STATE OF VERMONT
PUBLIC UTILITY COMMISSION

Case No. 17-3142-PET

Vermont Department of Public Service)
request for workshop on utility rate regulation)

COMMENTS AND RECOMMENDATIONS OF THE DEPARTMENT OF PUBLIC SERVICE ON FUTURE ALTERNATIVE REGULATION PLANS

During its October 6, 2017 workshop in this proceeding, the Public Utility Commission (the "Commission") notified the various workshop participants that the Commission would accept written comments and recommendations regarding the development of future alternative regulation plans made pursuant to 30 V.S.A. § 218d in advance of promulgating a proposed order. With this filing, the Department respectfully provides substantive recommendations for such an order from the Commission.

Alternative regulation is a highly technical undertaking, and the General Assembly assigned the Commission the role of applying its regulatory expertise in further defining requirements, standards, and procedures which would advance the broad, aspirational goals set forth in 30 V.S.A. § 218d. Alternative regulation plans are expressly authorized under exiting statutory law. Specifically, 30 V.S.A. § 218d lays out broad principles, priorities, and requirements for alternative regulation plans. The statute, however, lacks specific guidance regarding *how* an alternative regulation plan may satisfy the criteria and promote the public interest. Instead, 30 V.S.A. § 218d (e) and (h)[1] enable the Commission to establish

[1] 30 V.S.A. § 218d(e) provides that "[t]he Public Utility Commission may establish, by rule or order, requirements governing the filing of a petition to approve an alternative regulation plan." 30 V.S.A.§ 218d (h): "The Commission may establish, by rule or order, and may amend from time to time standards and procedures by which the effectiveness of the alternative form of regulation can be determined."

". . . requirements governing the filing of a petition to approve an alternative regulation plan" as well as "standards and procedures by which the effectiveness of the alternative form of regulation can be determined."

The Department believes that it would be appropriate for the Commission to issue an order in this case that refines the requirements for alternative regulation based the statutory criteria from § 218d and also offer guidance regarding how utilities may meet those criteria. By more clearly defining the features of a plan that comport with the statutory criteria, the Commission will facilitate the development of the next generation of alternative regulation plans, thereby promoting a productive and effective path for rate regulation that aligns with statutory requirements and promotes the general good.

Table of Contents

I. Goals for Alternative Regulation

Traditional regulation has governed utility ratemaking for over a century and will continue to provide an important role in rate regulation for the foreseeable future. Traditional regulation should continue to provide the framework for regulating most municipal and cooperative utilities (though some of these utilities may be well-served by implementing power or fuel adjustment clauses or other particular alternative regulation features). From the Department's perspective, traditional regulation is generally fair to both customers and utilities, in part because it establishes a strong link between the underlying costs and the revenues or revenue requirement that were established by regulators. Nevertheless, in recent years, it has become apparent that traditional regulation has various shortcomings and has not always been capable of effectively responding to relatively rapid technological and market changes that have affected the utility industry. The Department's July 18, 2017 comments highlight many such shortcomings. The Department believes that the Commission's order in this case should aim to combine the safeguards of traditional regulation with new "best practices" to protect ratepayers by ensuring that Vermont's energy policy objectives are met in a least cost manner while also allowing utilities to adapt to and incorporate promising new innovations.

The following goals should apply to future design and application of alternative regulation plans. Alternative regulation should be forward-looking and ideally balance flexibility for utilities to achieve state policy goals for the energy sector with ratepayer interests in affordability and economic development.

a. Affordability and economic development

One of the Department's primary goals for alternative regulation is to establish and maintain affordable retail rates that are just and reasonable. Reducing the price of electricity and natural gas is critical to vulnerable segments of the population and to business development in Vermont. The Department believes that both utilities and regulators should be focused on reducing consumer costs, or at least ensuring that growth in base-rate levels does not exceed the contemporaneous level of economic growth in the state. Alternative regulation can help achieve this objection because it offers the potential to be forward-looking in character, allows regulators more control over cost and price management over several years, and can foster new sources of revenue beyond traditional retail monopoly service. Alternative forms of regulation must place firm, but realistic price pressures on utilities that are consistent with the Vermont's commitments to long-term concerns of affordable service, protecting vulnerable segments of the population, and help to spur economic development in the private sector.

