The Commonwealth of Massachusetts

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

February 28, 2005

D.T.E. 04-77

Petition of Aquarion Water Company of Massachusetts for an accounting deferral of expenditures incurred and expected to be incurred in connection with the investigation of the contamination and subsequent treatment of two water supply wells in Millbury, Massachusetts.

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FOR: AQUARION WATER COMPANY OF MASSACHUSETTS
Petitioner

I. INTRODUCTION

On July 27, 2004, Aquarion Water Company of Massachusetts ("Aquarion" or "Company") filed a petition ("Petition") with the Department of Telecommunications and Energy ("Department") requesting an accounting deferral[1] of expenditures incurred in connection with the investigation of the contamination and subsequent treatment of two water supply wells in Millbury identified as Jacques Well No. 1 and Jacques Well No. 2 (collectively, "Jacques 1 and 2") that were found to contain perchlorate.[2] Aquarion requests deferral until the Company's next rate proceeding of approximately $812,102 in actual and anticipated expenditures related to testing, notification, labor, consulting fees, and the purchase and reimbursement to customers for supplemental water expenses (Exhs. DTE 1-5; DTE 1-6; DTE 2-2).[3]

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[1] Approving deferral of an expense allows a company to request recovery for that expense in the company's next rate case even though that expense was incurred before the test year chosen by the company. See Fitchburg Gas and Electric Light Company, D.T.E. 99-114, at 1 n.3 (2001).

[2] Perchlorate is widely used as a component of propellants in rockets, missiles and fireworks. According to the Massachusetts Department of Environmental Protection, perchlorate is a human health concern as it can interfere with iodide uptake into the thyroid gland, which can disrupt thyroid function and can potentially disrupt fetal and child development (Petition at 4, Massachusetts Department of Environmental Protection letter dated February 2, 2004).

[3] Shortly after the initial filing, Aquarion reported that this amount consisted of $409,152 in expenditures incurred through September 23, 2004, plus $402,950 in additional expenses anticipated through the end of February 2005 (Exhs. DTE 1-5; DTE 1-6). As of January 20, 2005, the Company reported that it had incurred $547,676 in perchlorate-related expenses (Exh. DTE 1-5 (Rev. January 27, 2005)).

On September 9, 2004, the Department issued a request for comments from interested persons. No comments were received. The Company has responded to 19 information requests issued by the Department.[4]

II. COMPANY PROPOSAL

In response to concerns about the presence of perchlorate in drinking water, the Massachusetts Department of Environmental Protection ("DEP") adopted an emergency regulation, effective February 27, 2004, for perchlorate monitoring and testing (Petition at 1; 310 C.M.R. § 22.06D). Pursuant to these emergency regulations, all community water systems and non-transient, non-community water systems were required to test for the presence of perchlorate. 310 C.M.R. § 22.06D. In addition, DEP has developed a standard operating procedure for evaluating perchlorate test results (Petition at 1). Under the standard operating procedure, sensitive subgroups, including pregnant women, children, and people with thyroid conditions are advised not to consume water if perchlorate levels exceed one part per billion ("PPB"), and all users are advised not to consume water with perchlorate levels exceeding 18 PPB (Petition at 1, DEP letter dated February 2, 2004).

As a result of the required sampling, the Company detected perchlorate levels of 42.6 PPB at Jacques Well No. 1 and 18.45 PPB at Jacques Well No. 2 (Petition at 1; Exh. DTE 1-4). Once the test results were confirmed, the Company took Jacques 1 and 2 off-line, and notified the public in accordance with DEP's standard operating procedure

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[4] The Department, on its own motion, moves the Company's responses to Information Requests DTE 1-1 through DTE 1-7; DTE 2-1 through DTE 2-8; and DTE 3-1 through DTE 3-4 into the evidentiary record in this case. In addition, the Department incorporates by reference the Company's Annual Returns to the Department for the years 2001 through 2003. 220 C.M.R. § 1.10(3).

(Exh. DTE 1-4). Jacques 1 and 2 will remain out of service until a DEP-approved treatment system is installed (id.). DEP subsequently approved a perchlorate treatment system for the Company with a projected activation date of February 2005 (Exh. DTE 2-7).

