nationalgrid

Jennifer Brooks Hutchinson
Senior Counsel

May 3, 2019

VIA HAND DELIVERY & ELECTRONIC MAIL

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

RE: Docket 4857 - Adoption of Performance Incentives Pursuant to R.I. Gen. Laws § 39-1-27.7.1(e)(3)
Joint Rebuttal Testimony

Dear Ms. Massaro:

On behalf of National Grid,[1] I have enclosed ten (10) copies of the Company's joint rebuttal testimony of Timothy R. Roughan and Patricia C. Easterly in response to the pre-filed direct testimony of the Rhode Island Division Public Utilities and Carriers on April 10, 2019 in the above-referenced docket.

Thank you for your attention to this transmittal. If you have any questions, please contact me at 401-784-7288.

Very truly yours,

Jennifer Brooks Hutchinson

Enclosures

cc: Docket 4857 Service List
Jonathan Schrag, Division
John Bell, Division
Leo Wold, Esq.
Christy Hetherington, Esq.

[1] The Narragansett Electric Company d/b/a National Grid (National Grid or the Company).

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Certificate of Service

I hereby certify that a copy of the cover letter and any materials accompanying this certificate was electronically transmitted to the individuals listed below.

The paper copies of this filing are being hand delivered to the Rhode Island Public Utilities Commission and to the Rhode Island Division of Public Utilities and Carriers.

Joanne M. Scanlon

May 3, 2019
Date

Docket No. 4915 - National Grid's Electric ISR Plan FY 2020
Docket No. 4857 - Performance Incentives Pursuant to R.I.GL. §39-1 27.7.1(e)(3)

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JOINT REBUTTAL TESTIMONY

OF

TIMOTHY R. ROUGHAN

AND

PATRICIA C. EASTERLY

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I. Introduction

Q. Mr. Roughan, please state your name and business address.

A. My name is Timothy R. Roughan. My business address is 40 Sylvan Road, Waltham, Massachusetts 02451.

Q. By whom are you employed and in what capacity?

A. I am employed by National Grid USA Service Company, Inc. as the Director of Retail Regulatory Strategy. My responsibilities include providing regulatory and policy direction on issues relative to distributed generation and grid modernization activities. I have worked on policies regarding net metering, non-wires alternatives (NWAs), and the infrastructure, safety, and reliability (ISR) plan.

Q. Please describe your educational background and professional experience.

A. I am a 1982 graduate of Worcester Polytechnic Institute with a Bachelor of Science in Mechanical Engineering and have worked for the Service Company or its predecessors for 37 years in multiple roles.

Q. Have you previously testified before the PUC or any other regulatory commissions?

A. Yes, I have testified before the PUC in many dockets; most recently in Docket 4563 (the revenue neutral rate case from 2015), Docket Nos. 4770 and 4780 (the general rate case and Power Sector Transformation proposal), and System Reliability and Procurement Plan. I have also participated in the stakeholder process before the PUC in connection with the Changing Distribution System, Docket No. 4600, and the Power Sector Transformation initiative that the Rhode Island Division of Public Utilities and Carriers initiated.

Q. Ms. Easterly, please state your name and business address.

A. My name is Patricia C. Easterly. My business address is 40 Sylvan Road, Waltham, MA 02451.

Q. By whom are you employed and in what position?

A. I am employed by National Grid USA Service Company, Inc. (NGSC) as the Director for New England Electric Business Unit (EBU) Planning and Performance Reporting. My responsibilities include overseeing the planning and overall performance reporting for the New England EBU. In this capacity I oversee the processes for the current year capital plan to ensure that it meets the company and regulatory objectives.

Q. Please describe your educational background and professional experience.

A. In 1983, I earned a Bachelor of Arts degree in Finance from Simmons College. In October 1983, I joined Peat, Marwick, and Mitchell in St. Louis, Missouri as a staff auditor, progressing to senior auditor and becoming a Certified Public Accountant in the State of Missouri. In November 1987, I joined Edison Brothers Stores in St. Louis as Assistant Controller. In June 1988, I joined NGSC as a financial analyst in the Accounting division. Since that time, I have held various positions within National Grid including Manager of Accounting, Director of Internal Audit, Transmission Finance Director, Distribution Finance Director, and Director Rhode Island – New Energy Solutions Planning, Budget and Performance, and Director for Finance Performance Management program. In September of 2018, I assumed my current position as Director – New England Electric Performance and Planning.