The State's objectives for maintaining low rates also tie closely to its objectives for development of renewable energy and environmental protection. The electric sector is rapidly evolving into one of the cleanest and, potentially, the lowest cost sources of energy. An important strategy for continued progress depends on an intelligent pursuit of new loads that can be readily managed by the customer or the utility, including electrification of transportation and

heating. Electrification will be more successful in an environment of low retail rates. Strategic development of new flexible loads through electrification can help contain escalation of electricity rates.

b. Accessibility

Traditional regulation, which relies on formal and open proceedings that include prefiled testimony, evidentiary hearings, and publically accessible orders from the Commission, is accessible to some extent for members of the public and any potentially interested parties. The Department believes that any future form of alternative regulation must provide a comparable degree of accessibility and transparency. Accordingly, as discussed in more detail below, the Department recommends that any alternative form of regulation include, at minimum, periodic cost-of-service reviews and clearly delineate how potential intervenors and members of the public can meaningfully involve themselves in the formation and implementation of alternative regulation plans.

c. Alignment of utility and customer interests

Of particular concern to the Department is the role that incentives, or rather misaligned incentives, can play under traditional or alternative forms of regulation. Utility incentives should be properly aligned with customer interests and promote the general good. Under traditional regulation, a utility has a natural incentive to control its costs. For example, the period between rate cases is referred to as a regulatory lag. Other things being equal, regulatory lag encourages cost-management and discipline because the time lag between rate cases presents an opportunity for the utility to maximize its return through close management of its costs. Future alternative

regulation plans should capture similar incentives to reward cost-management and financial discipline.

However, traditional regulation can provide misaligned incentives with respect to public policy ambitions for energy efficiency and net-metering. The Department believes that any form of alternative regulation must include a revenue decoupling mechanism. Like any for-profit business, utilities have a strong incentive to grow retail sales. This incentive stands in tension with efforts to promote efficiency upgrades and behind-the-meter generation, because if successful, such efforts depress overall retail sales. Utility regulators have developed various forms of revenue decoupling to counteract this tension. Revenue decoupling is discussed in more detail below on page 20.

Further, under traditional regulation, there is generally a strong incentive for utilities to grow capital investment because utility profits are directly linked to capital investment. Utility profit margins are established in rate proceedings based on the amount of net capital investment. From the Department's perspective, alternative regulation plans must be designed to ensure that capital investment is directed at necessary and least-cost projects that benefit ratepayers. Capital investment is discussed in more detail below on page 19.

The environment for delivery of energy service is changing. Vermont and New England have experienced nearly 11 years of flat to declining loads owing to slowing economic growth, energy efficiency investments, and robust growth in behind-the-meter generation. Distributed generation, combined with automation, advanced communications, and storage are changing the sector in fundamental ways. Advanced forms of alternative regulation can be used to foster an alignment of incentives between desired consumer outcomes and utility financial performance.

In order to facilitate the modernization of the industry, the Department believes it will likely be necessary for plans to contain incentives for utilities to enable delivery of services by third-party providers, such as platforms to provide efficient load-management oversight as load-controllable appliances become more common-place in residences.

d. Accommodation of different types of utilities

Vermont utilities vary in their size and financial structure (e.g. both private investor-owned utilities and public cooperatives and municipal utilities). The incentive to adopt an alternative form of regulation is likely strongest for the investor-owned utilities, though there are certain features of alternative regulation that may be attractive to publicly-owned, not-for-profit utilities. Any standards established by the Commission should recognize and accommodate distinctions in the type and scope of alternative regulation plans entered into by any electric utilities and should not foreclose the ability of cooperative and municipally owned utilizes to adopt alternative regulation plans.