Aquarion reports that as of January 20, 2005, it has incurred $547,676 in actual costs in connection with the investigation of the contamination and subsequent treatment of Jacques 1 and 2 (Exhs. DTE 1-5 (Rev. January 27, 2005); DTE 3-4). This amount consists of: (1) $56,899 in laboratory and sampling costs, (2) $2,085 in bottled water expense,[5] (3) $2,677 in customer notification expense, (4) $35,423 in employee labor expenses, (5) 36,964 in consulting services, (6) $382,977 in water purchases from the City of Worcester ("Worcester") for the purpose of supplying the Company's largest customer, Wheelabrator, and (6) $30,651 in miscellaneous expenses (Exh. DTE 1-5 (Rev. January 27, 2005)).

Aquarion contends that, absent approval of an accounting deferral, the Company will be obligated to write off the actual costs of $547,676 against expenses (Exh. DTE 2-2). The Company states that, assuming a total expense of $812,000, which includes actual plus projected costs,[6] the writeoff will result in a 9.8 percent increase in operating, maintenance and general expenses when compared to the twelve months ended December 31, 2003 (id.). The

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[5] The Company has been supplying bottled water to several elementary schools and nursing homes (Exh. DTE 1-5). In addition, the Company has been reimbursing customers directly for purchased bottled water and thyroid testing (Exh. DTE 1-5 (Rev. January 27, 2005)).

[6] The projected costs, totaling approximately $264,426, represent the residual balance from the Company's September 2004 estimate (Exhs. DTE 1-5 (Rev. January 27, 2005); DTE 1-6). This balance includes anticipated expenses for laboratory analysis, labor, legal expenses, and additional anticipated water purchases from Worcester (Exh. DTE 1-6).

Company asserts that the increase would lead to a reduction in after-tax net income of approximately $495,000 (43.6 percent) when compared to the same twelve-month period (id.).[7]

III. STANDARD OF REVIEW

The Department formulated its standard for reviewing requests for deferral accounting treatment in North Attleboro Gas Company, D.P.U. 93-229 (1994). In that case, the Department stated that a utility seeking deferral treatment must demonstrate prima facie in its petition that: (1) based on Department precedent, the annual expense may be recoverable as an extraordinary expense if it were incurred during a test year;[8] (2) a Department denial of the request for deferral would significantly harm the overall financial condition of the company; and (3) the Department's denial of the request for deferral is likely to cause the filing of a rate case that would include in its test year the expense for which deferral is sought ("North Attleboro standard"). Id. at 7.

The Department's review of a complete petition must strike a balance between historical ratemaking principles, which employ the test year method to determine a representative level of expenses, and administrative efficiency which might be achieved by avoiding either single-issue rate cases or rate cases precipitated by an extraordinary expense which may be recoverable if incurred in a test year. Thus, once a prima facie showing is made, the Department will evaluate the petition, considering such additional factors as: (1) the company's ability to choose a test year; (2) the company's history and frequency of rate

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[7] The reduction in after-tax utility operating income of approximately $495,000 is derived by multiplying the $812,000 in actual and projected expenses by 61 percent to account for income tax effects (Exh. DTE 2-2).

[8] For example, the company's request for deferral would be evaluated in terms of what would constitute an annualized amount. D.P.U. 93-229, at 7 n.9.

increases; (3) the company's frequency of requests for deferral; (4) the company's earnings in the year the subject expense was incurred; and (5) whether some voluntary agreement on the part of the petitioner (e.g., a settlement) would otherwise preclude bringing a G.L. c. 164, § 94 petition during the period for which deferral is sought. Id. at 7-8. Granting a deferral pursuant to this standard would not constitute a guarantee that the subject expense would be recoverable in a future rate case. Rather, subsequent ratemaking treatment of the expense would be considered in the company's next rate case. Id. at 8.

