

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

AQUA PENNSYLVANIA, INC.

Docket No. R-2011-2267958

**DIRECT TESTIMONY OF
DAVID P. SMELTZER**

**With Regard To Certain Expense Claims,
Proposed Capital Structure, Tax Issues, And
Return On Equity Considerations**

November 18, 2011

**AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER**

I. INTRODUCTION AND SCOPE OF TESTIMONY

1
2 **Q. What is your name and business address?**

3 A. David P. Smeltzer. My business address is 762 W. Lancaster Avenue, Bryn Mawr,
4 Pennsylvania 19010.

5 **Q. By whom are you employed and in what capacity?**

6 A. I am employed by Aqua America, Inc. as Chief Financial Officer (“CFO”). I am also
7 Senior Vice President Finance & CFO of Aqua Pennsylvania, Inc. (“AP” or the
8 “Company”).

9 **Q. Please summarize your educational background and business experience.**

10 A. I graduated from La Salle University in 1980 with a Bachelor of Science degree in Business
11 Administration, majoring in Accounting, and received my C.P.A. Certificate from the
12 Commonwealth of Pennsylvania in 1982. I was employed by KPMG Peat Marwick,
13 Certified Public Accountants (“KPMG”), from June 1980 until March 1986, when I joined
14 Philadelphia Suburban Water Company (“PSW”), corporate predecessor to AP. While
15 employed by KPMG, I worked initially as a Junior Accountant, advancing thereafter to
16 Senior Accountant and Manager. My assignments varied, including financial,
17 manufacturing and public utility clients. I was hired by PSW as Controller, was promoted
18 in 1991 to Vice President Rates & Regulatory Affairs, and in 1999 to my present position.
19 In these capacities, I have a broad base of experience in utility finance and regulatory
20 matters.

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 **Q. Are you a member of any professional organizations?**

2 A. Yes, I am a member of the American Institute of Certified Public Accountants, the
3 Pennsylvania Institute of Certified Public Accountants, and the National Association of
4 Water Companies ("NAWC"). I am Chairman of the NAWC Finance Committee, past
5 Chairman of the Pennsylvania Chapter of the NAWC, its Rates & Revenue Committee and
6 the NAWC's Rates & Revenue Committee.

7 **Q. Have you testified previously on behalf of the Company?**

8 A. Yes. I have testified before the Commission on numerous prior occasions, including base
9 rate proceedings spanning the past twenty years.

10 **Q. What is the purpose of your testimony?**

11 A. The purpose of my testimony is as follows: (1) to explain and support the derivation of
12 certain of the Company's rate base and expense claims in this proceeding; (2) to describe
13 the Company's proposed capital structure; (3) to address certain tax issues relating to the
14 so-called "IRS Repair Deduction"; and (4) to recommend the appropriate return on equity
15 to be utilized in this proceeding in light of the analysis of Mr. Paul R. Moul (AP Statement
16 No. 4) and other considerations.

17 **II. RATE BASE AND EXPENSE CLAIMS**

18 **Q. For which of the Company's claims are you responsible?**

**AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER**

1 A. As Mr. Packer notes in AP Statement No. 1, I am responsible for and will be testifying with
2 respect to the following claims:

3	<u>Adjustment</u>	<u>Exhibit No. 1-A, Page Ref</u>
4	Pension Expense	43
5	SFAS 106 Post Retirement Benefits	45

6 **Q. Please explain the adjustment to Pension Expense as shown on page 43 of Exhibit 1-A.**

7 A. The adjustment set forth on Page 43 was derived from an analysis performed by the
8 Company's actuaries, Towers Watson, and is based on the forecasted 2011 and 2012
9 actuarial results provided to the Company by Towers Watson in September 2011. As set
10 forth in AP's response to filing data request OE-14, Towers Watson estimates that the
11 Company will have a minimum funding requirement under the Employee Retirement
12 Income Security Act ("ERISA") of \$12.1 million for 2011 but could contribute up to \$136.4
13 million to its pension fund on a tax deductible basis. In the past, AP has often based its
14 ratemaking claim on the mid-point of the ERISA minimum and the IRS-deductible
15 maximum. That calculation would result in a request of \$74.3 million (($\$12.1 \text{ million} +$
16 $\$136.4 \text{ million}$) divided by 2). In this case, the Company is requesting a pension expense
17 allowance of \$12.2 million, which, in my judgment, is a reasonable estimate of the annual
18 amount that AP will contribute to its pension funds on an ongoing basis. From that figure, I
19 deducted \$3,203,376 for the portion expected to be capitalized and the historic test year
20 pension expense of \$7,184,333, resulting in a net rounded expense increase of \$1,812,300.

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 **Q. Please explain the Company's adjustment to Post Retirement Benefits (SFAS 106),**
2 **shown on page 45 of Exhibit 1-A.**

3 A. The Company's claim consists of three components: (1) the annual expense, which was
4 developed by Towers Watson, (2) the amortization over 18 years of the incremental SFAS
5 106 costs deferred from January 1993 until the effective date of rates reflecting the SFAS 106
6 costs, and (3) the amortization over a two year period of the difference between (a) the
7 actuarially determined amount applicable to the period from the end of the future test year of
8 the last case to the end of the future test year in this case and the amount awarded and
9 expended over the same time period. The accumulation of the three components mentioned
10 above is offset by a capitalized portion of the annual expense. The capitalized percentage is
11 the same as that used in the Payroll Expense adjustment on page 21 of Exhibit 1-A. The 2012
12 anticipated annual expense for AP's water employees is based on the Actuarial Valuation
13 Report dated September 2011 for the Company's Post Retirement Welfare Plan, which has
14 been submitted in response to filing data request OE-14. This adjustment increases pro-forma
15 operating expense by \$57,400.

16 **III. CAPITAL STRUCTURE RATIOS**

17 **Q. Mr. Moul's proposed rate of return, as set forth in Exhibit 4-A, is based on a projected**
18 **future test year-end capital structure consisting of 47.02% long-term debt and 52.98%**
19 **common equity. How were these figures derived?**

20 A. Consistent with past practice, the starting point was the Company's actual capitalization at
21 the end of the historic test year. The respective amounts of long-term debt and common
22 equity at June 30, 2011 were then adjusted to reflect anticipated changes during the future

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 test year. In sum, AP's total permanent capitalization is expected to increase by
2 approximately \$229 million over that period.