Q. Have you previously testified before the Rhode Island Public Utilities Commission (PUC)?

A. Yes. I have previously testified before the PUC in support of the Company's Rhode Island affiliate's Storm Contingency Fund and the Fiscal Year (FY) 2020 Electric Infrastructure, Safety and Reliability Plan in Docket No. 4915.

Q. On whose behalf are you submitting this joint rebuttal testimony?

A. We are submitting this joint rebuttal testimony on behalf of the Company.

II. Purpose and Structure of Rebuttal Testimony

Q. What is the purpose of your joint rebuttal testimony?

A. Our rebuttal testimony responds to the direct testimony of Jonathan Schrag, Deputy Administrator, Rhode Island Division of Public Utilities and Carriers (Division) and the direct testimony of the Division's consultant, Gregory L. Booth of PowerServices, Inc., who each testified on behalf of the Division regarding the Division's proposed Capital Efficiency Mechanism.

Q. How is your testimony structured?

A. Section I is the Introduction. Section II presents the Purpose and Structure of our rebuttal testimony. Section III provides the Company's overall comments with respect to a Capital Efficiency Mechanism. Section IV provides the Company's response to the Division's proposed Capital Efficiency Mechanism. Section V provides the Company's counterproposal for a Capital Efficiency Mechanism. Section VI is the Conclusion to our testimony.

III. Overall Comments

Q. Before responding to specific components of the Division's proposed Capital Efficiency Mechanism provided by Mr. Schrag in his direct testimony, are there any overall comments you wish to make regarding the Division's proposed Capital Efficiency Mechanism?

A. Yes, we do. First and foremost, the Company supports an efficiency mechanism that optimizes risk and spending for the benefit of customers. To accomplish that goal, we believe a method that encompasses a full scope of efficiency opportunity should be developed. The Division's proposal focuses on actual costs as compared with estimated costs submitted prior to the commencement of construction, which only captures execution savings and a small part of the overall planning lifecycle. Such a mechanism is too narrow. Rather, it is more appropriate and beneficial to customers to develop a framework for a Capital Efficiency Mechanism that captures efficiencies over the full life cycle of a project, rather than at the execution phase only. Such framework should encourage prudent risk taking to drive down costs.

Recognizing, however, the time it may take to develop such a framework and the Division's proposal to implement an efficiency mechanism in the near term, the Company proposes a two-step approach. The first step is to agree to an appropriate execution stage measure that would be temporary, and the second step would be to agree on a longer-term method.

Q. Please elaborate on why the Division's proposal does not ensure efficiency.

A. Centering an efficiency measure on project cost estimates without effective output measures does not ensure efficiency. A longer-term plan should incorporate output measures that allow for adjustments where inputs change (e.g. major new customer requests, such as distribution generation interconnections, or other changes in circumstances or project scope beyond the Company's reasonable control and that could not have been anticipated when the baseline was set). For example, an output measure could be aligned to a specific need that a project is designed to meet with the output being how the Company will meet that need as it progresses through the planning cycle. Finally, a mechanism measured on a project basis, rather than on a portfolio basis, dis-incentivizes innovation and reduces potential savings since a more diverse portfolio provides room to take some risks to drive efficiency; hence, evaluation should be on a total portfolio level that encompasses multiple projects.

Q. What is the Company's long-term vision for a Capital Efficiency Mechanism?

A. The Company proposes to develop a Capital Efficiency Mechanism that aligns with a longer-term vision of efficiency and to build a process that supports that vision as part of the fiscal year (FY) 2023 Infrastructure, Safety and Reliability (ISR) Plan. The framework for such process would include:

- The Capital Efficiency Mechanism would be a separate process from the ISR, but coordinated with the ISR;
- The Capital Efficiency Mechanism would be based on actual costs measured against clear outputs as compared with a baseline;
- Area Study project recommendations would be used as a baseline, subject to certain allowed adjustments (to be determined);
- Actual performance of closed projects would be compared to the Area Studies on a portfolio basis for all closed projects in a year;
- The Capital Efficiency Mechanism would be measured on a portfolio basis, and not on a project by project basis;
- A review process would be developed early in the project life cycle (e.g. as part of the Area Studies) that would leverage opportunities to create efficiencies, allow time to develop innovation where applicable, and avoid later project delays; and
- Bandwidths would be developed to associate with the level of risk assumed in the portfolio (i.e., a more diverse portfolio, less risk and smaller bandwidth; low diverse portfolio, more risk and, therefore, higher bandwidth).

