

February 28, 2020

VIA HAND DELIVERY AND ELECTRONIC MAIL

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

RE: Docket 4943 – Guidance Document Regarding Principles to Guide the Development and Review of Performance Incentive Mechanisms

Dear Ms. Massaro:

On behalf of The Narragansett Electric Company d/b/a National Grid (National Grid or the Company), enclosed, please find ten (10) copies of the Company's comments on the Draft Guidance Document entitled *Public Utilities Commission's Guidance on Principles for the Development and Review of Performance Incentive Mechanisms* in response to the Public Utilities Commission's Notice to Accept Comments in this docket issued on January 29, 2020.

Thank you for your attention to this filing. If you have any questions, please contact me at 401-784-4263.

Sincerely,



Andrew S. Marcaccio

Enclosures

cc: Docket 4943 Service List
John Bell, Division
Christy Hetherington, Esq.
Leo Wold, Esq.

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

February 28, 2020

Date

Docket No. 4943 – Performance Incentive Mechanism (PIMs) Guidance Document
Service List updated 1/7/2020

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Rhode Island Public Utilities Commission

In Re: Docket No. 4943 - Guidance Document Regarding Principles to Guide the Development and Review of Performance Incentive Mechanisms

National Grid's Comments on the Draft Guidance Document entitled *Public Utilities Commission's Guidance on Principles for the Development and Review of Performance Incentive Mechanisms*

National Grid¹ appreciates the opportunity to submit written comments on the Draft Guidance Document entitled *Public Utilities Commission's Guidance on Principles for the Development and Review of Performance Incentive Mechanisms* (Draft Guidance Document).

I. BACKGROUND/INTRODUCTION

On or around April 11, 2019, the Public Utilities Commission (PUC) initiated the above-referenced docket to establish clear, complete, and consolidated guidance on the PUC's policy for the appropriate use and design of performance incentive mechanisms (PIMs). The docket opened with the PUC's solicitation of comments on a Memorandum, dated March 5, 2019, from Commissioner Anthony to Chairperson Curran and Commissioner Gold entitled *Principles for Performance Incentive Mechanisms* (Memorandum).² National Grid was one of eight stakeholders to submit comments on the Memorandum. In December of 2019, the PUC issued a Discussion Document to address common themes raised by stakeholders, provide direct responses to certain excerpts within the comments, raise new questions based on some comments, and frame next steps for the development of PIMs guidance.³ On January 22, 2020, the PUC held a technical session in which National Grid and other stakeholders participated. On January 29, 2020, the PUC issued the Draft Guidance Document and solicited comments from stakeholders. National Grid is appreciative of this opportunity and hereby submits the below comments in response to the Draft Guidance Document.

II. GENERAL COMMENTS

The Company reiterates its belief that carefully designed PIMs can help advance Rhode Island's energy policy goals and provide broad new benefits to customers,⁴ and agrees that there is value in considering how traditional cost-of-service regulation can be modified to align utility incentives with outcomes tied to regulatory and policy goals. By providing utilities with a clear signal and economic rationale to pursue innovation in support of these goals, PIMs can create significant new value for customers by encouraging the Company to meet and exceed evolving and increasing needs and expectations of its customers and stakeholders. They do so by better aligning utility regulation with the sort of incentives other firms face in competitive markets,

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

² The PUC discussed the Memorandum at an open meeting on March 18, 2019.

³ The Discussion Document was dated December 19, 2019 and revised on December 23, 2019.

⁴ See National Grid's comments dated May 13, 2019 on the Memorandum which may be accessed at: [http://www.ripuc.ri.gov/eventsactions/docket/4943-NGrid-Comments\(5-13-19\).pdf](http://www.ripuc.ri.gov/eventsactions/docket/4943-NGrid-Comments(5-13-19).pdf);

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such as incentives for innovation, cost efficiency, and customer value. To that end, the Company is appreciative that the PUC is advancing the discussion about the appropriate role and use of PIMs and is offering guidance as to how it will review proposals containing PIMs.

In general, the Company supports the issuance of a PIMs Guidance Document as a valuable tool to inform PIMs proposal development. The Company does, however, have concerns with both the applicability of the principles as well as the construction of the principles themselves. First, as explained herein, statements in the document concerning applicability of the PIMs principles and their implication for future evaluation of an appropriate authorized return on equity (ROE) have the potential to increase regulatory risk to the Company and may undermine the prospective value of performance incentive mechanisms to Rhode Island customers. Second, the Company reiterates its comments on the principles themselves and offers additional evidence for its recommendations.

III. COMMENTS

A. Comments on Section II of the Draft Guidance Document entitled Applicability

1. The Company appreciates the PUC's statement under Section II.1.4. that "[p]erfect consistency with the Principles is not required for approval of a performance incentive mechanism."

The Company agrees with the statements made under Section II.1. of the Draft Guidance Document which set forth the PUC's expectations regarding applicability of the principles which will guide the review of proposed PIMs. In particular, the Company appreciates the PUC's statement under Section II.1.4. that "[p]erfect consistency with the Principles is not required for approval of a performance incentive mechanism." Overly rigid adherence to the specific language in the principles could preclude approval of potential PIMs that might have important, yet difficult to monetize, customer benefits, or that might support the achievement of important state policy goals. The Company believes it is beneficial for the PUC to retain discretion in its interpretation of the record and place emphasis on specific principles in evaluating performance incentive mechanism proposals.

2. The application of principles to ROE runs counter to the purpose of ROE and raises regulatory risk.

The Company is concerned with the statement made under Subsection II.2.d. that "[t]he principles will be applied to the current norms and default to the extent possible with specific consideration of applicable statutes, gradualism, and fair notice," having defined these current norms and defaults under Subsection II.2.a. as including "an allowed return on equity in rate base investments, statutory remuneration, and minimum service quality standards." The Company interprets this statement to suggest that the PUC intends to evaluate allowed ROE through the

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principles. As further explained below, application of the principles in this manner is likely to increase the Company's cost of capital by raising regulatory risk. Moreover, because of the fundamental importance of ROE to the utility's financial integrity, application of the principles to ROE would be expected to increase the cost and burden of regulatory proceedings.