There are several features which *any* plan should include, whether submitted by an investor-owned or public entity. These are the features outlined below in section III. Some features may be more appropriate for investor-owned utilities only, such as an earnings-sharing mechanism. Those features which the Department considers to be essential for investor-owned utilities, but also potentially beneficial for publically-owned and operated utilities, are outlined in Section IV "Optional Potential Plan Features."

e. Process timeframes

If utilities intend to adopt multi-year alternative regulation plans, the review process for such plans will necessarily require even more close review and examination than what is now

required for a typical traditional cost-of-serve filing. In addition to the cost-of-service review, a well-formed alternative regulation plan will require close examination of multi-year capital plans, pro-forma financials, year-to-year attrition relief, and a more rigorous review of the application of the power cost adjustment mechanism. Accordingly, while the Department believes that any alternative regulation plan must be supported at the outset by a cost-of-service review, the Department believes that it will be necessary to review such plans under the twelve month timeframe set out in 30 V.S.A. § 218d and not the seven month review deadline set by 30 V.S.A. § 227.

II. Review of existing statutory criteria and recommended guidance from the Public Utility Commission

Below, the statutory criteria laid out in 30 V.S.A. §218d are listed together with recommendations from the Department on how the Commission can develop proposed guidance for utilities to satisfy each criterion. In sections III and IV, the Department describes some of the specific tools and mechanism that would likely allow for alternative regulation plans can satisfy these criteria. Where those tools or mechanisms are mentioned in this section, they appear in italics.

a. 30 V.S.A. § 218d (a)(1): establish a system of regulation in which such companies have clear incentives to provide least cost energy service to their customers;

The Department recommends that future plans advance stronger and more effective incentives for cost-management than exist under traditional regulation and past forms of alternative regulation. Traditional regulation inherently creates an incentive to deliver least cost energy services, largely due to regulatory lag. However, frequent cost-of-service reviews reduce the strength of the incentive to manage costs. Cost-of-service reviews can produce rigid results,

are timely and burdensome, result in additional administrative costs for utilities, and put a strain on regulatory resources. These various factors lead the Department to conclude that well-designed multi-year alternative regulation plans can generate greater ratepayer benefits than traditional regulation. *Multi-year plans* also offer the opportunity to share or return a portion of savings to customers. Under traditional regulation, the utility keeps any additional profit that results from reducing costs between rate cases.

The Department recommends that the Commission's guidance place greater emphasis on *incentives* for cost-containment. Stronger incentives for cost containment can be achieved by requiring that plans be multi-year in character.

b. 30 V.S.A. §218d (a)(2) provide just and reasonable rates for service to all classes of customers

Cost-of-service ratemaking is specifically designed to arrive at just and reasonable rates. The Department recommends that a full formal cost-of-service review be conducted between alternative regulation plans, which initially, would therefore mean every three years at a minimum. *A full cost-of-service review* helps ensure that a revenue requirement is tied to costs and is verified through the regulatory process. The Department recommends that the Commission require that a formal cost-of-service analysis precede the implementation of any alternative regulation plan. The Department recommends further that a fully allocated cost-of-service study (*rate design*) be completed with sufficient frequency to ensure that costs are properly assigned and allocated to each customer class and rate categories. The metering and data technology that is available today should allow updates of customer and class load shapes with greater frequency than was possible in the past. Timely review of the rate design helps ensure that costs are fairly assigned amongst customer classes.

As noted above, the Department believes that just and reasonable rates should be tied to reasonable, evidence-based expectations of cost increases over the course of the future plans. Beyond an initial full cost-of-service, the components of electric rates should be approached in distinct ways.

During the course of the plan the Department recommends that the *base rate* adjustments be permitted to change based on year-to-year adjustments tied to inflation and reasonable adjustments for productivity that could offset inflationary pressures.