The Company proposes a period of discussion and analysis with the Division to more formally agree on the components and methods for a long-term measure.

In the interim, the Company also recognizes the Division's concerns with achieving efficient execution of capital investment programs in the context of the annual reconciling mechanism of the ISR. The Company is, therefore, amenable, on a temporary basis, to an efficiency mechanism similar to what the Division has proposed, with some critical modifications; however, such a temporary efficiency mechanism is contingent upon the Company and the Division working together to develop a longer-term efficiency mechanism to be implemented as part of the FY 2023 ISR. The Company's counterproposal for this short-term approach is presented in Section V of this testimony.

Q. How does this approach compare with the original Capital Efficiency Mechanism that the Company proposed in the Settlement Agreement filed with the PUC on June 6, 2018 in Docket Nos. 4770 and 4780 (the Settlement Agreement)?

A. The Settlement Agreement established a formula for determining the baseline in the Capital Efficiency Mechanism based on a three-year aggregate spending target, and at that time the Company anticipated that it would work with the Division to determine the appropriate spending targets through the annual ISR Plan process. As Mr. Schrag indicates in his direct testimony, the Settlement Agreement was approved without a Capital Efficiency Mechanism. Since that time, the Company has also given more consideration to the method proposed in the Settlement Agreement and believes there is a better way to drive efficiencies for customers and the Company.

IV. Response to Division's Direct Testimony

Q. Please summarize the Division's proposal for a Capital Efficiency Mechanism.

A. The Division has proposed a mechanism that will apply to discretionary projects only that emanate from Area Studies and exceed $500,000 (individually or as a group) (*See* Booth testimony at 14). The Division's proposed baseline for measuring performance is the project grade estimate (*See* Schrag testimony at 3). The mechanism will apply once a project is placed in service and eligible to be put into rate base. For multi-year projects, the mechanism will apply after project completion and will take into account the total spend across all years as compared to the baseline budget, and will not be an annual assessment. (*See* Booth testimony at 15). The Division has proposed a +/- 1 percent (%) bandwidth around the project grade cost. They propose a financial penalty equal to 20 percent (%) of the net present value of the revenue requirement on the difference between the project grade estimate and the final cost in excess of the +/- 1 percent (%) bandwidth, calculated over the projected depreciated life of the asset. The Division proposes an incentive equal to only 10% of the net present value of the revenue requirement on the difference between the project grade estimate and the final cost that is less than the +/- 1 percent (%) bandwidth (*See* Schrag testimony at 3-4). Under the Division's proposal, the incentive/penalty will be determined in the ISR process in the year following the date the project goes into service. Annual ISR budgets will not be a relevant baseline. Instead, the Company will be required to file a separate compliance filing listing all projects that have come into service in the prior calendar year and compare them to the previously established project grade estimates. (*See* Schrag testimony at 4). The Division proposes that the Company be required to file a project grade estimate prior to commencement of construction. If the Division disagrees with that estimate, they can dispute it and the PUC will make the final determination. (*See* Schrag testimony at 4-5). The Division's proposal also provides for a penalty/reward exogenous event exemption, granting both the Company and Division the right to seek such exemption if either believes that the final cost was materially affected by events beyond the control of the Company. (*See* Schrag testimony at 5). The Division proposes that Mr. Booth develop cost benchmarks from publicly available data, or data available from his experience with utilities in a similar geographic region. This collective data will be used to verify the baseline budget used in the mechanism. (*See* Booth testimony at 15-16)

Q. Does the Company agree with the Division's proposal?

A. Not in its entirety. Beyond the Company's view that assessing efficiency at the execution stage is not the right method, the Company disagrees with the following aspects of the Division's proposal: (1) use of project grade estimates as the baseline for measuring performance; (2) lack of the definition of how a project would be implemented; (3) lack of a cap and collar; (4) the low proposed bandwidth of +/- 1 percent (1%); (5) the asymmetrical incentive/penalty structure; (6) the filing of project grade estimates, which are subject to Division review and PUC adjudication/determination; (7) the provision for "other changes"; and (8) the proposed benchmark cost methods.

