N A R U C

National Association of Regulatory Utility Commissioners

State Commission Staff Surge Call: Performance-Based Regulation

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Most electric utilities operate under cost-of-service regulation, under which utilities request approval from state regulators to recover their net resource and infrastructure investment plus an annual rate of return. In response to emerging technologies, changing customer demands, flattening load, and public policy goals for the energy system, some commissions and utilities have begun working towards performance-based regulation (PBR). Under PBR, utility revenue remains largely cost-based, but additional revenue is earned when utilities meet commission-set performance outcomes such as greenhouse gas reductions or energy savings targets. On this call, commission staff from Minnesota, Pennsylvania, Rhode Island, and Hawaii shared how their states are approaching PBR.

Minnesota

Minnesota is still in the early stages of PBR. State legislation, Minn. Stat. 216B.16 allowed the PUC to "initiate a proceeding to determine a set of performance measures that can be used to assess a utility operating under a multiyear rate plan." The PUC opened a proceeding in this area, issuing an order in January 2019 establishing three steps in phase one of a two-phase PBR process: articulating goals, identifying desired outcomes, and specifying performance metrics.

The PUC identified five desired outcomes of PBR in the January order: (1) affordability; (2) reliability; (3) customer service quality, (4) cost-effective alignment of generation and load (including demand response); and (5) environmental performance. The order stated that PBR metrics should align with metric design principles that were established: tied to a policy goal, clearly defined and quantifiable, and comprised of data that is easy to obtain and verify. The PUC held a stakeholder meeting in March 2019 to discuss performance areas and metrics within each area. Approximately 50 attendees representing 20 organizations offered input.

Over the next several months, the PUC plans to have a comment period, then a hearing in late summer. Phase two will begin shortly after and will look at the details of the performance metrics and how they are calculated, verified, and reported. ~~.~~The process is expected to be completed around October 2019.

Pennsylvania

Pennsylvania is also at the beginning of PBR design and implementation. Recent legislation gave the PUC more optionality in designing performance-based rates. The commission has implemented incentive-based rates previously, usually in the form of base case return on equity (ROE) adders for exceeding benchmark levels of reliability.

In 2012, Pennsylvania aimed to reduce regulatory lag and remove an existing disincentive to infrastructure investments related to rate case lag. The resulting law, Distribution System Improvement Charges under Act 11, created a fully projected future test year (FPFTY), a 12-month period that begins with the first month in which new rates are in effect, and a distribution system improvement charge (DSIC) for electric utilities, based on previous success of accelerating infrastructure replacement with its water utilities. The DSIC can be adjusted each quarter to account for rates of return on and of qualifying capital investments made at the end of the FPFTY.

To use the DSIC, the utility must file a long-term infrastructure improvement plan (LTIIP) detailing increased investments in repair, improvement, and replacement of infrastructure. The LTIIP must contain types and ages of eligible property, a repair/replacement schedule, the location of assets, a reasonable estimate of the quantity of property to be improved, projected annual expenditures and cost-effectiveness measures, and how infrastructure replacement will be accelerated while improving safety and reliability. The LTTIP duration is usually 5 years, and accompanied be a more thorough mid-term review, as well as annual status report updates. A DSIC cannot exceed 5% of total rates and is reduced to zero if the utility over-earns, although the commission may adjust the cap higher to grant the utility a higher allowance.

In 2015, the commission opened Docket No. M-2015-2518883 on alternative ratemaking methodology. The goals of the docket were to remove disincentives to energy efficiency, conservation, and DERs; encourage more efficient operations; discuss new rate designs; and leverage data from advanced metering infrastructure. The resulting proposed policy statement order on May 23, 2017 included guidelines for the commission:

1. Policies must support the continued efficient use of all energy resources;
2. The evolution of a distributed energy environment requires substantial and well-targeted investment in distribution infrastructure;
3. Policies must encourage least-cost solutions, with cost recovery based on long-term cost causation;
4. Rate design should embrace, where feasible, the additional capabilities enabled by smart meter deployment;
5. Long-run costs are variable. Therefore, it may be appropriate for energy utilities to design rates in a manner that minimizes the long-term costs of serving existing and new loads. Given the substantial and ongoing LTIIP spending by the electric and natural gas utilities, a long-term approach to rate design may be appropriate.

Comments were due in October 2018, with a final order pending. As the commission considers a final order, the state passed Act 58 of 2018, removing barriers to alternative rate methodologies, including decoupling, PBR, formula rates, multiyear rates, or any combination of those four methodologies. The commission issued a tentative implementation order on August 23, 2018 specifying that all rate mechanisms must be approved in conjunction with a base rate proceeding. A final implementation order is still pending.

Rhode Island

Rhode Island is a restructured, decoupled state with one electric and gas utility, National Grid, and full competition for electric supply. The state also passed aggressive greenhouse gas reduction targets. Infrastructure is aging and the commission has not yet implemented a comprehensive modernization plan. Rhode Island’s Power Sector Transformation includes four work streams to continue modernization of the state electric system. A first phase report was released in 2017.

