PENNSYLVANIA
AMERICAN WATER

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**VIA eFiling**

Rosemary Chiavetta, Secretary
Commonwealth of Pennsylvania
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

**Re: Fixed Utility Distribution Rates Policy Statement**
**Docket No. M-2015-2518883**

Dear Secretary Chiavetta:

Enclosed for filing in the above-referenced matter are Comments on behalf of Pennsylvania-American Water Company.

If you have any questions, please do not hesitate to contact me.

Very truly yours,

Susan Simms Marsh

Susan Simms Marsh

Enclosure

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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| **FIXED UTILITY DISTRIBUTION RATES POLICY STATEMENT** | : : | **DOCKET NO. M-2015-2518883** |

# COMMENTS OF PENNSYLVANIA-AMERICAN WATER COMPANY ON THE PROPOSED POLICY STATEMENT

## I. INTRODUCTION

Pennsylvania-American Water Company ("PAWC" or the "Company") submits these Comments in response to Ordering Paragraph No. 4 of the Proposed Policy Statement Order entered by the Pennsylvania Public Utility Commission ("PUC" or the "Commission") on May 23, 2018, in the above-referenced docket ("Order"). The Order solicits comments on a Statement of Policy pertaining to "fixed utility distribution rates" and, more specifically, "alternative ratemaking methodologies," that the Commission proposes to set forth at 52 Pa. Code §§ 69.3301-69.3303 ("Proposed Policy Statement").

Both the Order and the Proposed Policy Statement deal, in very large part, with issues and concerns affecting the development of alternative ratemaking methodologies for utilities engaged in the distribution of electricity and natural gas.[1] PAWC understands and appreciates the important role that electricity and natural gas distribution service plays in the lives of the state's residents and in the development and expansion of business and industry. At the same time, PAWC believes it is critically important that the Commission not lose focus on the ways that properly designed alternative ratemaking methodologies can help to assure that water and wastewater utilities have the capability to provide safe and reliable service to their customers; to

[1] See, for example, 52 Pa. Code § 69.3301 (explaining the need to address rate designs that are consistent with government policy initiatives to "promote distributed energy") and § 69.3303 (discussing possible rate methodologies for electric and natural gas distribution utilities).

assist the Commission and the Pennsylvania Department of Environmental Protection ("DEP") in addressing the problems posed by small, troubled and non-viable water and wastewater systems; to promote the wise and efficient use of the Commonwealth's natural resources; and to maintain levels of prudent investment in new and replacement plant needed to meet evolving drinking water and environmental standards and rehabilitate aging infrastructure. Abundant, reliable supplies of water that meet the highest drinking water standards and the provision of safe, environmentally-sound and sustainable wastewater collection and treatment service are not only critical to the health and safety of the public, they are vital preconditions for economic development and job creation in the Commonwealth. In that regard, certain alternative ratemaking methodologies are particularly well-suited to assisting water and wastewater utilities in meeting the operational and financial challenges they face, while also assuring that customers' rates are just, reasonable, lawful and non-discriminatory.

The Company offers these Comments to center the Commission's attention on the facts and circumstances that differentiate water and wastewater utilities from other utility segments and, in so doing, to identify the alternative ratemaking methodologies that hold the greatest promise to help water and wastewater utilities meet the unique challenges they currently confront.

## II. CHARACTERISTICS OF WATER AND WASTEWATER UTILITY SERVICE

Since the comprehensive restructuring of the electric and natural gas industries in Pennsylvania in 1999,[2] water and wastewater utilities are the only vertically integrated segment of the utility industry. Water utilities have the obligation to source, treat, pump, store and deliver

[2] 66 Pa.C.S. § 2204(a) (implementation of customer choice for retail customers of natural gas distribution companies ("NGDCs")) and § 2806(b) (implementation of customer choice for retail customers of electric distribution companies ("EDCs")).

water to customers. Thus, electric distribution companies, for example, no longer need to raise capital to build, maintain and replace electricity generating facilities, because electricity is furnished by non-utility generators,[3] water utilities must obtain sources of supply (frequently impounding reservoirs they construct), build large-scale treatment facilities (or, alternatively, develop well-water supplies that may need some level of treatment), and install pumping stations and storage tanks to move water to elevations where it is stored for distribution. In addition, water utilities must maintain an extensive network of distribution mains to deliver water to customers' homes and businesses.