First, a utility's allowed ROE is fundamentally distinct from existing statutory incentives, performance incentive mechanisms, and service quality standards. The latter mechanisms reward or penalize the utility for its ability to meet specific objectives or targets. ROE, on the other hand, is a necessary compensation to utility investors for the opportunity cost of the capital that has been made available. It is the utility's primary vehicle for ensuring financial integrity and is essential to its ability to attract the capital that is needed to provide safe and reliable service at reasonable costs. Discussion of ROE in the context of performance incentives often overlooks the important societal purpose of a cost-of-service regulatory framework, namely, to *ensure the availability of capital at reasonable costs* in order that the Company can reliably and affordably provide its customers with what is an inherently *capital-intensive* service. An insufficient allowed ROE would directly threaten this fundamental outcome.

Furthermore, regulatory review of ROE is already subject to the standards that emerged from the *Hope*⁵ and *Bluefield*⁶ decisions, which provide that a utility's allowed ROE should be (1) comparable to returns investors expect to earn on other investments of similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain and support the company's credit and attract capital. Given the capital-intensive nature of utility service, an ROE that complies with these standards will inherently balance the long-term interests of customers and utility investors. The Company does not believe that there is any additional benefit to customers from applying additional standards to the evaluation of ROE, and has not seen one articulated during this proceeding.

The regulatory framework in which the utility operates is one of the most important factors considered by both debt and equity investors when conducting risk assessments. Because investors have many options for allocating their investment dollars, a utility's authorized returns must be adequate on a relative basis to ensure its ability to attract capital under a variety of economic and financial conditions. The amount and cost of debt capital available to utilities are influenced by the rating agencies' assessment of the regulatory environment. For example, both Moody's and S&P identify the supportiveness of the regulatory environment as an important consideration in developing their overall credit ratings for regulated utilities.⁷ Further, because a

⁵ *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591 (1944)

⁶ *Bluefield Water Works v. Public Service Comm'n*, 262 U.S. 679 (1923)

⁷ Moody's weighs Regulatory Framework and Ability to Recover Costs and Earns Returns, at 25% each, such that 50% of the weighting reflects assessment of regulatory environment. *See* Moody's Investor Service, Rating Methodology, Regulated Electric and Gas Utilities, December 23, 2013, at page 6. S&P's rating guidance notes that "we believe the fundamental regulatory environment in the jurisdictions in which a utility operates often influences

company's cash flows are allocated to debt investors before equity investors, equity investors are particularly concerned with the regulatory framework in which a utility operates and its effect on future earnings and cash flow. Any adjustment that undermines the relative attractiveness of a utility's base level of earnings opportunity would increase uncertainty and risk. Such an outcome would be expected to increase the perceived risk of the Company's regulatory environment relative to its peers. The expected impact of this result would be an increase in the Company's cost of both debt and equity, to the detriment of customers. Given the near-term capital investment needs implied by both asset replacement and distribution system modernization, maintaining the Company's credit ratings and overall financial integrity will be essential in order for the Company to raise the capital necessary to meet its obligations to customers most cost effectively.

A second area of concern with the PUC's statement is that, given the importance of allowed ROE to utility financial integrity and the cost of capital, application of the principles to ROE will result in a tremendous and costly analytical burden that does not add incremental knowledge or value and complicates the litigation of rate cases. The principles do not logically translate to consideration of ROE, rendering such an evaluation largely meaningless. Consideration of costs and benefits envisioned by the Docket 4600 framework should occur in the context of deciding whether to approve individual utility programs and investments, not in the context of determining whether a specific ROE is appropriate. As noted above, the standards provided by *Hope* and *Bluefield* provide the framework for evaluating the appropriate range of ROEs and balancing utility and customer interests.

3. The consideration of existing incentives when setting ROE will undermine PIMs and increase regulatory risk.

The Company is also concerned with the statement made in Subsection II.2.g. of the Draft Guidance Document which states that, "[t]he PUC will take into consideration any existing performance incentive mechanisms in proposals to set return on equity in rate base investments..." The Company believes that concerns about excess utility earnings are better addressed by an earnings sharing mechanism that that will ensure that total earnings (ROE + PIMs) remain within acceptable bounds.

3(a) The arguments for an asymmetric adjustment to ROE in the presence of PIMs are flawed.

Based on submitted comments in this proceeding and intervenor testimony in Docket 4770,⁸ the

credit quality the most." See Standard & Poor's, *Assessing U.S. Utility Regulatory Environments*, March 11, 2010, at page 2.

⁸ For example, Acadia Center's comments in this Docket 4943 argue that "[t]o achieve transformation of the utility business model and make progress in addressing improper incentives, PIMs must replace other utility revenue. By

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notion that ROE should be adjusted downward in the presence of PIMs appears to be driven primarily by concern about capital bias. The PUC echoed this notion in its December 23, 2019 Discussion Document, suggesting that "... utilities are driven by profit motive. If a utility's only, or dominant, profit opportunity is through capital investment, then the PUC must acknowledge such a utility has a capital bias."⁹ This assertion of capital bias is problematic, because it overlooks the essential services the Company provides, the societal benefit of the cost-of-service regulatory framework described above, the role of regulators in approving only investments that are both prudent and beneficial to customers, the Company's long history of making investments to benefit customers, and its ongoing activities that mitigate capital investments. The PUC's statement also fails to acknowledge the more complex reality that the utility cannot singularly focus on profit maximization. The Company's responsibilities to its customers, and its responsibilities to stakeholders, regulators, and policymakers may require the Company to undertake additional operating expenses and investments that run counter to maximization of ROE.

With respect to the Company's activity, assertion of capital bias ignores the significant efforts the Company already has undertaken, and is continuing to develop, to interconnect large amounts of customer driven distributed generation, as well as the Company's expanding efforts to engage customers in demand response and reduce peak demand, and evaluate non-wires-solutions which all seek to reduce or defer capital investments. Further, the Company has a long history of making investments and operational decisions for the benefit of customers under the current regulatory framework. Review of the Company's proposed capital investments through the Infrastructure, Safety, and Reliability (ISR) proceedings, for example, ensures that the Company's capital investments are least cost and in the best interest of customers.