Q. How do you respond to the Division's proposal to use project grade estimates as the baseline for measuring performance under a Capital Efficiency Mechanism?

A. As discussed in Section III, the Company believes a more appropriate and meaningful approach is to align an incentive mechanism around longer-term efficiencies that can be achieved over the life cycle of the project. The Division's proposal is centered upon project cost estimates and execution savings, and, therefore, only captures a small portion of the overall potential efficiencies. The Capital Efficiency Mechanism proposed in the Settlement Agreement was a portfolio measure (i.e., measured the delivery of the full portfolio of projects, rather than measured the delivery on a project by project basis). The Company continues to believe that a portfolio approach is superior to a project-by-project incentive because it allows for more opportunity for innovation and efficiency across the portfolio, rather than limiting it to individual projects. Therefore, the Company would continue to propose a portfolio-based measure for this item.

In addition, using the project grade estimates as the baseline will require the addition of another step in the estimating process to ensure the accuracy of the baseline if it becomes the basis for earning incentives or incurring penalties, which may increase costs for the

Company to administer. The Company also would require clarification for how project cost estimate baselines would be determined for projects already underway. For these reasons, the Company is amenable to using project grade estimates on a temporary basis only, subject to further collaboration with the Division on the development of a more appropriate baseline as part of a longer-term approach.

Q. Please explain the Company's current project approval process?

A. The Company obtains project approvals in accordance with its internal Delegation of Authority (DOA) governance policy. The DOA policy requires an appropriate level of management authorization prior to the start of any work, including engineering and construction. Projects under $1 million are authorized electronically where the project sponsor provides information on the cost and justification for the project. Projects over $1.0 million require the submission of a sanction paper that provides additional details, including project background, drivers, business issues, alternatives, cost analysis, schedule and implementation plan. It is important to note that while some sanction papers are for only one project, many sanction papers are for multiple projects. The governance process for project cost variances are done at the total paper level, not at the individual project level. A partial sanction paper may be submitted when full authorization cannot be requested due to the lack of a full scope or final cost, but approval must be obtained to progress funding for the project. In this case the partial paper will include a request for a spending authorization along with an estimate of total project costs.

Once a major project advances, it is subject to reauthorization if the Company expects project costs to exceed the upper limit of the approved amount. Lastly, when a major project is completed, the project manager is responsible for preparing closure papers which include information on a number of factors, such as a final cost, a discussion of whether project deliverables were achieved, and lessons learned as a result of project implementation.

Q. Please describe the project estimating process and how it interrelates with the approval process?

A. As part of its continuous improvement efforts, the Company launched a new Complex Capital Delivery process in April of 2018 for projects that are categorized as complex. The Complex Capital Delivery process was implemented with goals that include:

- Efficient progress supported by a Stage/Gate delivery model and reporting;
- Smooth achievement of necessary sanctions;
- Early agreement on scope, baseline schedule, and baseline cost;
- Accurate identification of risks and estimation of costs;

- Effective decision-making and analysis, reducing or eliminating need to revisit decisions, and;

- Efficient assumption of project responsibilities by downstream project leader.

In the Complex Capital Delivery process, the general levels of cost estimates include long-term investment/budget planning (process step 4.1), option comparison and selection (process step 4.2), project authorization or sanction (process step 4.3), and when required due to changes during final design or procurement events (process step 4.4). Each project transitions through these gated steps as engineering and design are refined. Estimates generated during the project sanction step (4.3) will usually be prepared by a dedicated estimating group. The estimator will develop the estimate based on project costs to date and expected values for labor, materials, overheads, risks, and other costs to complete the project based on project team input.

While project estimates are used in the sanction paper, the tolerances established for appropriate cost governance are not necessarily the same as the estimate accuracy. The sanctioning procedure requires the permissible upper and lower limit of variation in expected project spending to be expressed in percent. It further specifies that the tolerance for the request for money should always be +/- 10 percent (%) unless it can be justified otherwise by the author.

If the paper is a partial sanction, the total funding project cost should be included with a tolerance in line with the estimate accuracy at that stage. Full sanction tolerances should always be requested at +/-10 percent (%) unless it can be justified otherwise by the author.

