

Introducing the Janney RCI: Our Ranking of Water Utility Regulation & Valuation

Janney Water Journal - April 2011

INVESTMENT CONCLUSION:

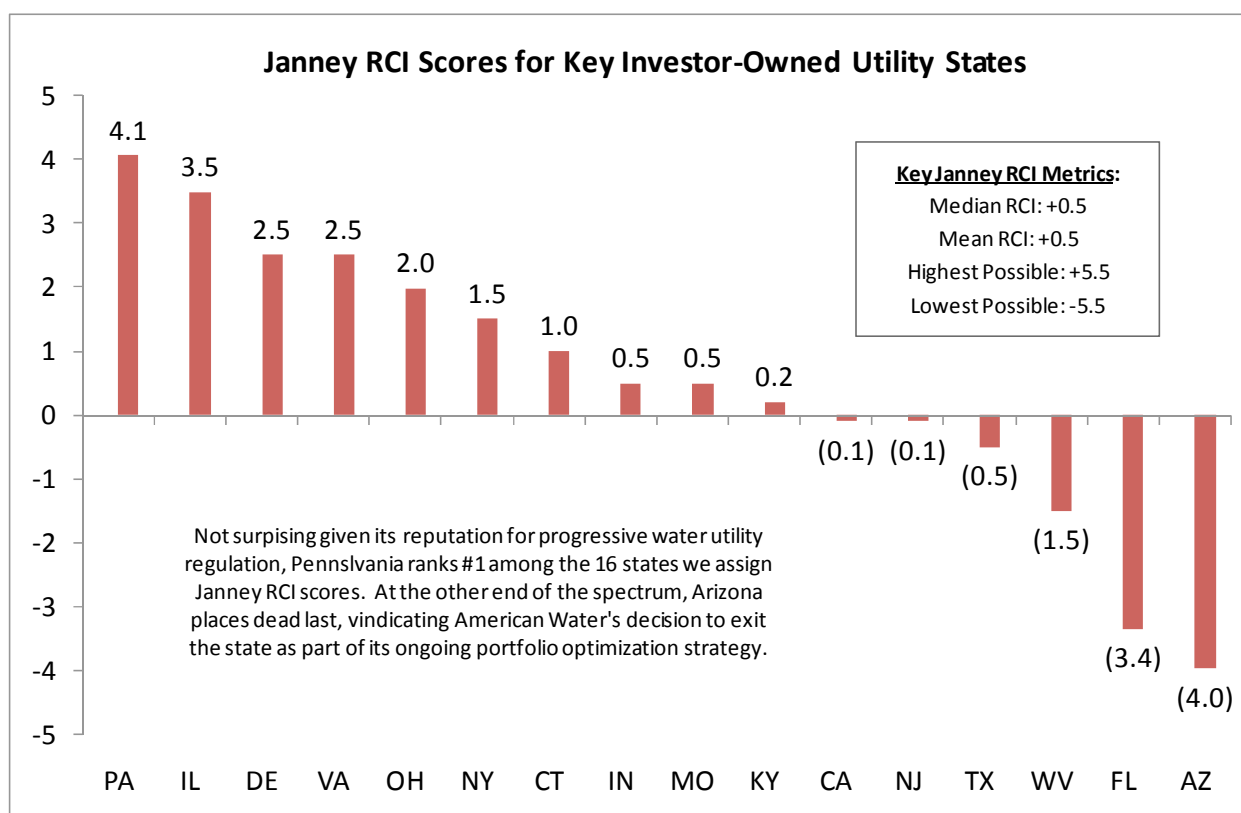
Having followed the water utility industry for years and - like many others - danced delicately around the issue of comparing state regulatory environments, we decided the time has come for a transparent, quantitative ranking system. Indeed, we believe regulatory climate is the single most important factor driving shareholder returns for water utilities, and that a clear scoring system on this key issue substantially demystifies the investment decision making process. With this in mind, we introduce our Janney Regulatory Climate Indicator (RCI), which assigns a numerical score to each state of relevance for the water utility peer group based upon key factors such as Returns on Equity and the existence (or lack thereof) of progressive regulatory mechanisms such as DSIC and Future Test Years. While we recognize that no such system is perfect and any attempt to tackle the issue will be controversial (hence the Street's historical reticence to do so), our system is transparent, easily understandable, and accurately depicts the relative attractiveness of various regulatory jurisdictions. In any event, we believe even detractors will find the Janney RCI a useful, refreshing step in the right direction toward a more open and candid discourse on the issue. Below we offer several key take-aways from our inaugural RCI rankings, and in the following pages we summarize our methodology and detail our findings.