3 **Q. What accounts for that increase?**

4 A. There are several factors. AP's long-term debt balance is anticipated to grow by nearly \$83
5 million as a result of the issuance of new and the retirement of existing debt series. The net
6 effect of these financings is a reduction in the Company's embedded long-term debt cost
7 rate from 5.56% to 5.41%. The Company's common equity is projected to increase by
8 \$146.2 million, by virtue of common equity infusions from its parent, Aqua America, and
9 future test year retained earnings. Details regarding all of these changes are provided on
10 Schedule 5 of Exhibit 4-A.

11 **IV. IRS REPAIR DEDUCTION**

12 **Q. Is AP considering making any change in tax accounting that may affect its income**
13 **taxes?**

14 A. Yes. AP is considering the adoption of a tax accounting change. For income tax
15 purposes, this change would categorize certain expenditures as repair or maintenance
16 expenses, which are deductible in the year incurred. This is in lieu of categorizing them
17 as capital costs, which are deductible ratably over the tax-depreciable life of the capital
18 asset to which they relate. If and when adopted, this tax accounting change will give rise
19 to a "catch-up" adjustment on the consolidated group's federal income tax return for the
20 year in which the change occurs and will produce higher levels of annual deductions in
21 subsequent tax years. (I will refer to the effects of the tax accounting change as the "IRS

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 Repair Deduction”). As explained below, the IRS Repair Deduction represents the
2 deferral rather than the elimination of tax liability.

3 **Q. What does the change in tax accounting method related to the IRS Repair**
4 **Deduction entail?**

5 A. In general, taxpayers are required to capitalize costs that are incurred to produce or
6 acquire new property or to add value to existing property, extend its useful life, or adapt it
7 to a different use. Incidental repair and maintenance costs do not have to be capitalized
8 and are charged to expense. As a result, they are deductible in the tax year they are
9 incurred if other criteria for deductibility are satisfied.

10 Whether repair and replacement costs should be expensed or capitalized is not decided by
11 a bright-line test. Where to draw the line between repair and replacement costs, on the
12 one hand, and capital additions, on the other, has led to disagreements between taxpayers
13 and the Internal Revenue Service (“IRS”). The expense-versus-capital determination
14 centers on the concept of a “unit of property.” Briefly, a “unit of property” is the
15 threshold for capitalization. When a unit of property is replaced, the replacement cost is
16 capitalized for tax purposes. Costs incurred to replace less than a unit of property are
17 deductible in the year incurred.

18 The unit-of-property concept is not limited to tax accounting. The same approach is
19 employed under regulatory accounting principles to determine whether costs should be
20 capitalized or charged to expense for purposes of recording costs in utilities’ regulated
21 books of account. For regulatory accounting purposes, utilities have been required to
22 identify costs based on units of property that, in general, are relatively small. This

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 comports with regulators' desire to have detailed information about the plant additions
2 and retirements that comprise the rate base on which utilities are entitled to earn a return.
3 Historically, the IRS made it very difficult, if not impossible, for utilities to employ units
4 of property for tax purposes that were larger than those they used to record costs in their
5 regulated books of account. Such a revision represents a change in the method of tax
6 accounting, which cannot be made without prior IRS permission, and the IRS simply
7 withheld permission for changes from smaller to larger units of property. However, that
8 started to change around 2008, when the IRS began to approve a few utilities' requests to
9 change their tax accounting to increase the size of units of property. The IRS followed
10 up its rulings for individual taxpayers by issuing Revenue Procedure 2009-39, which
11 gave automatic consent for taxpayers to make such changes by filing a notice.

12 **Q. Has the IRS offered any guidance on what it would consider appropriate "units of**
13 **property" for those utilities that are inclined to change their method of accounting?**

14 **A.** On August 19, 2011, the IRS, following a lengthy regulatory negotiation process with the
15 electric industry, issued Revenue Procedure 2011-43, which the IRS described as
16 providing "a safe harbor method of accounting that taxpayers may use to determine
17 whether expenditures to maintain, replace or improve electric transmission and
18 distribution property must be capitalized." As the IRS made clear, Revenue Procedure
19 2011-43 is specific to property used in the electric industry and, therefore, it is not
20 definitive in determining what the IRS may find acceptable for the water industry. The
21 IRS has not issued similar "safe harbor" guidance for any other utility segment.

**AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER**

1 **Q. How would a change in method of accounting to increase the size of units of**
2 **property and, thereby, increase the IRS Repair Deduction, affect a utility's tax**
3 **liability?**

4 A. The IRS Repair Deduction accelerates the time when a taxpayer can claim a deduction
5 for a given expenditure, but does not increase the total amount of the deduction. If a cost
6 is capitalized for tax purposes, it generates depreciation deductions over the capital
7 asset's depreciable life equal to the amount capitalized. At the end of the asset's
8 depreciable life, the sum of those deductions equals the asset's cost – neither more nor
9 less. If the same cost is categorized as a repair under a new definition of a unit of
10 property, it is deducted in the year incurred. In either instance, the sum of the allowed
11 deductions cannot exceed the cost incurred. However, if the deduction is taken in the
12 year a cost is incurred, the taxpayer gets a benefit by reducing its tax liability all in one
13 year instead of ratably over the life of the depreciable asset.

14 **Q. How would a change in AP's method of tax accounting affect its federal income**
15 **taxes for the tax year in which such a change occurs?**

16 A. When a taxpayer changes a tax accounting method, its historic tax books and records are
17 essentially restated to conform to what they would have looked like had the taxpayer
18 always used its new method. In the case of a unit-of-property change for water assets, the
19 utility will restate the tax basis of its assets as if it had always deducted those projects that
20 would have been repairs had its new unit of property definition been in use for prior
21 periods. The utility, therefore, needs to go back a number of years and determine, in each
22 year, what projects it capitalized that would have qualified as repairs under its new unit-
23 of-property definition. However, because the costs of those projects had, in fact, been

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 capitalized and depreciated for tax purposes, the cumulative incremental repair amount
2 must be reduced by the tax depreciation already claimed in order to arrive at a net amount
3 by which the tax basis of the assets will be reduced. Because reducing the tax basis will
4 deprive the utility of claiming a future deduction for the costs reflected in this basis
5 reduction, the tax rules allow the taxpayer to claim the entire basis reduction as a
6 deduction in the year in which the change is made. This deduction is authorized by
7 Section 481(a) of the Internal Revenue Code, and it is, in reality, a “catch-up”
8 adjustment.