Q. How do you respond to the Division's scope of projects to which the Capital Efficiency Mechanism will apply?

A. The Division has defined the scope of the Capital Efficiency Mechanism as discretionary projects only, which emanate from Area Studies and exceed $500,000 (individually or as a group). More definition is needed around what is meant by "individually or as a group" and how that would work to define the proposed scope of the Capital Efficiency Mechanism.

In addition, on page 9 of his testimony, Mr. Booth refers to a budget of $33 million for major discretionary projects compelled by Area Studies. This amount refers to the total portfolio of discretionary projects. Major projects emanating from Area Studies comprise a smaller subset of the total discretionary portfolio budget.

Q. Please explain what you mean by a cap and collar?

A. The Settlement Agreement provided for a cap on the reward or penalty that could be earned by or charged to the Company. Since neither the Company nor the PUC has had experience with implementing a capital efficiency mechanism, such as the one proposed here, it would be prudent for both customers and the Company to put limits on the amount of incentives and penalties that can be earned or charged until the Company, the Division, and the PUC gain more experience with the methods used under an efficiency mechanism so as to avoid unintended consequences.

Q. Please explain why you disagree with a proposed bandwidth of +/- 1%.

A. The Division's proposed bandwidth of +/- 1 percent (%) of a cost estimate is too low and effectively stifles innovation since such a low bandwidth encourages risk avoidance. It will lead to avoiding projects that may be lower cost but have a greater cost uncertainty. In addition, other considerations include the level of estimation accuracy implied in the Company's governance process, the level of estimation accuracy expected in the project grade estimates, the impact of any changes to Company processes that would be required, and an assessment of the inherent risk in the capital portfolio being assessed for efficiency. Using complex projects as an example (i.e. most of the projects coming out of Area Studies), the Company's current estimating process builds in a risk scenario of up to 50 percent (%) probability of the likelihood of such risks occurring, but does not cover 100 percent (%) of all risks. As many projects take time to construct, costs, such as material, labor, and permitting, can change over time from the planning stage to execution. In addition, as discussed earlier in the testimony, the Company's internal governance process recognizes spending variances within a +/- 10 percent (%) threshold for project grade estimates. This means there are still known risks within that 10 percent (%) threshold that are not priced into the cost estimates, and, therefore, warrant a bandwidth larger than 1 percent (%).

Q. Please explain why you disagree with the Division's proposed incentive/penalty structure.

A. The Division's proposed financial penalty for exceeding the bandwidth is 20 percent (%) of the net present value of the revenue requirement for the overspend calculated over the projected depreciated life of the asset, whereas the proposed incentive is only 10 percent (%) of the net present value of the revenue requirement for the savings. In addition, under the Division's proposal, the penalty is credited to customers in a single year, whereas the utility collects the incentive over three years. At a minimum, incentives and penalties should be symmetrical. The asymmetric structure proposed by the Division suggests that dollars spent above the cost estimate are more valuable to customers than dollars saved below the cost estimate. There is no reason to believe that a dollar of savings has less of an impact on customers than a dollar spent above budget, and the Division has offered no such rationale. Performance incentive mechanisms should be viewed as a tool to encourage utility innovation that would not otherwise be rewarded under standard cost of service principles. To create the benefits of innovation, an incentive mechanism needs to encourage, not penalize, prudent risk-taking and meaningfully reward the utility for superior performance. In fact an incentive that appropriately rewards savings is likely to foster innovation that results in future savings, providing further value to customers going forward.

Q. How does the Company respond to the Division's proposal for the Company to file a project grade estimate prior to commencement of construction and if the Division disagrees with such estimate, the PUC will make the final determination of the project grade estimate?

A. The requirement to file project grade estimates prior to commencement of construction, which would then be subject to a dispute resolution process at the PUC, is unduly burdensome for the Company, in that it would require the Company to make changes to its current estimation and sanctioning processes. The Company has not been able to assess the impact of this requirement and whether it will lead to inefficiencies, and if so, how that would impact the selection of an appropriate bandwidth. At a minimum, this process is likely to result in project delays. Rather, the Company would prefer to develop an approach that builds in a review process earlier in the project life cycle that would avoid later project delays.