The Department recommends that *capital expenditures* receive special consideration and treatment during the course of the plan. Multi-year rate plans should include well-formed capital plans that match at least match the full period of the plan (ideally by year), and provide mechanisms for ensuring prudent oversight and implementation of those capital plans. The Department recommends that the mechanisms in place to address capital planning and expenditures be treated as a distinct component of the base rate determinations of the plan.

The Department recognizes that certain components of costs, which are material in character, are outside the ability of the utility to control. Such costs may include recovery from extreme weather, changes to tax laws, or costs largely associated with regional power markets. Special provisions can be made in the context of the plan to allow such costs to flow through to ratepayers provided that every effort is made at the onset of the plan to distinguish and clearly identify the costs under the utility's control.

c. 30 V.S.A. §218d (a)(3) deliver safe and reliable service

The Department believes that the same or higher standards of performance and code compliance that apply under traditional regulation should provide a floor for service expectations

under alternative regulation. Under existing Board Rule 3.500, Vermont utilities are required to apply the National Electric Safety Cost. Electric and gas utilities in Vermont are required to establish and meet performance requirements under their Service Quality Reporting Plans. Any future alternative regulation plan should include metrics and performance criteria to encourage achievement of high standards of service reliability that are consistent with the requirements of customers. To the extent warranted, higher standards of reliability performance can be coupled with financial incentives or penalties as circumstances and customer requirements dictate. Customers can also enhance their own reliability further through the use utility or third party enabled product innovations including in-house storage devices and flexible loads.

The Department recommends that the Commission require that any future alternative regulation plans be tied to existing standards and requirements (from rules in place when a plan is adopted) but also allow for the establishment of metrics and/or standards of service that may enable and potentially require improvements for worker safety, customer safety, and service reliability.

d. 30 V.S.A. §218d (a)(4) offer incentives for innovations and improved performance that advance state energy policy such as increasing reliance on Vermont-based renewable energy and decreasing the extent to which the financial success of distribution utilities between rate cases is linked to increased sales to end use customers and may be threatened by decreases in those sales

This criterion has traditionally been met by various mechanisms of revenue *decoupling* (a topic discussed below on page 20). Decoupling remains an important part of electric regulation because it removes the utilities' natural financial incentive to oppose energy efficiency and behind-the-meter generation. However, while decoupling is generally an important aspect of regulation that is especially relevant for investor-owned utilities, there are additional, emerging

areas in which plans may encourage innovation, namely allowing *third party access* to provide value-added products and services.

Innovation is a broad concept. One area where innovation is needed is in finding new ways to manage the costs associated with the sub-transmission and distribution systems, and of managing exposure to the regional costs of upstream investments in regional network capacity and bulk transmission. Increasing emphasis on the former is necessary to manage a potential over-capitalized system to accommodate increasing penetration of distributed generation and so-called Tier III loads (for compliance with the Renewable Energy Standard ("RES")). Increasing emphasis on the latter is needed to manage Vermont's exposure to costs incurred by the region, deemed necessary for regional system reliability. The solutions will likely require a mix of direct utility initiative, and utility-choreographed activities by third-parties and even customers.

Utilities can function as either innovators in their own right or enable innovation by others. The electric utility industry is in the midst of rapidly expanding technology opportunities. The Department expects that this phenomenon will only grow with time. The range of relevant technologies include new developments in distributed generation, storage, load management, and communications. Innovation will likely extend to new business models and ways that Vermont utilities or third-parties can create value that can be effectively shared between ratepayers, the utility system, and new businesses (or the utility functioning as a business innovator). The Department expects Vermont's electric utilities to pursue least-cost pathways to manage costs in the future. The incentives embedded in future forms of regulation will be instruments to achieve this goal.

The Department recommends that a mechanism for utility innovation be included in proposed plans, and also that utilities establish standards for interconnection and integrating services with third-party partners and providers that will increase entry and expand the range of innovate services.

The Department further recommends that future regulation plans should include provisions to help ensure that the distribution utility is a neutral broker of valued system or customer services that are either self-provisioned, or can be delivered through capable third-parties.

