

Department of Legislative Services
 Maryland General Assembly
 2013 Session

FISCAL AND POLICY NOTE
Revised

House Bill 89

(Delegate Barkley, *et al.*)

Economic Matters

Finance

Gas Companies - Rate Regulation - Infrastructure Replacement Surcharge

This bill authorizes gas companies to file a plan with the Public Service Commission (PSC) requesting authorization to include a surcharge on customers' bills to recover specified costs associated with proposed eligible infrastructure replacement projects. The bill establishes a limit for the surcharge that may be imposed of \$2 per month for each residential gas customer. The surcharge for a nonresidential customer must not be less than the fixed annual surcharge applicable to a residential customer account, but also must be capped. PSC may approve a plan if certain conditions are met. The bill also specifies how a plan is accounted for in the event of a base rate case and how differences in the actual cost of a plan and the amount collected from the surcharge are handled.

The bill takes effect June 1, 2013.

Fiscal Summary

State Effect: Special fund expenditures from the Public Utility Regulation Fund increase by \$529,000 for consulting, litigation, staff, and review expenses in FY 2014. Future year expenditures reflect inflation, the removal of one-time start-up costs, and ongoing contractual services. Special fund revenues increase correspondingly from assessments imposed on public service companies. State expenditures (all funds) increase minimally beginning in FY 2014 as gas companies apply any approved surcharges to gas customers in their service territories and public service companies pass on the cost of assessments to all customer classes. Even though the bill takes effect June 1, 2013, it is assumed that State finances are not materially affected until FY 2014.

| (in dollars) | FY 2014 | FY 2015 | FY 2016 | FY 2017 | FY 2018 |
|----------------|-----------|-----------|-----------|-----------|-----------|
| SF Revenue | \$529,000 | \$224,700 | \$229,500 | \$234,600 | \$239,800 |
| SF Expenditure | \$529,000 | \$224,700 | \$229,500 | \$234,600 | \$239,800 |
| Net Effect | \$0 | \$0 | \$0 | \$0 | \$0 |

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Minimal increase in local government expenditures beginning in FY 2014, as gas companies apply any approved surcharges to gas customers in their service territories and public service companies pass on the cost of assessments to all customer classes.

Small Business Effect: Expenditures increase minimally beginning in FY 2014 as any surcharges and assessments are passed on to all customer classes.

Analysis

Bill Summary: It is the intent of the General Assembly that the purpose of the bill is to accelerate gas infrastructure improvements in the State by establishing a mechanism for gas companies to promptly recover reasonable and prudent costs of investments in eligible infrastructure replacement projects separate from base rate proceedings.

Infrastructure Replacement Surcharge

A gas company may file a plan and associated cost recovery schedule with PSC requesting authorization to include a surcharge on gas customers' bills to recover reasonable and prudent costs associated with proposed eligible infrastructure replacement projects. The estimated project costs approved in the surcharge are collectible during the same time the eligible infrastructure replacement is being made. The bill does not apply to gas cooperatives.

“Eligible infrastructure replacement” is defined as the replacement or improvement in the existing infrastructure of a gas company that is (1) made on or after June 1, 2013; (2) designed to improve public safety or infrastructure reliability; (3) does not increase the revenue of a gas company by connecting an improvement directly to new natural gas customers; (4) reduces or has the potential to reduce greenhouse gas emissions through a reduction in natural gas system leaks; and (5) is not included in the current rate base of the gas company as determined by the gas company's most recent base rate proceeding.

A plan for an eligible infrastructure replacement project must include (1) a timeline for completion of each eligible project; (2) the estimated cost of each project; (3) a description of customer benefits under the plan; and (4) any other information PSC considers necessary to evaluate the plan. The fixed annual surcharge may not exceed \$2 per month for each residential natural gas customer. The fixed annual surcharge for nonresidential customers may not be less than the fixed annual surcharge for residential customers, but also must be capped. To create a surcharge cap for all customer classes, costs must be allocated between residential and nonresidential customers consistent with

the proportions of total distribution revenues that those classes bear, as determined in the gas company's most recent base rate filing.