Wastewater utilities have the obligation to collect, transport, and treat large quantities of effluent before it is discharged in an environmentally compliant manner that will not create risks to public health or safety. This process is the mirror image of water supply – effluent (which becomes the Company's possession at its wastewater mains) is collected through an extensive system of gravity or force mains and transported to a central treatment facility, where it is properly treated before it is discharged to the waters of the Commonwealth. And, in some instances, there is also a "storage" function, as large-volume equalization basins may be needed to store effluent during high-flow periods, such as wet-weather events.

The utility industry is a capital intensive industry. Capital intensity is the ratio of total assets divided by total sales revenues, and it measures how much investment in fixed assets is required during a given period to produce $1.00 of sales revenue. Compared with other utilities, water and wastewater utilities are the most capital intensive utility in the industry due, in part, to the long average lives of water and wastewater assets. Water and wastewater utilities require significant amounts of external capital to fund their capital investment needs. The reduction in

[3] EDCs furnish default service to non-shopping customers, but do so by contracting for default generation supplies on a "pass-through" basis, and, as such, they serve only as a conduit between suppliers and customers.

Federal corporate income tax rates made by the Tax Cuts and Jobs Act ("TCJA"), combined with the TCJA's elimination of "bonus" depreciation, will reduce deferred taxes, which are an important source of internally-generated funds for water and wastewater utilities. As a result, while customers benefit from lower rates for utility service because of lower Federal and state taxes, the TCJA's changes cause water and wastewater utilities to depend more heavily on external sources of capital to fund their investment in new and replacement plant and equipment.

Like the water and wastewater industries overall, the Company has had to invest large amounts of capital in new plant and equipment, the majority of which is used to fund source of supply, treatment and distribution and collection assets. Between the end of the Company's fully projected future test years ("FPFTY") in its 2013 (December 31, 2014) and 2017 (December 31, 2018) base rate cases, the Company will have invested over $1.26 billion in new plant and equipment. A significant part of that total investment is needed to improve service to small, troubled water and wastewater systems that PAWC acquired in furtherance of the Commission's and DER's policy to encourage larger, viable utilities to acquire and upgrade smaller, less viable and service-troubled systems. In addition, PAWC continues to invest in new and replacement plant in order to remain in compliance with existing drinking water and environmental regulations and to assure its future compliance with new and evolving regulatory standards.[4]

While PAWC has been making substantial investments in new and replacement plant, it has been experiencing, and will continue to experience, a well-documented multi-year trend of declining per-customer residential consumption.[5] PAWC has performed comprehensive analyses

[4] To cite just two important examples, during 2017 and 2018, the Company will have expended over $100 million in water treatment plant upgrades and water treatment facilities, and $52.6 million to rehabilitate impounding dams at its reservoirs to meet applicable safety standards for design-level floods.

[5] Metered water consumption is also the principal billing determinant for wastewater service. Consequently, declining residential usage also affects wastewater revenue between base rate cases.

of residential consumption that clearly demonstrate this trend. The analysis presented in the Company's 2017 base rate case established an on-going reduction in residential consumption of 920 gallons (2.14%) per year.[6] The primary forces driving this decline are water-efficient plumbing fixtures and water-efficient appliances, which are mandated by Federal law,[7] as well as increased emphasis on conservation and the environment, Company and government programs encouraging efficient water and energy use,[8] and changes in consumer behavior in response to price signals.

Although the Company has been successful in controlling its operating and maintenance ("O&M") expenses,[9] the factors discussed above – large and increasing investment in new plant and equipment and declining per-customer load – have a significant negative impact on earnings and on financial metrics that are important to investors on whom the Company relies for increasing amounts of external capital. These negative forces must be considered in setting the Company's rates.