The Department also recommends that approval of plans be contingent on the inclusion of provisions that decouple revenue growth (or declines) from profitability.

e. 30 V.S.A. §218d (a)(5) promote improved quality of service, reliability, and service choices

The Department believes that future alternative regulation plans should ideally include requirements that maintain or potentially improve the quality and reliability of service. The Department recommends that *performance incentive mechanisms* be used to provide foundations for service requirements that apply across the network. Providers can be encouraged to improve upon standards of service and reliability already available through the addition of new service choices. This objective can be achieved by the distribution utility or by third-parties. For example, the coupling of storage with distributed generation could provide outage ride-through. Flexible loads such as electric vehicle charging and water heating could also be aggregated to provide demand response. The distribution utility may then benefit as either a provider of these solutions or by providing intermediate services such as software integration for third parties to

receive notices of peak events. Alternative regulation plans should enable and encourage both the utility and third parties to deliver least-cost and new services.

The Department recommends that the Commission require that future alternative regulation plans include performance standards for maintaining and improving the quality of service, improving reliability, and include mechanisms for expanding the range of optional services either by the utility or by utility partners. Potential tools in this include performance incentive mechanisms (that include an appropriate mix of positive incentives and penalties), open access tariffs, and time of use rates.[2]

f. 30 V.S.A. §218d (a)(6) encourage innovation in the provision of service

This criterion overlaps with subsection 30 V.S.A. §218d (a)(4) and (5). The Department recommends that the Commission encourage utility innovation as discussed under those subsections above.

g. 30 V.S.A. §218d (a)(7) establish a reasonably balanced system of risks and rewards that encourages the company to operate as efficiently as possible using sound management practices

It will be necessary to rely on and build upon the relatively balanced system of risks and rewards that are associated with traditional regulation. As noted above, a traditional cost-of-service review should bookend a multi-year framework to provide a mechanism for strengthening incentives for cost management. This is likely best accomplished by enhancing the effects of naturally occurring regulatory lag. As noted above, the Department recommends that the Commission allow for a *multi-year framework* to emphasize the incentive for the utility

[2] Note that some of these tools will be appropriate for alternative regulation plans while other are better handled through rate design proceedings.

to manage its cost and explore other ways to capture additional value. *Performance metrics* and appropriate use of financial incentives and/or penalties can be employed to help reinforce or even accentuate a reasonable balance. As already noted, to ensure sound management practices, plans should contain boundary provisions which provide *appropriate capital management*. For example plans may contain an annual cap on capital spending which is developed based on the utility's capital plan.

The Department recommends that any framework adopted by the Commission include mechanisms that reward the utility for effective cost containment through higher returns and reduce earning for ineffective cost management. The Department recommends that special emphasis be placed on safeguarding ratepayers on matters related to capital planning and investment. Clearly defined requirements for boundaries on investment should be in place at the onset of the plan. Plans must also account for potential strategic underinvestment and financial windfalls. The Department recommends that early plans filed include effective use of metrics to monitor and gauge the performance of the utility. The Department recommends that, over time, metrics be coupled with appropriate financial incentives and penalties.

h. 30 V.S.A. §218d (a)(8) provide a reasonable opportunity, under sound and economical management, to earn a fair rate of return, provided such opportunity must be consistent with flexible design of alternative regulation and with the inclusion of effective financial incentives in such alternatives

Traditional regulation affords utilities an opportunity to earn a fair rate of return. The manner in which utilities are afforded that opportunity may change under alternative forms of regulation, but the fundamental opportunity should remain in place.

The Department recommends that the Commission require that plans provide a fair opportunity for the utility to earn its authorized return, but that reasonable boundaries or caps be

established on the equity earnings of the utility. Such boundaries or caps are necessary in any form of alternative regulation because the utilities inherently have substantially greater visibility into costs and their ability to manage those costs than regulators. The framework should reward strong utility performance but also recognize that for monopoly institutions, there must be reasonable boundaries on earnings. While any alternative regulation plan should allow a clear opportunity for a utility to realize its authorized return, this objective must not overshadow the need to maintain rates that promote affordability and economic development throughout Vermont. This balance could be achieved through an *earnings sharing mechanism.* As an example, a well-formed earning sharing mechanism might cap the earnings of the utility at some level above that approved in the cost-of-service. Downside risks to the company's earnings are addressed through the exogenous adjustment mechanism, a power cost adjustment mechanism, and the inherent abilities of management to manage their costs and operations.