PSC may approve a plan if it finds that the investments and estimated costs of eligible infrastructure replacement projects are reasonable and prudent and designed to improve public safety or infrastructure reliability over the short and long term. PSC must approve the cost recovery schedule associated with a plan at the same time that it approves a plan. Costs recovered may relate only to the projects within the approved plan. The surcharge applies for five years from the date of initial implementation of an approved plan.

The bill specifies requirements for calculating the estimated cost of a project and requires a gas company to include (1) the pre-tax rate of return on the gas company's investment in the project; (2) depreciation associated with the project, based on new assets less retired plant; and (3) property taxes associated with the project, based on new assets less retired plant. The pre-tax rate of return must be calculated using the gas company's capital structure and weighted average cost of capital approved by PSC in the gas company's most recent base rate case.

PSC must take final action to approve or deny a plan within 180 days after a gas company files a plan. PSC may hold a public hearing before taking final action on the plan. If PSC does not take final action to approve or deny a plan within that time period, a gas company may implement the plan without PSC approval. If a plan is implemented without PSC approval, the gas company must refund to customers, with interest, any amount of the surcharge that PSC later determines is not reasonable or prudent. PSC must take final action to approve or deny an amendment to an approved plan within 120 days after an amendment is filed.

Unless a plan is filed in conjunction with a base rate case, PSC may not consider any unrelated revenue requirement or ratemaking issue when reviewing a plan for approval or denial. Any adjustments for return on equity based on an approved plan must only be considered and determined in a subsequently filed base rate case.

Continuous Oversight

A gas company must file a reconciliation to an approved plan with PSC each year to adjust the amount of the surcharge in order to account for any difference between the actual cost of a plan and the actual amount recovered under the surcharge. A gas company must provide a refund on customers' bills, including interest, if the actual cost of a plan is less than the amount collected under the surcharge. If the actual cost of a plan is more than the amount collected under the surcharge, and PSC determines that the higher costs were reasonably and prudently incurred, PSC must authorize the gas

company to increase the surcharge to recover the difference, subject to the limits specified in the bill.

PSC may review a previously approved plan, and if it determines that an investment or cost of a project no longer meets the requirements of initial approval, it may reduce future base rates or surcharges or alter or rescind approval of that part of the plan.

Base Rate Proceeding Changes

In a base rate proceeding subsequent to the approval of a plan, PSC must take into account any benefits realized by the gas company as a result of an approved surcharge. Within five years of the initial implementation of an approved plan, the gas company must file a base rate case application. If a plan approved by PSC is still in effect at the time of the base rate case, any eligible infrastructure costs included in new base rates must be removed from the surcharge; however, the surcharge mechanism must continue for eligible future infrastructure project costs that are not included in the base rate case.

If PSC establishes new base rates for a gas company that includes costs on which a surcharge is based, the gas company must file a revised rate schedule with PSC that subtracts those costs from the surcharge.

Current Law: PSC regulates gas distribution companies, including monitoring retail competition and customer choice, to ensure that safe, reliable, and affordable gas service is provided. Rates charged by a gas distribution company are specified in the company's tariff and are approved through an order made by PSC. Through the ratemaking process, a gas distribution company is allowed to charge just and reasonable rates for the regulated services it renders. If a gas distribution company incurs a cost to upgrade natural gas infrastructure and the company seeks to recover those costs, it is done through a base rate proceeding.

The regulation of pipeline safety occurs at both the federal and state levels. PSC regulates intrastate pipeline safety. PSC may enter and inspect, at reasonable times and in a reasonable manner, the pipeline facilities and the pipeline procedures of those involved with them and books, records, papers, and other documents relevant to determining compliance with regulations. Whenever the commission finds a particular facility to be hazardous to life or property, it is empowered to require the person operating such facility to take those steps necessary to remove such hazards.

