

Pennsylvania House Consumer Affairs Committee

Testimony of David G. DeCampli, president, PPL Electric Utilities

House Bill 1294

April 28, 2011

Good morning, Chairman Godshall, Chairman Preston, and members of the Committee:

Thank you for the opportunity to be here today to express PPL Electric Utilities' support for House Bill 1294 and discuss its vital importance to utilities across this Commonwealth.

Infrastructure is defined as an underlying base or foundation.

When it comes to public utility infrastructure, that base or foundation must be kept strong and safe. The consequences of failure affect the safety of residents, businesses, and the strength of our economy.

Here in Pennsylvania and indeed, across the nation, the very real issue of aging infrastructure and investing in infrastructure is on the minds and lips of many — and with good reason.

There's a fine distinction I would like to offer at the outset.

There's plenty of attention lately being given to our transportation infrastructure and our bridge deficiencies in Pennsylvania. Today, we're talking about investments to be made by utilities, not money needed from state or federal governments at a time when budgets are constrained.

Simply put, House Bill 1294 will benefit consumers, the economy, and utilities alike.

It will provide the Public Utility Commission with the authority to review and approve alternative rate-making mechanisms on a case-by-case basis, to help utilities move forward with the efficient planning and construction of needed investments to preserve high levels of reliability — at an overall lower cost to consumers — and generate much-needed jobs.

At PPL Electric Utilities, we believe timely, well-planned infrastructure investment is vital. Without it, our ability to fulfill our obligations to provide quality service to our customers would be diminished.

We value our fiduciary duty to maintain and operate our delivery system to provide customers with safe and reliable electric service. Our long history of award-winning customer service shows we willingly accept that responsibility.

For those members who may not be familiar with PPL Electric Utilities, we serve 1.4 million customers — about 3 million people in all — in a 10,000-square-mile area that includes all or parts of 29 counties in eastern and central Pennsylvania.

Our electric delivery system is made up of more than 50,000 miles of (transmission and distribution) power lines, nearly 1 million poles and towers, and more than 400 electric substations, which are the hubs for power delivery in local communities.

The distribution system, the focus of HB 1294, generally consists of the substations, distribution circuits and feeders, and associated equipment that feed electricity to our customer locations – homes, businesses, and the like.

The transmission system, which generally falls under the jurisdiction of the federal government, is the superhighway that makes up the nation's electric grid. These are the higher-voltage facilities that connect power plants to the substations, and connect one utility to the other.

My remarks today will explain:

- How we've invested in our electric transmission and distribution systems in the past,
- Why we must accelerate investment in our electric infrastructure going forward, and
- The various challenges that presents.

The alternative rate-making authority that would be granted to the PUC under House Bill 1294 would enable utilities to make more effective and cost-efficient investments in their distribution systems. It would streamline the existing rate-making process, reduce regulatory lag, and provide benefits across the board.

We've researched the types of regulatory mechanisms being used elsewhere and found 20 states are using various forms of rate-making that allow for timely capital cost recovery by electric utilities. A range of mechanisms is working in different circumstances.

Pennsylvania already permits some forms of alternative rate-making for electric utilities when it aligns with public policy. For example, we have rate riders to recover the cost of energy efficiency and conservation programs, and universal service programs for low-income customers.

The last major capital infusion into the PPL Electric Utilities transmission and distribution systems came 40 to 50 years ago, with the advent of suburban sprawl. Home air conditioning became the norm, and electric appliance use increased. Much of our system was built during that period of widespread economic growth.

However, that electric delivery infrastructure installed four and five decades ago is at, or nearing the end, of its useful life. Beyond that, there are places where equipment has been in service even longer, dating to the days of President Calvin Coolidge.

Customer expectations are high. The average residential customer now uses 750 or 1,000 kilowatt-hours a month, compared with the former standard of 500 kilowatt-hours. For some households using air conditioning in the summertime or depending on electric heat in the winter, the average usage is even greater. Our service area is vast, and the customer usage patterns vary considerably as well. We're faced with needing to invest more than ever into our aging electric infrastructure to ensure strong reliability and efficient operations.

These facilities have served us well — they've been inspected and maintained regularly. But it's time for upgrades, modernization, and rebuilding of those vintage lines from earlier eras of our electric distribution framework.

We've invested in capital improvements at a fairly steady rate since that last major infusion, about \$200 million to \$250 million per year in recent years. Increased revenue from electric sales growth generally allowed us to absorb fluctuations in capital expenditures or greater operating expenses between traditional rate cases, which typically were spaced several years apart.

But now, electricity use has leveled off — partly due to the economic conditions of the past few years and partly resulting from greater acceptance of energy efficiency and consumer conservation. Consequently, there is a lower level of revenue growth between rate cases, making it much more difficult to absorb capital expenditure increases.

Before we undertook any significant increase in capital investment, however, we needed to develop a plan — a roadmap for reliability.

Consequently, PPL Electric Utilities took a full year to perform an in-depth assessment of the health of our transmission and distribution systems. We completed that review in early 2009, looking at 30 million pieces of equipment and assessing the age, health and performance of our system.

Our study highlighted a growth in non-storm-related equipment failures since 2000. These failures drive up maintenance and emergency response costs and siphon off valuable resources.

Our comprehensive systemwide study, the troubling trend of equipment failures, and the age of our infrastructure brought us to one inescapable conclusion:

If the status quo is left unmitigated and unchanged, we'll be facing deteriorating service reliability — below PUC reliability performance standards and below what our customers have come to expect.

In our most recent customer satisfaction surveys, our efforts to maintain our poles and wires well and provide strong service reliability were recognized. We must now move beyond maintenance to replacement.

