nationalgrid

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May 13, 2019

VIA HAND DELIVERY & 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
<u>National Grid's Comments</u>

Dear Ms. Massaro:

On behalf of National Grid,[1] I enclose one original and nine copies of the Company's comments to Commissioner Abigail Anthony's Memorandum Regarding Principles to Guide 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 April 11, 2019.

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

Very truly yours,

Jennifer Brooks Hutchinson

Enclosures

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

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

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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 Commissioner Anthony's March 5, 2019 Memorandum regarding Principles for Performance Incentive Mechanisms

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National Grid[1] appreciates the opportunity to submit written comments on Commissioner Anthony's Memorandum dated March 5, 2019 (Memorandum) regarding principles to guide the development and review of performance incentive mechanisms.

<u>Background/Introduction</u>

At its March 18, 2019 Open Meeting, the Rhode Island Public Utilities Commission (PUC) discussed Commissioner Anthony's Memorandum and the need to create clear, complete, and consolidated guidance on the PUC's policy for the appropriate use and design of performance incentive mechanisms. On April 11, 2019, the PUC issued a Notice to Accept Comments on the concepts and principles contained in the Memorandum, including areas that are unclear or need further clarification, or require further technical exploration. The Memorandum is organized into four parts:

- Purpose and background;
- How Docket 4600 relates to principles of performance incentive mechanisms and the nature of risk in costs and benefits;
- Five proposed principles for performance incentive mechanisms; and
- Next steps for additional work.

The Company has organized its comments and recommendations around these four parts. As a starting point for its comments and recommendations, the Company provides some general comments about performance incentive mechanism principles and observations regarding certain over-arching concepts contained in the Memorandum.

<u>General Comments</u>

The Company agrees with Commissioner Anthony that there is value in developing guiding principles for the use and design of performance incentive mechanisms. Further, the Company agrees that it makes sense to look to the standards for incentives that have emerged under Least Cost Procurement and System Reliability as a starting point for thinking about general principles for performance incentive mechanisms. The Company further suggests that any principles

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

adopted in Rhode Island reflect best practices and lessons learned as informed by both the literature and the experience of various jurisdictions regarding the development of performance metrics, targets and incentive mechanisms[2]. The Company suggests a broader stakeholder process that allows for explicit consideration and incorporation of such lessons learned and best practices in the PUC's principles for designing effective performance incentive mechanisms.

Any principles guiding the development of performance incentives must start with the threshold question of the intended purpose of utility performance incentives. The objectives of Docket 4600, the Power Sector Transformation Initiative, and state greenhouse gas emissions reduction goals will require substantial efforts by the Company that extend well beyond the Company's traditional business obligations of providing safe, reliable, and affordable electricity service. Meeting these objectives will require the Company to innovate regarding technology adoption and deployment, business and management practices, and the customer relationship. This type of innovation and the risk associated with it is not encouraged under the current regulatory framework. Although traditional cost of service regulation supports cost-recovery and earnings on investment deemed prudent by regulators, it is not sufficient to drive innovative utility performance in delivering these new objectives.

Well-designed performance incentives, provide utilities with a clear signal and economic rationale to pursue innovation in support of regulatory and policy goals, can create significant new value for customers by encouraging the Company to meet and exceed evolving and increasing needs and expectations of its customers. They do so by better aligning utility regulation with the sort of incentives other firms face in competitive markets, such as incentives for innovation, cost efficiency, and customer value. The value of incentives is explicitly recognized in the Docket 4600 goals, which include as one of the goals to "[a]lign distribution utility, customer, and policy objectives and interests through the regulatory framework, including rate design, cost recovery, and incentives."[3]

Achievement of the potential benefits of utility innovation to Rhode Island customers requires a broader view of performance incentive mechanisms than that expressed in the Memorandum, which takes a more limited view of performance incentives as a tool for "improving utility performance in certain areas."[4] Docket 4600 and the Power Sector Transformation (PST) Initiative have made it clear that the investments and activities necessary to achieve the desired transformation of Rhode Island's power sector should be spurred by providing the Company with performance incentives, which reward the Company fairly for taking on the risk of applying resources and making investments in areas that are not an ordinary part of its daily business of providing safe, reliable, and affordable electric service. The Company is concerned that

[2] For example, the public utility commissions of Hawaii, Minnesota, Michigan, and New York are currently in the process of either reviewing, developing, or implementing performance incentive mechanisms.
[3] Public Utilities Commission's Guidance on Goals, Principles and Values for Matters Involving The Narragansett Electric Company d/b/a National Grid (Guidance Document), Docket No. 4600A at 4.
[4] Memorandum at 2.

grounding principles for performance incentive mechanisms in a narrower view of their purpose will create the risk that transformation of the power sector in Rhode Island does not achieve its true potential benefit for customers.

