BEFORE THE HOUSE CONSUMER AFFAIRS COMMITTEE OF PENNSYLVANIA

Representative Joseph Preston, Jr., Chairman

Testimony of

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Regarding
Special Session House Bill 40 and House Bill 41
Natural Gas Issues

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Chairman Preston and Members of the House Consumer Affairs Committee

My name is Sonny Popowsky. I have served as the Consumer Advocate of Pennsylvania since 1990, and I have worked at the Office of Consumer Advocate since 1979. Thank you for inviting me to testify here today regarding Special Session House Bills 40 and 41, which address a number of issues that are of great importance to Pennsylvania natural gas consumers.

House Bill 40, sponsored by Chairman Preston, would expand the Pennsylvania Infrastructure Investment Authority (PennVest) to provide low interest loans (and, in certain cases, grants) to natural gas distribution companies for the replacement of structurally deficient and aging natural gas pipeline facilities. The Bill would also ask the electorate to approve $1 billion of indebtedness to fund this program.

House Bill 41, sponsored by Representative Evans, would authorize the Pennsylvania Public Utility Commission (PUC) to order the purchase of the Philadelphia Gas Works (PGW) by a capable public utility under certain circumstances. The Bill would also permit the establishment of an automatic rate surcharge, under which all Pennsylvania natural gas utilities, including PGW, could begin to charge customers for the cost of distribution system improvements without filing a base rate case.

I will now address each of these provisions.

House Bill 40, in my view, could provide a valuable source of low-cost funding for Pennsylvania natural gas utilities, including PGW, to finance needed system improvements at a lower cost to customers than traditional external financing. The existing PennVest fund has been highly successful over the years in assisting our water and wastewater utilities in making necessary investments. Under House Bill 40, not only would all of our natural gas utilities have access to loans at a very low (2% or less) interest rate, but a municipally-owned utility such as PGW that is operating under specified financial constraints, would qualify for outright grants. This is similar to the successful approach that PennVest has taken with respect to water and wastewater funding.

Importantly, the benefit of the low cost and no-cost capital from PennVest funding generally has flowed through to customers in water and wastewater rates, though in the case of one small water utility, our Office had to go to Commonwealth Court to reverse a decision by the PUC that would have allowed the utility to charge customers for a low cost PennVest investment as if it were funded in part with high cost common equity.

As a representative of Pennsylvania natural gas consumers, I would welcome low-cost funding and grants that will reduce the capital costs that must be paid by Pennsylvania consumers as part of their natural gas service. As you are well aware, natural gas bills have grown significantly from their levels of just a few years ago. It is increasingly difficult for many Pennsylvania households to keep up with these bills. By providing low cost or no cost financing for system improvements, House Bill 40 would enable gas utilities, including PGW, to fund needed investments at a lower overall cost to their consumers. The more difficult question, of course, for you, as legislators, and ultimately for the voters of Pennsylvania, is whether, in light of competing priorities, this is a good use of the Commonwealth's indebtedness powers. Purely from a utility consumer perspective, however, I believe the availability of low cost loans and outright grants provided through House Bill 40 would be a substantial benefit to Pennsylvania natural gas consumers and I support it.

Turning to House Bill 41, I also support in principle the provisions of the Bill that would give the PUC the authority to order the acquisition of PGW by a capable public utility. Having said that, I would hasten to add that I see such a mandated acquisition as a last resort, to be utilized only if other methods of ensuring reliable natural gas service to PGW customers at reasonable rates have failed.

The mandatory takeover provision in House Bill 41 is an expansion of an amendment to the Public Utility Code that was added in 1992 to allow the PUC to order the acquisition of very small water and sewer utilities by capable public utilities. In order to be subject to this law, the utility to be acquired must have 1200 or fewer customer connections. Although this law has been on the books for fifteen years, it has been used very sparingly, in only a handful of cases, including a case that our Office recently initiated involving a very troubled small water and sewer utility whose service problems cry out for immediate and extraordinary relief. The vast majority of utility mergers and acquisitions are voluntary in nature, with the purchaser and the seller coming to terms that must be approved by the PUC.

But even though Section 529 has been directly used very infrequently, the fact that the Commission has this tool in its toolbox arguably has led to public benefits because the owners of troubled small water and sewer utilities may realize that if they do not correct their problems or sell their business voluntarily to an entity that can resolve those problems, they are subject to the provisions of this law. In addition, to the extent that the acquiring companies in these types of cases are healthier and larger companies, the costs of bringing a small troubled utility into their system can be spread across a much larger customer base.

In the case of PGW, of course, we are not talking about a small utility, but a massive entity with some 500,000 customers, substantial debt, and other potential liabilities. Clearly, great care must be exercised to ensure that any acquisition would not only benefit the customers of PGW, but also that such benefits do not come substantially at the expense of the customers of the acquiring utility. It should also be recognized that, to the extent that PGW is acquired by an investor-owned utility, certain tax and financial benefits that accrue only to publicly-owned entities would be lost. It is my understanding that studies conducted for PGW and the City of Philadelphia in 1999 and 2001 identified between $40 million and $50 million per year of savings that result from municipal ownership. That may not be a reason in itself to refrain from ordering a sale of PGW, because those savings arguably might be overcome by economies of scale and scope that could be produced by joining a larger utility entity. But both the costs and benefits of public ownership certainly must be carefully considered before any mandatory acquisition is ordered.