KEY POINTS:

- **The States: PA on top as expected, but some surprises down the league table.** Not surprising given the PA PUC's near unanimous reputation as the most progressive of the state utility commissions on water issues, Pennsylvania ranks #1 of the 16 key states with a Janney RCI score of 4.1 (out of a possible range of -5.5 to +5.5). Among other key states - Illinois ranks #2 (RCI: 3.5), Delaware #3 (RCI: 2.5), Connecticut #7 (RCI: 1.0), California and New Jersey tie for #11 (RCI: -0.1), and Texas ranks #13 (RCI: -0.5). For detailed rankings and inputs see table on page 6.
- **American Water (AWK-BUY): RCI reinforces AWK as our top water utility idea.** Among the anxieties of this type of analysis is the fear that the results will contradict one's previously held views, but our 100% objectively designed system reinforces AWK as the most compelling stock idea in the space. While the company's weighted-average RCI (1.2) lies below key peer Aqua America (2.6), our implied fair value analysis suggests the valuation disconnect between the two companies more than reflects this. In addition, the potential implementation of a DSIC in New Jersey (20% of regulated revenue) represents a potentially significant regulatory catalyst.
- **Aqua America (WTR-Neutral): Premium valuation justified, but upside limited.** With its strong position in top-ranked Pennsylvania and diversified mix of additional states, Aqua America's RCI score (2.6) is second to only Pennsylvania pure-play York Water Company (YORW-BUY). Still, our RCI-based implied fair value analysis indicates that WTR's premium valuation appropriately reflects the company's favorable regulatory exposure, and upside remains limited. Overall, Aqua America remains the "best-of-breed" player in the investor-owned water utility space, and we believe any meaningful pullback in WTR shares should be viewed as buying opportunity.
- **California: CA regulation sub-par already, and uncertainty continues to loom.** While water utility regulation has improved in recent years, the state lacks key regulatory mechanisms and remains a below average capital destination in our view. Overall, we continue to believe that the discount valuations currently assigned to California-centric utilities American States Water Company (AWR-Neutral) and California Water Service Company (CWT-Neutral), appropriately reflect the fact that California regulation (though improved from years ago) remains so-so at best and that recent changes to the CA Public Utility Commission heighten uncertainty going forward.

JANNEY RCI: NOT PERFECT, BUT A USEFUL PIECE OF THE PUZZLE

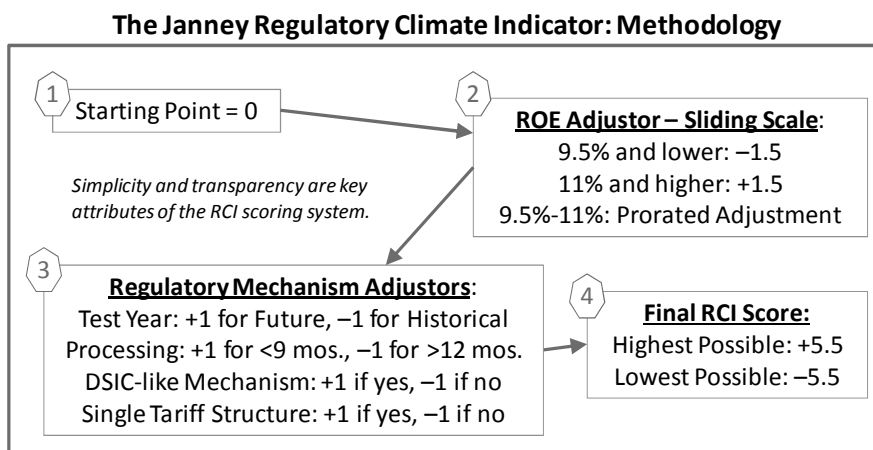
After following the water utility industry for more than five years and frequently speaking with investors frustrated by the difficulty of comparing regulatory environments, we believe the time is right for a simple, easy to understand system for making these comparisons. While we recognize that no such system is perfect, we are firm believers in not allowing the “perfect to be the enemy of the good” and therefore launch our Janney Regulatory Climate Indicator (RCI). Predictable given its attempt to quantify the unquantifiable, the RCI has its flaws, but we believe it will provide a useful tool for investors as they formulate a mosaic of the space. Our RCI scoring system, described in more detail on page 3, essentially starts each state at a baseline score of “0”, applies an adjustment factor based upon recent awarded returns on equity (the higher the better), and then further adjusts this figure depending on whether a state has implemented key progressive regulatory mechanisms (DSIC, future test year, single tariff, etc).



