Recommendations on Principles for the Design of Performance Incentive Mechanisms

Docket 4943

13 May 2019

Introduction

The Division welcomes the opportunity to provide these comments in Docket 4943, "Guidance Document Regarding Principles to Guide the Development and Review of Performance Incentive Mechanisms". The Division supports the goal of the Memorandum[1] to provide more guidance on how to design and implement Performance Incentive Mechanisms (PIMs) in Rhode Island. The Division offers these comments to ensure that PIMs are designed and implemented in a way that accounts for the existing financial incentives and regulatory context in Rhode Island and is consistent with the goals for Rhode Island's electric distribution system as expressed by the Public Utilities Commission and stakeholders.[2] The Division recommends that additional opportunity for discussion among stakeholders in response to these comments is required prior to adoption of any principles.

The Role of PIMs in the Rhode Island Regulatory Context

Over the last decade, Rhode Island's electricity and gas industries have begun to change in response to new opportunities provided by increased customer engagement, distributed energy resources, opportunities for grid modernization, and potential third-party vendors of new products and services. Rhode Island's regulatory environment is evolving as well, with increasing requirements from the legislature, innovative ideas from stakeholders,[3] and a new multi-year rate planning process to focus the electric and gas utility's attention and incentives on reducing costs and improving performance.

If implemented effectively, PIMs have the potential to play an important role in the evolving industry and regulatory context in Rhode Island. PIMs can provide regulatory guidance on specific activities and outcomes that are important to the Commission and are important for achieving Rhode Island's energy policies and goals. The Commission's PIM principles should be designed with this important role in mind.

In addition, PIMs, when taken together, have an opportunity to broadly reshape the way that regulated utilities prioritize and undertake their business activities. In this way, PIMs necessarily interact with the regulated utility's existing incentives. Regulated utilities have in place a variety of financial and non-financial incentives regarding many dimensions of their performance. One of the utility's most prominent financial incentives is to make capital investments to increase rate base. By increasing rate base, the utility creates the potential to earn greater returns for shareholders. The utility also faces less-tangible incentives as a result of the value of maintaining good relationships with customers, regulators, legislators, and others. PIM principles should be designed to complement these existing incentives, replacing some and reinforcing others.

The gas and electric utility already has several PIMs in effect as a result of legislation and, in the case of energy efficiency, as a result of a long history of collaboration and oversight by the Commission, the Division, OER, and others. Some of these PIMs are outside of the control of the Commission and stakeholders. PIM principles should be designed with these incentives in mind, not necessarily to be

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1 Memorandum from Commissioner Anthony to Chairperson Curran and Commissioner Gold, Principles for Performance Incentive Mechanisms, March 5, 2019 (Commission Memo).

2 These comments were drafted with the assistance of Tim Woolf of Synapse Energy Economics.

3 Power Sector Transformation, Phase I Report. November, 2017.

identical but to recognize their role and minimize inconsistencies. An approach to PIMs design that requires an exact precision of consistency and demonstrated benefits may have the unintended result of reinforcing the current utility incentive structure.

The Division believes that the long-term regulatory policy objective for the design of PIMs is to transition from development of stand-alone individual PIMs to an integrated and coherent, if not entirely consistent, suite of incentive mechanisms. The timing and integration of various PIMs will be an important consideration. The Division recognizes the challenge of how best to address cross-programmatic areas of utility performance and of the potential for uncoordinated PIMs proposals and review. For example, load forecasting is a utility function that operates in several programs such as Energy Efficiency, Infrastructure Safety and Reliability, and Gas Cost Recovery. It would be detrimental to regulatory policy to allow the first PIM developed to set the level for an entire suite of PIMs or to have PIMs considered in several dockets simultaneously without coherent cross-reference. Accordingly, the Division recommends that prior to the next general rate case the Commission establish on its own, or ask the Company and Division to work with stakeholders to develop, a blueprint for PIMs development. This blueprint would identify the areas in which PIMs should be developed and the process for Commission integrated review. Such a blueprint should be specific enough o coordinate PIMs development and review while remaining flexible enough to incorporate new ideas.

One potential result of a broad suite of PIMs might be to affect how the Commission considers the acceptable range of the authorized base Return on Equity (ROE). As the Commission is aware, National Grid's most recent earnings demonstrated over 130 basis points of earnings derived from PIMs, largely from energy efficiency. As additional PIMs are developed, the revenues they generate may affect whether the base ROE can operate at the lower end of the acceptable range established by the Commission.

The Role of PIMs in Advancing Rhode Island Energy Goals

In designing the Commission's PIM principles, it is also necessary to consider the important role that they have the potential to play in advancing Rhode Island energy policies and goals. Certain energy policy goals, such as promoting customer engagement, enabling third-party vendors of electricity and gas products and services, or promoting new technologies, are not part of the Company's historic or core business activities and the Company has little or no incentive to achieve them. In fact, some of these energy policy goals might work directly against the Company's historic practices or financial incentives by reducing the need for new capital investments, and enabling companies that might be viewed as the Company's competitors.

