BEFORE THE PENNSYLVANIA HOUSE
CONSUMER AFFAIRS COMMITTEE

Representative Joseph Preston, Jr., Chairman

Testimony of

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Regarding
Utility Infrastructure in Pennsylvania

Harrisburg, PA
September 12, 2007

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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 the state of our natural gas, water and electric utility infrastructure in Pennsylvania.

I am not an engineer, but my impression is that, for the most part, the state of our natural gas, electric, and water public utility infrastructure in Pennsylvania is sound. There are certainly problem areas, particularly with respect to the service provided by some of our very small water utilities, who continue to have difficulty meeting the challenges of operating a modern water system. We have also seen a troubling spate of recent water line breaks, even among our largest water utilities. In addition, we continue to see significant localized electricity outages that reflect the need for vigilance with respect to the maintenance and inspection of distribution lines to the extent that such outages occur much more frequently in some areas than can be blamed solely on extreme weather conditions or other "natural" causes.

From a consumer perspective, it is also important to ensure that our utilities are meeting their continuing infrastructure requirements in the most cost-effective and economic manner. In some cases, that means that existing water and natural gas pipes can be repaired or reconditioned, rather than replaced in every instance. Moreover, each utility is differently situated, and the conditions of its facilities may vary based on a number of factors such as weather and environmental and geological conditions that do not lend themselves to a simple formulaic schedule for infrastructure rehabilitation and repair. Rather, each utility must carefully analyze its own infrastructure on a comprehensive basis and must take the steps necessary to

ensure that its wires and pipes and other critical infrastructure are maintained in the most reliable and economical manner.

I recognize that the maintenance and improvement of our utility infrastructure costs money, and that the utilities who 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. It must be remembered that what natural gas pipes, water pipes, and electric distribution lines have in common is that they are all part of the monopoly distribution service of our regulated utilities. While the generation and commodity portions of the electric and natural gas industries have been opened to competition, distribution service for electric, natural gas, and water utilities remains a monopoly. That is because, for economic and environmental reasons that have held true for more than a century, it makes no sense to have multiple competing electric lines or natural gas pipes or water pipes running down all of our streets and into each of our homes and businesses. Because these services are monopolies, however, this means that consumers are wholly dependent on our public utility laws and our Public Utility Commission to ensure that they receive safe and reliable service from these facilities and that they are protected from having to pay excessive or exorbitant rates.

Traditionally, utilities in Pennsylvania and across the Nation have recovered the cost of infrastructure improvements through base rate cases, in which all of the monopoly utilities' investments, expenses, and revenues are examined at the same point in time. 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 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. This would be like raising the tolls on the Pennsylvania Turnpike every time a stretch of road was repaired or

improved, or raising tax rates every time there is an increase in one line item in a state or municipal budget. In setting utility rates, it is important to look at all the utility's costs and revenues, not just a single utility cost item that may be added between rate cases.

Consider this example: I own a $100,000 home with a 10% interest rate mortgage. I decide to finance a $20,000 addition to my home, but at the same time, I refinance my entire mortgage at an 8% interest rate. So now, I am paying an 8% rate on a $120,000 debt, rather than a 10% rate on a $100,000 debt. Charging customers a DSIC between rate cases is like charging the homeowner in this example for the $20,000 cost of the new home improvement, but ignoring the 2 percentage point lower interest rate on the entire mortgage. In a full base rate case, customers who pay the cost of a new investment will also receive the benefit of the lower interest rate. With a DSIC, the customers only see the bad, not the good.

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. This is not a hypothetical point. In the 2004 PPL Electric base rate case, 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 net 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 electric, natural gas, and water revenues across Pennsylvania could increase rates by hundreds of millions of dollars annually, all without the benefit of a base rate case review to determine whether any such increases are justified. 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 at existing rates. The fact is that we have some electric and natural gas utilities that have not filed for base rate increases since the late 1980's and early 1990's. When, in 2006, Penelec and Met Ed filed their first base rate cases since 1986 and 1992, respectively, the distribution portion of both Companies' rates were actually reduced, not increased. If those Companies had DSIC's in place, their distribution rates would have increased each year as a matter of arithmetic, even though their overall cost of providing distribution service had decreased. Indeed, if we now add DSICs to electric and natural gas utility rates, customers can expect to see steady and persistent increases in their water, natural gas, and electric rates, 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 a benefit to customers. It is not supposed to be easy for a monopoly utility to raise its rates. Again, customers have nowhere else

to go for electric, natural gas, and water distribution service. That is why those customers have a right to challenge proposed rate increases before the Public Utility Commission.

A "general" base rate case in Pennsylvania must be ruled upon by the PUC within nine months of the date it is filed. Under the Pennsylvania Public Utility Code, the utility is allowed to base its claim on a future test year that roughly coincides with the period in which the rates are being examined by the Commission. In my experience over the past 28 years, the majority of base rate cases are amicably settled among the parties before the nine-month period expires. In addition, particularly for small utilities, the Commission has developed a series of processes designed to reduce litigation costs, such as mediation.

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 net increase in revenue requirement is added to rates at the end of the case.

In sum, I believe that the state of utility infrastructure is generally sound. I also believe that our utilities can meet the challenges of adding infrastructure in the future without eliminating the statutory protections that Pennsylvania consumers currently rely upon to ensure that their rates are just and reasonable.

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

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