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BILL NO:	**Senate Bill 541** **Gas Companies-Infrastructure Replacement Surcharge**
COMMITTEE:	**Finance**
HEARING DATE:	**March 6, 2012**
SPONSORS:	**Senators Astle and Kittleman**
POSITION:	**Oppose**

Senate Bill 541 amends the Public Utilities Article (PUA) to allow the Maryland Public Service Commission (PSC) to approve gas utility surcharges up to $2 per month per residential customer ($24.00 per year) without the benefit of a traditional rate review. The purpose of the surcharge is to provide "up-front" funding to gas utilities for replacement or improvement of existing gas infrastructure. Projects receiving surcharge funding must be targeted to, among other things, improved public safety or infrastructure reliability. While the Bill has been modified since its prior introduction in 2011 as Senate Bill 332, it differs very little in any important respect. The changes made since last year do nothing to assuage the Office of People's Counsel's core concerns that the surcharge approach leads to rates that will inevitably be unjust and unreasonable. The Office of People's Counsel (OPC) **OPPOSES** Senate Bill 541.

The type of surcharge sought by this Bill violates long-standing principles of ratemaking law and policy, subjects residential ratepayers to unwarranted distribution rate increases without an evidentiary hearing, and eliminates the ability of the Commission to balance the interests of the utility shareholders and ratepayers in setting rates. While the bill is framed as a safety measure, in fact it is a revenue measure favoring the gas utilities because they will take advantage of regulatory lag and higher than warranted returns in the five year period between onset of the plan and the next rate case.

Under the PUA, utility companies have an obligation to "furnish equipment, services, and facilities that are safe, adequate, just, reasonable, economic and efficient..." PUA § 5-303. The utility is compensated through the approved rates it charges its customers. Those rates have been subject to PSC review and approval for over one hundred years. By law, the PSC is required to determine the "just and reasonable rate" that may be charged. PUA §§4-101 *et. seq*. The determination of the just and reasonable rate requires an evidentiary process, in which opposing parties may seek discovery and provide testimony and evidence for the Commission's consideration. This process allows stakeholders like the PSC Technical Staff, OPC and representatives of other customer classes to scrutinize the utility's "case" for a rate increase, and present opposing testimony. The PSC thus gets the benefit of a full assessment of the utility's revenue, expenses and appropriate profit level before deciding the reasonable rates for the utility to carry out its business responsibilities and have an opportunity to earn the designated profit level.

Senate Bill 541 would result in a diminishment of the Commission's ratemaking authority for a single type of utility expense without providing for a process to examine any off-sets to that expense. For example, it is conceivable that the expenses that would be recovered under this plan should be offset by reduced overall operations and maintenance expenses yet the Bill contains no mechanism to take that reduction into account.

The ratemaking process has worked well for decades and there is no reason to tread down the disfavored path of single issue ratemaking. Evidence and testimony introduced by OPC and other parties during the evidentiary ratemaking process have often resulted in utility rate requests being dramatically reduced by the PSC. Rate cases provide the opportunity for OPC and its witnesses to point out areas of utility over-reaching or mistake. This bill would remove that opportunity and impair the PSC's ability to ensure that rates are "just and reasonable."

Furthermore, OPC questions the basis for the Bill. The Bill states that "the purpose of this section is to *accelerate* gas infrastructure improvements in the State by establishing a mechanism for gas companies to promptly recover investments in eligible infrastructure replacement." §4-210 (B). However, there is no indication anywhere that gas companies are not already doing necessary improvements without having the ability to impose a surcharge on customers, or that gas utilities are not recovering prudently incurred costs for infrastructure investments.[1] If the utility rates are not adequate, the utility has the ability to request a rate increase. What it cannot do is fail to maintain a safe and reliable system.