As mentioned above, we realize that no rating system of this type is perfect, and we acknowledge the inevitable criticisms that will come from states (and companies operating therein) ranking poorly. Still, inputs to the Janney RCI formula were carefully deliberated with an eye toward favoring those states whose regulatory systems facilitate strong returns on capital and investment outperformance, and the RCI rankings pass a key sanity check in that the rankings correspond with the more informal pecking order of state regulatory environment we've arrived at after years of following the space. For example, the state of Pennsylvania places #1 in the rankings with an RCI score of 4.1 while Arizona places dead last with an RCI of -4 (note that possible RCI scores range from -5.5 to +5.5). Given that Pennsylvania is universally regarded as the most progressive regulatory jurisdiction in the nation and that major publicly-traded companies like American Water (AWK-BUY) and American States Water (AWR-Neutral) have been exiting Arizona, these outcomes confirm the soundness of the Janney RCI scoring methodology.

JANNEY RCI: SUMMARY OF METHODOLOGY

In designing a system for quantifying the relative attractiveness of various state regulatory systems, we adhere to the maxim that “less is more” and deliberately favor elegance over complexity. Although a more intricate approach would have benefits, we believe a simple, transparent system sacrifices little in the way of accuracy while possessing the key advantage of being easily understandable.



Step-by-Step RCI Calculation:

1. **Starting Point.** All states are created equal, beginning the process with a baseline score of 0.
2. **Allowed Return on Equity Adjustment.** The first, and most significant, adjustment to the baseline score of 0 is the ROE adjustor. Using an average of recent awarded ROEs in the state, the baseline score is adjusted to reflect the attractiveness of returns on capital. States with ROEs of 9.5% and below have 1.5 points subtracted from the baseline, while states with ROEs of 11% and above have 1.5 points added to their baseline score. States with ROEs in between 9.5% and 11% receive a pro-rated adjustment according to their position in this range, with any state exactly at the midpoint of 10.25% receiving no adjustment to the starting point.
3. **Regulatory Mechanism Adjustments.** The next set of adjustments takes into account whether a state has in place key regulatory mechanisms that we believe reduce regulatory lag or otherwise improve the investment climate. These simple +1/-1 adjustments are as follows:
 - +1 if a state has in place a DSIC, -1 if not.
 - +1 point if a Future Test Year is used, -1 if Historical (0 for Historical/Updated).
 - +1 if rate cases must be processed in 9 months or less, -1 if 12 months or more.
 - +1 if a state has in place single tariff rate structures, -1 if not.
4. **Summation = Final RCI Score.** After all adjustments have been made to the initial starting point of 0, the end result is the Janney RCI score. The highest possible RCI score is +5.5 (0 + 1.5 for an 11% ROE + 1 for DSIC + 1 for Future Test Year + 1 for 9 month rate case processing + 1 for Single Tariff = 5.5). Conversely, the lowest possible score is -5.50. Interpreting RCI scores is easy: higher scores denote states with more capital-friendly regulatory environments.

JANNEY RCI: A LOOK AT KEY REGULATED TERRITORIES

Pennsylvania: The Gold Standard (#1 of 16). With its reputation for progressive regulation and status as a preferred capital destination, it's not surprising that Pennsylvania places #1 among the states included in our RCI rankings. A number of factors contribute to Pennsylvania's status as the gold standard in water utility regulation, but the key driver is that the Pennsylvania Public Utility Commission holds true to a simple concept: grant highly competitive allowed returns on capital and minimize the drag that the regulatory process creates on realized returns. The importance of the latter part of this equation cannot be understated, and the PA PUC has a long history of open mindedness toward forward-looking, creative regulatory mechanisms on this front. A notable example is that the state pioneered the Distribution System Improvement Charge (DSIC), which has long been viewed as an industry best practice and is increasingly seen by investors as a baseline standard of an acceptable regulatory environment.