Recognize the Differences between Electricity and Gas Businesses. The Resilient Rhode Island Act is an example of an important policy goal affecting the Company's activities and incentives. In order to meet the requirements of this act, the electricity industry will need to prepare for electrification, adoption of distributed energy resources, and other initiatives that reduce consumption and decarbonize the grid. The gas industry will also need to make significant changes to meet the medium- to long-term requirements of this act. Given the different nature of these two industries, especially the different carbon emissions profiles from gas versus electricity consumption, the PIM principles should allow for different performance areas and different incentives for electricity versus gas services, where such differences are

warranted. In addition, the Commission should consider how these principles might apply to other regulated sectors, such as wastewater and water utilities.

Account for Qualitative Benefits. The Division is concerned that the Commission's proposal, particularly the text supporting the proposed principles, may place too much emphasis on the demonstration and verification of monetary benefits when designing PIMs. The Division shares the Commission's goal of ensuring that customers receive the maximum amount of net benefits that can be provided by PIMs, but the Division is concerned that an over-emphasis on quantification of monetary benefits could undermine this goal.

First, utilities are already subject to a variety of financial and non-financial incentives that are blunt, imprecise, and not monetized, as noted above. The most obvious is the incentive for a utility to make capital investments to increase rate base. There also are many other, less obvious financial and non-financial incentives that influence utility decision-making but are not subject to a strict BCA where all costs and benefits must be monetized. Consequently, any exercise in modifying utility incentives will inherently be imprecise and will require some degree of uncertainty and regulatory judgment regarding existing incentives. Excluding non-monetized benefits from the analysis could create a different standard of review for the new incentives relative to the many existing incentives. This could lead to skewed results that tend towards maintaining current incentives and precluding new and improved incentives.

Second, there are several benefits associated with power sector transformation that are very difficult to put into monetary terms, such as increased customer engagement, market transformation of technologies, increased access to competitive, third-party service providers. If the standard does not allow for consideration of these hard-to-monetize benefits it could make it difficult to incentivize the utility to achieve state energy policy and regulatory goals, many of which are based on benefits that are difficult to monetize.

Third, PIMs are intended to allow the utility some latitude to experiment and innovate to achieve goals. If the standards require overly precise accounting of benefits prior to authorizing the PIM, it will naturally limit the potential for experimentation, creativity, and innovation by the utility.

Fourth, there are several existing PIMs in Rhode Island that are based on statutory requirements but are not based on a strict BCA that includes only monetized benefits. Precluding the use of non-monetized benefits for new PIMs would create an inconsistent standard across existing and new PIMs. Again, this would likely lead to an unintended bias towards maintaining current incentives and precluding new and improved incentives.

Fifth, an emphasis on monetization of benefits is inconsistent with the stakeholder input and the Commission's guidance on BCAs from Docket 4600. In the guidance document from that docket the Commission was clear that qualitative analysis of costs and benefits should be included in the BCA, and that the benefit-cost framework "will not be the exclusive measure of whether a specific proposal should

be approved."[4] This is an example of an energy policy goal that has been clearly established in Rhode Island that should be applied consistently to PIMs.

The Commission's memo acknowledges that BCAs for utility resources and programs can account for qualitative benefits, as provided in the 4600 Guidance Document, but maintains that using qualitative benefits for making payments to utilities is different and warrants different treatment.[5] The Division is concerned with this conclusion. The memo makes a distinction between making a payment to the utility versus making a payment for a resource or a program. But the the Division is concerned that this may be a distinction without a difference. From the perspective of the customers who are making the payments, either to support a program or pay for a utility incentive, there is no difference. Both payments are designed to result in net benefits to customers, and both payments involve uncertainties and unknowns. The fact that the payments might have different implications for the Company is not relevant to customers. (The implications for the Company should be addressed by the Commission through application of the PIM principles, e.g., the principle that an incentive should offer no more than necessary to align utility performance with the public interest.)

Finally, there are many ways to use quantitative metrics to demonstrate that qualitative benefits can be, or have been, realized. For example, the "benefits" of increased customer engagement or increased access to third-party service providers can be monitored and demonstrated with quantitative metrics – even if those benefits are not put in monetary terms. This offers a reasonable degree of certainty of benefits without requiring the monetization of benefits that are very difficult to monetize.

Comments on Specific Principles

The Division supports many of the principles set forth in the memo. However, we off several suggestions below for improving them, particularly in light of the comments provided above. We address each proposed principle in turn. The final section of our comments provides the Division's recommendations for re-working some of the principles.

Principle 1: As proposed, this principle requires that there be a history of performance in the relevant performance area, in order to demonstrate either underperformance or improved performance. The Division is concerned that for some performance areas there might be little or no history, and the utility's current incentives are not aligned with the public interest.

Principle 2: The Division supports the essence of this principle, but we are concerned that it is too narrowly focused on quantifiable and monetary benefits.