Most fundamentally, it is unclear what supporters of a reduction in ROE to address concerns about capital bias believe will be accomplished by this outcome. The capital needs of the distribution system, and the Company's consequent investment proposals, will not be affected by this result, nor will the potential benefit to customers of prudent capital investments. It will not make non-wires-solutions viable in situations where they otherwise would not be. There is no

increasing the portion of the utility revenue requirements that is recovered through PIMs while reducing the portion recovered from rate base, PIMs can help shift the financial incentives away from capital investments and toward achieving consumer-friendly outcomes." See [http://www.ripuc.ri.gov/eventsactions/docket/4943-Acadia-Comments\(5-13-19\).pdf](http://www.ripuc.ri.gov/eventsactions/docket/4943-Acadia-Comments(5-13-19).pdf) at pages 4-5. In the context of Docket 4770, the Direct Testimony of Tim Woolf and Melissa Whited on behalf of the Division of Public Utilities and Carriers argued that "[t]he shareholder revenues provided by existing and proposed PIMs will be significant enough to warrant the Commission establishing National Grid's authorized ROE at the lower end of the reasonable cost of equity range. Such a shifting of revenue sources will mitigate the Company's incentive to increase rate base and focus management's attention on achieving power sector transformation goals." See http://www.ripuc.ri.gov/eventsactions/docket/4770-DIV-Woolf-Whited_4-6-18.pdf at page 5.

⁹ See PUC Discussion Document, December 23, 2019, http://www.ripuc.ri.gov/eventsactions/docket/4943-PPIMs_PUC_Discussion_Doc_Rev12-23-19.pdf at page 5.

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reason to expect that it will enhance any of the outcomes that might be the focus of earnings opportunities under PIMs, and as discussed below, could detract from them by reducing the Company's willingness to put forward PIMs proposals. Further, a reduction in ROE may inhibit the Company's access to reasonable-cost capital over time, and ultimately raise the cost of capital that Rhode Island's customers face.

In Docket 4770, it was also suggested that the potential for upside revenue for PIMs reduces utility risk, warranting a reduction in allowed ROE.¹⁰ However, there is no evidence that the availability of performance incentive mechanisms would reduce the Company's risk, or increase its overall return potential,¹¹ relative to its peer group. Earnings from PIMs, especially in the near term, are likely to be highly uncertain. For potential PIMs earnings to materially impact the views of investors, they have to result in the Company being viewed as less risky to its peers to such a degree that investors would specifically and measurably reduce their return requirements. Given the increasing prevalence of utility performance incentives, this is an unlikely result. A recent brief by American Council for an Energy Efficient Economy (ACEEE), for example, identified 29 states with utility energy efficiency performance incentives for electric utilities that have upside potential.¹² The implication of this prevalence is that any meaningful impact of upside incentives on cost of capital would likely already be reflected in the proxy group data that is used to calculate cost of equity.

Finally, it is important to note that commenters have not articulated the need for a symmetrical positive adjustment to ROE in the presence of downside risk from PIMs or service quality standard penalties, which the Company already has in place. In a risk-focused argument for ROE adjustment in the presence of PIMs, given the increased risk that could be associated with downside adjustments or penalties, as well as the role of the regulatory framework in protecting utility financial integrity, a symmetrical adjustment would be the only reasonable outcome.

¹⁰ For example, the Joint Direct Testimony of Tim Woolf and Melissa Whited, on behalf of the Division in Docket 4770, argued that "[t]he Commission could select an authorized ROE that is at the lower end of a reasonable range, in order to reflect the revenues that a utility is expected to recover through its PIMs. This lower authorized ROE could also be justified because the PIMs reduce the utility's risk by providing regulatory guidance and some assurance that the costs associated with PIM initiatives will be allowed into rates."

See http://www.ripuc.ri.gov/eventsactions/docket/4770-DIV-Woolf-Whited_4-6-18.pdf at page 17.

¹¹ It is notable that the average ROE for electric utilities in general rate cases in the U.S. was 9.65% in 2019. This does not reflect potential from performance-based rates or incentive mechanisms. There is no indication that PIMs would provide the Company, which has a 9.275% ROE a higher relative return opportunity than other utilities. See S&P Global Market Intelligence, Regulatory Research Associates. RRA Regulatory Focus: Major Rate Case Decisions – January – December 2019. January 31, 2020.

¹² See ACEEE, 2018. Snapshot of Energy Efficiency Performance Incentives for Electric Utilities. Topic Brief. December 2018. <https://www.aceee.org/sites/default/files/pims-121118.pdf>.

3(b) The downward adjustment of ROE will undermine PIMs and/or increase company risk.

A reduction in allowed ROE to account for PIMs earning potential has the potential effect of making PIMs penalty-only. By adjusting the allowed ROE from what it would have been in the absence of PIMs to a lower level, unless the potential upside from PIMs is substantially larger than the basis point equivalent reduction in allowed ROE, the Company is at risk of losing revenues that would have been received in a regulatory construct without PIMs.

As is the case with penalties for PIMs in new performance areas,¹³ the prospect of an ROE reduction in the context of PIMs would have the effect of reducing and potentially diminishing entirely, the Company's appetite to put forward PIMs proposals. In the absence of true upside potential, the Company has no incentive to devote resources to consider how it might utilize PIMs to create incremental value, nor would the Company have any incentive to put forward targets that might be beyond its immediate reach. The direct result of this outcome is a missed value opportunity for customers.

Finally, requiring the Company to meet performance incentive mechanism targets simply to earn its required ROE is a fundamental change in the utility regulatory framework that could cause debt and equity investors to view the Company as riskier than peers in the proxy group used to estimate the cost of equity. As such, introducing a framework where the Company needs to meet additional performance hurdles to earn what would have otherwise been its authorized ROE is likely to increase investors' perception of the Company's risk and therefore its cost of equity, to the detriment of customers.