The Company firmly believes that carefully designed performance incentives can help advance Rhode Island's energy policy goals and provide broad new benefits to customers. Specifically, the Company believes that incentives are most likely to be appropriate and effective where: (1) there is a demonstrated market failure or a unique strategic role that can be served by the utility; (2) there is an opportunity to produce significant benefits to customers and/or promote Rhode Island's energy policy goals; and (3) the distribution company plays a distinct and clear role in bringing about the desired outcome.[5]

Costs and Benefits

Section II of the Memorandum addresses costs and benefits and differentiates between cash benefits, monetizable benefits, and qualitative benefits, and their implications for customer risk under Performance Incentive Mechanisms. In general, the Company agrees that it is important to evaluate the costs and benefits associated with Performance Incentive Mechanisms targets and incentive levels, how those benefits might accrue to customers, and the level of uncertainty involved in benefit assessment. However, it is important to note that movement toward outcome-based performance incentives, where the utility is to achieve a specific objective with less regulatory oversight of how this is accomplished, runs counter to the use of a detailed benefit cost analysis to determine incentive levels. Guidance around performance incentive mechanisms should reflect this.

Commissioner Anthony states that qualitative benefits present the highest risk because these benefits are not "readily measured and have unknowable economic value to customers."6 For these reasons, Commissioner Anthony asserts that "a commission should disregard qualitative benefits when considering the payout to the utility."7 While the Company generally agrees that the emphasis in determining incentive value should be on quantitative, monetized benefits, qualitative benefits should still be considered in the evaluation of the overall Performance Incentive Mechanism, even if the qualitative benefits are not included in the calculation of the incentive payment. This is especially the case when the purpose is to support key policy goals/objectives, but ability to quantify the impact is limited. In addition, the Company believes that performance incentive mechanisms focused on benefits that can be quantified, but not easily translated into monetary values, such as electric service reliability, may still provide important opportunities to advance outcomes for customers.

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[5] *See* Docket No. 4780, Testimony and Schedules of the Power Sector Transformation Panel, Book 1 of 3, Schedule PST-1, Ch. 9 at 2 (Bates Page 163).
[6] Memorandum at 2.
[7] *Id.*

For these reasons, the Company recommends a full portfolio of benefits be considered when developing performance incentive mechanism targets and incentives. Specifically, the Company should be permitted to use all quantifiable benefits contained in the Docket 4600 Benefit-Cost Framework to justify a performance incentive mechanism. If such benefits are tangible enough to direct the investment of customer dollars, they should be tangible enough to justify the overall need for a performance incentive and associated metric. There should be symmetry between the quantifiable benefits used in benefit-cost tests and those used to justify a performance incentive.

Finally, the Company disagrees with the suggestion in Commissioner Anthony's Memorandum that the utility is shielded from risk due to the potential error in estimated benefit values. Using an example of a $100 estimate per ton value of carbon dioxide (CO_2), Commissioner Anthony states, "there is some risk that the actual value of carbon dioxide emissions reduction is greater than or less than $100 per ton of CO_2." [8] She goes on to state:

> [i]f a commission were to allow a utility an incentive of five percent of this value and pay that value in cash to the utility, then the utility is shielded from the risk that the actual value of CO_2 reduction is less than or greater than the estimated value, whereas society is fully exposed to this risk.[9]

Following this example, if a commission determines that it is fair to pay the utility five percent of the per ton value of CO_2, assuming $100 value per ton, but the true value of a ton of CO_2 is $200, then the utility is actually under-compensated for the value it creates (*i.e.*, the utility should have been paid $10 instead of $5). When considering risk in developing principles for performance incentive mechanisms, a commission should acknowledge that risk can go both ways. For example, benefits can be inherently uncertain, and may under- or over-materialize. Costs may also be uncertain, and achievement of targets may require the utility to put shareholder dollars at risk.

<u>Principles for Performance Incentive Mechanisms</u>

Section III of the Memorandum discusses five principles for performance incentive mechanisms. The Company provides its comments on each of the enumerated principles below:

[8] Memorandum at 4.
[9] *Id.*

> *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 Company strongly suggests expanding this principle, as discussed in the general comments above, in order to recognize the important role that performance incentive mechanisms can play in fostering utility innovation and supporting utility activities beyond the utility's traditional obligation to provide safe, reliable and affordable service.[10]

For example, a successful performance incentive mechanism will send a signal to the Company to focus limited management time and resources to achieve a specific outcome that would not have occurred otherwise. If there is an ongoing need for the continued pursuit of a specific state or regulatory policy objective, performance incentive mechanisms can, over time, become a more integrated part of the Company's core business, such as what has occurred with energy efficiency.

