BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Compliance of Commonwealth of Pennsylvania with Section 410(a) of the American Recovery and Reinvestment Act of 2009	: : : :	Docket No. I-2009-2099881

ADDITIONAL REPLY COMMENTS of THE ENERGY ASSOCIATION of PENNSYLVANIA

The Energy Association of Pennsylvania ("Association") hereby submits its additional reply comments to the May 6, 2009 Investigation Order and the subsequent October 27, 2009 Secretarial Letter, investigating policies and actions that should be implemented to ensure compliance with the requirements of Section 410(a) of the American Recovery and Reinvestment Act of 2009 ("Recovery Act"). In the Investigation Order, the Commission asked stakeholders to offer comments concerning whether the Commission should adopt actions, orders, policy statements or regulations to ensure that utility company financial interests are aligned with the promotion of customer conservation and energy efficiency. Pursuant to the Recovery Act, the Commission's Order specifically sought input on whether to implement, in appropriate proceedings, general ratemaking policies that align financial incentives with the efficient use of energy and which provide timely cost recovery and timely earnings opportunities for both natural gas and electric utilities.

Initial comments and reply comments were filed by various parties in July and August of 2009. The Commission then conducted a Technical Conference on November 19 to further gather input from the public. The instant additional reply comments submitted by the Association address issues raised at the Technical Conference.

As reflected in the Recovery Act, as well as recently passed state legislation (AEPS and Act 129), the energy industry and its various regulating bodies are facing a paradigm shift. New policy at both the state and federal levels strongly emphasizes conservation, energy efficiency and energy independence and recognizes that providing consumers with timely proper price signals is a crucial tool in meeting these policy objectives. The regulatory direction identified in the Recovery Act, coupled with recent legislative and policy directives in the Commonwealth, requires a new mind-set.

Regulatory lag, deferred costs, and "waiting until the next rate case" for recovery are historic remnants of a by-gone regulatory era. The parties that support these status-quo concepts fail to grasp the magnitude of the shift in practice that the utility industry faces as it is directed to urge customers to consume less energy while maintaining its obligation to provide safe, reliable and cost-effective service. At the November Technical Conference, the industry testimony was uniform in stating that the current rate practice does act as a financial disincentive to the promotion of conservation and energy efficiency. Since the Commission and the utilities seek to encourage conservation and energy efficiency, regulation needs to support practices and operations that achieve the new paradigm.

Regulatory Lag Must be Addressed if Fundamental Shifts in Energy Usage are Going to Occur

To meet the Recovery Act's challenge to align utility financial incentives with helping customers use energy more efficiently, the Commission should address what is commonly known as "regulatory lag." That is, since traditional base ratemaking only implements changes in rates prospectively[1] revenues lost between the time energy efficiency measures begin to take effect and the next base rate case cannot be recovered absent the use of some other regulatory mechanism.

Under traditional base rate ratemaking, rates are reset only intermittently and customers are charged largely on a volumetric basis. Under this volumetric approach, utility returns on fixed costs increase as sales increase (and as expenses are managed downwards). This approach discourages utilities from inducing customers to use less of their service; as sales decline, company returns decline and, as utilities escalate spending on conservation programs, their returns decline further. In addition, rate increases in traditional base rate ratemaking may only be made on a prospective basis, in accordance with certain notice requirements.[2] Accordingly, although rates may be reset to allow a reasonable rate of return in a base rate case, lost revenues incurred during the period before the case, cannot be recovered. Thus, current rate practices actually create a financial disincentive, discouraging rather than promoting, conservation and energy efficiency.

[1] 66 Pa.C.S. § 1308(a); 66 Pa.C.S. § 1308(d).
[2] *See* Pa.C.S. § 1308(a).

A collective review of the testimony provided at the Technical Conference strongly suggests that Pennsylvania needs to be proactive to better align utility financial interests with those of conservation and energy efficiency. Once that premise is accepted, the focus is necessarily on the type of ratemaking methods that can be employed in support of conservation, energy efficiency and energy independence policies.

At the Technical Conference, a variety of options were discussed by utilities, the U.S. Department of Energy and even Standard & Poor's Rating Service, such as decoupling, higher basic service charges, a lost distribution revenue recovery mechanism in Act 129 energy efficiency riders, and straight fixed variable plans. The single consistent theme was the need for flexibility. As the Association emphasized in its comments this past summer and as the presentations at the November conference demonstrated, an innovative flexible approach in adopting a mechanism to address the existing financial disincentive and regulatory lag will ensure that practice achieves policy goals.

<u>The Negative Financial Consequences of Deferral Were Highlighted by Standard & Poor's</u>

Testimony offered by Richard Cortright[3] of Standard & Poor's Rating Service emphasized that "the results of regulatory rate-making procedures can have significant impact on credit worthiness of rating utilities." (Transcript at p. 95). As stated by Mr. Cortright, utility credit rating is a function of the regulatory relationship - the consistency and predictability of

[3] The Association wishes to express its appreciation to Commissioner Wayne Gardner for seeking financial expert testimony in this docket which adds to the intellectual debate. (Page 93)

cash flow – that enables utilities to maintain a relatively high-credit rating as compared to their unregulated corporate counterparts with similar financial profiles. Transcript pp. 96-97.