9 **Q. Why has AP not changed its method of tax accounting to increase the size of units of**
10 **water utility property?**

11 A. That change has not been made because, as I previously explained, the IRS has not
12 provided guidance on what it would consider acceptable unit-of-property definitions for
13 linear assets, specifically, water mains and accessories, which comprise the bulk of water
14 utilities’ depreciable property. However, as I also explained, until such a change is made,
15 AP is able to continue to realize depreciation deductions from its capitalized additions.
16 Therefore, the total tax deductions that will accrue to AP with respect to expenditures that
17 may be re-characterized if the unit-of-property definition changes will not be reduced
18 simply because a change in method of tax accounting is deferred until the IRS provides
19 appropriate guidance to taxpayers.

20 **Q. Does AP anticipate making a change in its method of tax accounting in the future to**
21 **increase the size of units of property used to determine the IRS Repair Deduction?**

22 A. Yes, AP anticipates making such a tax accounting change in a future federal income tax
23 return after the IRS provides appropriate guidance to clarify the parameters it will find

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 acceptable for changes in unit-of-property definitions for water utilities and the method it
2 will accept for applying such new unit-of-property definitions to expenditures that were
3 capitalized in the past. Currently, that guidance does not exist, and proceeding without
4 appropriate guidance could result in IRS challenges to deductions, the imposition of
5 interest on alleged underpayments of tax and possibly penalties.

6 **Q. When proper guidance is given, how does AP propose to reflect the effects for**
7 **ratemaking purposes of any change in tax accounting method?**

8 A. AP proposes to flow through the tax effects of the IRS Repair Deductions. With respect
9 to the deduction associated with the “catch-up” adjustment, AP proposes to defer the tax
10 effect on its books of account and amortize it for book purposes. For rate purposes, the
11 tax effect would be grossed-up by the appropriate revenue expansion factor, and the
12 resulting amount would be returned to customers by a bill credit or similar mechanism
13 over seven years. The unamortized portion would not accrue interest and would be
14 subject to adjustment based on any action the IRS may take that would affect this
15 mechanism. To the extent that the deduction arising from the “catch-up” adjustment
16 causes Aqua to experience a net operating loss (“NOL”) for Pennsylvania state income
17 tax purposes, the amount to be amortized as a credit to rates would be reduced to reflect
18 the tax benefits that are not available because of the state NOL. To the extent the state
19 NOL caused by the “catch-up” adjustment is used, the amount to be amortized would be
20 adjusted accordingly to reflect the availability of the NOL to reduce AP’s state income
21 tax liability. When AP files its first base rate case following the change in accounting
22 method, it will address, in the context of that filing, the accounting and ratemaking
23 treatment to appropriately provide customers the tax benefit related to the unamortized

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 balance. The ratemaking treatment adopted at that time will replace the then-existing bill
2 credit or other rate adjustment mechanism.

3 With respect to the on-going annual amount of IRS Repair Deductions following a
4 change in tax accounting method, the resulting tax effect would be reflected on a flow-
5 through basis in computing the Company's tax expense in the year in which such
6 deductions are actually claimed on the consolidated tax return. As a consequence, an
7 appropriate annual amount of IRS Repair Deduction would be used to determine Aqua's
8 base rate revenue requirement in a base rate case.

9 **IV. RETURN ON EQUITY CONSIDERATIONS**

10 **Q. Please explain how the Company derived its requested equity allowance in this**
11 **filing.**

12 **A.** In AP Statement No. 4, Mr. Moul has developed a range of 11.50% to 12.31% for the
13 cost of equity. For this proceeding, I have chosen to utilize 11.5%, which is actually the
14 low end of Mr. Moul's range, and to that have added 25 basis points for exemplary
15 managerial performance.

16 **Q. Please explain why you believe the Company is entitled to an equity allowance that**
17 **recognizes exemplary managerial performance.**

18 **A.** For many years, AP has provided its customers with excellent water service at reasonable
19 rates. This has not come about by accident, but instead is the product of a dedicated and
20 knowledgeable workforce which is constantly seeking to improve quality and control
21 costs. To this end, the Company has accepted the challenge of acquiring troubled or

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 weaker water systems in an effort to promote the Commission's goal of water supply
2 regionalization and has implemented a program to facilitate the payment of water bills by
3 its low income residential customers. AP is an acknowledged leader in the water utility
4 industry and, in my opinion, its exemplary performance should be recognized through the
5 equity return rate authorized in this proceeding. Indeed, this type of incentive should
6 further induce the Company to continue to seek out ways of providing better service and
7 encourage other utilities to do the same.

8 **Q. Could you be more specific with respect to the measures undertaken by the**
9 **Company which you believe should enter into the Commission's determination of an**
10 **appropriate equity return rate?**

11 **A.** Certainly. In my view, the Company's performance in the following areas fully supports
12 a return of 11.5% plus 25 basis points:

13 **1. Water Quality.**

14 AP is in compliance with all existing Federal and State drinking water standards at
15 every one of its 120 water systems in Pennsylvania. AP provides filtration for all
16 surface water sources and disinfection for all ground water sources and specialized
17 treatment for specific contaminants where necessary.

18 AP's surface water plants have been upgraded over the past three decades with new
19 equipment, instrumentation and technology in advance of increasingly stringent
20 drinking water regulations and standards – from the Surface Water Treatment Rule to
21 the Interim Enhanced Surface Water Treatment Rule. Testing of our source waters

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 over the past four years under the Stage 2 Enhanced Surface Water Treatment rule
2 has demonstrated that additional levels of treatment were not required to address
3 *Cryptosporidium*, a parasite made infamous by a waterborne disease outbreak in
4 Milwaukee in 1993. The good quality of AP's source water can, in part, be attributed
5 to decades of efforts by AP to protect its surface water sources.

6 In 2008, AP acquired the assets of the Emlenton water system. The Pennsylvania
7 Department of Environmental Protection (PADEP) had issued orders to the former
8 owners of the system to make immediate improvements. AP closed on the system
9 December 31, 2008 and entered into a Consent Order and Agreement with PADEP to
10 bring the system into compliance. By January 23, 2009, AP had made the
11 improvements necessary to lift a boil water advisory that had been in effect since
12 April 29, 2008. In 2010, AP completed and commissioned a new treatment plant, and
13 the PADEP order was closed out on January 18, 2011.