In summary, Rhode Island customers benefit from the Company's ability to access low-cost capital in order to make investments in the system. The Company must demonstrate to the PUC that such investments are prudent and in the best interests of customers in order for the investments to be approved. Adjustments to the regulatory framework that would fundamentally change the factors being considered in determining the Company's allowed ROE would have the impact of increasing the Company's regulatory risk relative to its peers, such that the Company's cost of capital increases. Lowering ROE in the presence of PIMs would also undermine the Company's willingness to put forward PIMs proposals. Both of these outcomes are to the detriment of customers. A purpose of PIMs and other regulatory incentives is to address some of the concerns about outcomes raised by stakeholders, and currently, the Company, working closely with stakeholders, continues to make progress on incentive structures to advance energy efficiency, peak reduction, and non-wires alternatives, all of which can have the effect of

¹³ It is worth noting that the Joint Direct Testimony of Tim Woolf and Melissa Whited on behalf of the Division in Docket 4770 recognized the potential disincentive the Company would face in the presence of PIMs with penalties, noting that "assigning penalties to the PIMs will be more likely to discourage the Company from pursuing an initiative than encourage it." See http://www.ripuc.ri.gov/eventsactions/docket/4770-DIV-Woolf-Whited_4-6-18.pdf at page 26.

avoiding or deferring capital investment. A reduction in allowed ROE is an unnecessary change to the utility business model, and threatens forward progress while risking higher capital costs to customers. Finally, concerns about excess utility earnings are more effectively addressed through an earnings sharing mechanism that would allocate returns that are over a certain level back to customers.

4. Statutory incentives should be exempt from the application of the principles.

The Company also believes that remuneration set by statute should be distinct from any PIMs that are set forth in the Draft Guidance Document. In essence, the General Assembly performed its own analysis, in lieu of an analysis that would be guided by a final Guidance Document, and set forth a rate for remuneration that it deemed appropriate given its objectives.

B. Recommended Changes to Section II of the Draft Guidance Document entitled Applicability

For the reasons stated above, the Company calls for amendments to Subsections II.2.a, II.2.f., and II.2.g, and the deletion of a Subsection II.2.d. and clarification of the effect of this document to new dockets so that Subsections II.2. and II.3. of the final Guidance Document reads as follows:

2. The PUC recognizes that some utility incentives have varying degrees of consistency with these principles.

(a) This includes ~~an allowed return on equity in rate base investments, statutory remuneration, and~~ minimum service quality standards.

(b) The PUC recognizes these incentives are the current norms and default in utility regulation and are reasonably allowed.

(c) The Principles reveal weaknesses and strengths of the current norms and default.

~~(d) The Principles will be applied to the current norms and default to the extent possible with specific consideration of applicable statutes, gradualism, and fair notice.~~

~~(e)~~(d) The PUC expects to use these Principles to evaluate proposals that reasonably modify the current norms and default to reduce or eliminate the impact the inconsistencies of these incentives have.

~~(e)~~(e) The PUC will apply the Principles to proposals for other performance incentive mechanisms with consideration of any existing incentives, ~~including return on equity in rate base, statutory remuneration,~~ and minimum service quality standards, to the extent possible.

~~(f)~~(f) The PUC will take into consideration any existing performance incentive mechanisms in proposals to set ~~return on equity in rate base investments or~~ minimum service quality standards, to the extent possible.

3. The effect of this document is immediate upon adoption by the PUC and will be applied in any case, filed on or after the effective date of this document, that proposes performance incentive mechanisms for an investor-owned utility.

C. Comments on Section IV of the Draft Guidance Document entitled Principles

1. The Company reiterates its comments on the principles and offers additional support.

The principles contained within the Draft Guidance Document match the principles contained within the Memorandum. On May 13, 2019, the Company provided comments on the principles.¹⁴ The Company incorporates those comments herein. In addition, the Company procured the Brattle Group, Inc. (Brattle) to review the principles contained within the Memorandum and Draft Guidance Document and provide an opinion concerning whether or not the principles are well suited to the full scope of PIMs that may be considered by the PUC going forward, and possible implications of their application in practice. Brattle provided its opinion and findings through a report entitled *Comments on Commissioner Anthony's Principles for Performance Incentive Mechanisms*, dated February 18, 2020 (Brattle Report).¹⁵

The Brattle Report contains two recommendations to enhance the principles. See below excerpt from the Report:

First, while we fully agree that the Commission should use quantifiable and verifiable analysis to inform its decision making (concerning PIMs and incentive levels) to the extent possible, it should not close the door on using qualitative benefits in determining incentive levels. Second, the Commission should recognize that incentives are set in order to induce action on the part of the utility and that incentives derived from a strict net benefit test as currently articulated in the Principles may not always be sufficient to motivate the desired utility

¹⁴ See National Grid's comments dated May 13, 2019 on the Memorandum which may be accessed at: [http://www.ripuc.ri.gov/eventsactions/docket/4943-NGrid-Comments\(5-13-19\).pdf](http://www.ripuc.ri.gov/eventsactions/docket/4943-NGrid-Comments(5-13-19).pdf)

¹⁵ The Brattle Report is attached hereto as Exhibit A.

behavior. Accordingly, the Commission should allow itself some leeway in setting incentive levels, including examining the experiences in other jurisdictions and iterating incentives based on recent experience.

When making decisions on PIMs, flexibility for the PUC is important. The Company believes the language of Subsection II.1.4. of the Draft Guidance Document which reads, “[p]erfect consistency with the Principles is not required for approval of a performance incentive mechanism”, is an important step towards ensuring such flexibility exists.

D. Recommended Changes to Section IV of the Draft Guidance Document entitled Principles

The Company suggests the below changes to principles 1-4 as recommended by Brattle.

Principle 1. A performance incentive mechanism can be considered when the utility lacks an incentive (or has a disincentive) to better align utility performance or services with the public interest and there is evidence of underperformance, ~~or~~ evidence that improved performance will deliver incremental benefits or evidence that new or expanded utility services will deliver incremental benefits.

Principle 2. Incentives should be designed to enable a comparison of the cost of achieving the target to the potential quantifiable and cash benefits, however the resulting net benefits should not be fully determinative of the incentive level to be applied unless benefits and costs are both predominantly quantifiable.

Principle 3. Incentives should be designed to maximize ~~customers' share of total quantifiable, verifiable net benefits~~ total net benefits. Consideration will be given to the inherent risks and fairness of allocation of both cash and non-cash 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.~~ Incentive designs should consider practical constraints and be set at levels that align utility performance and services with providing the highest net benefits in the public interest.

