

The Distribution System Improvement Charge: A Rip-Off For Consumers

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Investor owned water utility companies are pushing unreasonable rate schemes on consumers across the country. These schemes involve special surcharges that automatically increase water bills without a full public review, so that private utility companies can more quickly make a return on certain water distribution projects and ensure their long-term profitability.¹ The companies are essentially trying to boost their earnings and shed regulatory oversight that protects consumers.

Although the scheme goes by different names in different states, it is most commonly referred to as a Distribution System Improvement Charge (DSIC).² This innocuous-sounding name obscures the real objective: to boost and ensure corporate profits by shifting risks to the public and bypassing standard consumer protections. (Community activists fighting this scheme have noted that a more fitting title would be a Reduction in Public Oversight For Financing, or RIPOFF.) In the states where it is allowed, it is a boon for the private water industry that comes at the expense of the public.

Avoided Public Oversight

The DSIC scheme allows investor owned water utilities to increase customer bills without the standard regulatory process that protects the public from the exploitative prices and unfair practices possible under private monopolies.³ In most states, a public utility commission oversees the finances and approves the rates of investor owned water utilities to prevent the companies from abusing their monopoly power.⁴ By avoiding full regulatory scrutiny, surcharge schemes can lead to unwarranted profits,⁵ as well as skewed investment decisions. They incentivize certain projects at the expense of other, possibly more prudent, ones,⁶ and can compel companies to overinvest to maximize their financial benefit from the scheme.⁷

David Sade, West Virginia's deputy consumer advocate, said that allowing such a scheme would "remove one of the most important counterbalances to the inclinations of monopoly utilities to overbuild, or 'gold plate' their systems." Taking time to conduct a full financial review, Sade explained, "serves to encourage monopoly utilities to engage in prudent investment decisions and operate more

efficiently."⁸ DSIC schemes bypass this necessary public oversight.

Automatic Rate Increases

With the DSIC scheme, investor owned water utilities can automatically increase customer bills up to a certain percentage — from 3 percent to 10 percent, depending on the state⁹ — after repairing or replacing water pipelines. Then, when private water utilities want a larger increase, they follow the normal procedures and file a rate case.¹⁰ The largest investor owned water utilities typically file for rate increase every two years,¹¹ whether or not they have imposed surcharges.¹² When they do, they roll any existing surcharges into their base rates and reset the surcharge to zero.¹³ This obscures the long-term consumer cost of the mechanism. Over time, the rolled-in surcharges can add up to a considerable premium on customer bills.

For example, infrastructure surcharges added \$80 million to Aqua Pennsylvania's total authorized revenues between 1997 — when the scheme went into effect — and mid-2010 (see graph). The company received, on average, only

"[I]t is inappropriate to tilt the regulatory balance against consumers and shift business risk away from water companies simply for the purpose of creating an incentive for these companies to fulfill their basic obligation to provide safe and adequate water service."

— from the National Association of State Utility Consumer Advocates' resolution against automatic infrastructure surcharges²⁰

about 3 percent of its actual revenue from current surcharges in any given year. However, because the surcharges were rolled into base rates every two years, the cumulative effect of these surcharges is significant. Surcharges accounted for about 36 percent of the total increase in the company's authorized revenues from 1997 to 2010. As of mid-2010, about one fifth of its annual operating revenue could be traced back to their surcharge scheme.¹⁴ This scheme worked to ensure the company's long-term profitability at the expenses of consumers.

Inflated Water Bills

The DSIC scheme can overcharge consumers. The surcharge is based on a limited view of utility finances. It increases customer bills to cover the cost and corporate profits associated with certain projects without accounting for and offsetting any decreases in operating expenses that result from those projects. Rehabilitating water pipelines, for example, reduces main breaks, water loss and related costs.¹⁵

Surcharge schemes inflate a company's allowed return on equity — its profit — by reducing regulatory lag,¹⁶ which is the time between when a corporation makes an investment and when it can start making a return on that investment. Regulators set a utility's authorized return on equity to compensate it for the risks associated with lag, but when surcharges cut lag time, there is not a corresponding decrease in the allowed return.¹⁷ That means consumers continue to pay for business risks that the surcharge removes.