The commission has also not yet issued a universal policy on performance incentives. However, state legislation governing the commission contains strong least-cost procurement and cost-effectiveness guidelines, pushing the commission to look for procurements that maximize benefits and/or minimize net costs to customers. Rhode Island has had incentives for energy efficiency since the 1990s as well as penalties for poor performance on safety and customer service.

Over the last two years, stakeholders, with concurrence from National Grid, have been pushing for the commission to take more action on performance incentive mechanisms (PIMs). PIMs were proposed in a number of settlements before the commission during that timeframe, though all but one were rejected. Reasons for rejection included:

- The existence of net benefits related to PIMs was unproven
- Financial rewards for the company were based on assumptions about unquantified benefits
- There was clear factual evidence that utility was already meeting or exceeding its proposed performance target
- The mechanisms were action-based and connections between actions and metrics were not clear
- An incentive for company to do the thing already existed, therefore PIMs would be a double incentive

With rejections piling up and stakeholder support for action, the commission felt the need to clarify its stance on PBR. Commissioner Abigail Anthony and staff developed principles for PIMs to be released in an eventual guidance document. The guidance will not define the goal of PBR or set forth a policy statement but should provide some clarity to the utility and stakeholders. Commissioner Anthony and staff decided on five principles for PIMs, released as a memo for feedback at an open meeting:

1. PIMs should be considered when the utility lacks incentive or has disincentive to align performance with public interest, and when there is clear evidence of underperformance;
2. Incentives should enable a comparison of cost of achieving the target and quantifiable cash benefits;
3. Incentives should maximize customers' share of net benefits, with consideration given to risks and allocation of benefits, including societal benefits;
4. Incentives should offer the utility no more than necessary to align behavior with the target; and
5. Utilities should be offered the same incentive for performance, no matter what method the company uses to get there.

The commission will gather stakeholder feedback on the memo and release a guidance document towards the end of the summer.

Hawaii

The Hawaii PUC opened a docket on PBR in April 2018 setting the intention to look at alternative regulatory mechanisms and their relevance to increase renewable electricity generation, reduce costs, and improve customer service. While Hawaii has already adopted elements of PBR, the goal of this docket was to look comprehensively at PBR options and improvements to the existing regulatory structure.

The proceeding began with an exploratory phase. The commission acknowledges throughout the docket that PBR can take many forms and mean different things. The exploration was spread over two phases:

- Phase one: to assess and evaluate the existing regulatory framework and opportunities for targeted improvement in utility performance
- Phase two: to develop a new comprehensive PBR framework including incentives, if appropriate, to align the financial interests of utilities and consumers.

Phase one began in summer 2018 and extended through December. The commission convened a series of stakeholder workshops, with facilitation assistance from the Rocky Mountain Institute. At each workshop, stakeholders and commission staff discussed their desired goals and outcomes for utility regulation, looked at existing frameworks, and talked about elements of PBR. Staff issued informational reports before each workshop to help all stakeholders start from a common knowledge base and collaborate effectively. After each workshop, stakeholders filed briefs describing their positions on discussion items.

In February 2019, commission staff issued a staff proposal for stakeholder comment with recommendations on various PBR mechanisms. The proposal and other workshop materials are posted on the PUC's website. Parties have filed their positions and will be able to file reply statements in April. Staff expect the commission to issue a decision on the staff proposal providing comments and further areas of focus for phase two.

Proposed guiding principles for PBR included: a customer-centric approach with immediate bill savings, promoting administrative efficiency and reducing regulatory burden and complexity for all stakeholders, and ensuring the financial integrity of utilities as Hawaii transitions to a more comprehensive PBR framework. Staff propose:

- Moving from a three-year multi-year rate plan to a five-year multiyear rate plan with a revenue cap to strengthen cost control incentives and simplify trackers and adjustments;
- Instituting an earnings sharing mechanism with upside and downside for utility.
    - Hawaii has one now, such that if utility earnings exceed a certain threshold, they share revenue back with customers.
    - Staff is proposing a flexible collar around allowed earnings if the utility exceeds an authorized amount. If earnings fall below, customers would see rates go up in order to bring utility earnings back up to an acceptable level. Staff thought this was important to ensure financial integrity and provide opportunity to use PIMs to have more revenues tied to performance incentives;
- Tracking key outcomes through scorecards, with some outcomes tied to explicit targets and financial incentives; and
- Introducing shared savings incentives, an innovation pilot program similar to an existing program in Vermont, and opportunities for utility to earn profits on partnerships with third-party service providers.

The commission may choose to adopt or modify the staff proposal or take other actions before shifting into phase two. Phase two will also consist of detailed stakeholder conversations. Any PBR elements that are actually implemented would go into effect in 2020 or later.

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