That is illustrated by the PSC's recently completed rate case involving Washington Gas Light (WGL) where these principles were discussed.[2] In rejecting WGL's request for exactly the type of mechanism proposed by the Bill, the Commission noted that WGL agreed that it had been able to get appropriate rates approved by the PSC in the past and that those rates allowed it to meet its obligation to provide safe and reliable facilities.[3] The infrastructure surcharge plan presented in that case by WGL was for infrastructure improvements in excess of $640 million over a 30 year period. The first five year phase of the plan would cost ratepayers approximately $115 million. The PSC approved

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[1] In WGL's recently concluded rate case, OPC witness Dr. Dismukes showed that WGL was doing a very good job on maintaining safety and reliability <u>under traditional regulation</u>. Dr. Dismukes undertook a comparative analysis of mains and service line replacements and leak trend comparisons for WGL and other regional gas utilities. From that analysis, Dr. Dismukes concluded that there is no need for a special regulatory mechanism to recover pipeline replacement investments. In short, his analysis showed that WGL "has one of the lowest, if not the lowest, share of leak-prone pipe (mains and services) among comparably-sized Mid-Atlantic gas utilities. Second, the Company has exhibited replacement trends for leak-prone mains and service lines that are relatively comparable, if not better, than other regional utilities. Third, to the Company's credit, its long-run corrosion-related leak-improvement performance has been good over the past two decades, reducing mains and service line leaks from peak 1992 levels by over 50 percent. These reductions have occurred without a unique investment cost recovery rider that can lead to regulatory risks and ratemaking challenges." Dr. Dismukes prepared a similar analysis for weld related leak trends for service lines and mechanically coupled pipe and reached a similar conclusion. While he acknowledged that WGL had some "challenges" in 2004 through 2006, his analysis shows that WGL had *improved* its leak performance since then under *traditional* regulatory cost recovery. See generally, Dismukes Direct Testimony, OPC Exh.38, pp.16-26.

[2] Re Washington Gas Light Company, __Md. PSC __ (Case No. 9267) (Order No. 84475, November 14, 2011).

[3] WGL witness Chapman agreed that even with the challenges of necessary repairs and replacements inherent in the gas business under a traditional form of regulation and ratemaking, the "company has managed its reliability and safety responsibilities well over that period of time." Mr. Chapman also acknowledged that, in general, the Company has been able to gain appropriate rate increases at the Commission such that it could continue to meet its obligations. See Transcript pp.97-99, Case No.9267.

implementation of the plan, considering it a "proactive" way to manage risk in the normal course of infrastructure improvements; however, the PSC found that cost recovery for those improvements should properly be addressed in future rate cases. The PSC invited WGL to file for rate recovery as soon as practicable.[4] It appears that the PSC is signaling that cost recovery will be granted in future rate cases for infrastructure investments of the type proposed by WGL so long as the basis for and prudence of those investments can be examined by the parties and pass scrutiny by the Commission. Therefore, OPC believes that there is no reason to enshrine the infrastructure mechanism into law nor to remove the ratepayer protections that have existed for over a century.

The Bill also presents practical utility ratemaking problems. First, if passed, the surcharge would arguably make gas utilities less risky as an investment. However, the Bill provides for no mechanism for the Commission to reflect immediately, as it should, the reduction in risk through a reduced authorized rate of return. In fact, proposed §4-210 (D)(6)(III) appears to explicitly *prohibit* the Commission from reflecting the reduction in risk in rates until the company files its next rate case. Therefore, the company could conceivably be the beneficiary of an excessive return on equity for years. That section alone reveals that the Bill is a revenue enhancer for the gas utilities. In OPC's opinion, this inability to reflect lack of risk through a reduction to the authorized rate of return will subject residential ratepayers to unjust and unreasonable rates for the foreseeable future.

[4] Order No. 84475, pp.106-108.