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IV. CONCLUSION

In conclusion, the Company respectfully requests that the PUC consider the Company's comments and recommended changes in connection with the development of a final Guidance Document.

FEBRUARY 4, 2020

Comments on Commissioner Anthony's Principles for Performance Incentive Mechanisms

William Zarakas is a Principal with The Brattle Group. Pearl Donohoo-Vallett is a Senior Associate with The Brattle Group. The opinions expressed in this white paper reflect the analyses and opinions of the authors and does not necessarily reflect those of The Brattle Group, its clients or consulting staff.

I Introduction

National Grid requested that we review Commissioner Anthony's *Principles for Performance Incentive Mechanisms* and provide our opinion concerning whether or not these principles are well suited to the full scope of performance incentive mechanisms (PIMs) that may be considered by the Rhode Island Public Utilities Commission going forward, and possible implications of their application in practice.¹

Our review of the methodologies used by state regulators to set incentives (i.e., rewards and/or penalties) for performance in specified areas (such as reliability, customer service and energy efficiency) suggests that most, if not all, regulators have developed incentive structures on an *ad hoc* basis. Such an approach has sufficed when performance incentives were applied sparingly and did not constitute a material amount of utility earnings. However, performance based regulation (PBR) – which, depending upon the definition employed, may include multiyear rate plans (MPRs) and PIMs – has received renewed attention in recent years, and we expect that PIMs will play a larger role in regulation going forward.²

¹ Commissioner Anthony's draft Principles were described in a March 5, 2019 Memorandum to Chairperson Curran and Commissioner Gold.

² Much of the increased interest in PIMs is due to the need to provide utilities incentives to work outside of their traditional business model; e.g., to engage in actions that advance societal or policy goals.

This will require that the principles and methodologies used to specify incentive structures will need to fully reflect commission policy and be consistently applied.³

Commissioner Anthony's initiative places Rhode Island at the forefront of addressing the role that PBR, and in particular PIMs, will play going forward.⁴ As we discuss more thoroughly below, we generally find that the Principles outlined by Commissioner Anthony provide reasonable guidance on the application of performance incentives. However, we also find that the Principles, as currently articulated, may be overly restricted to consideration of directly quantifiable and monetizable benefits (cash and non-cash),⁵ and leave out streams of benefits that, from a practical standpoint, may be quantifiable, but difficult or impractical to monetize.

There is little question that incentives based on quantitative analysis is preferred by economists and regulatory analysts, as well as Commission Anthony and ourselves. However, limiting the selection of PIMs, as well as tying the associated incentive level, to strictly monetizable benefit streams may produce unintended consequences. Rather than safeguarding utility stakeholders by assuring that only cost beneficial programs be undertaken by utilities and that utilities are not unduly enriched by excessive compensation, it is possible that some initiatives (that the Commission and stakeholder groups view as important) will be overlooked and/or incentive levels may be set at levels that are insufficient to induce beneficial utility actions. Expanding the methodologies addressed in the proposed Principles should avoid such a result without negating the preference placed on verifiable quantitative analysis when possible.

The remainder of our comments are organized as follows: In Section II, we provide an overview of the types of incentive mechanisms that are either in place or currently being considered in Rhode Island and elsewhere the U.S. We include this section as both information and, perhaps more importantly, to ensure clarity in the nomenclature applied to the types of incentives used in the regulation of utilities. In

³ Traditional rate of return regulation is the predominant form of regulation applied to public utilities, and has stood the test of time. However, analysts have suggested there may be various deficiencies and/or unintended incentives, such as: incentives to build up utility rate base, counter-incentives to procure non-utility solutions (sometimes referred to as "non-wires alternatives" or NWA's) and minimal incentives to engage customers. Several jurisdictions are considering a more prominent role for PBR (which as noted above includes PIMs) in the regulation of public utilities as a way to mitigate these deficiencies and/or unintended incentives.

⁴ Other jurisdictions active in the advancing the use of PIMs as a regulatory mechanism include New York, Hawaii, Massachusetts and Minnesota.

⁵ We define quantifiable benefits as those for which generally accepted analyses yield a value stream that reduces costs ("cash" benefits) and/or provides value to customers and/or society ("non-cash" benefits). Monetized benefits are the sum (in total or subject to some discount) of these cash plus non-cash benefits. Our review of the Principles Memorandum indicates that these definitions are in line with the way they are used by Commissioner Anthony.

Section III, we provide the results of our review of the methodologies used by various state regulatory commissions in setting incentive levels and structures – or, in other words, how regulators have determined how much incentives should be and why. We provide comments on each of the five principles in Section IV and provide our concluding comments and recommendations in Section V.

II Scope of Utility PIMs

For this, and for other similarly situated cases that we have worked on, we have adopted a categorization for the various targeted incentive mechanisms that we have observed in utility regulation.⁶ We use this classification system in order to be more precise in our description of types of incentives and facilitate the discussion of the regulatory mechanisms (in this case, PIMs) and the way they are applied.⁷ With this in mind, we categorize utility performance incentives in two groups: “traditional” PIMs and “emerging” PIMs.

Traditional PIMs refer to incentive mechanisms that address performance in specific areas of utility operations, covering basic and well-established areas of utility performance, such as system reliability, various aspects of customer services and/or employee safety.⁸ The incentives assigned to traditional PIMs tend to be asymmetrical and penalty-only; that is, utilities face a monetary penalty if their performance does not meet established targets, but performance above target levels does not merit a monetary reward. A 2012 survey indicates that traditional PIMs are in place in 14 states for electric utilities.⁹ Rhode Island’s reliability and customer service standards under National Grid’s Service Quality Plan are examples of traditional PIMs.

⁶ “Regulatory incentives” is a broad and widely used term that addresses a range of addendums to traditional rate of return regulation, such as multiyear rate plans. Our discussion here is intentionally limited to performance incentives targeted at specific areas of utility performance (such as reliability) and excludes broader incentive schemes (such as multiyear rate plans).

⁷ We also find it important to note that we are not attempting to force a specific system of classification for its own sake, nor do we intend to create arbitrary distinctions or apply undue complexity to the issue at hand.