We believe it is essential to significantly step up capital investments now — as we have planned — to ensure continued reliability.

In the big picture, we're planning to invest more than \$3.4 billion in our transmission and distribution systems from this year through 2015.

Just under half, or about \$1.6 billion of those capital expenditures, are earmarked for the distribution system. Under our current plans, our distribution investments in 2015 would be double what they were in 2005.

This year alone, we anticipate investing about \$450 million in transmission and distribution system capital improvements. About \$300 million of that total will be invested in the distribution system, a 41 percent increase over 2009 investments.

And with those increased investments comes increased employment. In 2009, PPL Electric Utilities employed 130 construction and support contract workers to complete distribution system projects. In 2011, we anticipate hiring an additional 160 to 170 contract workers to complete the 2011 plan.

This almost exclusively unionized contract workforce is in addition to our workforce of almost 700 bargaining unit employees performing this type of work.

Next year our capital investment for both transmission and distribution infrastructure will grow to more than \$600 million, and in 2013, to more than \$860 million.

Our long-term plan for the efficient and proactive replacement of aging infrastructure allows us to follow a life cycle approach to replace critical equipment, such as substation transformers and circuit breakers.

We expect our ramp-up in capital spending will continue well beyond this initial five-year planning period. We're just beginning to address — on a prioritized basis — a systemwide infrastructure condition.

The job is big, requires significant capital investment, and is essential to our ability to continue providing the safe and reliable service our customers have come to expect.

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However, increased investment in the electric infrastructure presents certain challenges. We have a capital-intensive business. Each year, we must borrow substantial amounts of money to make system improvements and operate our business. The increase in capital required to do what we believe is necessary strains our ability to borrow funds. Just like any individual consumer or business, increased borrowing has an adverse effect on credit ratings and leads to higher financing costs.

One credit rating service has already expressed concern about our credit rating, given the planned increases in our transmission and distribution system investments and the expected impact on our cash flow ratios, driven, in part, by regulatory lag.

Consider this excerpt from a Moody's Investment Services report in April 2010:

The downgrade for PPL EU reflects our continued expectation that beginning in 2010, the company's cash flow credit metrics will decline dramatically from their recent levels and will remain towards the lower end of the ranges indicated in Moody's August 2009 Rating methodology for Regulated Electric and Gas Utilities (the Regulated Methodology) rated Baa for the foreseeable future. The expected decline in metrics comes as PPL EU implements market rates for generation while simultaneously incurring increased expenditures for capital investment to support and maintain the reliability of its aging distribution and transmission systems.

As a result, PPL EU's debt burden will increase, and cash flow coverage of debt and debt service is expected to be dramatically reduced. For example, for the foreseeable future, the ratio of cash flow from operations excluding changes in working capital (CFO Pre-WC) to debt, calculated in accordance with Moody's standard analytical adjustments, is expected to remain in the low-to-mid teens, and the ratio of CFO Pre-WC plus interest to interest is anticipated to remain around three times.

I previously referred to regulatory lag and would like to expand on that issue.

Each year, the company borrows large amounts of money in hopes of recovering on the investment years later through a rate case. Over time, during the prolonged period between the new investment and the setting of new rates, the lag contributes to a declining return on equity.

As we borrow more, and the recovery is uncertain and lags behind, credit rating agencies question whether our cash flow will be able to cover increased financing costs. If our cost of capital increases, our credit ratings would erode further, and expose consumers to increasing operational problems and the higher cost of borrowing funds.

This pressure on the ability to raise capital makes it more difficult for us to enter into more cost-effective, long-term contracts for labor and materials, which can translate into cost savings.

The costs we'll incur under our ramped-up investment plan are costs we would incur and ultimately seek to recover from customers irrespective of the legislation. Quite simply, this work needs to be done.

We are just seeking to recover these costs in a more timely way. Without more timely recovery, we would be forced into more frequent traditional and costly rate cases under current rate-making procedures.

Under House Bill 1294, the PUC would have the authority to review and approve alternative rate-making proposals.

HB 1294 does not take away the PUC's oversight authority. Nothing would be automatic.

The PUC will maintain its ability to ensure any cost recovery allowed is appropriate, justifiable and necessary. Changes in utility rates would continue to be held to the "just and reasonable" standard.

When conventional rate cases prolong aligning rates with true utility costs, consumers are exposed to larger rate changes.

With alternative rate-making, consumers would experience more predictable, incremental rate adjustments. Our estimates show the work we have planned now would result in modest annual increases in delivery costs of about 1 percent a year for the next decade under an alternative rate-making mechanism.

A higher degree of certainty regarding the financing and recovery of program costs can lead to efficiencies in work planning, procurement, and resource commitments that may reduce the overall cost of the program.

It also would provide incentives to commit to making longer-term capital investment plans and would help ensure sufficient labor resources stay in Pennsylvania.

In the absence of alternative rate-making, utilities may find it more difficult to make needed investments, which could undermine service quality and operating performance.

With HB 1294, policymakers have an opportunity to make infrastructure investment a more effective and efficient process in Pennsylvania.

It is good public policy and should move forward along with electric system infrastructure upgrades statewide.

We are grateful for the leadership of Chairman Godshall, Chairman Preston, and others on this issue. Already, we see a great amount of bipartisan support.

Amending Title 66 and giving the PUC the authority to consider alternative rate-making mechanisms makes good, common sense for everyone. It's the right thing to do – for the state's economy, its infrastructure needs, and the safety of its residents.

Thank you. I'd be glad to respond to any questions.

