

Prepared Testimony of  
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*before the*

Pennsylvania House of Representatives  
Consumer Affairs Committee

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Chairman Godshall, Chairman Preston, members of the Committee, I appreciate the opportunity to speak with you today about House Bill 1294. This legislation will give the Pennsylvania Public Utility Commission (PUC) the authority to allow utilities to recover in a timelier manner the capital costs associated with investments in infrastructure. The bill also allows water and wastewater utilities to combine the revenue requirements used to determine rates. For the reasons discussed below, the PUC supports the passage of this legislation.

While the ratemaking model currently employed at the PUC has worked relatively well for many decades, it does not adequately address the challenges we face today or going forward. In Pennsylvania, and across the nation, much of our utility infrastructure is over 70 years old. Replacing this infrastructure – from gas pipelines, to electric transmission lines, to wastewater collection systems – is extremely expensive. However, for both safety and reliability reasons, many of Pennsylvania's aging pipes and wires should soon be replaced. While many utilities are accelerating their infrastructure replacement schedules to address this challenge, replacing Pennsylvania's aging utility infrastructure remains a massive and expensive undertaking.

Even though utilities are investing significant amounts of money to replace and repair their physical infrastructure, the existing ratemaking methodology used by the PUC does not allow utilities to recover these costs in a timely manner. Utility ratemaking is founded upon the relationship between revenues, operating expenses, and investment (or rate base). Historically, utility companies counted on revenues increasing and

expenses decreasing as they became more efficient. Utilities could also assume that their rate base would grow, at least in partial relationship, to revenues. Times are different today.

Utilities are seeing their revenues decrease. Energy efficiency measures such as Act 129, while achieving their stated goals, are encouraging less consumption per customer, which means less revenue for utilities. With respect to expenses, while there is always room for increased efficiencies and innovation, most utilities have already taken numerous steps to reduce expenses and increase productivity. At the same time, utilities have seen rate base increase because infrastructure replacement generally does not generate a single dollar of new revenue. Thus, while utilities' revenues are decreasing, their expenses and rate base are increasing.

In order to ensure the continued safety and reliability of our utility system, it is essential that the PUC and the Legislature help Pennsylvania's utilities resolve the problem of aging infrastructure in our state. House Bill 1294 will do this by allowing the PUC to consider new ratemaking methods that will better address the challenges the utility industry faces today. By reducing regulatory lag and incenting investment in infrastructure, this legislation will ensure that the utility infrastructure in the Commonwealth will be updated in an expeditious manner, resulting in a safer and more reliable utility system.

One of the alternative ratemaking methods House Bill 1294 would allow the PUC to consider is the use of a fully projected future test year. Traditionally, when a utility

wants to increase its rates, it files a rate case with the PUC using a test year comprising of the utility's revenues and expenses during the 12-month period immediately following an historic test year. Ideally, a test year should reflect as closely as possible the conditions the utility will face when the rates being established will be in effect. However, the test year the PUC currently uses almost always results in "regulatory lag" because, by the time the rates go into effect at the conclusion of the rate case, the information relied upon from the test year is outdated.

House Bill 1294 would instead allow utilities to use, with the PUC's approval, a fully projected future test year. Under this approach, utilities' rates and costs will match the first year new rates are in effect. This will significantly reduce regulatory lag and will encourage less frequent base rate case filings, saving utilities and customers millions in rate case expenses.

Another alternative ratemaking method that House Bill 1294 would allow the PUC to consider is an automatic adjustment charge that enables utilities to recover certain infrastructure improvement costs between base rate cases through a surcharge on customers' bills. This surcharge is often called a Distribution System Improvement Charge (DSIC) by the water and natural gas industry, and a Collection System Infrastructure Charge (CSIC) by the wastewater industry. These surcharges ensure the least possible rate impact on customers by spreading out over time the cost of replacing and enhancing Pennsylvania's utility infrastructure.

Pennsylvania implemented the DSIC for the water industry in 1997. Over the past fourteen years, the DSIC has had substantial impact on accelerating water infrastructure replacement in Pennsylvania. Prior to the DSIC, Pennsylvania American Water Company (PAWC) projected that it would take about 225 years to upgrade its entire system. With DSIC, the projected amount of time for upgrades to the PAWC distribution system is about 117 years – a timeframe that more closely matches the expected service life of the system.