With those major caveats, however, I agree that there may come a time when the public interest demands dramatic action with respect to the future of PGW, and the Pennsylvania Public Utility Commission may be in the best position to mandate such action. House Bill 41 would provide the PUC with the authority to take extraordinary action in the event that extraordinary events require it. Important principles and details must be worked out regarding who would be responsible for each of PGW's existing liabilities, how consumers of both PGW and of any acquiring utility would be protected, and other matters. But I would look forward to working with Representative Evans and the members of this Committee in developing legislation that addresses the future of PGW in a responsible and forward-looking manner.

The last part of House Bill 41 would establish a distribution surcharge for all natural gas utilities in Pennsylvania, with a special surcharge provision that applies only to PGW. For the reasons that I stated before this Committee at its hearing in Harrisburg on September 12, 2007, I respectfully disagree that a distribution system improvement charge is either necessary or in the best interest of Pennsylvania consumers.

Again, the basis of the distribution system improvement charge is found in a Public Utility Code provision that was added for water companies in 1996 to allow those water utilities to increase rates between base rate cases in order to cover the costs of new distribution improvements. At that time, many water utilities were filing base rate cases almost annually to cover the cost of new infrastructure required to meet state and federal safe drinking water laws.

In contrast, some of our major natural gas utilities have not filed base rate cases in decades. The last base rate increase for PECO Gas was in 1988. The last base rate cases filed by UGI, Columbia, and Peoples (Dominion) were in 1995, while the last Equitable case was in 1997. I am not aware of any evidence that these utilities have had difficulty maintaining safe natural gas service and making necessary infrastructure improvements during these many years in which their base rates have remained unchanged. This is important, because if a 5% or 7.5% distribution system improvement charge had been in effect all those years, the customers of those utilities would have paid tens of millions of dollars in higher rates for no apparent purpose.

This is not just a hypothetical point. Just this week, PECO Gas issued a press release announcing that it had completed $12.3 million in upgrades to its suburban Philadelphia natural gas facilities, including the replacement of 58,000 feet of cast iron and bare steel mains.

And, PECO Gas did all this without raising its rates. In the press release announcing the system improvements that PECO issued on Tuesday, November 6, the Company stated:

> During the past 20 years, PECO has made significant upgrades to its natural gas delivery system and expanded capacity, serving about 7,000 new customers each year – all without an increase in the company's delivery and service charges since 1988. By saving customers money through the use of new technologies, increasing sales, operational mergers and other efficiencies PECO charges remain among the lowest in Pennsylvania.

This is how ratemaking is supposed to work. Between base rate cases, a utility makes certain investments that increase costs, but the utility may also add customers who provide more revenues, or it may operate more efficiently to reduce costs in other areas.

In a base rate case, all of the utility's costs and revenues are looked at together in order to determine whether the company needs to increase its base rates. In contrast, a distribution system improvement charge simply takes out of context one cost element – the cost of new pipes – and raises the utility's overall rates to reflect that additional cost, without considering any offsetting changes.

It is true that improvements to our natural gas infrastructure cost money, and utilities that make prudent investments that are used to serve the public must be permitted an opportunity to earn a fair return on those investments. That does not mean, however, that we need to remove the protections of the Public Utility Code in order to make it easier for utilities to increase their rates between rate cases, without hearings and without any meaningful ability for customers to oppose such increases.

Traditionally, utilities in Pennsylvania and across the Nation have recovered the cost of infrastructure improvements through base rate cases, in which all of the utilities' investments, expenses, and revenues are examined at the same point in time. As I mentioned earlier, in 1996, the General Assembly created an exception to this process for water utilities at a time when water companies contended that they were subject to very substantial new infrastructure requirements. In the case of those water utilities, the General Assembly allowed the establishment of a special surcharge, called the distribution system improvement charge (or DSIC) that allowed utilities to recover a return of (depreciation) and return on (interest and profit) new distribution plant investments between base rate cases. The investments recovered through these surcharges, which are permitted to increase every three months, are subject to Commission audit to ensure that they are correctly calculated and accounted for, but are not reviewed by the Commission to determine whether the investments are needed or are prudently incurred before their costs are placed in rates. Initially, the DSIC surcharges were limited by the PUC to no more than 5% of the utility's revenues, but earlier this year, the Commission approved – over the objection of my Office, the Office of Small Business Advocate, the Office of Trial Staff, and the Company's large industrial customers -- an increase in the DSIC surcharge of Pennsylvania American Water Company (PAWC) from 5% to 7.5%. Indeed, it appears from the Commission's Order in that case, that the Commission believes it has the discretion to allow the surcharge to increase to 10% or even higher if it chooses to do so.