Q. Please explain what you mean by a provision for other changes?

A. The Division proposes an "exogenous event" only exemption for cost impacts due to events beyond the Company's control. There is no other provision for appropriate scope changes. While the Company's processes are intended to capture scope requirements early in the project lifecycle, there could still nonetheless be appropriate scope changes that occur after the project grade estimate stage. Without a process to accommodate legitimate changes, the Company could be penalized for a modification to a project (and the resulting project costs) that is prudent and in the best interest of customers.

Q. How do you respond to the Division's proposal for developing benchmark costs?

A. The testimony of Mr. Booth on pages 15-16 refers to him developing benchmark cost data that will be used to compare to the Company's baseline budget. There is no reference to how this benchmark data will be developed and whether the Company will play a role in the development of those benchmark costs. The Company believes for a benchmark to be successful, it should be clear, simple, easily understood by all parties, and clearly consistent with the methodology with which the benchmark is used. Without having a collaborative process around the establishment of such benchmarks, it may lead to inefficiencies in the process if benchmarks are used, absent a clear understanding and agreement.

Q. Are there aspects of the Division's proposal with which the Company does agree?

A. The Division states that their proposal presents a first step towards a Capital Efficiency Mechanism, which they anticipate will evolve through iteration and continued learning and collaboration. This view aligns with the Company's proposal for the parties to collaborate towards a longer-term approach. While the Company is amenable to the Division's proposed approach to achieving execution savings in the short-term, the Company has proposed some modifications to certain provisions of their proposal in Section V, below.

V. <u>Company Counterproposal</u>

Q. Please describe the Company's short-term counter proposal for the Capital Efficiency Mechanism.

A. The Company proposes the following modifications to the Division's proposal as a short-term approach:

- Cap and collar in the first fiscal year in which the Capital Efficiency Mechanism is implemented, subject to periodic updates until the long-term plan is in place;

- Increased bandwidth;

- Inclusion of some output measure, subject to appropriate adjustments for prudently incurred project scope changes or other reasons beyond the Company's reasonable control that were not anticipated when the project grade estimate was established; and

- A symmetrical incentive and penalty structure in recognition of the value of cost savings to customers and to incent utility innovation.

Q. What does the Company propose for a cap and collar?

A. The Settlement Agreement capped the reward or penalty at $2 million. The Company proposes a $1 million cap and collar as an initial step.

Q. What does the Company propose for a bandwidth?

A. The Company proposes a bandwidth of +/- 10 percent (%) to encourage prudent risk taking and be more consistent with existing governance processes.

Q. What does the Company mean by "output measures"?

A. As discussed earlier in the testimony, there is no other provision for appropriate scope changes. The Settlement Agreement provided for adjustments to the baseline for things such as the impact of a critical system safety failure, unforeseen reliability need, legislative or regulatory changes, and/or major new customer requests. The Company maintains that some process to accommodate legitimate changes is still necessary even under a short-term approach.

Q. What incentive/penalty structure does the Company propose?

A. The Company proposes an incentive of 20 percent (%) to be collected in a single year to align with the Division's proposed penalty structure. This range will more appropriately incent the Company as it is symmetrical and provides a good starting point for an efficiency mechanism.

Q. Does the Company propose an alternative to using project grade estimates as a baseline?

A. As discussed in Section IV, above, the Company continues to believe a portfolio approach is the preferred method; however, the Company is amenable to using project grade estimates as a temporary method until a more appropriate baseline can be developed, subject to the modifications proposed here and, further provided that, those project grade estimates are not subject to a dispute resolution process before the PUC. Instead, the Company proposes that the Division and the Company work towards the development of a review process that more closely aligns with the Company's internal governance process and that can be implemented earlier in the project life cycle.

Q. When does the Company propose to implement the short-term Capital Efficiency Mechanism?

A. The Company is amenable to implementing a short-term Capital Efficiency Mechanism with the FY 2021 and FY 2022 ISR plans, subject to agreeing on a method for addressing projects already underway, and further provided that the PUC approves the short-term mechanism as proposed by the Company (including the condition to evolve to a longer-term plan with the FY 2023 ISR) and the timing of such approval aligns with the timing of the Company's normal planning process for the ISR.

VI. <u>Conclusion</u>

Q. Does this conclude your rebuttal testimony?

A. Yes.