> *Principle 2*: *Incentives should be designed to enable a comparison of the cost of achieving the target to the potential quantifiable and cash benefits.*

The Company agrees that performance incentive mechanism proposals should enable comparison of costs and benefits but would suggest that these principles and guidance recognize and reflect the limitations of benefit-cost analysis and not treat the numerical results of a benefit-cost analysis as dispositive of whether a certain performance incentive mechanism is worthwhile. The PUC recognized the limitations of the benefit-cost analysis in the Docket 4600 Guidance Document:

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[10] For example, work by Synapse Energy Economics has noted that performance incentive mechanisms "allow regulators to provide specific guidance on important state and regulatory policy goals" and that "in the absence of performance metrics and incentives, utilities have little incentive or guidance for achieving policy goals." Further, the report states that "[t]hey can help provide greater regulatory guidance to address new and emerging issues, such as grid modernization, or to attain specific policy goals, such as promoting clean energy resources." *See Utility Performance Incentive Mechanisms: A Handbook for Regulators*, Synapse Energy Economics, Inc., prepared for the Western State Energy Board, published March 9, 2015, at 8. http://www.synapse-energy.com/sites/default/files/Utility%20Performance%20Incentive%20Mechanisms%2014-098_0.pdf

> [T]he Benefit-Cost Framework will not be the exclusive measure of whether a specific proposal should be approved. For example, there may be outside factors that need to be considered by the PUC regardless of whether a specific proposal is determined to be cost-effective or not. This may include statutory mandates or other qualitative considerations. This is consistent with the PUC's broad regulatory authority in setting just and reasonable rates.[11]

The PUC's benefit-cost guidance should apply equally to the evaluation of performance incentive mechanisms as it does to other types of proposals. Further, the PUC must recognize the challenges inherent in benefit-cost analysis where outcome-based targets are supported by multiple programs, which have multiple objectives and benefits that extend beyond the focus of the performance incentive mechanism. Further, the PUC's principles for performance incentive mechanisms must recognize that a shift toward outcome-based performance incentive mechanisms conflicts with the use of a detailed cost-benefit analysis to determine appropriate incentive levels. Costs, and thus net benefits, will be known with less certainty under an outcome-based approach. In a purely outcome-based approach where the metric and target are not tied to a single utility program, the costs of achieving this target become more difficult to estimate with certainty.

> *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.*

The Company has two related comments on the first part of this principle. First, the Company suggests that this principle be focused on maximizing the net benefits created by the performance incentive mechanism (as alluded to on page 7 of the Memorandum), rather than maximizing the *share* of total net benefits to customers. The Company's performance incentive mechanism proposals have all been intended to ensure that customers receive the majority of benefits created. The Company would caution, however, that an explicit focus on maximizing the *share* of net benefits to customers could have the consequence of reducing the *total* net benefits created for customers. This is because management focus on the incentive is expected to increase with the size of the potential incentive. To the extent that increasing the share of potential net benefits to customers reduces Company performance, net benefits to customers could be lower than they might be under a slightly lower customer share of net benefits.

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[11] Guidance Document at 7.

Second, the Company would suggest that this principle, either as drafted, or modified to focus on maximizing total net benefits to customers, be qualified as aspirational in nature. Otherwise, the principle risks creating an impossible analytical standard that undermines the potential value to be gained from performance incentive mechanisms. It will not be possible to determine analytically whether the share of net benefits to customers, or total net benefits, has been truly maximized. For example, neither the utility nor stakeholders would not be able to evaluate with any certainty how a change in the utility incentive from 30 percent of net benefits to 20 percent in net benefits will impact the utility's performance, and thus the total net benefits provided to customers. This principle is further challenged by the aspiration to move toward more outcome-based incentives, where costs (and thus net benefits) will be known with less certainty.

Instead, the Company suggests that this principle be rewritten as a balancing test, with a focus on sizing the incentive in a manner intended to ensure both a meaningful incentive for the Company and meaningful net benefits to customers. The Company agrees with Commissioner Anthony's sentiment that the PUC should consider "the inherent risks and fairness of allocation of both cash and non-cash system, customer, and societal benefits."

Finally, on page 7 of the Memorandum, it states, "[a]n incentive should offer the utility no more than necessary to motivate performance." (This concept is further developed in Principle 4). This statement seems to overlook the fact that performance, and thus benefits created, is expected to increase with the size of the incentive. While the Company agrees with the PUC's desire to ensure that customers receive meaningful value for performance incentive mechanisms, incentives should be designed such that the rewards increase proportionally to performance.