IV. ANALYSIS AND FINDINGS

Utilities may not typically recover through rates any expenses that were incurred prior to the test year. Otherwise, a company making adequate earnings during a particular year could "bank" its expenses to a deferred account and collect them in a future rate case. Commonwealth Electric Company, D.P.U. 88-135/151, at 28-29 (1989); see Oxford Water Company, D.P.U. 88-171, at 29-30 (1989). If certain conditions are met, however, the Department may allow a company to defer accounting treatment of expenses incurred prior to the test year and will consider the subsequent ratemaking treatment of those expenses in the company's next rate case. See D.P.U. 93-229, at 7-8.

In the present case, Aquarion seeks to defer approximately $812,000 in actual and projected costs related to the investigation of the contamination and subsequent treatment of Jacques Well Nos. 1 and 2. As of January 20, 2005, the Company has incurred $547,676 in actual costs for laboratory analysis, bottled water purchases, customer notification expenses, employee labor costs, engineering and design costs, purchased water expenses, and miscellaneous charges (Exh. DTE 1-5 (Rev. January 27, 2005). The remaining $264,426 are

projected expenditures remaining from the Company's September 2004 estimate (id.; DTE 1-6). As an initial matter, the Department must consider which of these expenditures are eligible for deferral consideration.

With respect to the perchorate-related costs actually incurred, $510,712 is associated with activities that are part of a utility's operating and maintenance expense, such as supplemental water purchases, water testing, customer notification, and legal expenses (Exh. DTE 1-5 (Rev. January 27, 2005)). Therefore, these costs represent operating expenses that are eligible for deferral. The remaining $36,964 is identified by the Company as "Jacques Wells Treatment (Eng. & Design)" (id.). These engineering and design costs include $30,081 in evaluation costs and $6,883 in expenses associated with the installation of sewer service at the Company's Burbank Street water tank (Exh. DTE 1-5 (Rev. January 27, 2005) - Invoice Nos. 001-25437 and 002-26437). The $31,081 in evaluation costs are associated with the actual identification of the scope and cause of the perchlorate contamination (id.). These costs are not associated with construction and, therefore, are eligible for deferral. However, based on the Company's description of the expenditures and our review of the related invoices, the $6,883 in expenses associated with the installation of sewer service at the Company's Burbank Street water tank are for plant additions and, therefore, are capitalizable (id.). These expenditures should be booked to plant accounts in accordance with the Uniform System of Accounts for Water Companies, 220 C.M.R. §§ 52.00 et seq. The costs associated with capitalizable items are recovered through a combination of depreciation expense and a return on the undepreciated balance. Hingham Water Company, D.P.U. 1590, at 22-23 (1984). The North Attleboro standard pertains to the deferral of extraordinary expenses; there is no basis

on which capitalizable items that have been placed into service may be accorded deferred accounting treatment. D.P.U. 92-239, at 7-8. Therefore, capitalized items are not eligible for deferral. Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 6 (2004); Cambridge Electric Light Company/Commonwealth Electric Company, D.T.E. 99-90-C at 21 (2001). Accordingly, the Company's request to defer $6,883 in expenses related to the installation of sewer service at the Burbank Street water tank must be denied.

Regarding Aquarion's request to defer $264,426 in projected expenditures related to additional legal fees, water testing, labor, and purchased water expense, the North Attleboro standard does not provide for the deferral of future expenses, even if an estimate of the expense is available. Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 11 (2004). Therefore, the Department finds that Aquarion's request for deferral of approximately $264,426 in future expenditures is premature. Accordingly, the Department denies, without prejudice, the Company's request to defer the costs related to expenditures anticipated to be incurred after January 20, 2005.

With respect to the $540,793 in expenditures actually incurred, the Company's request for deferral must be evaluated in terms of what would constitute an annualized amount. D.T.E. 99-114, at 6; D.T.E. 93-229, at 7 n.9. The expenses that are eligible for deferral consideration were incurred by Aquarion over a period of approximately eight months (May 2004 through January 2005). In view of the eight-month period of time over which Aquarion incurred these costs and the fact that the Company expects to have a treatment system in place by February 2005, the Department finds that an appropriate annualized amount is equal to the total incurred cost of $540,793 (Exh. DTE 2-7).