14 On April 1, 2009, AP became the designated owner of assets of the Washington Park
15 water system. Aqua entered into a Consent Order and Agreement with the PADEP to
16 bring the system into compliance. Within weeks of closing, AP had installed new
17 chlorination equipment on the existing wells, fixed leaks in the system, drilled a new
18 well, and installed a temporary well station and tank. On June 3, 2009, the boil water
19 advisory that had been issued in June 2007 was lifted.

20 AP installs specialized treatment to address contaminants when they could occur at
21 levels above drinking water standard. AP was one of the first water providers in
22 Pennsylvania to use disposable media to remove arsenic to meet the more stringent

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 drinking water standard that was lowered from 50 parts per billion (“ppb”) to 10 ppb
2 effective in 2006. AP also acquired the Honesdale system that had one well source
3 that exceeded the arsenic standard. AP designed, permitted and installed treatment
4 and the system is now in compliance.

5 AP operates a central water quality laboratory in Bryn Mawr that conducts hundreds
6 of thousands of tests annually on water samples from AP systems. The laboratory has
7 a national reputation in the field of testing for trace levels of taste and odor
8 compounds. AP maintains a Technical Services Department that is located in the
9 laboratory and is staffed to handle water quality complaints exclusively. Having this
10 staff with ready access to the resources of PA’s central laboratory allows for prompt
11 response, investigations and resolution of water quality complaints. I believe the low
12 level of water quality complaints from AP customers attests to the ongoing
13 commitment of AP’s management to the quality of water delivered to our customers.

14 **2. System Reliability.**

15 Reliable utility operations require 24-hour per day uninterrupted service to all
16 customers, including customers with specific health care and public safety needs such
17 as hospitals, outpatient surgical centers, schools and public and private fire protection
18 systems.

19 As many will recall, the area experienced two significant weather events that left
20 many customers without electricity in August and September, 2011. AP’s customers
21 were never without water during these storms and, while a limited number of

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 customers in Sayre, Bradford County were under a precautionary boil water order due
2 to pipeline failures, they too remained with service.

3 The facilities that AP has installed over the years, combined with its professional
4 operations and maintenance staff, assures that customers' needs are met and
5 uninterrupted service is provided. These proactive measures include the adding of
6 about eighteen inches of concrete to existing flood walls at our Pickering Water
7 Treatment Plant; replacing antiquated pump stations that were below flood levels
8 with new stations that are above flood levels; and the food-proofing of existing wells
9 with flood doors and stop logs. In each case, the improvements allowed critically
10 important facilities to remain in operation. Further, many of the Company's water
11 plants are equipped with back-up generators to allow continued operations even in the
12 event of loss of power.

13 **3. Cost Containment.**

14 The Company continually looks for ways to control operating costs. While the
15 acquisitions over the past several years have contributed to the overall gains in
16 productivity, there has also been a conscious effort by management to review staffing
17 needs and operating procedures with the purpose of improving service while
18 controlling costs. To this end, AP reviews its workforce complement and cost drivers
19 on a consistent basis.

20 The Company has also taken advantage of refinancing opportunities and lowered
21 interest rates on its long term debt from a weighted cost of 8.5% at year end 1994 to
22 5.41% as proposed in this filing. In addition, through its parent, Aqua America, the

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 Company has implemented an extremely successful Customer Stock Purchase
2 Program which has kept the costs of raising equity capital to a minimum.

3 4. **Reasonable Rates.**

4 As the result of its cost containment efforts and quality management, AP has been
5 able to keep its rates affordable, notwithstanding a tremendous investment in new and
6 replacement plant in the past several years. The Company's reasonable rates have
7 been cited by Standard & Poors as one of the Company's strengths.

8 5. **Customer Service.**

9 For many years, AP has provided its customers with a high level of customer service.
10 In recent years, through a combination of technological and management initiatives,
11 the Company's customer service operations have improved its key call center
12 statistics. Continuing a long history of excellence, AP's customer service operations
13 launched new self-service options, an environmentally-friendly paperless billing and
14 payment service, and hosted a customer service certification program.

15 6. **Acquisition of Troubled or Weaker Water Systems.**

16 In the last 15 years, AP has acquired many community water systems previously
17 owned and operated by entities within the public or private sector (private investor
18 owned or homeowners associations). While several of these systems were included
19 on the Commission's troubled water company list, a majority, if not all of those
20 systems serving less than 3,300 connections, exhibited problems that would have also
21 qualified them to be on the Commission's list. Upon acquiring these systems, AP
22 made immediate improvements in quality, supply and customer service. At the same

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 time, existing customers have enjoyed the benefits of improved efficiency and the
2 spreading of fixed costs over a larger customer base. From a more macro viewpoint,
3 the regionalization of water systems will allow for consistent, reliable water service,
4 which, in turn, improves the economics and quality of life of the region. The
5 Company intends to continue to acquire systems within its existing markets (30
6 county service area) in Pennsylvania as well as adjacent areas so as to provide
7 solutions to the long-term water supply requirements of an even larger portion of
8 Pennsylvania. Some of the recent acquisitions or filings with the Commission
9 include the former Sand Springs Water Company, Inc. (Luzerne County) and Mifflin
10 Township Water Authority (Columbia County). Attached hereto as Appendix A is a
11 sampling of recent newspaper clippings regarding AP's exemplary service to newly
12 acquired customers.

13 **7. A Helping Hand – Low-Income Customer Assistance Program.**

14 AP implemented a program in 1994 designed to facilitate the payment of water bills
15 by its low income residential customers. This program is called A Helping Hand. It
16 is the first program of its kind offered by any investor-owned water utility in
17 Pennsylvania and has been looked at as a model by other utilities. This program
18 provides water audits, appropriate repairs where necessary and, upon the
19 identification of qualified customers, the partial forgiveness of prior arrearages.

20 **8. Infrastructure Rehabilitation.**

21 Fifteen years ago, AP embarked on a substantial capital program intended to ensure
22 long-term viability of its underground piping infrastructure through significant annual

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 investments in infrastructure rehabilitation (main replacements and main cleaning and
2 lining). Having previously rehabilitated less than 0.1% of its infrastructure on an
3 annual basis, the Company was then on a schedule to rehabilitate its aging system
4 over approximately 1,000 years. Recognizing that the life of pipe approximated 100
5 years, it was imperative that the infrastructure that was installed during the
6 Company's first 100 years of service be replaced during its second 100 years of
7 service. Since that time, AP has dramatically increased its infrastructure
8 rehabilitation program. Unlike numerous other water systems in the country, AP has
9 positioned itself well to ensure continuity of service through a sound utility
10 infrastructure for the foreseeable future.