Background:

Cost Recovery Surcharges – Maryland

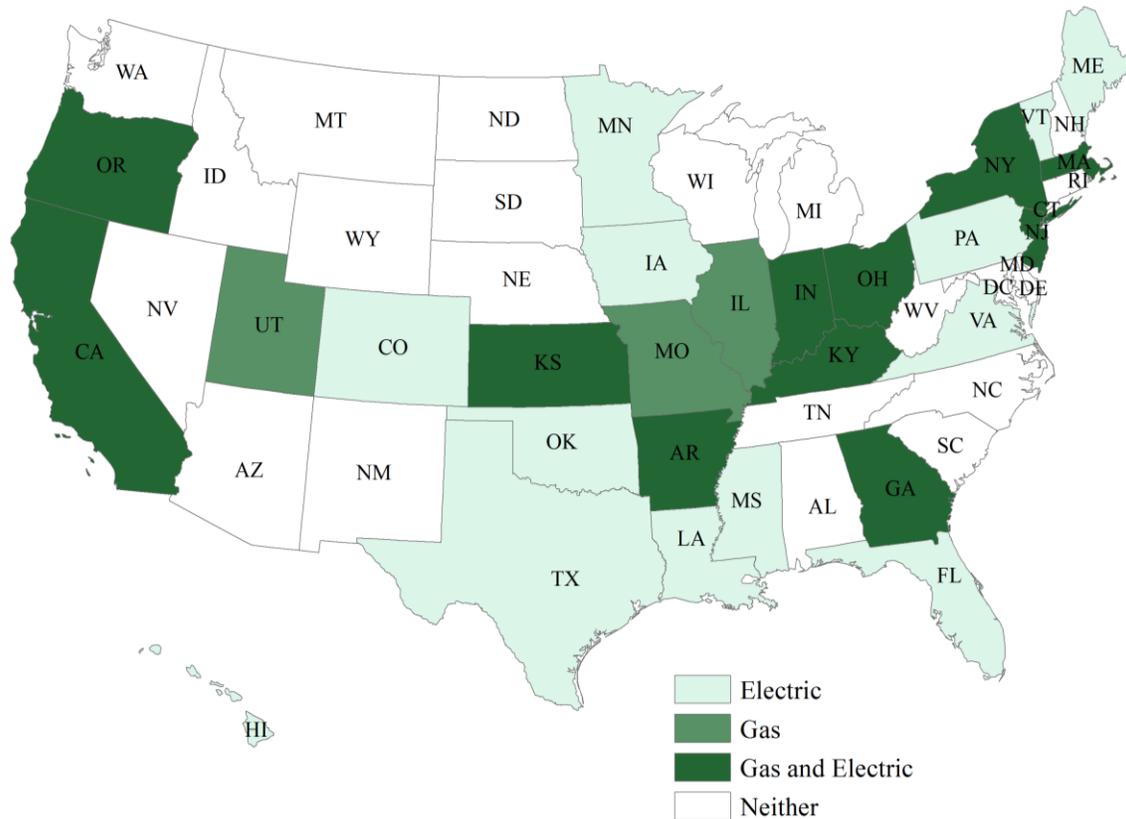
Since 2009, PSC has declined to authorize at least five requests for surcharge mechanisms (or “trackers”) by public service companies. In 2012, PSC denied requests for surcharges for electric distribution infrastructure investments by Potomac Electric Power Company (Pepco) and Delmarva (Case Nos. 9285 and 9286). The surcharges, known as Reliability Investment Mechanisms, would have accelerated the recovery of costs associated with certain reliability capital expenditures. In 2011, PSC denied Washington Gas Light Company’s (WGL) request for a surcharge associated with an accelerated pipeline replacement plan (Case No. 9267), as discussed below. Further, PSC denied Baltimore Gas and Electric’s (BGE) request for accelerated cost recovery of expenses related to smart meters (Case No. 9208) in 2010 and Delmarva’s request for surcharge recovery outside of rates for pension and other employment costs (Case No. 9192) in 2009.