Pennsylvania was the first state in the nation to enact and use the DSIC, and since that time, it has become a national “best practice.” Seven other states have now adopted mechanisms similar to Pennsylvania’s water DSIC. Due to in large part to the DSIC, the PA PUC was recognized by Standard & Poor’s for effectively encouraging water company investment in infrastructure improvements. The DSIC has also been recognized in a resolution passed by the National Association of Regulatory Utility Commissioners (NARUC) as a national best practice regulatory tool. In addition, the Council of State Governments included DSIC in its model legislation. The DSIC is one of the most important regulatory tools of the past decade and it was created in Pennsylvania.

Given the success Pennsylvania has had with the water DSIC, a logical next step is to expand the DSIC, or a similar ratemaking mechanism, to other sectors of the utility industry, such as the natural gas, electric, and wastewater sectors. Currently, there are approximately 11,000 miles of cast iron, unprotected bare steel, and even a small portion of wooden natural gas pipes in Pennsylvania that have reached or are reaching the end of

their useful lives. If left in place, these facilities will continue to deteriorate. Although I believe the natural gas transportation network in Pennsylvania as whole is very safe, the recent tragic events in Allentown and Philadelphia have proven that we must take every step possible to replace vulnerable pipelines.

Natural gas companies spend millions every year repairing, replacing and maintaining the pipelines. As explained above, the current process for recouping the costs of making these upgrades is insufficient and results in unnecessary delay. House Bill 1294 would allow utilities to request permission from the PUC to use a mechanism similar to DSIC to recoup the revenue needed to upgrade and improve the pipelines in a timely manner. This DSIC mechanism would allow natural gas companies the flexibility to perform safety upgrades without a lengthy process to approve the rates necessary to make the large capital investment, and would encourage companies to replace pipelines under an expedited schedule.

In addition, the DSIC and CSIC will provide ratepayers with improved service quality and greater rate stability. By replacing aging infrastructure at an accelerated pace, there will be fewer main breaks, less frequent service interruptions, increased safety, and lower levels of unaccounted for natural gas and wastewater. The DSIC saves costs, not only in reducing frequency of rate cases, but by incenting capital investment to replace aging infrastructure. The infrastructure replacement encouraged by the DSIC would also help create hundreds of jobs — utility positions and pipeline contractors — needed to support the infrastructure replacement program. In light of today's difficult financial

markets, DSIC and CSIC are the type of innovative regulatory policies expected as rating agencies tighten their ratings benchmarks and are a key element in maintaining access to capital markets on reasonable terms.

It is also important to note that under House Bill 1294, utilities will not be able to implement a DSIC or CSIC without PUC approval. When a utility seeks to implement a surcharge such as DSIC, these requests receive closer scrutiny and review than time allows during a base rate case. In addition, the PUC has many safeguards to ensure the DSIC is implemented appropriately. For example, the PUC caps the surcharge to a percent of the total utility bill and requires that all customers receive notice of any such rate change. In addition, the PUC performs annual reconciliation audits to ensure that over-collections are refunded with interest and under-collections are included in future rates without interest recovery. Finally, the PUC reduces the surcharge to zero if the utility is over-earning. Through these safeguards, the PUC will ensure the DSIC and other related surcharges are implemented in manner that protects and benefits customers.

House Bill 1294 would also permit utilities to combine the revenue requirements of water and wastewater operations. Recently, the cost of wastewater treatment and collection has risen exponentially. As a result, many wastewater utilities have been granted significant rate increases by the PUC, which, in many cases, have resulted in rate shock for customers. By allowing utilities that provide both water and wastewater services to combine their revenue requirements, this will spread the increasing costs of