⁸ The number of PIMs includes within each of these three performance areas tends to vary among jurisdictions. In some cases, a traditional PIM (say, system reliability) may be broken down into disaggregate components (say, by various measures of reliability, such as SAIDI, SAIFI, CAIDI, and/or by geographic subdivision). A review of various PIMs plans indicates that the more detailed and expansive plans (e.g., plans that include many performance measures broken down by geographic region) have evolved over time (e.g., Consolidated Edison).

⁹ O’Neil Management Consulting LLC, “Recommendations for Strengthening the Massachusetts Department of Public Utilities Service Quality Standards,” December 13, 2012.

Emerging PIMs refer to a more recent version of PIMs that address policy goals, such as emission reductions and DER interconnections, or otherwise reflect new approaches to providing utility services, such as using non-wires alternatives. These PIMs are used to incentivize utilities to pursue activities beyond their core functions and/or pursue activities or initiatives that may be otherwise contrary to optimizing their financial performance.¹⁰ The incentive structure applied to emerging PIMs is primarily based on rewards – in other words, these incentives are typically asymmetric upward. A well-known set of emerging PIMs have been developed in New York and are referred to as earnings adjustment mechanisms (EAMs). These PIMs set targets and provide incentives with respect to DER utilization, peak reduction, and energy efficiency, among other measures.¹¹ The Public Utilities Commission of the State of Hawaii is also currently involved in developing and implementing a set of emerging PIMs and has prioritized development of PIMs focusing on interconnection experience, customer engagement, and distributed energy resource asset effectiveness.¹² In Rhode Island, an example of emerging PIMs include the System Efficiency incentive mechanism, which evaluates annual peak saving capacity from resources including incremental demand response, distributed photovoltaic solar, and storage, and the System Reliability Procurement incentive for non-wires alternatives.

¹⁰ This was summarized in the New York Public Service Commission's 2016 Order on Reforming the Energy Vision:

"Staff's proposal to create new incentive measures is directed not to traditional basic service but to new types of performance expectations. Some of these new expectations run counter to conventional methods of operation and, importantly, also run counter to the implicit financial incentives that are embedded in the cost-of-service ratemaking model. If cost-of-service calculations are to remain the basis of utility rates for the foreseeable future, then creating new earning adjustment opportunities are both a fair and a necessary means of promoting change."

New York Public Service Commission, "Order Adopting a Ratemaking and Utility Revenue Model," Case 14-M-0101, May 19, 2016 at 59.

¹¹ See: Con Edison 2018 Energy Efficiency Earnings Adjustment Mechanism Achievement Report, April 1, 2019 and Consolidated Edison, Re: Case 16-E-0060 – 2018 Distributed Generation Interconnection Earnings Adjustment Mechanism Report, April 1, 2019.

¹² See: Public Utilities Commission of the State of Hawaii, Decision and Order No. 36326, Docket No. 2018-0888, 2019 and <https://www.transmissionhub.com/articles/2016/07/n-y-psc-adopts-revised-nwa-project-cost-allocation-recovery-methodology-proposed-by-central-hudson.html>

III PIM Incentive Types

The incentives for PIMs generally seek to mimic the function of a competitive market; that is, rewards and/or penalties are set at a level that provides incentives sufficient for a utility to act in pursuit of the stated objective.¹³ In the case of PIMs – assuming that the utility initiative is net beneficial on an overall basis – a reasonable incentive should be set to a portion of the total net value created, which ideally can be measured in a monetized manner. However, this is not always the case, which is borne out in practice; some incentive levels are set based on “best” possible assessments, the levels used in other jurisdictions and ongoing iteration. As summarized in the table below, we observe two broad types of incentives that are applied to PIMs: 1) “shared savings” type incentives, through which monetizable cash and non-cash net benefits are split between customers and the utility; and 2) incentives that are estimated nearly entirely through consideration of qualitative evidence and/or augmented to reflect consideration of qualitative factors.

Incentive Type	Performance Area	
	TRADITIONAL	EMERGING
Shared Savings Mechanism Cash Benefits and/or Monetized Non-Cash		<ul style="list-style-type: none"> Greenhouse Gas Reductions Non Wires Alternatives
Qualitatively Estimated	<ul style="list-style-type: none"> Customer Services Reliability Levels 	<ul style="list-style-type: none"> DG Interconnection Customer Engagement

A shared savings arrangement involves sharing the net benefits produced by a relevant utility activity, with the monetary amount of incentive to the utility tied to a predetermined sharing formula applied to

¹³ In addition, the guidelines for PIM specification typically call for PIMs to be clearly defined, measureable and, ideally, outcome based.

the ex-ante (estimated) or ex-post (actual) benefit produced.¹⁴ Setting incentive levels under this approach is inherently appealing because it suggests that the activity under consideration is value-creating (to customers) and that the utility, by receiving only a portion of the total net benefit created, is not being over compensated for its efforts. As indicated in the table above, some but not all of the incentives derived for PIMs in use today are quantifiable and monetizable, and therefore amenable to a shared savings approach.

In contrast, qualitative estimates of benefits are generally considered in cases where the methods that could be used to quantify a stream of benefits are not available, tested and/or readily replicable. We are aware of and/or have participated in numerous studies concerning difficult-to-quantify benefits streams. Many of these studies are “one-off” (i.e., difficult to replicate on an ongoing basis) and/or involve a broad range of speculative assumptions and inputs. Thus, the level of effort required to complete a quantification study that estimates the dollar value of benefits may be disproportionately large compared with the associated level of accuracy. Methodologies or rules-of-thumb estimation procedures may evolve with ongoing focused study and research (e.g., the social cost of carbon).¹⁵ However, in the meantime, qualitative assessments of benefits will need to be used in setting incentives – otherwise, potentially important policy initiatives may go unaddressed because, while they are undisputedly expected to produce benefits, are not amenable to meaningful monetization.

In practice, the incentives applied to PIMs are set using a combination of shared savings and qualitative methodologies, depending on circumstances and on the specific area of performance. As shown in the table above, the incentives for PIMs that address non-wires alternatives and the reduction of greenhouse gases are based on cash and non-cash monetizable benefits, respectively.