In Case No. 9267, WGL requested that PSC approve, in addition to a rate increase, an accelerated pipe replacement plan. WGL planned to spend \$115 million over five years to replace piping infrastructure and sought to recover the costs through a customer surcharge. In a November 2011 decision, PSC authorized WGL to accelerate its plan – but declined to authorize the associated surcharge – citing that a surcharge would represent a fundamental shift from traditional ratemaking principles. PSC found that WGL has historically demonstrated the ability to replace its infrastructure when necessary to ensure safety and reliability, and that it can do so using traditional ratemaking procedures without compromising its ability to earn an appropriate return. WGL witnesses confirmed in the proceeding that WGL had the operational and financial ability to accelerate its pipe replacement plan.

Cost Recovery Surcharges – Nationally

In contrast to PSC’s recent decisions, many other states have adopted surcharge mechanisms similar to those authorized in the bill. According to a 2012 report by the American Gas Association, as of March 2012, 19 states had full (as opposed to partial) infrastructure cost recovery mechanisms for gas companies. Similar surcharge mechanisms have also been authorized for electric companies. A 2011 report by the Edison Electric Institute reports capital expenditure surcharge mechanisms for both electric and gas companies. As shown below in **Exhibit 1**, the report indicates that, as of April 2011, 13 states had electric-only mechanisms, 3 states had gas-only mechanisms, and 11 states had both gas and electric mechanisms. The report indicates that gas trackers often focus on the cost of replacing old cast iron and bare steel mains, consistent with the stated purpose of the bill.

Exhibit 1
Recent Capital Expenditure Surcharge Precedents by State
April 2011



Source: Edison Electric Institute: *Innovation Regulation: A Survey of Remedies for Regulatory Lag*

Natural Gas – Regulation, Pipeline System Incidents

The U.S. Department of Transportation, Office of Pipeline Safety (OPS) is the federal safety authority for ensuring the safe, reliable, and environmentally sound operation of the nation’s pipeline transportation system. Natural gas pipelines in Maryland may include large-diameter lines carrying natural gas to population centers, as well as small-diameter lines that may deliver natural gas to businesses and households. According to OPS, pipelines are by far the safest method for transporting energy products. However, when pipeline incidents occur they can present significant risks to the public and the environment. According to the U.S. Department of Transportation’s Pipeline and Hazardous Materials Safety Administration, there were 30 “significant incidents” in Maryland from 2002 through 2011, totaling \$12 million in property damage and causing one fatality and 16 injuries.

State Fiscal Effect: Gas companies typically file for rate review every few years. This bill allows a gas company to seek cost reimbursement at any period, and requires PSC to review each proposal. As a result, the number of filings by gas companies that need to be evaluated and approved by PSC increases.

Special fund expenditures from the Public Utilities Regulation Fund increase by \$529,009 in fiscal 2014, which accounts for a 30-day start-up delay. This estimate reflects the cost of hiring one half-time accountant and one half-time engineer at PSC to review and verify applications, calculate surcharges, and verify that infrastructure investments meet legislative criteria. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses. Additional costs are incurred by the Office of People’s Counsel (OPC) for consulting and litigation expenses for additional surcharge cases brought before PSC.

| | |
|--|------------------|
| Half-time Positions | 2 |
| Salaries and Fringe Benefits | \$67,356 |
| Initial Case Litigations | 300,000 |
| Annual Case Reviews | 150,000 |
| Other Operating Expenses | <u>11,653</u> |
| Total FY 2014 Administrative Expenditures | \$529,009 |

Future year expenditures reflect half-time salaries with annual increases and employee turnover, the elimination of start-up costs, and annual increases in ongoing operating expenses. Future year expenditures also include \$150,000 annually for OPC to contract with expert witnesses. Litigation and case review expenses assume three gas companies file with PSC for the surcharge in fiscal 2014. Estimates do not assume any change in the expected frequency of base rate cases filed with PSC.