There is general recognition that the type of surcharge mechanism proposed by the Bill can result in *higher* utility costs overall. The National Regulatory Research Institute (NRRI) noted:

> First, they [the surcharges] undercut the positive effects of regulatory lag on a utility's costs. "Regulatory lag" refers to the time gap between when a utility undergoes a change in cost or sales levels and when the utility can reflect these changes in new rates. Economic theory predicts that the longer the regulatory lag, the more incentive a utility has to control its costs; when a utility incurs costs, the longer it has to wait to recover those costs, the lower its earnings are in the interim. The utility, consequently, would have an incentive to minimize additional costs. Commissions rely on regulatory lag as an important tool for motivating utilities to act efficiently. As economist and regulator Alfred Kahn once remarked:
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> > Freezing rates for the period of the lag imposes penalties for inefficiency, excessive conservatism, and wrong guesses, and offers rewards for their opposites; companies can for a time keep the higher profits they reap from a superior performance and have to suffer the losses from a poor one.
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> Rational utility management, as a general rule, would exert minimal effort in controlling costs if it has no effect on the utility's profits. This condition occurs when a utility is able to pass through (with little or no regulatory scrutiny) higher costs to customers with minimal consequences for sales. Cost containment constitutes a real cost to management. Without any expected benefits, management would exert minimum effort on cost containment. The difficult problem for the regulator is to detect when management is lax. Regulators should concern themselves with this problem; lax management translates into a higher cost of service and, if undetected, higher rates to

> the utility's customers. Regulators should closely monitor and scrutinize costs, such as those subject to cost trackers, that utilities have little incentive to control.[5]

The annual filing of "amendments" to the plan does nothing to allay the concerns that the companies will be beneficiaries of excessive returns and regulatory lag. Those annual "amendments" merely adjust for differences between estimated costs of the projects in the plan and the amount recovered by the surcharge. All that the annual process will do is create extra accounting review work for PSC and OPC accounting witnesses at additional expense to the agencies. The expert witnesses presumably will be limited to a review of initial estimates against submitted work orders/invoices for comparisons sake. Those annual reviews will not allow the parties to take any meaningful actions to reduce distribution rates in the interim between the beginning of the plan and the rate case which must be filed five years later.

The Bill continues to suffer from other drafting infirmities. For example, the Bill allows for recovery of project costs "at the same time the eligible infrastructure replacement is *made*." Section 4-210 (D)(3)(III). That section is unacceptably vague as the word "made" could mean either "started", "in progress" or "completed." That section could lead to approval of collection of project costs if, for example, a ditch was started for an $11 million portion of the project and the Company walked away and did no more work for years. This is a key problem with the overall approach of the Bill: it allows recovery from ratepayers of expenses based merely on a plan or a theory of work rather than for

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[5] Case No. 9267, OPC Ex. 38, p.14. (quoting K. Costello, "How Should Regulators View Cost Trackers?", National Regulatory Research Institute :4-5 (date) (footnotes excluded).

recovery of expenses that are prudent and reasonable and subject to close scrutiny.

Similarly, the Bill provides that the Commission "may hold a public hearing;" the Bill does not explicitly state that any hearing must be an *evidentiary* proceeding and that other parties must be allowed to present evidence. Without that key inclusion, ratepayers' interests in just and reasonable rates are undermined.

A gas utility's core responsibility is to provide safe and reliable service, and to operate and maintain its system accordingly. Thus, the infrastructure safety and reliability improvements contemplated by this Bill are not new or unique. In fact, they are the *sine qua non* of providing gas distribution service: on-going and routine expenditures. Even if a gas utility faces a major and sudden need for reliability or safety improvements (and there is no evidence of such a problem in Maryland), utility regulatory accounting requires that these rising expenses be normalized, that is, the rates should reflect only capital expenditures that are in excess of the Company's normal capital spending.

In the past few years, gas and electric utilities in Maryland and other states have sought surcharges and other direct pass-through mechanisms for a variety of expenses – infrastructure improvements, pension costs and uncollectible expenses, for example. OPC believes that approval of this bill would open the door for other utilities to seek surcharge recovery for other expenses, and undermine the ratemaking process that has served both customers and shareholders by requiring the PSC to balance their interests.

For these reasons, OPC recommends an **UNFAVORABLE** report.