11 **9. Tax Programs.**

12 Aqua takes advantage of key tax programs to ensure the lowest possible cost of
13 service for its customers. Over the years, Aqua has continually taken advantage of
14 bonus tax depreciation whenever it was available to generate key tax savings which
15 are then incorporated into the Company's rate base calculation providing a significant
16 source of cost free capital in support of the Company's infrastructure capital
17 investments. In fact, since the Company's last rate case, the effective utilization of
18 available bonus tax depreciation has resulted in an increase of over \$100 million in
19 the deferred tax balance used to offset the Company's rate base for ratemaking
20 purposes. To put it another way, the Company's rate base claim in this proceeding is
21 about \$228 million greater than its claim in the last proceeding. Without the
22 utilization of bonus depreciation, the rate base increase could have been as much as

AQUA PENNSYLVANIA, INC.
DIRECT TESTIMONY OF DAVID P. SMELTZER

1 \$328 million, or 44% greater, causing the rate increase to raise from the current 9.4%
2 request, to 12.7%. Further, as I previously discussed, the Company is proposing a
3 mechanism whereby the tax savings attributable to any future utilization of the IRS
4 Repair Deduction will be passed through to customers as soon as practical.

5 **10. Environmentally Friendly Initiatives.**

6 Electric power is the single biggest purchased expense that Aqua manages. To
7 minimize its purchased power costs, the Company began to look at creative
8 opportunities to utilize solar energy to reduce the amount of power it buys from the
9 electric grid. In 2009, the Company built a 1 MW solar field on a former
10 sedimentation basin at its Ingrams Mill Water Plant in the Brandywine Valley. The
11 field quietly reduces the power consumption of the plant by 30%. In 2011 the
12 Company expects to complete a 1.8 MW solar field on vacant ground at its Pickering
13 Water Plant complex in Valley Forge. The field will reduce Pickering's large overall
14 power consumption by 8%. Both are examples of the innovative use of land assets in
15 new ways to benefit our customers. Aqua recognizes that solar energy has many
16 more benefits than reducing its appetite for power. First, as a corporate citizen, being
17 environmentally conscious is simply the right thing to do. Second, it helps lower
18 carbon emissions into the atmosphere compared with purchasing electricity generated
19 from alternative forms of energy. And finally, the effort is consistent with
20 Pennsylvania's reported desire to be a leader in the development of renewable
21 resources.

22 Further, in the area of fleet management, there are several "green" initiatives that AP
23 has either already implemented or has under consideration, including:

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- 1 • Purchased a clean burning oil furnace to heat the Springfield garages. This
- 2 furnace is fueled with oil our mechanics retrieve from vehicles.
- 3 • Fueling all Southeast Pennsylvania diesel powered vehicles on B5 bio fuel in
- 4 efforts to receive a 5% reduction on fuel dependency on foreign oil.
- 5 • AP continues to lead by example in environmental sustainability and the green
- 6 movement.

7 11. **From time-to-time, AP is recognized in Pennsylvania for excellence in a key**

8 **area of operations. Following are examples of awards the Company has**

9 **received since its last rate filing:**

10 **Governor’s Award for Environmental Excellence (April 20, 2010)**

11 The Governor’s Awards for Environmental Excellence are presented each year by

12 the Pennsylvania Department of Environmental Protection to highlight the best in

13 environmental innovation and expertise throughout the Commonwealth. The

14 awards are the highest statewide honor bestowed upon businesses and

15 organizations for environmental performance and innovation from cleaning up

16 watersheds, saving energy, and eliminating pollution, to reducing waste and more.

17 AP was selected to receive the prestigious award for its construction of a 1.1

18 megawatt photovoltaic solar farm at its Ingram’s Mill Water Treatment Plant in

19 East Bradford Township, which serves drinking water to the West Chester,

20 Pennsylvania area. AP’s Ingram’s Mill renewable energy project uses high-

21 efficiency panels to convert sunlight into useful power, thereby reducing the

22 region’s power generation requirements. The project was partially funded with a

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1 \$1 million grant through the federal stimulus program which is administered
2 through the Pennsylvania Energy Development Authority (PEDA).

3
4 ***Green Power: Turn it On!* Award from Citizens for Pennsylvania's Future**
5 **(September 16, 2010)**

6 The Citizens for Pennsylvania's Future (PennFuture) awards recognize
7 individuals and organizations annually for their work in promoting clean energy.
8 The *Green Power: Turn it On!* campaign is a multifaceted, multiyear campaign
9 aimed at developing the renewable energy market in the state. AP was selected
10 for its construction of the 1.0 megawatt photovoltaic solar farm at its Ingram's
11 Mill water treatment plant.

12
13 **2011 Diamond Award (February 3, 2011)**

14 The Diamond Award honors outstanding achievements in engineering, and
15 recognized AP's Valley Forge Park Water Main and Stream Restoration Project.
16 The Valley Forge Park Water Main and Stream Restoration Project also received
17 the award of Excellence in the conservation and environmental category by the
18 Association of Conservation Engineers as part of their 17th annual Carl Anderson
19 Conservation Project Engineering Awards program.

20
21 **Water Resource Association's Business and Industry Award (April 20, 2011)**

22 The Water Resource Association presented Aqua with its Business and Industry
23 Award, highlighting several of the Company's accomplishments including the on-

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1 line publication of its first Sustainability Report; the Ingram’s Mill Solar Power
2 project; its leadership in replacing aging distribution system infrastructure,
3 thereby reducing the impact of main breaks and water loss; the development of an
4 award-winning Asset Information Management System to track its infrastructure
5 and prioritize water main replacement; and the consistent reduction of its fuel
6 usage and emissions over the last three consecutive years—most recently marked
7 by a 10 percent reduction in average fuel usage.

8
9 **Chester Ridley Crum Watersheds Association (CRC) Award (November 3,**
10 **2011)**

11 AP was honored by the Chester Ridley Crum Watersheds Association (CRC) at
12 the organization’s Annual Awards Dinner. The award notification letter stated:
13 “Aqua will be honored for its 125 years of delivering clean water to residents in
14 our area, and the many investments it has undertaken to provide sustainable
15 management of water resources, state-of-the-art drinking water treatment
16 technology, and conservation of natural resources.”