The table also indicates that many of the incentives for traditional PIMs have been based on more qualitative considerations than on quantitative methodologies. Specifically, our review of the incentives applied to traditional PIMs indicates that the penalty amounts for reliability and customer service PIMs are based on general understanding of a reasonable and meaningful amount, and on the “best practices”

¹⁴ Not surprisingly, the calculation of ex ante and ex poste benefits requires selection of a quantification methodology and the application of numerous inputs and assumption, all of which are typically subject their own sets of debate and argumentation.

¹⁵ The issue of valuing non-priced consequences or “externalities” is an evolving exercise. Some benefit streams have transitioned from primarily qualitative to generally quantifiable. However, variations in estimated benefits are directly acknowledged in the seminal studies themselves. Furthermore, assumptions, inputs and methodologies are also subject to debate.

used in other jurisdictions.¹⁶ This is a somewhat surprising observation at first glance, because reliability and customer service are core and long-standing areas of utility operations. However, placing a value on the incremental monetary value (or loss of value) from improving (deteriorating) levels of performance in these areas is a challenging analytical proposition.¹⁷ Nonetheless, regulators have recognized the importance of reliability and customer service and estimated meaningful incentives based on the best information available.

Incentives for PIMs may also be set using a combination of quantitative and qualitative factors when applicable, with monetizable net benefits estimates being moderated (up or down) to reflect qualitative factors. We expect that qualitative consideration will need to be factored into the setting of incentives for many of the emerging PIMs being considered – either because the associated benefits are inherently difficult to monetize (e.g., PIMs addressing customer “experience”) or quantification does not capture the full scope of benefits making the associated incentive insufficient to produce actionable results.

IV Comments on Proposed Principles

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 of underperformance or evidence that improved performance will deliver incremental benefits.

The performance incentives in place and/or being considered in Rhode Island, as well as elsewhere in the U.S., are intended to address gaps and/or disincentives embedded in the traditional rate of return regulatory framework. The various regulatory performance incentives in place in Rhode Island today each address areas that are 1) of high priority to the Commission and 2) are insufficiently incentivized under the traditional rate of return framework to deliver the desired results. We find that calls for utilities to use (cost effective) non-wires alternatives as an alternative to traditional utility-owned infrastructure build-outs to be a good example. Non-wires alternatives related initiatives, identified as a priority for many commissions including the Rhode Island Commission, are not financially incentivized

¹⁶ We use “best practice” to mean the practices used in other jurisdiction. We do not mean to imply that the practices used in other jurisdictions necessarily reflect rigorous comparative analysis and are therefore superior to alternative applications.

¹⁷ We have conducted several studies of the incremental value to customers of improved levels of reliability using a value of loss load (VOLL) methodology.

under the traditional rate of return framework, so an alternative incentive (i.e., a PIM) needs to be developed in order to deliver incremental benefits. The scope of Principle 1 may also increase as regulators direct utilities to engage in as-of-yet undefined innovation and new product and service offerings. Accordingly, Principle 1 may benefit from modification to ensure that such new initiatives are included within its scope.

PRINCIPLE 2

Incentives should be designed to enable a comparison of the cost of achieving the target to the potential quantifiable and cash benefits.

Principle 2 stresses the importance of the Commission understanding two ways of measuring net benefits: cash benefits and overall quantifiable benefits (which includes cash benefits as well as monetized non-cash benefits). The Principles Memorandum suggests that benefit-cost analyses should be used in two ways. First, a candidate program should be required to pass a benefit-cost test before it is implemented by the Commission. For this, per the Principles Memorandum, it is reasonable and appropriate to consider cash and quantifiable non-cash benefits, as well as qualitative benefits.¹⁸ Second, the Principles indicate that the Commission should use a benefit-cost analysis (for a specific utility program) in determining the incentive used for that program. In this case, the Principles Memorandum indicates that qualitative benefits should be excluded from consideration, and determination of incentive payments to the utility should be limited to a portion of quantifiable benefits.

We agree that it is important to understand both costs and benefits as well as the differences among benefit streams (i.e., cash and non-cash benefits) as part of the Commission's PIM review process. However, sole reliance on quantitative analysis for purposes of setting incentive levels may result in an understatement of the incentive needed to produce sought-after results. As discussed above, this may have a significant impact on the effectiveness of some the emerging PIMs being considered by the Rhode Island Commission. For example, several regulatory commission are examining PIMs that promote improving customer engagement, interactions and/or experiences with the utility, which they believe will provide considerable benefits, in terms of lower future energy bills and greater awareness of choices and options. These benefits are difficult to monetize without a specialized study and, even then, would be subject to considerable debate. Customers will undoubtedly benefit from such initiatives, but the "right"

¹⁸ Principle Memorandum, page 4: "Are qualitative benefits treated differently in program review versus PIMs?"

incentive level for the enabling PIM will need to be determined using testing, experience from other jurisdictions and iteration.

PRINCIPLE 3

Incentives should be designed to maximize customers' share of total quantifiable, verifiable net benefits. Consideration will be given to the inherent risks and fairness of allocation of both cash and non-cash 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.

We provide our comments on Principles 3 and 4 together, as they are closely related, and concern the setting of incentives and the sharing of produced net benefits. We address four facets of performance incentives related to these principles below: net benefits sharing, incentive levels, qualitative considerations, and consumer protection and affordability.

Net Benefits Sharing

Principles 3 and 4 are primarily concerned with the split of net benefits: customers should receive as much as possible, and utilities should receive no more than is necessary for them to engage as needed to produce the intended result. This sharing guidance is reasonable on an overall basis, but should be secondary to the goal that performance incentives produce the greatest net benefit possible. Conceptually, maximizing the net benefits associated with a specific utility program requires applying the appropriate level of incentive – too little will produce a sub-optimal level of net benefits and too much results in a deadweight loss to consumers.^{19,20} A literal implementation of Principle 3 risks that the Commission will expend greater effort on minimizing the portion of net benefits that goes to utilities (as compensation from performance incentives) than in finding the right balance to maximize net benefits. Finding the appropriate balance for performance incentive is not an easy calculation. Most likely, incentive levels will need to be adjusted over time, and involve adjustments based on experience and observed results.²¹ Principles 3 and 4 should be approached with this in mind.

¹⁹ In economics, a deadweight loss is the loss to consumers that occurs when equilibrium between supply and demand is not achieved, typically due to the imposition of taxes, tariffs or other governmental intervention.