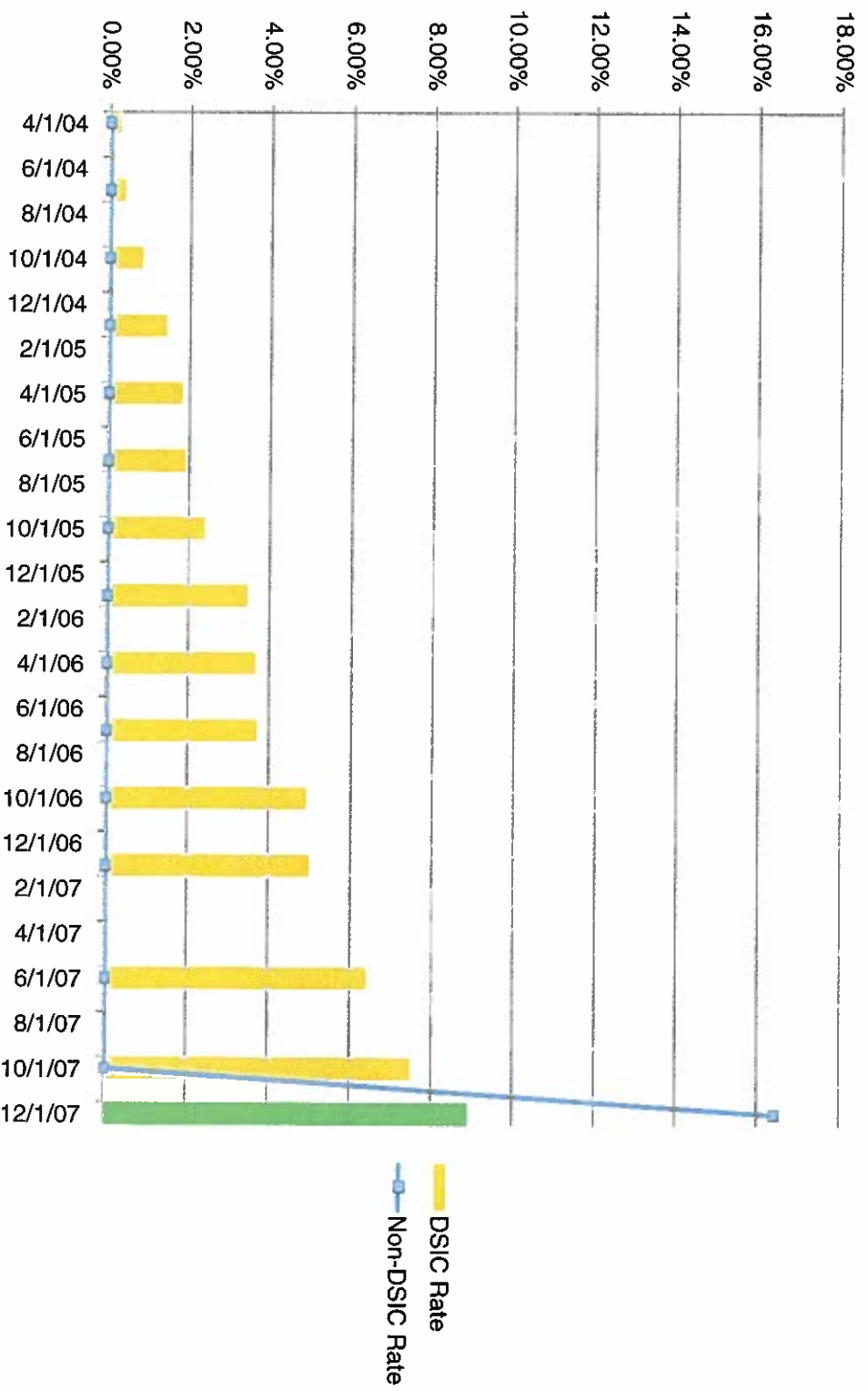
wastewater treatment and collection across a larger group of customers, thereby mitigating the dramatic rate increases for wastewater customers.

This approach makes sense when considering economies of scale. The number of wastewater customers in Pennsylvania is relatively small, which means it is difficult for those customers to absorb large rate increases. In contrast, there are a large number of water customers in Pennsylvania. Thus, if a portion of the wastewater rate increase is spread across the water customers, it will only result in a very small increase in the water customers' bills. This approach also allows wastewater customers to more gradually adjust to their increased rates.