17 AP has long partnered with CRC in protecting the water resources of the Chester,
18 Crum and Ridley creeks, and has provided financial, logistical and volunteer
19 support for the organization’s annual stream cleanups, riparian tree planting
20 projects, and other activities and events. In 1999, AP acquired the Willistown
21 Woods wastewater plant that discharges to the Ridley Creek and spent \$1.8
22 million completely rebuilding the plant, bringing it into environmental
23 compliance. In the past four years, AP has invested more than \$1 million

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1 improving the former Media wastewater plant and collection system. These
2 investments support the common goals of Aqua and CRC in protecting the water
3 supply for about a quarter of a million people in Delaware County. The company
4 has also invested \$33 million on upgrades to its Crum Creek Water Plant and is
5 presently embarking on a \$14 million upgrade to its Ridley Water Treatment Plant
6 in Media.

7
8 **President's Award from the Delaware County Chamber of Commerce**
9 **(November 18, 2011)**

10 The Delaware County Chamber of Commerce will recognize AP for its decades-
11 long support of the Chamber through financial contributions and volunteerism.
12 AP is one five companies selected for the prestigious award from a group of 54
13 companies that were also considered.

14 The foregoing programs confirm the Company's determination to provide its
15 customers with the highest quality service at the lowest possible price and should
16 be taken into account by the Commission in establishing the appropriate equity
17 return rate in this case.

18 **V. CONCLUSION**

19 **Q. Mr. Smeltzer, please summarize why you believe the Commission should grant the**
20 **Company's requested rate increase.**

21 **A.** Only with the approval of an adequate ROE can the Company hope to continue to address
22 the formidable tasks of rehabilitating its infrastructure, acquiring and repairing troubled

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DIRECT TESTIMONY OF DAVID P. SMELTZER

1 systems, and maintaining quality service. The Commission has given clear signals that
2 service quality is a critical component in establishing rates. The Commission should now
3 give a signal that it is prepared to assist utilities in maintaining excellent service quality by
4 approving AP's requested rate increase.

5 **Q. Does that conclude your testimony at this time?**

6 **A. Yes, it does.**

SHENANGO VALLEY

Aqua Pa. investing more than \$23 million over 2 years locally

By Susan Simmons
Administrative Assistant, Aqua Pa.

Aqua Pennsylvania's Shenango Valley Division invested \$14.8 million in 2010 and has budgeted an additional \$8.4 million this year. The bulk of the capital budget both years has been for water main replacement.

"Without the long-term commitment that we have shown in investing in our infrastructure, we would likely be looking at a dire situation with our pipe," said Division Manager Jack Walter. "Water main breaks during the winter have been trending downward and no main breaks have oc-

curred on ductile iron pipe installed as part of the replacement program. This shows the positive impact infrastructure replacement can have on service reliability and quality.

"If you are not replacing at least one percent of your water main each year," Walter said, "you are falling behind in terms of the necessary rehabilitation and reliability of the entire system. We have more than 340 miles of water main in the Shenango Division (including saellite systems) and need to average 3 miles of replacement main each year just to keep up with depreciation."

In 2010, the utility replaced almost 87,000 feet (16.5 miles) of pipe. Since 2000 it has replaced about 20 percent of its Shenango Valley system.

Construction was completed on a new 750,000-gallon elevated tank on Route 62 that has improved storage, system reliability, pressure and fire flows in the borough of Mercer and surrounding areas.

Two booster stations were started during 2010 which will be completed in 2011. A new drive for one of the send out pumps at the treatment plant was installed for better energy efficiency and improved operational control.

Aqua Pennsylvania is an operating company of Aqua America, one of the largest U.S.-based, publicly traded water utilities serving almost three million customers in 13 states and has invested \$1.3 billion in capital improvements in the last 5 years.



Emlenton

Continued from Page 1

Jack Walter, Aqua Pennsylvania's district manager for western Pennsylvania, said the existing water treatment plant will remain in operation as well and will be upgraded and changed to help keep it active.

With the new plant, water from the Allegheny River will be run up the hill to be treated.

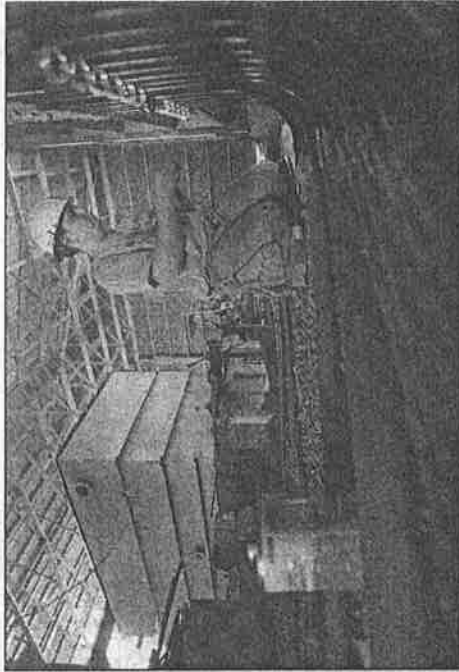
The process of water treatment starts with the water coming into the plant to be treated with chemicals and de-

stabilized, then goes through the process of sedimentation so the dirt in the water settles out. Then filtration occurs, and finally the water is disinfected and sent out to the customer.

Emlenton will now have two generators to ensure that the borough has water when the power goes out.

"More water, more projects," Walter said jokingly. Barry Louise, president of Emlenton Borough Council, said working with Aqua Pennsylvania has several benefits.

"Working with them keeps costs down," Louise said. "There's no point in us paving a



By Jerry Sowden

Matt McCombs of Greensburg Environmental installs rows of electrical conduit inside the new Emlenton water treatment building.

Just cutting down on the cost of chlorine for the pools saved the borough \$2,000.

All tests that have been run on the water since the lift of the ban have been clean, according to Walter.

"The town went so long without water, four or five months, I think they're just appreciative and glad to have it," Walter said.

Walter agreed and said Emlenton's water is back to normal and just as good as anywhere else.

"We're on par with everything that anyone else is doing," Walter said.

Construction on the new water treatment plant is expected to be finished by June, according to Walter.

History

Continued from Page 1

An invitation to the Edwin W. Bettes Camp, Sons of Veterans, second military ball in 1888, has survived in good condition, and is in the items for sale.

The organization was formed in 1887 with the merger of a camp on Oil City's South Side and another on the North Side.