Principle 3: The Division supports the essence of this principle, but we are concerned that it also is too narrowly focused on quantifiable and monetary benefits.

Principle 4: The Division supports this principle as proposed in the memo.

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[4] Rhode Island Public Utility Commission, Public Utilities Commission's Guidance on Goals, Principles and Values for Matters Involving The Narragansett Electric Company d/b/a National Grid, Docket 4600, page 6.

[5] Commission Memo, pages 3-4.

Principle 5: The Division supports the essence of this principle, but we note that existing utility incentives should be considered in applying this principle. For example, two resources might achieve the same benefit (e.g., meet peak demand), but one resource might require utility capital investment that provides a rate of return, while the other resource might require more of operational expenditures which do not provide a rate of return.

New Principle: The proposed set of principles does not explicitly encourage PIMs to be designed to maximize net benefits to customers. The Division recommends adding a new PIM to address this important goal.

New Principle: The Division recommends adding a new principle to encourage PIMs to be focused on desired outcomes, as opposed to specific inputs or processes.

New Principle: The proposed set of principles does not make any distinction between PIMs that apply to electricity services versus those that apply to gas services. The Division supports the application of the PIM principles to both electric and gas services but is concerned that there may be instances where the gas utility should have different financial incentives than the electric utility. The Division recommends adding a new principle to allow for this flexibility.

Improved Clarity

The Commission Memo recommends maintaining both the "old standards" as well as the new principles. The Division is concerned that this approach could be confusing and cumbersome to implement. The Division recommends combining the old standards and the new principles into one set of principles. Given the significant overlap between the standards and the principles, this will require only modest edits to the new principles.

For each of the old standards we provide below a summary of how the standard is, or could be, accounted for in the new principles:

1) *Incentive should promote the realization of new consumer and societal benefits.*
   This is addressed in Principle 1.

2) *Incentive should incentivize behavior the utility would otherwise not undertake.*
   This is addressed in Principle 1.

3) *There should be a clear nexus between the metric and the expected benefits.*
   This is addressed in Principle 3.

4) *There should be a clear, stated reason why the incentive is needed to achieve each specific objective.*
   This is addressed in Principle 1.

5) *Incentive should be designed to promote superior utility performance and significantly advance the expected benefits as efficiently as possible.*
   This is not explicitly addressed in any of the proposed principles. We recommend adding a new principle on maximizing net benefits.

6) *Incentive should be designed so that customers receive most of the benefit.*
This is addressed in Principle 3.

7) *Incentives may be designed to grant increasing levels of rewards to the utility for higher levels of performance*.
This is not explicitly addressed in any of the principles proposed by the Commission but would be addressed by the new principle on maximizing net benefits proposed by the Division.

8) *The design and implementation of the incentive should be completely transparent and fully document and reveal inputs and methodologies to ensure no duplication of incentives across various ratepayer funded programs*.
The transparency and documentation standard is addressed in Principles 1 and 2, but the "no duplication" standard is not addressed anywhere. We recommend modifying Principle 4 to prohibit duplicative incentives

9) *Incentive should be designed to enable a comparison of the cost of achieving the metric to the potential benefits*.
This is addressed in principle 2.

10) *Incentives may be designed to promote objectives including comprehensiveness, customer equity, lifetime net benefits, increased customer access to capital, market transformation, resiliency, connectivity, and operability*.
This standard is not really needed. It is partly addressed in Principles 1 and 3.

11) *There should not be multiple incentives for attaining the same objective*. We recommend modifying Principle 4 to prohibit duplicative incentives

Recommendations

The Division recommends the following changes to the proposed principles to address the issues discussed above.

> PRINCIPLE 1: A performance incentive mechanism can be considered when the utility lacks an incentive (or has a disincentive) to better align utility performance with the public interest and there is evidence that a performance incentive will improve the alignment of performance and the public interest.
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> PRINCIPLE 2: Incentives should be designed to enable a comparison of the expected cost of achieving the target to the expected benefits. Costs and benefits should be defined according to the Commission's 4600 Guidance Document.
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> NEW PRINCIPLE: Incentives should be designed to maximize the expected net benefits of the desired outcome.
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> PRINCIPLE 3: Incentives should be designed to maximize customers' share of total expected net benefits of the desired outcome. Consideration will be given to the inherent risks and fairness of allocation of both monetary and non-monetary system, customer, and societal benefits.

PRINCIPLE 4: An incentive should offer the utility no more than necessary to align utility performance with the public interest. This includes, among other things, that the utility should not be provided with multiple incentives for achieving the same outcome.

PRINCIPLE 5: The utility should be offered the same incentive for the same benefit. No action should be rewarded more than an alternative action that produces the same benefit. Consideration will be given to the other financial incentives provided by the existing ratemaking context.

NEW PRINCIPLE: Financial incentives should be designed to achieve specific desired outcomes and provide the utility with sufficient flexibility as to how those outcomes are achieved.

NEW PRINCIPLE: Financial incentives for the gas utility can be different for the electric utility, if warranted and justified by the proponent.