Existing ratemaking methods, even with the use of FPFTYs (authorized in 2012) and the distribution system improvement charge ("DSIC") (which has been in effect since 1996 for water companies), do not fully offset the significant negative impact of the structural and systemic

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[6] This analysis was presented with, and is explained in, PAWC Statement No. 9 (the Direct Testimony of Gregory P. Roach) at Docket No. R-2017-2595853.

[7] Over time, as new residential housing is constructed and older homes remodeled or upgraded, more efficient plumbing fixtures are installed to meet Federal standards and local building codes. Additionally, older appliances are replaced by newer, more water-efficient appliances, while, at the same time, appliances continue to become more water and energy efficient. Thus, the trend of declining residential consumption is reasonably expected to continue for many years.

[8] For example, energy efficiency and conservation ("EE&C") plans mandated by Act 129 of 2008 for major EDCs and EE&C plans filed voluntarily by other energy utilities have the collateral effect of reducing water usage.

[9] To illustrate, the Company's claim for O&M expenses for water operations (excluding depreciation) in its 2017 base rate case was approximately $2.4 million *less* than the amount it requested four years earlier in its 2013 base rate case filed in April 2013, even though the Company expanded its water service footprint by acquiring a number of water systems during that interval.

forces that work in combination to continually erode water and wastewater utility earnings between base rates cases under the existing regulatory scheme. [10] However, as explained hereafter, there are alternative ratemaking methodologies that have now been authorized by Act 58 of 2018 ("Act 58") that can help to ameliorate the impact of those negative forces.

## III. ACT 58 AND THE PROPOSED POLICY STATEMENT

As previously explained, the Order was entered and the Proposed Policy Statement was formally issued on May 23, 2018. Approximately one month later, on June 28, 2018, Act 58 became law when it was signed by Governor Wolf. Act 58 amended the Pennsylvania Public Utility Code by adding Section 1330. Section 1330 begins with a "Declaration of Policy" that sets forth legislative findings and declarations that inform the meaning of its subsequent provisions, which, in relevant part, authorize the Commission to approve various forms of alternative rate mechanisms, including:

> (i) decoupling mechanisms;
> (ii) performance-based rates;
> (iii) formula rates;
> (iv) multiyear rate plans; or
> (v) rates based on a combination of more than one of the mechanisms in subparagraphs (i), (ii), (iii) and (iv) or other ratemaking mechanisms as provided under this chapter.[11]

[10] Notably, the DSIC, and the collection system improvement charge or "CSIC" for wastewater utilities, permit water and wastewater utilities to recover the fixed costs of only a portion of their investment, principally, plant that replaces or rehabilitates "distribution" or "collection" infrastructure. DISC/CSIC-eligibility does not even include all of the investments water and wastewater companies make in their distribution and collection assets and does not include any of their investments in some of the largest projects they undertake, such as those needed to meet water source of supply, treatment and storage requirements and wastewater treatment plants and associated facilities. Additionally, the DSIC and CSIC are subject to overall "caps" that can preclude recovery of the fixed costs of eligible investments made after the cap has been reached.

[11] 66 Pa.C.S. § 1330(b)(1).

Section 1330(b)(2) also authorizes the Commission to approve the use of "alternative ratemaking" mechanisms in conjunction with existing rate forms, such as Section 1307 automatic adjustment clauses.[12]

Act 58 differs from the Proposed Policy Statement in ways that have both legal and practical significance. At the most fundamental level, Act 58 is a duly enacted statute, has the force and effect of law and binds both the Commission and the entities that are subject to the PUC's jurisdiction. In contrast, the Proposed Policy Statement, upon final adoption, would be a "policy statement" that was issued without the formalities required by the Commonwealth Documents Law to promulgate a "regulation."[13] Consequently, the Proposed Policy Statement (even if adopted as "final") cannot establish a "binding norm."[14] Rather, like any statement of policy, it "announces the agency's tentative intentions for the future," and "[w]hen an agency applies the policy in a particular situation, it must be prepared to support the policy just as if the policy statement had never been issued."[15]

When the Proposed Policy Statement was issued, the Commission did not have the opportunity to consider either the General Assembly's Declaration of Policy in Act 58 or the express authorizations of alternative ratemaking methods that Section 1330 added to the Public Utility Code. As a consequence, there is now explicit legislative authorization for the Commission to approve a wide range of alternative ratemaking mechanisms, including those specifically identified in Sections 1330(b)(1)(i)-(iv), various combinations and permutations of those specifically-identified methodologies (as Sections 1330(b)(1)(v) and 1330(b)(2) authorize),

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[12] 66 Pa.C.S. § 1330(b)(2).