²⁰ This balance can also be looked at in terms of the price elasticity of demand; maximum revenues for a product or service are derived when prices are set with respect to the responsiveness of consumer to price changes. Raising the price too much will drive customers away and result in a decline in total revenues while not raising prices enough results in leaving money on the table.

²¹ The time period between adjustments should provide sufficient time for the utility to plan, implement, and modify needed measures.

Incentive Levels

Incentives are intended to provide financial motivation for a utility to engage in initiatives that it would not otherwise undertake, such as procuring renewables and/or distributed resources, and need to be sufficiently sized to induce action. Setting the incentive amount to a portion of the net benefits will likely be sufficient to induce such action in many cases, but may be insufficient in others.²² That is, the Commission may conclude that a utility initiative is beneficial to customers and/or other shareholders based on a net benefits test, but find that the goal is not attained because the incentive is insufficient to motivate the utility to engage as needed. Thus, incentives need to be set at realistic levels, which may involve the application of practical considerations more so than a proportion applied to a strict calculation of quantifiable net benefits.

Qualitative Considerations

As we discussed above, benefits streams do not always lend themselves to quantification, cash or otherwise. Determining the incentive structures for hard-to-monetize benefit streams will require considering benefits that cannot be verified via quantitative methodologies, or risk failing to achieve its goals in these areas. As one example, the net benefits of customer engagement (e.g., customer awareness of choice) will likely be difficult to quantify, while the costs to a utility to enable enhanced customer engagement will likely be high. In this case, tying incentive levels to quantifiable net benefits will likely be insufficient to motivate the utility to take the appropriate steps, absent a mandate or other regulatory treatment.

Consumer Protection and Affordability

We infer that Principle 4 also provides guidance that performance incentives should not harm consumers by materially impacting the affordability of electricity service.²³ Incentives that are tied to cash net benefits will, by definition, lower customer bills. However, it is possible that bills will increase in cases where incentives are set based on the sum of cash and non-cash net benefits – even though consumers and/or society are better off from the realization of non-cash benefits. For these cases, the Commission

²² The Commission can, of course, adopt regulations that require the utility to take certain actions. However, such a direction reflects a mandate rather than harnessing market forces to drive innovation and performance.

²³ The Principles Memorandum states that, “In combination with Principle 3, Principle 4 seeks to define consumer protection against unreasonable or excessive incentive payments.” (page 8) While, on strict basis, this may mean that utilities should not receive incentive payments that are too high, it may also reflect concerns that utility incentive payments may result in higher bills to customers.

should assess the total ratepayer impact to determine whether the impact of incentive payments (in the pursuit of approved policies and goals) results in a burdensome level of bill increases.

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.

We interpret “benefit,” as used here, to mean achievement of an outcome, in contrast to the way it is used in Principles 1 through 4 (i.e., as stream of benefits and net benefits). With this in mind, Principle 5 provides guidance that outcomes and incentives should be aligned via a one-to-one relationship, meaning that multiple incentives should not be employed in pursuit of a single outcome. We agree with this guidance and find that it is generally in line with the predominance of regulatory practice in place in the U.S. today. That is, incentives should be clearly specified in terms of outcomes and compensation, and utilities should not be compensated twice for the same benefit.

V Conclusions and Recommendations

The Principles for Performance Incentive Mechanisms Memorandum authored by Commissioner Anthony advances an important conversation about the appropriate role and use of specified performance incentives,²⁴ beyond the incentives embedded within the traditional rate of return regulatory framework.²⁵ This is both important for Rhode Island and timely on the national front, as analysts and regulators are examining the feasibility and merits of tying greater amounts of utility earnings to performance going forward.

As indicated earlier, the Principles are primarily geared toward quantitative analysis of benefits and costs, while, in practice, many of the evolving program areas being considered by regulators are not amenable to such a preferred methodology. We share the preference for incentive design that follows a shared savings methodology, however we find that practical considerations has necessitated expanding the

²⁴ The Principles Memorandum was the catalyst behind Docket No. 4943, *Guidance Document Regarding Principles to Guide the Development and Review of Performance Incentives Mechanisms*.

²⁵ Peter Bradford, a former Chairperson of the New York Public Service Commission is reputed to have stated that “all regulation is incentive regulation.” As indicated earlier in this whitepaper, the performance incentives discussed in the Principle’s Memorandum concern those that are more narrowly specified; i.e., addressing specific areas of utility performance, as opposed to utility performance overall.

information considered in designing incentives to also include qualitative factors. Failing to consider qualitative factors may result in incentive levels being set at levels that are insufficient to induce the needed utility actions, creating a circumstance in which the sought-after benefits to customers may be foregone. Our review of the incentives set for the existing scope of PIMs indicates that qualitative considerations have played predominant roles in defining the incentives for traditional PIMs that cover reliability and customer service.

We make two broad conclusions and recommendations to enhance the proposed Principles. First, while we fully agree that the Commission should use quantifiable and verifiable analysis to inform its decision making (concerning PIMs and incentive levels) to the extent possible, it should not close the door on using qualitative benefits in determining incentive levels. Second, the Commission should recognize that incentives are set in order to induce action on the part of the utility and that incentives derived from a strict net benefit test as currently articulated in the Principles may not always be sufficient to motivate the desired utility behavior. Accordingly, the Commission should allow itself some leeway in setting incentive levels, including examining the experiences in other jurisdictions and iterating incentives based on recent experience.

We also provide modest edits (in italics) to the Principles 1 through 4 below, reflecting the comments and analysis that we presented 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 *or services* with the public interest and there is evidence of underperformance, evidence that improved performance will deliver incremental benefits *or evidence that new or expanded utility services will deliver incremental benefits*.

Principle 2 Incentives should be designed to enable a comparison of the cost of achieving the target to the potential quantifiable and cash benefits, *however the resulting net benefits should not be fully determinative of the incentive level to be applied unless benefits and costs are both predominantly quantifiable*.

Principle 3 Incentives should be designed to maximize *total net benefits*. Consideration will be given to the inherent risks and fairness of allocation of both cash and non-cash system, customer, and societal benefits.

Principle 4 *Incentive designs should consider practical constraints and be set at levels that align utility performance and services with providing the highest net benefits in the public interest.*