

RRA REGULATORY FOCUS

Commission authorizes management performance bonus for Aqua Pennsylvania

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Market Intelligence

In a combined base rate case for Aqua Pennsylvania Inc. and Aqua Pennsylvania Wastewater Inc., the Pennsylvania Public Utility Commission authorized the companies a 25-basis-point management performance bonus, bringing Aqua's authorized return on equity to 10.0% in this litigated proceeding.

The change in ROE has prompted the PUC staff to recalculate the rate increase and revise its final order, which is expected to be published by the May 19 suspension date.

As these companies are the largest subsidiaries of Essential Utilities Inc., this base rate proceeding addresses approximately half of the company's total regulated rate base.

The Take

* Return on equity had been a notable area of dispute between the parties, with the PUC staff and intervenors recommending ROEs of 8.9% and 8.0%, respectively, which were substantially below both the company's proposed 10.75% ROE and the proxy 9.80% ROE recently adopted by the PUC for use in water utility infrastructure recovery mechanisms.

* Details on the overall revenue increase and rate design issues associated with the subsidization by the larger water utility business of rates for recently acquired wastewater systems were not mentioned during the open meeting.

* Regulatory Research Associates considers the regulatory climate for water utilities in Pennsylvania to be constructive from an investor perspective.

Motion on management performance bonus put forth during public meeting

In making a motion to award Aqua Pennsylvania, or Aqua PA, a 25-basis-point management performance adjustment, Commissioner Ralph Yanora stated, "Aqua has answered the call to provide emergency assistance at the request of the public, public advocates and government agencies. Given the nature and frequency of these emergencies, the company should be recognized for its efforts to serve as a ready and willing ally in water and wastewater emergencies. Affording Aqua a modest management efficiency adjustment to its cost of capital because of its exemplary emergency service is a just, reasonable and affordable approach to addressing its ongoing emergency aid efforts. It would be inequitable to proceed otherwise as there is no provision of the Public Utility Code that demands utilities exhaust employees or financial resources because of emergencies occasioned by others."

The motion passed 3-0; however, Chair Gladys Brown Dutrieuille disagreed with the size of the management performance bonus, proposing a 10-basis-point award would be more appropriate. According to Brown Dutrieuille, each 10th of a percentage point boost in ROE adds approximately \$2.9 million in revenue for Aqua PA.

The Pennsylvania PUC has granted management performance adjustments to ROE in previous rate cases, ranging from five to 25 basis points.

ROE discussion

The 10.0% ROE authorized for Aqua PA is above both the nationwide average for water utility rate cases as well as the ROE authorized by the PUC for infrastructure investments.

In the first four months of 2022, three water utility rate cases were completed with an average ROE of 9.63%, as monitored by RRA. For the trailing 12 months ended April 30, 10 water utility rate cases were completed, with the cost of capital parameters disclosed in eight proceedings. The average ROE authorization was 9.53%, with both the highest and lowest ROE authorizations coming out of litigated proceedings.

On Jan. 13, in the context of its quarterly utility earnings review, the PUC established the proxy equity returns to be used by electric, gas and water utilities to calculate revenue requirements for the prospective quarterly adjustments under utility distribution system improvement charges. The 9.80% ROE specified for water utilities was unchanged from the prior quarter and remains above recent averages authorized in the investor-owned water utility cases covered by RRA.

Rate case history

In combined filings tendered on Aug. 20, 2021, Aqua PA requested an \$86.1 million, or 16.9%, increase in water revenue based upon a 10.75% return on equity (53.95% of capital) and a 7.64% return on year-end rate base valued at \$3.818 billion for water and \$198 million for wastewater for a test period ending March 31, 2023. Aqua Wastewater proposed an \$11.6 million, or 31.2%, revenue increase using the same cost of capital parameters and a rate base valued at \$198 million for the same test year.

The Bureau of Investigation and Enforcement supported a \$33.9 million combined rate increase, reflecting an 8.9% return on equity (53.95% of capital) and a 6.64% return on a total rate base valued at \$4.014 billion. The bureau is recommending a rate base of \$3.816 billion for Aqua PA and a rate base of \$198.4 million for Aqua Pennsylvania Wastewater.

The Office of Consumer Advocate, or OCA, recommended a \$12.1 million, or 2.2%, revenue decrease, referencing "the continued impact of the COVID-19 pandemic on Aqua's service territory" to support its recommendation. The OCA-proposed rate decrease reflects an 8.0% return on equity (50% of a hypothetical capital structure) and a 6.0% return on a rate base of \$4.007 billion.

On Feb. 18, an administrative law judge recommended a \$31.8 million rate increase, based upon an 8.9% return on equity (53.95% of capital) and a 6.64% return on a rate base of \$4.008 billion.

Evaluation of Pennsylvania regulatory climate

RRA considers the regulatory climate for water utilities in Pennsylvania to be constructive from an investor perspective. Legislative changes over the past decade have allowed the PUC to rely on fully forecast test years in general rate cases, expanded the use of infrastructure surcharge mechanisms to include wastewater investments and facilitated the consolidation of municipal systems. Rate settlements, which are utilized frequently, are typically black box and do not specify traditional regulatory parameters underlying the approved revenue requirements. The ROE that water utilities can apply to infrastructure surcharge mechanisms is adjusted quarterly and is currently above the average ROE authorized in recently decided rate cases for water utilities nationwide.

Regulatory risk has intensified in recent months as a result of conflict between Gov. Tom Wolf, a Democrat, and the Republican-controlled General Assembly, related to the governor's decision to enter Pennsylvania into the Regional Greenhouse Gas Initiative. As a result, the Senate has refused to act on new gubernatorial appointments to the PUC, resulting in two vacancies, and the near-term potential for a third vacancy, on the five-member panel.

RRA accords Pennsylvania regulation an Above Average/2 rating, as it pertains to water utilities.

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