Once an annual expense is established, the Department next considers whether the expense meets the first part of the North Attleboro standard -- namely whether the expense may be recoverable as a nonrecurring expense if it was incurred during a test year. Commonwealth Electric Company, D.P.U. 88-135/151, at 28-29. Based upon the Company's description of the expenses at issue, the laboratory, customer notification, purchased water and miscellaneous costs are nonrecurring expenses. Nonrecurring expenses incurred in the test year are ineligible for inclusion in the cost of service unless it is demonstrated that they are extraordinary in nature and amount as to warrant their collection by amortizing them over a period of time. Fitchburg Gas and Electric Light Company, D.T.E. 99-115, at 5 (2001); Fitchburg Gas and Electric Light Company, D.P.U. 1270/1414, at 33 (1983).

With respect to whether the expenses at issue are extraordinary in nature, the Department has recognized that safe and clean water is essential to our basic well being. Water companies are required to deliver a safe and reliable water supply. See e.g., South Egremont Water Company, D.P.U. 95-119/122, at 10-11 (1996); Dedham Water Company, D.P.U. 85-188, at 9-10 (1986); G.L. c. 111, § 5G. The expenses at issue are directly related to Aquarion's discovery of perchlorate contamination in its water supply and its subsequent efforts to bring its water supply in compliance with DEP regulations. Major contamination incidents are not part of a water company's day-to-day operations and expenses resulting from such incidents are not of a routine nature. Accordingly, we find that the expenses directly incurred as a result of the perchlorate contamination are extraordinary in nature.

With respect to whether the expenses at issue are extraordinary in amount, Aquarion argues that its perchlorate-related expenses are significant because denial of its petition will

result in a reduction of approximately 43.6 percent in net income (Exh. DTE 2-2).[9] However, the standard for comparison to determine eligibility for deferral accounting is based on total operating revenues, not a subset of revenues (i.e., net income) or balance sheet entries (i.e., common equity). Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 9 (2004); D.P.U. 93-229, at 7; see also Boston Gas Company, D.T.E. 03-40, at 30 (2003); Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 80-81 (2002).

The Company's operating revenues during calendar year 2003 were $12,057,442 and were $6,088,000 for the six months ending June 30, 2004 (Exh. DTE 2-5; 2003 Annual Return at 302). In the current economic climate, we are persuaded that a one-time expense of $540,793 for a water company with annual revenues of approximately $12 million is extraordinary in amount. See Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 9 (2004). Having found that the $540,793 in expenses is sufficiently extraordinary in nature and amount to be eligible for recovery as a nonrecurring expense if it were incurred during a test year, Aquarion's request satisfies the first part of the North Attleboro standard.

The Department must next consider whether a denial of the deferral request would significantly harm the overall financial condition of the Company. Based on the Company's net income available for common dividends and common equity balance,[10] Aquarion's return on equity ("ROE") during 2001 was 8.53 percent (2001 Annual Return to the Department

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[9] Adjusting the Company's calculation to include only the $540,793 in actual expenses eligible for deferral consideration, the writeoff of these expenses would have an after-tax effect of approximately $329,400, representing a reduction to net utility operating income of approximately 29 percent.

[10] A water company's common equity consists of common stock, premium on common stock, retained earnings, and surplus invested in plant. 220 C.M.R. § 31.01; see also Aquarion Water Company of Massachusetts, D.T.E. 02-57, at 5 (2002).

at 201, 301). The Company's ROE declined to negative 5.52 percent in 2002 and then increased to 13.92 percent in 2003 (2002 Annual Return to the Department at 201, 301; 2003 Annual Return to the Department at 201, 301). For the first half of 2004, the Company reported a net income available for dividends of $206,000 on a common equity balance of $8,035,000, representing an annualized ROE for 2004 of approximately 5.1 percent (Exh. DTE 2-5).