The regulatory relationship and its generally positive influence on utility credit rating can become stressed however at times when costs are rising and capital expenditures are increasing. Mr. Cortright noted that Pennsylvania regulators and the utilities under their jurisdiction, particularly electric, gas and water, are facing such a scenario with the current need for major capital expenditures on infrastructure coupled with the rising costs of production/generation, transmission and delivery to consumers. Transcript at pp. 97-98. At such times, delaying recovery of costs over which utilities have little control can have a negative impact on credit rating. Delays in recovery impacts cash flow, which impacts credit risk, leading to a higher cost of capital and, in turn, higher rates for ratepayers. (Transcript pp 96-99).

Rather than deferring costs, Mr. Cortright opined that establishing appropriate recovery mechanisms, such as trackers, alleviates stress on the regulatory relationship, thus holding down the cost of capital for utilities, maintaining creditworthiness and attracting investors to this fundamental industry for the U.S. economy. On the other hand, a delay in the ability of a utility to get cost recovery and the risk that full recovery may not be granted even in successful base rate proceedings, reduces utility value and investor interest. Accordingly, during a recession, wherein capital investment is tight, it is advisable to provide financial incentives to the utility industry and to assure cost recovery so as to encourage the dramatic change in behavior required by consumers to achieve policy objectives set by the Commonwealth and the federal government.

Positive Incentives, Not Penalties, Will Drive the Kind of Aggressive Conservation Efforts Envisioned by the Recovery Act and Act 129

In comments, some suggested that the penalties set forth in Act 129 will properly align incentives[4]. However, penalties only drive compliance with minimum mandated requirements. Act 129 and the Recovery Act both clearly contemplate encouraging utilities and customers to conserve energy over and above mandated levels.[5] The Energy Efficiency and Conservation Program that the Commission must adopt under Act 129 must include "[p]rocedures to make recommendations as to additional measures that will enable an electric distribution company to improve its plan and exceed the required reductions in consumption[.][6]" And the Energy Efficiency and Conservation Plan that electric distribution companies must develop and file under Act 129 must "include specific proposals to implement energy efficiency and conservation measures to achieve or exceed the required reductions in consumption[.][7]" Moreover, section 410(a) of the Recovery Act offers states the opportunity to receive extra funding if they will seek to put in place general policies to ensure that utility and customer incentives are aligned with the goal of energy efficiency.[8]

Only positive incentives will drive more aggressive promotion of conservation and energy efficiency and achieve the strongest results. Such incentives could include a rate-of-return adder, performance-target incentives, shared-savings mechanisms or accelerated depreciation. Moreover, the Commission could establish positive incentives using its existing

[4] *See e.g.*, Comments of the Office of the consumer Advocate at 7 (July 6, 2009) (opining that prospective penalties in Act 129 assure that electric utilities have proper financial incentives).
[5] *See* 66 Pa.C.S. § 2806.1(a)(6); Recovery Act § 410(a)(1).
[6] 66 Pa.C.S. § 2806.1(a)(6).
[7] 66 Pa.C.S. § 2806.1(b)(1)(i)(A).
[8] Recovery Act § 410(a)(1).

legal authority.[9] In particular, Section 523(a) of the Public Utility Code provides that "[t]he Commission shall consider…the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this title." Section 523(b)(4) further provides that the commission must specifically consider the "[a]ction or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management [.]" Through positive incentives, Pennsylvania will be meeting the objective of the Recovery Act, Act 129 and regulatory policies to encourage an educated consumer base to use energy more efficiently so as to conserve resources and mitigate price increases.

Conclusion

The testimony and comments submitted in this investigation illustrate that the Recovery Act, Act 129 and a myriad of other statutes and policies are aimed at changing the utility industry by, inter alia, endeavoring to change the usage patterns of utility consumers through timely price signals. Smart meters, time-of-day pricing, conservation, usage and demand reduction targets all fail if the public does not receive proper price signals. In turn, without public participation, policy objectives will not be achieved. The financial disincentives of old regulatory policies discourage both utilities and consumers from embracing the goals of conservation and energy efficiency. Delayed recovery of costs sends the wrong signals to investors and consumers alike and does not properly align financial incentives as required under the Recovery Act.

The Association appreciates the Commission's willingness to investigate and resolve issues facing the energy industry as it adjusts to this new paradigm – one which encourages

[9] Initial comments on Behalf of the Office of Small Business Advocate at 7 (July 6, 2009).66 Pa.C.S. § 2806(i) ("The commission has authority to use performance-based rates as an alternative to existing rate base/rate of return ratemaking[.]"). *See also* 66 Pa.C.S. § 501, 1307, 1308

efficient use of energy while still providing sufficient revenue to deliver safe, reliable and cost-effective service. The Association and its members welcome the opportunity to participate in the recently formed working group in this docket which will consider alternative rate-making structures. The industry encourages the Commission to adopt a policy statement which meets the requirements of the Recovery Act and provides opportunities for utilities to promote energy efficiency and conservation while maintaining the financial soundness of the industry.

Respectfully Submitted,

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