A delegate badge from the state Firemen's Convention in Oil City in 1909 features a celluloid inset of an oil derrick. One of the most interesting oil-related pieces is a large letter opener from

Tulsa, Okla. A detailed photo booklet is from Harvey Guide Oil Co. of Kansas City, Mo., and Tulsa. Calendars from Franklin (1940) and Knox (1933) were issued by Sterling Oil Co.

Offered for sale will be wood planes owned by J.W. Brady, a local contractor who built the present courthouse. The society will also sell a 1903 Oil City Blizzard newspaper calendar and an original yellow dog lantern.

Several items are from the Harvey Fritz jewelry store in Oil City and they include colorful booklets from 1924, Franklin signs, 42- and 44-star U.S. flags





PET MEMORIAL

On Friday, May 28th, Venango Newspapers will publish "For Pet's Sake" A special edition focusing on our pets. Included will be a "Pet Memorial" page. If you would like to include a memorial for your pet please complete the form below and submit with photo & payment. Photos will be returned after being published.



-Jake-
January 18, 2002
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Sample Ad 1 1/2" x 3"

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Date of Passing _____
Message (15 Words or less) _____

Submitted by _____
Address _____
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Nate Byham heads to rookie camp — Page 9

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Two years later, Emlenton water still clean

New treatment plant being built, other projects ongoing

By KRISTI CUMMINS
Staff writer

It's been more than a year since Aqua Pennsylvania took over in Emlenton and the boil order on tap water was lifted.

The boil order, which was issued two years today on April 29, 2008, was put into effect when disease-causing organisms were found in the water after a routine inspection by the state Department of Environmental Protection.

Aqua Pennsylvania stepped in and took over the Emlenton Water Co. on Dec. 31, 2008, and after only a month the tap water was declared safe to use for all purposes.

The organisms that were found in the water, Cryptosporidium and Giardia, are protozoans that can make people sick. The two protozoans, as well as bacteria and viruses, can cause symptoms such as nausea, cramps, diarrhea and headaches.

Since Aqua Pennsylvania took over, Nancy Marano, the borough manager, says Emlenton residents can see Bill Kalp, a satellite facility operator for Aqua Pennsylvania, driving around town all the time, making sure things are run-

ning smoothly on a daily basis. "He's our first contact," Marano said. "He does everything. Reads meters, fixes water mains, everything."

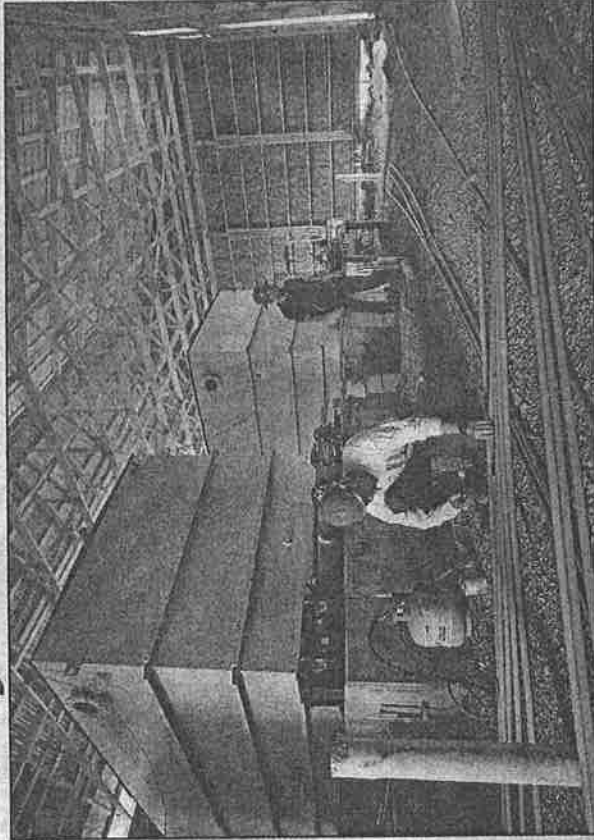
Not long after Aqua Pennsylvania took over, the company began working on some projects, including installation of thousands of feet of water line on three streets uptown to help increase water pressure for residents.

Two other projects included pipe replacement and paving on various streets. The three big projects cost a total of \$650,000.

But the biggest project that deals with the water in Emlenton is the construction of a new water treatment plant at the top of Kerr Avenue. The old plant is located along the Allegheny River in downtown Emlenton.

Marano said Aqua Pennsylvania has had the borough very active and informed in what's going on with the new treatment plant. "They agreed to make it as aesthetically pleasing as possible to fit in with the residential area," Marano said.

See EMLENTON, Page 8



By Jerry Sowden

Carl Stouffer (left) of Greensburg Environmental installs electrical conduit inside the new water treatment facility in Emlenton as job superintendent Rodney Dempsey keeps an eye on the progress.

Job hunting?



Looking for a job?

There are more than 56,000 jobs



Oil-gas group says tax would be 'killer'

APPENDIX A

The Progress News

724-867-1112 ~ 410 Main Street ~ Emlenton, PA 16373 www.myprogressnews.com Tuesday, July 26, 2011

Aqua PA Inc., To Replace Water Lines

Representatives from the Emlenton Borough Council, Penn DOT, Wilson Construction and Aqua PA Inc., met on Thursday, July 21, 2011 to discuss the installation of over 9000 feet of water lines for Emlenton area residents.

Aqua Pennsylvania, Inc., continues to provide the Emlenton area with a much needed update to its water service facility. It's \$3.3 million dollar flow into the Emlenton community is a testament with its state of the art facility. As the hot summer months approach, we can be thankful for a water quality and supply that has seen an about face over the past several years.

As part of their ongoing commitment, Aqua PA continues to update and replace the old corroded lines that are entrenched beneath.