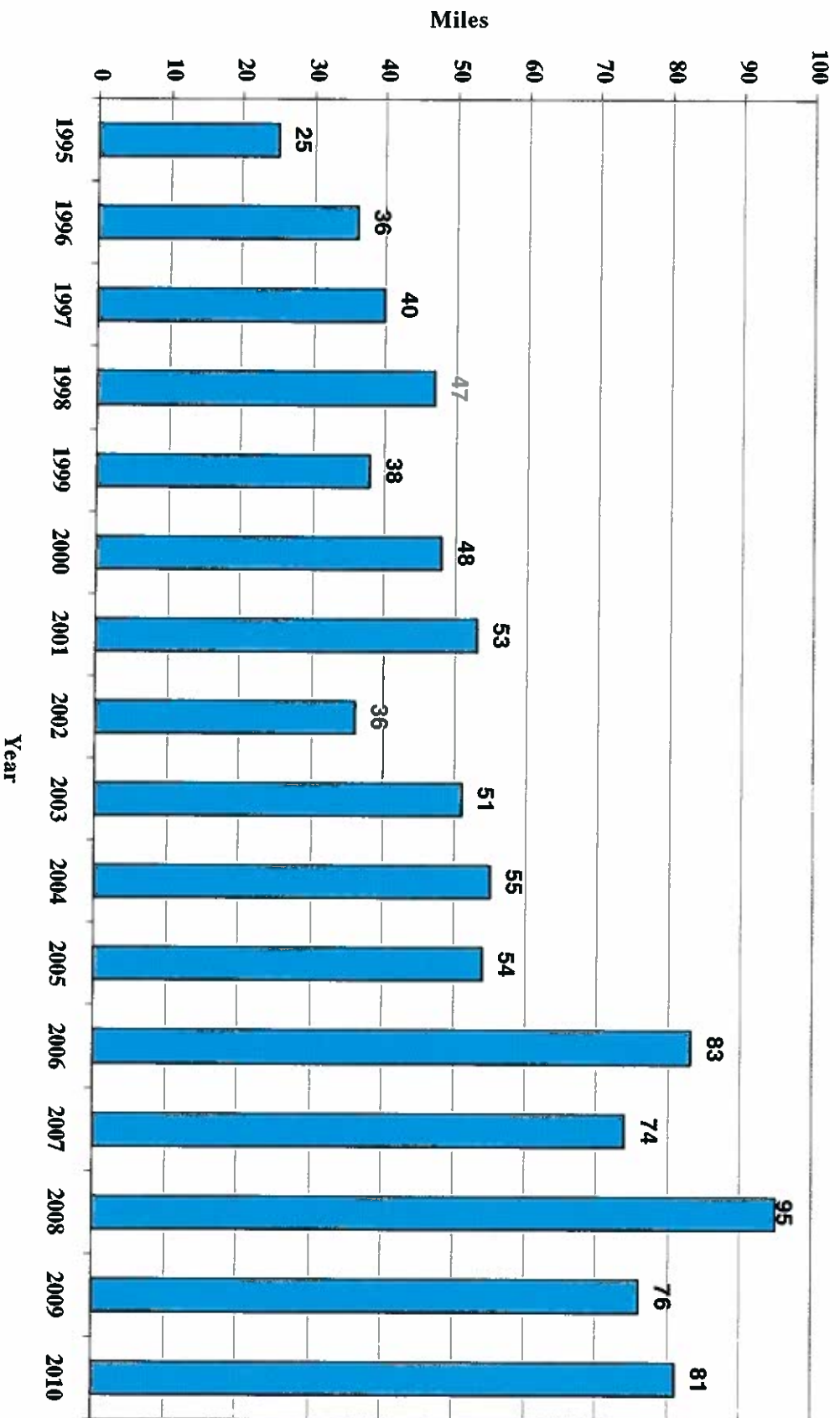
The statutory changes embodied in House Bill 1294 are necessary to enable the PUC to address the regulatory challenges facing us. The alternative ratemaking mechanisms permitted under this legislation will encourage investment in our state, accelerate aging infrastructure replacement, and result in greater rate stability for customers. For these reasons, the PUC encourages the Legislature to pass House Bill 1294.