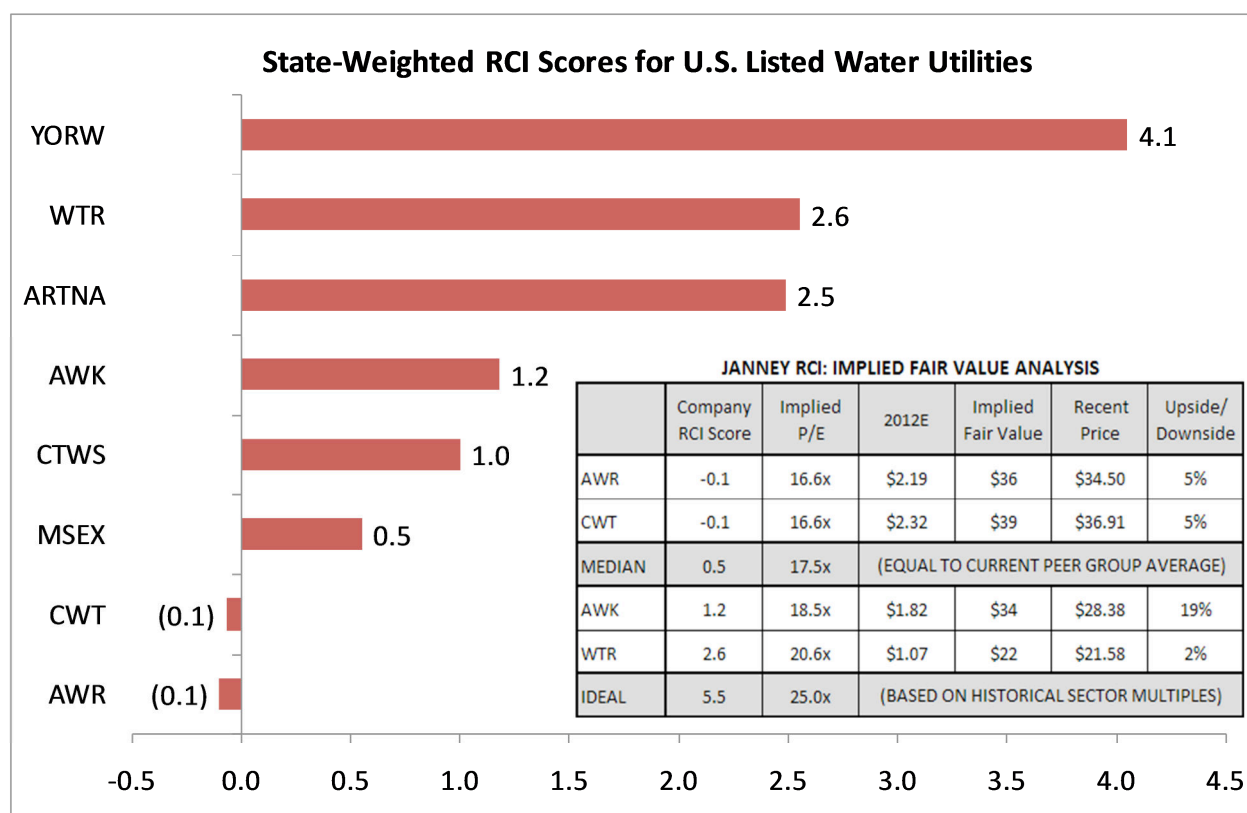
Connecticut: WICA Changes the Game (#7 of 16). Long viewed as a challenging place for regulated water utilities to do business, Connecticut's Department of Public Utility Control has been slowly evolving toward a more progressive regulatory approach in recent years. The cornerstone of the state's gradual positive trajectory was the adoption of an infrastructure surcharge mechanism, dubbed the Water Infrastructure and Conservation Charge (aka "WICA"), implemented in 2007. While granted returns on equity remain sub-par (Connecticut Water's latest granted ROE was 9.75%), the WICA closes the gap meaningfully between granted and realized returns, and is a significant driver of Connecticut's placing above the median in our RCI rankings. With the WICA and other regulatory best-practices (single tariff billing, prompt rate case processing) in place, only Connecticut's non-competitive ROEs (CT ranks dead last on this metric) keep the state from moving into the upper echelon of regulatory jurisdictions.

New Jersey: Late-Blooming Up & Comer (#11 of 16). Also viewed historically as a difficult regulatory environment, New Jersey looks likely to follow Connecticut's path of adopting (albeit belatedly) a DSIC-like mechanism. With comment sessions ongoing, we believe the Board of Public Utilities is likely to adopt a surcharge mechanism in the near-term, and that this would be a significant step in the right direction that would make New Jersey much more attractive from a capital allocation perspective. Indeed, given the significant impact of regulatory lag on realized returns in New Jersey and the fact that granted returns on equity are actually quite competitive (recent allowed ROEs have been in the 10.3% range), adoption of a DSIC-like system would (depending on the exact terms) immediately vault New Jersey into the top echelon of water regulatory jurisdictions. Given its prevalence in the industry (AWK, MSEX, and WTR all have significant NJ operations), New Jersey is a key state to watch going forward.