[13] 45 P.S. §§ 1201-1202.

[14] *Dep't of Envtl. Res. v. Rushton Mining Co.*, 591 A.2d 1168, 1173 (Pa. Cmwlth. 1991).

[15] *Id.*, quoting *Pac. Gas & Elec. Co. v. Fed. Power Comm'n*, 506 F.2d 33 (D.C. Cir. 1974).

and additional alternative rates and rate mechanisms "not limited to" those mentioned in Section 1330.[16]

Additionally, Act 58's explicit legislative "findings" and "declarations" differ in material respects from the statement of "purpose and scope" that appears in the Proposed Policy Statement. Of particular significance for water and wastewater utilities, given their need to continue to invest in plant and equipment for all the reasons previously discussed, Section 1330's Declaration of Policy affirms that it is the "policy of the Commonwealth that utility ratemaking should encourage and sustain investment . . . to enhance the safety, reliability or availability of utility infrastructure consistent with the efficient consumption of utility service." In contrast, the Proposed Policy Statement does not include such an affirmation and, in fact, offers at least one stated "purpose" that, absent further elucidation that is not provided elsewhere in the Proposed Policy Statement, could be considered inconsistent with Act 58's Declaration of Policy.[17]

It is not the purpose or intent of these Comments to identify all of the actual or potential differences between the Proposed Policy Statement and Act 58 or to discuss their materiality. Rather, the Company urges the Commission to proceed cautiously in deciding whether to issue a final Policy Statement at this docket given the fact that the Commission's initiative has now been overtaken by intervening events – namely, the enactment of Act 58 and the addition of Section 1330 to the Pennsylvania Public Utility Code.

[16] *See* 66 Pa.C.S. § 1330(b)(1) ("including, but not limited to, the following . . .").

[17] Proposed Section 69.3301 "invites" proposals in base rate cases of rate designs that, *inter alia*, "avoid future capital additions." Various inferences could be drawn from the stated "purpose," such as, that rate designs that help promote "efficiency programs" could conceivably reduce the need for certain kinds of "future capital additions." However, the full import of that stated "purpose" is not developed in any subsequent sections of the Proposed Policy Statement. Thus, on its face, this provision appears to be in tension with the legislative findings and declarations of Act 58.

Significantly, the Commission recognized the impact Act 58 has had on this docket by extending the comment period in this proceeding after Act 58 became law.[18] Moreover, as directed by Section 1330(d), the Commission has initiated a separate proceeding to develop "by regulation or order" the "specific procedures for the approval of an application to establish alternative rates." [19] In the Act 58 Tentative Implementation Order, the Commission stated that it intended to continue to investigate the "appropriateness" of the Proposed Policy Statement because the guidance that could be provided appears "to remain relevant to utilities and interested stakeholders in future Section 1308 base rate proceedings."[20] The Company submits that the possible guidance on alternative ratemaking methodologies the Commission may wish to explore at this docket should be carefully coordinated with the implementation procedures being developed in the proceeding initiated by the Act 58 Tentative Implementation Order. Any guidance that the Commission chooses to consider at this docket, whether articulated in a "final" Policy Statement or by other means, must be consistent with the legislatively-enacted terms of Act 58 and should not attempt to restrict the scope and flexibility that Act 58 grants to utilities to propose alternative ratemaking methodologies tailored to the specific needs and challenges faced by different segments of the utility industry and to different companies within those segments.

## IV. MATCHING ALTERNATIVE RATEMAKING METHODOLOGIES TO THE CHARACTERISTICS, NEEDS AND CHALLENGES OF WATER AND WASTEWATER COMPANIES

As previously explained, Act 58 was carefully crafted to maximize the breath of alternative methods of ratemaking that could be designed and proposed by utilities in order to

[18] *See* Secretarial Letter, *Alternative Ratemaking Methodologies*, Docket No. M-2015-2518883 (August 14, 2018) (extending comment period on the Proposed Policy Statement in light of Act 58).