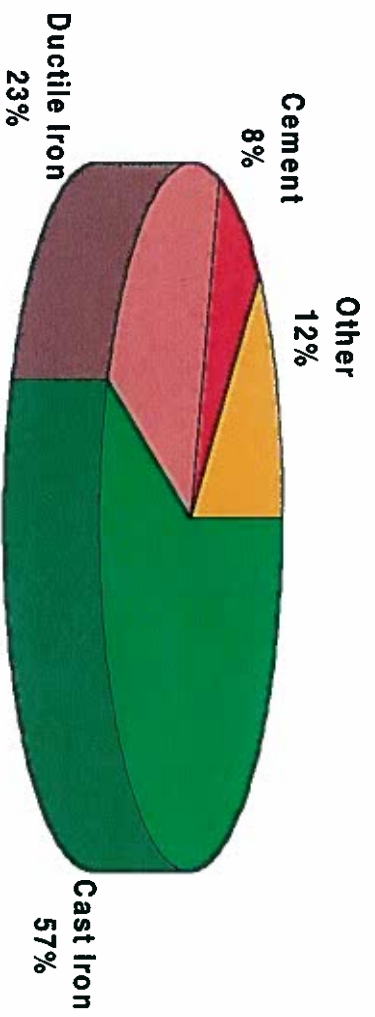
# DSIC Rate Gradualism

## Smaller rate increases over time

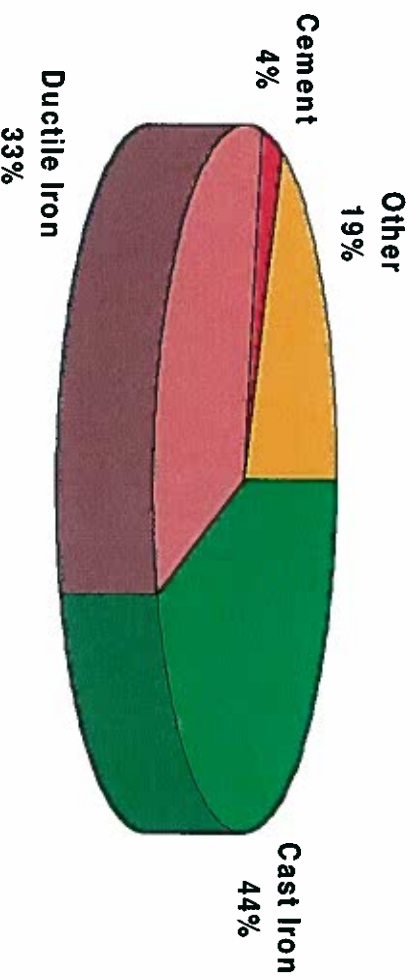


# Pennsylvania American Water: Miles of Pipe Replaced

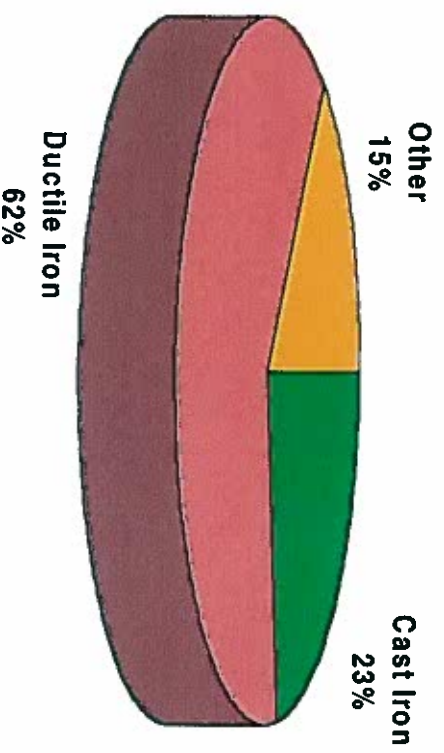




**1997 (pre-DSIC)**



**2008**



**Projected after Completion of Targeted Pool of Pipe**