California: Is Decoupling a Good Thing? (#12 of 16). California water utility regulation is a case of good news/bad news, with the CA Public Utility Commission progressive on some key issues (eg. a true future test year) but notably behind the times on others (eg. no DSIC). Ironically, one of the supposed crowning achievements in CA water regulation – so-called "decoupling" – is counterproductive in our view and emblematic of the CPUC getting "too cute" rather than sticking with tried and true best practices with proven results in other states. By allegedly mitigating some of the "risk" associated with operating a water utility business in California, decoupling opens the door to the argument that lower returns are appropriate. In addition, the sheer complexity of the "balancing accounts" used to implement the system has proven a turn-off for investors. Ultimately, we believe the recently revamped CPUC would be well advised to focus on the basics, such as improving ROEs and implementing a DSIC mechanism.

STATES ARE INTERESTING, BUT HOW DO THE COMPANIES STACK UP?

While the Janney RCI is designed as a tool for comparing regulation on a state-by-state basis, the trend in recent years among water utilities has been toward greater geographic diversification. Therefore in order to use the RCI to compare the regulatory mix of individual companies, below assign company-specific RCI scores using a weighted average based on the percentage of regulated revenue each company derives from various states. Not surprisingly, the tails of this analysis are those companies with concentrated exposure to individual regulatory jurisdictions. Of course, this can work out for better or worse depending on which state(s) each company is levered to. York Water (YORW-BUY), for example, is at the head of the class with an RCI score of 4.1 – a product of its being the lone pure-play on top-ranked PA. At the other end of the spectrum, American States Water (AWR) and California Water (CWT) score poorly on this metric, a function of their concentrated exposure to California, whose RCI lies below the median.



Meanwhile, those investor-owned water utilities boasting more diversified state regulatory exposure – most notably BUY-rated American Water Works (serving 20 states) and Neutral-rated Aqua America (serving 12 states) – lie somewhere in between the single-state utility extremes. Aqua America’s heavy footprint in Pennsylvania enables the company to garner a significant edge over American Water Works, which comes as no surprise given that investors historically value WTR shares at a significant premium not only to AWK but also to most others in the peer group. Middlesex Water’s (MSEX-BUY) weighted RCI score looks so-so at best, but we would note that the New Jersey Board of Public Utilities is actively considering a DSIC-like surcharge mechanism, which would provide Middlesex an RCI boost given the company’s heavy exposure to New Jersey (75% of revenue). A NJ DSIC would also accrue to American Water’s benefit given that the company derives more than 20% of regulated revenue from New Jersey.

JANNEY REGULATOR CLIMATE INDICATOR: METHODOLOGY, STATE DETAIL AND LEAGUE TABLE

REG. ELEMENT	GRANTED ROE	TEST YEAR	PROCESSING	DSIC	SINGLE TARIFF		RCI SCORE	RCI RANK
					Yes = +1	No = -1		
RCI PARAMETERS	Sliding Scale 9.5% & Below = -1.5 11% & Above = +1.5	Future = +1 Historical/Updated = 0 Historical = -1	<9 mos. = +1 9-12 mos. = 0 >12 mos./None = -1	Yes = +1 No = -1	Yes = +1 No = -1			
PENNSYLVANIA	1.1	1	0	1	1	1	4.1	1
ILLINOIS	0.5	1	0	1	1	1	3.5	2
DELAWARE	-0.5	0	1	1	1	1	2.5	3
VIRGINIA	0.5	1	1	-1	1	1	2.5	3
OHIO	0.0	0	0	1	1	1	2.0	5
NEW YORK	-0.5	0	0	1	1	1	1.5	6
CONNECTICUT	-1.0	-1	1	1	1	1	1.0	7
INDIANA	-0.5	-1	0	1	1	1	0.5	8
MISSOURI	-0.5	-1	0	1	1	1	0.5	8
KENTUCKY	-0.8	1	0	-1	1	1	0.2	10
CALIFORNIA	-0.1	1	-1	-1	1	1	-0.1	11
NEW JERSEY	-0.1	0	0	-1	1	1	-0.1	11
TEXAS	1.5	-1	-1	-1	1	1	-0.5	13
WEST VIRGINIA	-0.5	-1	0	-1	1	1	-1.5	14
FLORIDA	-0.3	-1	0	-1	-1	-1	-3.4	15
ARIZONA	-1.0	-1	0	-1	-1	-1	-4.0	16

Source: Janney Capital Markets, Company Reports, State Regulatory Agencies

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