As you may be aware, PAWC also sought to implement a surcharge for its wastewater (sewer) division called a Collection System Improvement Charge (or CSIC). The PUC approved that surcharge and my Office successfully appealed on the ground that the automatic capital recovery surcharges permitted under the Public Utility Code are limited to water utilities. The Commonwealth Court agreed with my Office that the CSIC was not permitted under the Public Utility Code, but the Court also discussed the policy objections to a clause that allows a utility to recover capital expenditures through an automatic surcharge mechanism. As stated by Judge Leavitt in her Opinion for the Commonwealth Court:

> Utility's Wastewater Charge will entail regulatory oversight that amounts to no more than a mathematical exercise. The after-the-fact audit will require Utility to show only that it did, in actuality, spend the funds for the intended policy and not, for example, that a new pumping station was needed and was operating effectively…..
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> …. the "cursory" review undertaken for a surcharge is not a substitute for the review undertaken in a base rate case to determine whether a rate is just and reasonable.

Popowsky v. PA PUC, 869 A.2d 1144, 1156 (Comm. Ct. 2005).

More important than the lack of substantive Commission review, in my opinion, is the fact that a surcharge for capital expenditures is contrary to the general concept of just and reasonable rates because it allows recovery of a single cost increase, while ignoring all of the other changes, both positive and negative, that occur between base rate cases. Again, to quote from the Commonwealth Court in the PAWC CSIC case:

> The surcharge is quite different from a base rate. In Pennsylvania, as in most jurisdictions, rates for public utilities are set using what is known as the test year concept, which requires taking a snapshot of the utility's revenues, expenses and capital costs during a one-year period. The object of using a test year is to reflect typical conditions. Test year expenses may be adjusted or normalized where atypical or non-recurring. Under the test year concept, revenues, expenses and capital costs are to be simultaneously reviewed for the same period of time so that a utility may prove its new rates are "just and reasonable."

869 A.2d at 1152.

Unlike a traditional base rate case, in which all costs and all revenues are considered simultaneously, a DSIC is a one-way street that can only increase rates between rate cases, even if a utility's other costs are going down or its revenues are going up. In setting utility rates, it is important to look at <u>all</u> the utility's costs and revenues, not just a single utility cost item that may be added between rate cases.

In the utility ratemaking context, customers who pay a DSIC are charged for the utility's distribution improvements, but do not get the benefit of the utility's reduced investment in depreciated or retired plant. In a base rate case, these changes would offset each other. In the 2004 PPL Electric base rate case, for example, the Company unsuccessfully sought approval of a distribution surcharge. The OCA's expert witness was able to demonstrate that in the four years prior to that rate case, the Company's <u>net</u> distribution plant had actually declined in an amount of $14.8 million per year. That is, the decline in the rate base value of existing distribution plant exceeded the additions to distribution plant by $14.8 million per year. There is nothing wrong with that in a base rate case, because both increases in plant and decreases in plant are reflected in rates simultaneously. With a DSIC, however, the new plant investments would have been reflected in rates each year, while the offsetting depreciation and retirement of existing plant – on which the utilities are still earning a return – would be ignored.

Depending on the level of the surcharge and the base against which the surcharge is applied, this is not a small matter. A 5% or 7.5% surcharge on all natural gas revenues across Pennsylvania could increase rates by tens of millions of dollars annually, all without the benefit of a base rate case review to determine whether any such increases are needed. If utilities can demonstrate on an overall basis that they require such an increase in rates, then so be it. But they should not be allowed to raise their rates each year or each quarter, simply because they are spending more money in one area, while they are spending less money in other areas, or may be benefiting from increases in sales revenues from new customers at existing rates. If we now add DSICs to natural gas utility rates, customers can expect to see steady and persistent increases in their already high natural gas bills, all without the benefit of public hearings and full PUC review.

It is true that a DSIC makes it easier for a utility to raise rates when it spends money to add infrastructure. But in my mind, that is not necessarily a good thing. It is not supposed to be easy for a monopoly utility to raise its rates. Customers have nowhere else to go for natural gas distribution service. That is why those customers have a right to challenge proposed rate increases before the Public Utility Commission.

Utilities have a right to be compensated for investments in plant that is prudently added and that is used and useful in serving customers. But that is best accomplished through a base rate case, in which all the utilities' costs, revenues, and required rate of return are measured at the same point in time, and only the <u>net</u> increase in revenue requirement is added to rates at the end of the case.

In sum, I support the extension of PennVest funding to natural gas utilities in House Bill 40, because I believe that would reduce costs for Pennsylvania natural gas consumers. I would respectfully oppose the expansion of the distribution system improvement charge to natural gas utilities in House Bill 41, however, because I believe that would unnecessarily raise rates for those same consumers. In addition, I support the principles behind the provisions of House Bill 41 that would allow the PUC to order the acquisition of PGW by another utility, but I would submit that such a forced acquisition should be viewed as a last resort that would be implemented only if the customers of both PGW and the acquiring utility could be protected.

Thank you again for the opportunity to testify today on these matters of great importance to Pennsylvania natural gas utility consumers. I would be happy to try to answer any questions you might have at this time.

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