The Department of Legislative Services (DLS) notes that this estimate includes costs for one public hearing, which PSC may schedule under the bill. In addition, OPC advises that the additional caseload anticipated from the bill, if it were coupled with only a slight increase in other cases, might require the office to request an additional assistant people’s counsel; any such costs are not included in the above estimate.

Special fund revenues increase correspondingly from assessments imposed on public service companies to recoup costs incurred by PSC and OPC as authorized under current law. State expenditures (all funds) increase minimally beginning in fiscal 2014 as gas companies apply any approved surcharges to gas customers and public service companies pass on the cost of assessments to all customer classes.

Additional Comments: DLS advises that the overall effect of the bill on ratepayers is unclear. As discussed above, PSC has consistently declined to authorize similar

surcharge mechanisms requested by public service companies in recent rate cases. Further, PSC has indicated in its testimony on similar bills (SB 332 of 2011 and SB 541/HB 662 of 2012) that currently, ratepayers finance infrastructure projects through traditional ratemaking, based on work performed (and costs incurred), and that a surcharge as defined in the bill would be based on projected costs. This shifts financial risk from the gas or electric companies to the ratepayers and decreases cost-containment incentives.

To elaborate, the recovery of costs through a surcharge happens earlier than if costs were recovered in base rates (concurrent with expenditures rather than after project completion and determined in a base rate case). Thus, there is a mismatch between the recovery of the infrastructure costs and the benefits from the infrastructure investment. As a result, it could be said that the risk of recovery for the company is reduced – *i.e.* shifted to ratepayers by virtue of the fact that ratepayers pay for the costs earlier.

DLS notes that, following implementation of a surcharge, it is also possible – but not guaranteed – that customers may benefit from reduced financing costs which would otherwise be passed on to ratepayers in a rate case. However, any potential change in financing costs should be considered in conjunction with the potential change in project costs (which may be higher but still considered prudent by PSC) under an accelerated plan rather than with traditional investment and cost recovery.

Further, the bill requires PSC to take into account any benefits a gas company realizes from the surcharge in a base rate proceeding following approval of the surcharge – but a rate case may be up to five years after initial implementation of the surcharge. Customers may also benefit from any incremental improvements in gas service reliability.

Surcharge Revenues

Statewide, the surcharge has the potential to generate a maximum of approximately \$36 million annually if the maximum surcharge is assessed on all existing gas customers. However, DLS notes that the surcharge could be phased in over multiple years. The bill requires that, to create a surcharge cap for all customer classes, surcharges be allocated between residential and nonresidential customers consistent with proportions as determined in the company's last rate case. The residential/nonresidential split is approximately 70/30 and 66/34 for BGE and WGL, respectively.

The combined residential gas customer base of the State's two largest gas companies – BGE and WGL – was 1.02 million in September 2012 (610,000 for BGE and 413,000 for WGL). Accordingly, a maximum monthly surcharge of \$2 per residential customer generates \$24.6 million annually from residential accounts (\$14.7 million for BGE and \$9.9 million for WGL).

Assuming that the nonresidential customer cap is set so that residential revenues reflect the proportion of total revenues as required by the bill (*i.e.*, 70% for BGE and 66% for WGL), the surcharge generates a maximum of \$36 million annually. Thus, revenue from nonresidential customers is \$11.4 million (\$6.3 million for BGE and \$5.1 million for WGL). Additional surcharges levied by other, smaller, gas companies increase the statewide total.

Additional Information

Prior Introductions: A similar bill, SB 541 of 2012, received a favorable with amendments report from the Senate Finance Committee but failed on second reading in the Senate. Its cross file, HB 662 of 2012, passed the House with amendments but received an unfavorable report from the Senate Finance Committee. A similar bill, SB 332 of 2011, and its cross file, HB 856, were heard by the Senate Finance Committee and the House Economic Matters Committee, respectively, but subsequently withdrawn.

Cross File: SB 8 (Senators Astle and Middleton) - Finance.

Information Source(s): Public Service Commission, Office of People's Counsel, U.S. Department of Transportation, Edison Electric Institute, American Gas Association, Department of Legislative Services

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