III. Required plan features

In addition to the above, the Department recommends that the Commission provide additional guidance on opportunities for greater regulatory transparency and accessibility, clear policy objectives for plans that are filed, and recommendations for addressing the challenges of associated with protecting vulnerable segments of the population.

a. Transparency and opportunities for public involvement.

By using the term "transparency," the Department refers to the ability of the public and outside parties with potential interest in the outcome of the proceeding to follow the process, the positions of the active parties to a proceeding, and the ability to read and understand the reasoning that was applied by the Commission in developing any orders. Transparency includes

an understanding of and respect for the integrity of the process employed by the Commission. Transparency is also related to the need to enable meaningful participation from the public and any interested parties in future cases, including the ability to participate in the process and interact with decision-makers at appropriate junctures. Any such participation, however, must be balanced with the need for timely and efficient resolution of the matters under review. The Department believes that this pending proceeding, which has included multiple workshops open to the public, is a step in the direction of trying to improve transparency and opportunities for public engagement in the alternative regulation process. The Department recommends that any order issued by the Commission in this case should detail the Commission's expectations for the processes that will be used to ensure that there is adequate opportunity for public engagement in future alternative regulation cases.

Alternative regulation plans should all have a clear plan for the involvement of the public, and ample opportunity for interveners to become involved in both the formation and implementation of the plan. There are many potential tools for engagement, including: (1) prospectively reaching out to interested trade groups and non-profits; (2) the Company, Department, and/or Commission can provide publicly accessible information on filings and cases through their websites; (3) more actively promoting public hearings; (4) and the use of earned media. Another potential tool for public engagement is a Citizen's Technical Advisory Panel, in which members of the public participate in educational sessions and then provide their feedback, concerns, and opinions about issues in the case. Legal representation would not required, and the Commission may consider these opinions in formulating its review of proposed plans. The Department believes that it may also be helpful for the Commission to hold a public workshop

with a utility in advance of filing a proposed alternative regulation plan. Such a workshop could allow for feedback from the public, interested parties, the Department, and the Commission in advance of the utility finalizing the details of a proposed alternative regulation plan.

b. Periodic full cost-of-service reviews.

The Department believes that full a cost-of-service review will be a necessary component of any future alternative regulation plans. A cost-of service review provides a foundation that is both compensatory to utility investors and fair to ratepayers. While cost-of-service reviews can be burdensome and time-consuming, they are essential for establishing baseline rates that are tied to a utility's actual costs. As noted above, the Department supports the concept of multi-year alternative regulation plans. However, this support is contingent on completing a cost-of-service review that would bookend other features of alternative regulation plans. The Department further recommends that if the Commission allows utilities to utilize multi-year rate plans, then the Commission should limit those plans to a three-year term for the immediate future. The cost-of-service review will likely be embedded within, or conducted in parallel to the Commission's review of an alternative regulation plan. The Department recommends the former so that costs for the first year can be reviewed in the context of the regulatory review of subsequent periods.

Over time and with the benefit of experience, it may become appropriate for the Commission to allow plans with longer timeframes. The primary advantage of longer timeframes is that there is a stronger alignment of financial performance with actions of the utilities, without some of the risks of misaligned incentives that exist with traditional cost-of-service's link between capital growth to profits and profitability. However, for any initial multi-year plans, the Department believes that a three-year period is appropriate.

c. Well-formed mechanisms for managing capital planning and spending.