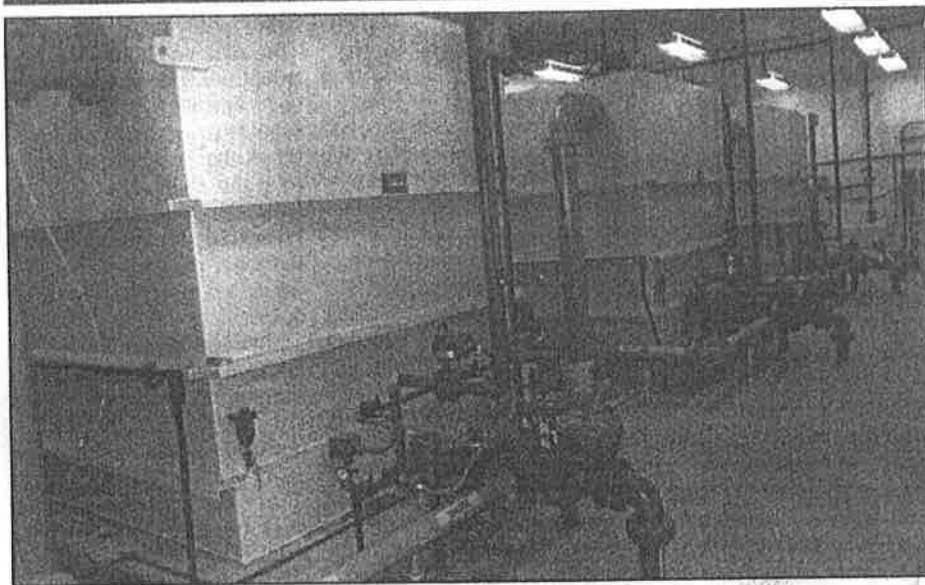
In the next several months Aqua PA Inc., with services provided by Wilson Contracting, will lay new lines on Main Street, Myrtle Avenue, a section of Kerr Avenue from Chestnut Street to Hill Street and a portion of Walnut from Kerr Avenue to Hickory. When said and done over 9000 feet of new water lines will carry water to area residents.

With the project currently underway, the scheduled itinerary includes 3,200 feet of 8" line for Main Street of which 2031 feet are along State Rt. 38; Myrtle Avenue will see a reduction in the size of the line from 8th street to beyond 1st street which will include 2,400 feet of 8" line with a reduction to a 4" line of about 400 feet, followed by a reduction to a 2" for about 560 feet extended to the Sloan and Wagner residences; 2,700 feet of 8" line for Walnut and 430 feet of a 6" line for a portion of Kerr Avenue between Chestnut St. and Hill St. Anticipated work-flow will be Main Street, Myrtle Avenue, Kerr Avenue and then Walnut Street.

Construction Coordinator for Aqua PA Inc., Robert Kimmel stated that, "barring any unforeseen emergencies, residents would not be without water for more than twenty to thirty minutes. We need this time so we can switch from the old line to the new." But with old lines anything can happen and residents are asked to remain patient throughout the process.

Motorists are asked to drive slow and obey all traffic construction signs as many construction personnel will be on the streets.

March 1, 2011
Progress News



Inside view of the newly constructed water treatment plant in Emlenton

PA DEP Gives Aqua "Clean Bill Of Health" Following \$4.5 Million Capital Investment In Emlenton Water Plant

BRYN MAWR, PA - Aqua Pennsylvania, Inc., (Aqua) announced today that it has satisfied the requirements of the Pennsylvania Department of Environmental Protection (DEP) consent order agreement (COA) for its Emlenton water system 17 months before the final completion date of July 1, 2012, following two years and \$4.5 million of capital investments in the system. "We are very happy to see that all of the work we have completed for the Emlenton water system has resulted in the termination of the COA," said Aqua Pennsylvania President Karl Kyriss. "From getting the nine-month-old boil order lifted just three weeks after purchase to managing the design and construction of a new water treatment plant, we have worked diligently and invested a lot of money in the Emlenton water system so these customers can

get the water quality and reliability they deserve. The termination of the COA was the icing on the cake."

Specific improvements Aqua has made to the Emlenton water system over the two years it has owned the system include \$2.8 million for construction of a new 288,000-gallon per day water treatment plant; \$925,000 to replace 11,400 feet of old water main; and \$392,000 of improvements to the existing finished water reservoir, including the installation of a dome roof.

Aqua entered the COA as a commitment to the DEP that the problems it inherited from the Emlenton Water Company on December 31, 2008, would be resolved on or before July 1, 2012. Emlenton had been under a boil advisory for nine months. Immediately upon purchasing the system, Aqua scrambled to make temporary improvements

to lift the boil order in 23 days. "Early termination of the COA stands as final testament to Aqua's aggressive actions and commitment to providing quality water and reliable service for the customers of Emlenton who had suffered enough," said Kyriss.

The Emlenton water system serves approximately 1,200 people in portions of Emlenton Borough and Richland Township, Venango County in western Pennsylvania. "Many historic small towns across Pennsylvania are experiencing an economic resurgence due to Marcellus Shale exploration," Kyriss said. "Having a modern infrastructure, especially a dependable public water supply, is critical for communities such as Emlenton to take advantage of opportunities for growth and development."

Aqua Pennsylvania serves approximately 1.4 million people in 30 counties throughout Pennsylvania. It is the largest operating subsidiary of Aqua America, Inc., (NYSE:WTR) which serves approximately 3 million people collectively in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Florida, Indiana, Virginia, Maine, Missouri and Georgia, and is listed on the New York Stock Exchange under the ticker symbol WTR.

Aqua finishes improvements to Emlenton water system

Company completes work ahead of schedule

Aqua Pennsylvania Inc. has announced it has satisfied the requirements of the state Department of Environmental Protection consent order agreement for its Emlenton water system 17 months before the final completion date of July 1, 2012.

Aqua has invested \$4.5 million for improvements since it purchased the system two years ago.

"We are very happy to see that all of the work we have completed for the Emlenton water system has resulted in the termination of the (consent order agreement)," Aqua Pennsylvania president Karl Kyriss said. "From getting the nine-month-old boil order lifted just three weeks after purchase to managing the design and construction of a new water treatment plant, we have worked diligently and invested a lot of money in the Emlenton water system so these customers can get the

water quality and reliability they deserve," Kyriss added.

Specific improvements Aqua has made to the water system over the last two years include \$2.8 million for construction of a new 288,000-gallon per day water treatment plant, \$925,000 to replace 11,400 feet of old water main and \$392,000 of improvements to the existing finished water reservoir, including the installation of a dome roof.

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Immediately upon purchasing the system, Aqua made temporary improvements to lift the boil order in 23 days.

"Early termination of the (agreement) stands as final testament to Aqua's aggres-

sive actions and commitment to providing quality water and reliable service for the customers of Emlenton who had suffered enough," Kyriss said.

The Emlenton water system serves about 1,200 people in portions of Emlenton Borough and Richland Township, Venango County.

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(Compiled by newsroom staff)