[19] Tentative Implementation Order, *Implementation Act of 2018 Alternative Ratemaking for Utilities*, M-2018-3003269 (August 23, 2018) ("Act 58 Tentative Implementation Order").

[20] Tentative Implementation Order, p. 10 n.4.

afford them flexibility to match ratemaking methodologies to the characteristics of their service and to the needs and challenges they face. As discussed in Section II, *supra*, there are a number of factors that differentiate water and wastewater utilities from other forms of utility service.

Like the water and wastewater industries as a whole, the Company faces the dual challenges of having to sustain, and likely increase, current high levels of investment in new and replacement plant and equipment while facing an on-going, multi-year decline in residential consumption (and sales). Two of the alternative ratemaking methodologies specifically identified in Section 1330(b)(1) appear well-suited to addressing these conditions – multi-year rate plans and decoupling mechanisms.

Multi-year rate plans that are properly designed and implemented can help address the regulatory lag and attendant attrition that result from sustained and increasing levels of investment. Multi-year rate plans will also provide the Company longer and clearer lines of sight for obtaining rate base recognition of major projects, which will assist in short and long-term planning and provide greater flexibility in timing the construction of larger projects. More importantly, multi-year rate plans will allow the Company and the Commission to better match changes in rates to the actual and anticipated in-service dates of utility plant and will avoid the erosion of earnings (and attendant adverse impact on financial metrics actively monitored by prospective investors) that can occur under existing ratemaking approaches.

Revenue decoupling will help to address declining sales driven by declining residential consumption. While the projected declines can be calculated and reflected, to a certain extent, in test-year estimates under current ratemaking procedures, this approach does not address fully the declines that continue to occur over the entire period that base rates remain in effect. Moreover, revenue decoupling provides the opportunity to better match actual declines in consumption with the sales projections used to set rates. Additionally, because reduced consumption can allow the

Company to avoid certain short-term marginal costs (such as the production costs of water for water service), even with revenue decoupling, customers that reduce their consumption will see an absolute savings in their water bills. By the same token, factors that might cause breaks in the trend of declining consumption can, should they occur, be properly taken into account as well.

Appropriate, effective customer protections can be built into both multi-year rate plans and revenue decoupling. In fact, the use of multi-year rate plans is likely to provide a greater opportunity for statutory advocates and interested parties to review the Company's short and long-term capital planning. Revenue decoupling can be paired with features that can protect consumers and help stabilize rates. Of course, all of these factors would be carefully considered before the Company would propose an alternative rate methodology and would be fully reviewed in the context of the base rate proceeding in which approval is sought.

The two alternative ratemaking methodologies discussed above do not exhaust the possibilities that exist to address the challenges faced by water and wastewater utilities. Thus, the Company intends to carefully consider other methodologies that were discussed in the Order. These may include the introduction of demand charges for certain customer classes and stand-by charges for larger customers that experience periodic large peaks for which the Company must maintain adequate capacity on a 24-7-365 basis even though that capacity is only infrequently used by the customer (and, therefore, usage-based charges do not recover the costs the customer is actually imposing).

Moving forward, the Commission should assure that the facts and circumstances specific to the water and wastewater utility segment and, in particular, the needs and challenges unique to those utilities, are given careful consideration in developing procedures to implement all forms of alternative ratemaking methodologies.

## V. CONCLUSION

PAWC appreciates this opportunity to address the Commission regarding issues of importance to the continued provision of safe, reliable, high-quality and environmentally sustainable water and wastewater service. The Company respectfully requests that, as the Commission continues to investigate the design and implementation of alternative ratemaking methodologies at this docket and in the proceeding initiated by the Act 58 Tentative Implementation Order that it recognize, acknowledge and address the issues and concerns that are unique to the water and wastewater industries and, in particular, the operational, economic, service-related and public policy factors that differentiate water and wastewater service from other forms of utility service in this Commonwealth.

Respectfully submitted,

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