:

Regulatory Research Associates (RRA), a service of SNL Energy, provides information of state commissions, regulatory climates, and past and pending regulatory matters. RRA has assigned a rating of Average/2 to the New Jersey regulatory climate. *RRA maintains three principal rating categories: above average, average, and below average. It tries to maintain an approximately equal number of ratings above the average and below the average. Within the principal rating categories, the number 1-3 indicated relative position. 1 indicates a stronger rating, 2 indicates a mid-range rating, and 3 indicates a weaker rating.* We would note that this is only from the perspective of the electric and natural gas utility sectors. RRA does not monitor water utility topics or regulatory activity, given the sector's small size.

The following excerpt is taken from an RRA Research Note published on January 26, 2010:

> "We consider the New Jersey regulatory climate to be relatively neutral from an investor viewpoint. While equity return authorizations have historically been significantly below prevailing industry averages when established, the BPU's most recent authorization was in line with industry averages, and the parties' recommendations in pending rate cases have also been closer to industry average return authorizations. The power to serve electric customers who do not select a competitive generation provider is procured through a competitive bid process, and the incumbent utilities are not at risk for fluctuations in market prices. Despite volatility in wholesale power markets, there have been no initiatives to significantly alter the procurement paradigm. Retail competition has been in place in the gas industry for several years and the incumbent local distribution companies that continue to offer default commodity supply service are permitted to adjust rates in a timely manner to reflect changes in the market price of gas, and may retain a portion of the benefits associated with certain non-traditional activities. In addition, the BPU has approved

pilot revenue decoupling mechanisms for the gas utilities. On a less positive note, the BPU has placed stringent conditions on energy utility mergers, and failure to reach an agreement among the parties led to the demise of major merger proposal. We accord New Jersey regulation an Average/2 rating."

Investors categorize the New Jersey regulatory environment as "improving".

Investors like:

- Allowance of Purchased Gas/Water Adjustments
- Creation of Energy Master Plan
- Accelerated Infrastructure Program
- Off-System Sales Sharing
- Successful Wholesale Auction
- Focus on Energy Efficiency
- Conservation Incentive Program

Investors dislike:

- Historic Below-Average Return on Equity (ROE)
- Slow to Respond to Merger Activity
- Delays Implementing Water Infrastructure Surcharges (DSIC)
- Use of Historical Test Years

The commission has historically granted allowed ROE's that have been below the national average, however, recent ROEs have been more in line with the national average. The 10.3% ROE the BPU has granted in recent electric, natural gas, and water utility base rate proceedings compare favorably to the year-to-date national average ROE (as of December 1, 2010) of 10.29% for electric and 10.09% for gas utilities. It is difficult to pinpoint an exact ROE average for the more fragmented water utility sector, however, we believe the average is currently at our about 10.25%. State regulators are known for dragging their feet on merger activity and corporate changes, such as the abandoned merger between Exelon (EXC) and Public Service (PEG) and the spin-out of American Water from former German parent RWE.

Investors view the regulatory climate in New Jersey more favorably for the electric and gas utilities compared to the water utilities despite the comparable ROEs granted across the utility sub-sectors. The electric and natural gas sectors enjoy more regulatory certainty and the stabilizing effect of multiple regulatory mechanisms. The BPU was an early adopter of the decoupling mechanism for natural gas utilities, which is now utilized in over 20 states. The Conservation Incentive Program (CIP), which began as a pilot program in October 2006, has been deemed a success by utilities and the Commission alike, stabilizing earnings and customer bills as intended. The most recent positive development in New Jersey has been in efforts to solidify the state's energy policy through the Energy Master Plan (EMP).

The following excerpt taken from a research report published September 2009 provides our assessment of the New Jersey regulatory environment, as it relates to the natural gas industry.

State legislatures and public utility commissioners have adopted a variety of methods for grappling with the current economic downturn. More constructive regulatory environments continue to support infrastructure investments and treat utilities as partners. We are encouraged by New Jersey's Energy Master Plan, released last October, which sets clear, long-term energy efficiency and renewable energy goals and works with utilities in pursuing these goals. As part of the Plan, utilities have been encouraged to accelerate capital expenditure programs, with a mechanism in place that allows an immediate return on these investments. Utilities are also playing a more direct role in encouraging energy efficiency. Spending related to these programs has already begun, and is modestly contributing to earnings at some utilities. Although allowed ROEs remain below the national average, we find the New Jersey regulatory climate constructive for electric and gas utilities, with regulatory mechanisms that help stabilize earnings. Recent efforts to formalize the new state energy plan further improve our view of the state's regulatory environment.

Please refer to the research report "New Jersey Energy Master Plan Stimulating Utility Earnings Growth" published on September 9, 2009 and the slides "The View from Wall Street: A Securities Industry Perspective" from a speech given to the New Jersey Utilities Association on June 11, 2009 for additional details.

INVESTOR VIEW ON DSIC:

Investors view the distribution system improvement charge (DSIC) favorably and have been disappointed that the Board of Public Utilities has yet to enact a DSIC in New Jersey. The mechanism has been in existence since 1997 and currently exists in nine states. The DSIC allows water utilities to better manage their capital budgets, cash flows, and financing needs. The mechanism gives utilities an opportunity to earn closer to their stated return by minimizing regulatory lag. ***No precedent exists for a ROE reduction or a rate stayout stipulation in conjunction with the creation of a DSIC.***

The following excerpt is taken from our "Water Utilities 101: A Primer for Investors," published by Janney Montgomery Scott for investor clients in November 2007.

> As the water utilities increase their attention to efficient asset management and replacement of deteriorating infrastructure in an effort to get their pipe networks on a 100 to 200 year replacement cycle, rather than the lagging 400-500 year cycles they operated under historically, their levels of spending will likely continue to exceed operating cash flow for some years to come, continuing their reliance on regulators to provide a fair and timely rate of return on that investment.

The capital needed to finance this considerable infrastructure investment comes at a price. Investors expect utilities to allocate their capital to projects that will generate fair and timely returns. Since the utilities have a limited amount of capital to allocate towards this monumental task, states are competing with one another for these infrastructure dollars. The problem of aging infrastructure exists throughout the country and regulators have used the DSIC mechanism as an incentive for water utilities to allocate capital in their states. There is a direct correlation between policy and investment.

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