Although the Company's 13.92 percent ROE in 2003 is in excess of the 11.5 percent ROE approved by the Department in Massachusetts-American Water Company, D.T.E. 00-105, at 3 (2001), a single year of financial results provides an insufficient basis for determining a particular company's future earnings. Eastern-Essex Acquisition, D.T.E. 98-27, at 18 (1998). This is especially true in the case of a small investor-owned water utility, where a single unplanned event, such as the contamination of supply sources, may drastically affect the company's operations and financial performance for that year. Consequently, water companies, in general, experience greater earnings volatility than other regulated utilities. Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 10 (2004); Generic Cost of Capital for Water Companies, D.P.U. 96-90-A at 8 (1997). Therefore, we find that denial of Aquarion's request to defer $540,793 in perchlorate-related expenses would significantly harm the overall financial condition of the Company. Accordingly, Aquarion's request meets the second part of the North Attleboro standard.

Turning to the third part of the North Attleboro standard, whether denial of the petition would trigger a rate case filing, history shows that the Company has filed rate cases approximately once every five years. See e.g., Massachusetts-American Water Company,

D.T.E. 00-105, at 1 (2001); Massachusetts-American Water Company, D.T.E. 95-118, at 1 (1996); Massachusetts-American Water Company, D.T.E. 90-146, at 1 (1990). While past rate-filing practices by a particular company do not predetermine future conduct, Aquarion, like other water companies, is faced with significant capital expenditures required to ensure compliance with the Safe Drinking Water Act.[11] 42 U.S.C. §§ 300f et seq. In addition, as a small water company serving a primarily residential customer base, Aquarion has limited growth opportunities through additional sales. Aquarion Water Company of Massachusetts, D.T.E. 03-127, at 11 (2004). Therefore, we conclude that denial of the petition would likely trigger the filing of a rate case by Aquarion.

Having met the prima facie requirements of the North Attleboro standard, Aquarion's request to defer $540,793 in perchlorate-related expenses must be evaluated considering such additional factors as Aquarion's ability to choose a test year, the history and frequency of Company rate increases, the frequency of Company requests for deferral, the Company's earnings in the year the subject expense was incurred, and whether some voluntary agreement precluded the Company from bringing a G.L. c. 164, § 94 petition during the period for which deferral is sought. D.P.U. 93-229, at 7-8. As noted above, history indicates that the Company files a rate case approximately once every five years. A review of the settlement agreement in the Company's most recent rate case in Massachusetts-American Water Company, D.T.E. 00-105 (2001), indicates that the Company is not under any restrictions regarding either the date to file a future rate case or the test year to be used (Exh. DTE 2-3).

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[11] See e.g., Aquarion's recent construction of a water treatment facility in its Millbury service territory. Aquarian Water Company of Massachusetts, D.T.E. 02-57, at 1-2 (2002).

Aquarion has sought two other accounting deferrals since its last rate case in 2001, one related to pension and post-retirement benefits other than pension expense, and one for security-related costs. Aquarion Water Company of Massachusetts, D.T.E. 03-127 (2004); Aquarion Water Company of Massachusetts, D.T.E. 03-91 (2003); Massachusetts-American Water Company, D.T.E. 00-105 (2001).

Taking the above factors into consideration in conjunction with Aquarion's prima facie showing, the Department finds that the Company has met the requirements of the North Attleboro standard. Therefore, Aquarion's request to defer $540,793 in contamination-related expenses actually incurred is granted. Granting this deferral does not constitute a guarantee that this expense will be recoverable in a future rate case. Rather, the Department will consider the subsequent ratemaking treatment of the expense as part of the Company's next rate case.

V. ORDER

Accordingly, after notice and consideration, it is

ORDERED: That the petition of Aquarion Water Company of Massachusetts for an accounting deferral regarding $540,793 in contamination-related expenditures actually incurred is GRANTED; and it is

FURTHER ORDERED: That the petition of Aquarion Water Company of Massachusetts for an accounting deferral regarding projected perchlorate-related expenditures is DENIED without prejudice.

By Order of the Department,

_____/s/_____
Paul G. Afonso, Commissioner

_____/s/_____
James Connelly, Commissioner

_____/s/_____
W. Robert Keating, Commissioner

_____/s/_____
Judith F. Judson, Commissioner

_____/s/_____
Brian Paul Golden, Commissioner

An appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part. Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of the twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. G.L. c. 25, § 5.