The Company does not agree with the suggestion on page 7 of the Memorandum that, over time, the proportion of benefits paid to the utility decrease and the proportion that accrue to customers increase. Rather, how the proportion of benefits paid to the utility evolves over time should be situation specific.

In general, the Company would expect to propose a set of targets for a given performance period that require an increasing level of effort to achieve each year. In such case, there is an argument for potentially increasing the share of net benefits, or at a minimum retaining the same share, over the course of the performance period, because additional effort and innovation will be required to achieve targets. In cases where targets are set at a given level, but require incremental effort each year, incentives should recognize that it may actually become more difficult and more costly for the Company to achieve the same incremental target in year 2 as opposed to year 1 (*e.g.*, movement up the marginal cost curve for energy efficiency programs). Scaling back the incentive over the course of the performance period is likely to result in fewer benefits to customers. In practice, as performance incentive mechanisms are implemented, the Company expects that targets will evolve to become increasingly ambitious based on performance in the previous performance period, such that any previous innovative performance becomes the new baseline. Given the incremental effort needed to continually advance performance, there is not a compelling argument for a blanket assumption that the share of net benefits awarded to customers should increase over time.

More generally, if an incentive is reduced simply because the Company has excelled at performance over many years, it will send a signal that it is no longer important to prioritize those efforts. This creates the risk that the Company will cease to focus on areas of policy importance that may not align with its traditional business obligations. If the desired outcome of a performance incentive is to align specific efforts with those that are core to the Company's business, then it is important for those efforts to be rewarded in a similar manner and sustained so long as there is a continued policy need. As long as the Company can demonstrate continued significant effort, appropriate risk, and incremental net-benefits from the achievement of the desired outcome, and there is still a need for the outcome, then there should be no reason to reduce a performance incentive.

> *<u>Principle 4</u>: <u>An incentive should offer the utility no more than necessary to align utility performance with the public interest</u>.*

Similar to Principle 3, above, Principle 4 also does not take into account the relationship between the size of the incentive and performance. Performance incentive mechanism principles should clearly recognize that in order to spur Company action, incentives must be sufficiently meaningful to attract management attention, particularly when they are intended to encourage Company activity outside of traditional business obligations in support of broader policy goals or would require the Company to expend shareholder resources. Conversely, principles should avoid creating unintended consequences that discourage appropriate risk taking as prudent risk is a component to innovation. Further, principles should recognize that Company performance is likely to improve with the size of the potential incentive. Thus, focus on limiting an incentive to "no more than necessary to align utility performance with the public interest" could, in practice, limit the benefits achieved on behalf of customers.

In addition, page 9 of the Memorandum states "[t]he key point here is that in evaluating proposals against Principle 4, a commission must find evidence that the incentive is no larger than necessary to achieve the target." Similar to Principle 3, this principle risks creating an impossible analytical standard, and is not consistent with the implementation of outcome-based incentives. Instead, the principles should focus on balancing the various considerations discussed under Principle 3.

<u>Principle 5</u>: *<u>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</u>.*

The discussion around Principle 5 seems to suggest a movement towards outcome-based incentives, which the Company generally supports. However, in the context of outcome-based incentives, the notion of rewarding a utility action becomes less relevant, since individual utility actions and their contributions to an overall target would receive less scrutiny because, as noted in the Memorandum "the utility will be motivated to find the lowest cost and most cost-effective methods to earn the reward." Generally, the Company agrees that the same outcome should not be rewarded differently, though in the near term, where proceeding-specific incentives are likely, differences in incentives could be warranted by differences in associated ancillary benefits. More clarity could be provided with respect to the second sentence of this principle, Multiple programs will likely come into play to varying degrees in pursuing targets of outcome-based metrics. The Company respectfully requests further explanation and guidance of how Principle 5 would be applied and how proponents of a performance incentive proposal should use the benefit-cost analysis to support outcome-based performance incentive mechanisms.

<u>Next Steps and Conclusion</u>

Section IV of the Memorandum discusses certain next steps, including areas that will require further exploration. The Company believes that development of principles for performance incentive mechanisms for Rhode Island would benefit from a stakeholder process that would enable broader expert input and consideration of experiences in other jurisdictions, as well as identify policy areas and outcomes where performance incentive mechanisms might be best applied in Rhode Island. This process could expand upon the work done in Docket 4600 and the PST Initiative around performance incentive mechanisms. Further, the Company agrees that more work is needed around developing metrics and targets and identifying policy areas for performance incentive mechanisms and looks forward to being part of that effort.

In conclusion, the Company respectfully requests that the PUC consider these comments in connection with developing a final Guidance Document in this proceeding.