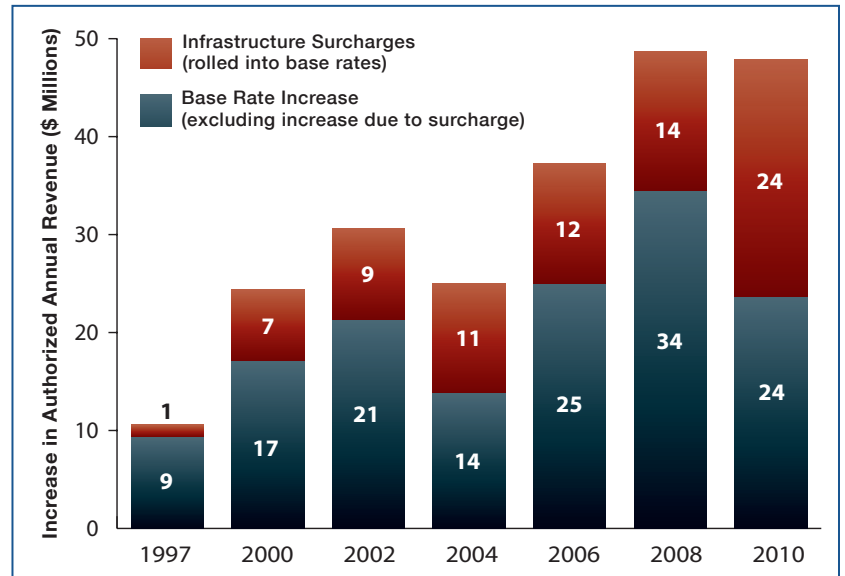
Calculations of infrastructure surcharges also typically overestimate the cost of financing projects at the expense of consumers. These calculations are based on the cost of long-term debt, even though water utilities tend to use cheaper short-term debt to pay for the types of projects funded by the surcharge.¹⁸

Unnecessary Consumer Burden

The DSIC scheme puts an unjustified financial burden on consumers. Water corporations claim that it is necessary for improving water systems, but as New Jersey's Division of Rate Counsel said, "This argument for an incentive is disingenuous because a utility should not need an extra incentive to fulfill its obligations to provide safe, adequate, and proper service to New Jersey ratepayers."¹⁹

In other words, the DSIC is an unnecessary special corporate perk that rewards investor owned water utilities for making improvements that they should be making anyway. If the corporations cannot meet their obligations to provide safe and sound water service using standard rate practices, then they should get out of the water business.

Aqua Pennsylvania's Rate Increase History: How Infrastructure Surcharges Have Inflated Rates



Since the implementation of the infrastructure surcharge in 1997 through mid-2010, Aqua Pennsylvania's authorized revenue has increased by a total of \$224 million, \$80 million of which is from infrastructure surcharges.¹⁴

The Private Water Industry's "Major Coup"

An industry analyst has called legislative action allowing a DSIC scheme a "major coup,"²¹ and another has referred to infrastructure surcharges as "the holy grail" for investor owned water utilities.²²

Nick DeBenedictis, CEO of Aqua America, attributed his company's stable earnings to infrastructure surcharges,²³ and in 2011, the company focused 44 percent of its planned capital investments on projects covered by them.²⁴ American Water, another investor owned water utility, sees the surcharge mechanism as part of its strategy to "ensure" long-term profitability.²⁵ The company expects to eventually recover one-fifth of its capital investments through such schemes. Reducing regulatory lag "boosts the timeliness of earnings," CEO Jeff Sterba explained to Global Water Intelligence. "That's why we're focused on the development of a DSIC-like distribution recovery mechanism in New Jersey."²⁶

To date, eight states — Connecticut, Delaware, Illinois, Indiana, Missouri, New York, Ohio and Pennsylvania — permit the use of infrastructure surcharges, and two states — California and New Hampshire — have pilot programs. The industry is aggressively pushing regulators and legislators in other states, particularly New Jersey, to follow suit.

Stop the Rip-Off

State legislators and regulators should prevent this consumer rip-off. Certainly we must invest in our water distribution systems, but infrastructure surcharges are a false solution

to our infrastructure needs. Infrastructure surcharges are merely moneymaking schemes for private water companies and their Wall Street investors without any consumer benefit. They are clearly not in the public interest. Everyone depends on safe and high-quality water, and it is essential that this shared public resource be regulated for the public good rather than private gain.

Endnotes

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Origins: "The Nick DeBenedictis Bill"

Pennsylvania was the first state in the country to allow water infrastructure surcharges. In the mid-nineties, during the final hour of a state legislative session, Pennsylvania lawmakers passed a law — tagged onto a piece of legislation that restricted inmate phone calls — that authorized a Distribution System Improvement Charge. The measure was dubbed "the Nick DeBenedictis bill" after the head of the company now called Aqua America. DeBenedictis' company, along with the Pennsylvania arm of American Water, devised the scheme, and several state politicians credited his lobbying efforts and campaign contributions with the bill's passage. The scheme went into effect at the beginning of 1997.²⁷

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