HANDY LAW LLC

Memorandum
From: Seth Handy
To: Public Utilities Commission
Date: May 13, 2019
Regarding: Docket 4943 - Comments on Principles for Performance Incentive Mechanisms

We provide these comments from our firm. We are not acting as counsel in this docket.

We ask the Commission to add consideration of how performance incentive mechanisms are designed to interact with traditional cost of service rates.

In the recent rate case, New Energy RI's expert, Karl Rabago advocated to "begin a process of transitioning from traditional cost of service rate making toward performance-based earnings models." Docket 4770, Rabago Direct at p. 8 - 15. "This transition would enable the reduction of risk associated with operating a distribution utility that embraces and supports rate innovation and third-party and customer-driven market development." Mr. Rabago continued to illustrate:

> the potential to reduce return on equity requirements through revenue stabilization mechanisms and performance-based earnings, noting that such measures could enhance the attractiveness of the Company to investors through upside earnings opportunities. Our utility company is experiencing relatively flat sales, but has nevertheless managed to consistently increase both its electricity rate base and its operating income. Traditionally, electric utilities have funded capital expansions and revenue growth through year-over-year increases in sales. System-wide economies of scale favored large solutions over small ones, centralized investments over distributed ones, utility investments over customer investments. With flat electricity sales trends, a new approach is required.
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> The Company faces a challenge. Because revenues are flat, the traditional utility model, even for a restructured utility that does not own generation, offers little hope of continuing to increase returns to shareholders (income) through increasing capital investments (net plant) absent a willingness on the part of regulators to maintain and enhance revenue stabilization mechanisms, or to pass along revenue increases and increased rates of return (increased revenues). In the electric industry today, many utilities seek revenue security through increased fixed customer charges, the collection of demand-related costs through fixed charges, increased rates of return, and the dampening or elimination of price signals encouraging more efficient consumption and self-generation. In economic terms, the traditional monopoly will seek to increase the collection of economic rents.

> There are alternatives. As recognized by both the Rhode Island Legislature and the Commission, the Company could embrace and begin to actualize an agenda of transformation. Elements of this transformation include performance-based revenue models that **displace** cost of service approaches, increased emphasis on customer engagement, stronger encouragement of energy efficiency and other distributed energy resources as an alternative to utility capital investments, and ultimately, market-based earnings derived from fair and competitive energy service markets. (emphasis added)
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> In the end, even higher rates could be justified by higher distribution platform service value and lower customer bills. But to get there, the Company will have to trend toward, and not away from, its own transformation, and to embrace a vision of improved economics for the Company and Rhode Island through this change. The Company must take a leadership role in moving away from the traditional model where net plant investment directly correlates with utility income. Restructuring removed the electricity generation component of the traditional capital investment driver, but the Company must embrace a model in which non-utility and customer investments in distribution-level infrastructure and capability is as much a resource as utility-owned investments. Finally, the Company ought to embrace a model in which income is related to performance in achieving the Commission' priorities for electric service in Rhode Island.

The recent System Integration Rhode Island report, built on this concept. That report describes the current context as follows:

> Cost of service regulation is universally done in the US in the investor-owned utility sector to determine the revenue requirement for utility delivery service. In cost of service regulation, the regulator determines the expenses and investment necessary to deliver safe and reliable service, meeting all state requirements, and it also sets a return on equity investment in order to assure adequate availability of reasonably priced capital to maintain the ability of the utility system to do its job. This rate of return on equity investment is applied to the accumulated undepreciated rate base of the utility. This is principally the remaining book value of all the assets in the company's accounts, as well as other assets created by accounting orders, known as regulatory assets. The product of the rate base and the return on equity is added to expenses to create the utility revenue requirement. In Rhode Island, the specific capital investment requirements to maintain the system are identified in distribution planning and selected for prospective recovery of forecasted investment in the Infrastructure, Safety, and Reliability (ISR) Plan. . . Performance regulation is a variant of cost of service regulation. Instead of only relying on a return on equity for the amount in the revenue requirement associated with return on investment, regulators identify factors related to utility performance that can be readily measured, and a compensation or reward is available for exemplary performance relative to these factors (emphasis added). . .In some cases, relatively stronger performance incentives exist. One is

> the Energy Efficiency Program, and the other is the return on equity discussed above from distribution delivery services. National Grid delivers shareholder value if it achieves established savings targets for energy efficiency savings and runs the distribution system efficiently, and is at some risk for both over and under spending to achieve these savings. However, for other processes like SRP, there is no incentive or financial structure in place.

Any principles for the implementation of PIMs ought to consider this context. It should move Rhode Island toward the opportunities associated with displacing cost of service model with incentives better aligned with Rhode Island policy and a future that better reflects such economic realities. PMI principles that do not transition away from the cost of service rates, cannot be expected to fully resolve and align conflicting incentives. PMIs will not generate the real drive for the transition contemplated in Power Sector Transformation unless they work to displace the traditional cost of service approach. Performance must not only be gravy; it must become the utility's main course.