Electric and gas utilities are capital intensive. As noted above and in earlier comments, there is a long-standing concern rooted in regulatory theory and practice that utilities will over-invest in capital projects if given the right conditions. Capital spending is one of the primary drivers of a utility's revenue requirement. The provision of utility service requires an appropriate level of ongoing capital investment, but determining *what* that appropriate level has proved to be a vexing exercise. Concerns over cost containment must be balanced with a utility's obligation to maintain a safe and reliable infrastructure and make investments in modernization.

One potential mechanism would be as follows. Utilities applying for alternative regulation plans would be required to create a capital spending plan, closely tied to the integrated resource plan and historic patters, which would identify specific investments and a justification for those investments. Investments should be firmly grounded in a need to provide safe, reliable and cost-effective service. An example of such plans can be found in the Construction Work Plans ("CWPs") required by the USDA Rural Utility Service. Although CWPs are focused on distribution system investments, the Department envisions that a capital spending plan would encompass all types of capital investment including information technology investments. Based on this plan, an annual capital expenditures cap could be placed on capital spending, and utilities would have flexibility to manage capital investments under the cap. Underspending could be subject to recapture through a customer credit.

IV. Other potential plan features.

Certain features of plans may be more important for some Vermont distribution utilities than others. The Department believes that some of the following features should be reflected in investor-owned utility alternative regulation plans, but these features may also be appropriate to include in alternative regulation plans from publicly-owned utilities. Nevertheless, the details of each feature may vary significantly across systems.

a. Decoupling.

Decoupling is a tool, long employed in Vermont and other jurisdictions, which breaks the link between utility profits and sales. The goal of decoupling is to reduce or eliminate the utility's disincentive to invest in efficiency measures or support distributed generation (e.g. net-metering). Mechanisms for decoupling ensure the collection of a defined amount of *revenue*, independent of changes in sales volumes during that period, with the potential exception of customer growth related costs and revenues.[3] There are several methods of decoupling that vary in the underlying mechanics and application.[4] Alternative regulation plans should generally contain decoupling provisions, the details of which may vary plan to plan.

b. Multi-year rate plans.

Multi-year plans help to encourage a stronger alignment of incentives between financial performance and cost management. Effective multi-year plans harness and enhance the desirable incentives that are associated with traditional regulation (regulatory lag). Research reported by

[3] An important distinction must be made here between *revenue* and *profit*. Utilities which are poorly managed may not earn their full allowed return on equity even if they collect the entire revenue requirement.
[4] The Department recommends as background reading the Regulatory Assistance Project's publication, *Revenue Regulation and Decoupling.* (2011). Available at https://www.raponline.org/wp-content/uploads/2016/05/rap-revenueregulationanddecoupling-2011-04.pdf.

Pacific Economics at the September workshop demonstrates that multifactor productivity can improve under such plans.[5] Multi-year rate plans are a generally desirable feature in which the revenue requirement is determined at the outset of the plan by way of a full, traditional, cost-of-service rate case then escalated by some index, sometimes referred to as an attrition adjustment mechanism (ARM) or by a pre-determined amount each year. The duration of the plan should not be so long as to risk a significant mismatch between costs and revenue, which would be a windfall to either the utility (if costs go down) or to ratepayers (if costs go up). Under multi-year rate plans, there is a financial benefit to utilities that manage costs through effective and prudent practices. Prudent regulation incorporates design features that minimize the potential for perverse incentives to undermine service quality and reliability by cutting costs associated with providing quality, reliable service. The Department recommends that where multi-year rate plans are in use, performance incentives should generally be incorporated to help ensure a strong alignment between outcomes that benefit ratepayers and those that further objectives for the sector (e.g., renewables and new business models).

c. Performance incentive mechanisms and metrics.

Performance incentive mechanisms (PIMs) are metrics that combine with targets (or other bounding triggers or thresholds) and financial incentives directed toward utility performance in specified areas of interest to consumers and policy-makers. Areas of interest to consumers include retail service quality, reliability and power quality. Areas of interest for policy-makers, participating consumers, and new businesses include responsive interconnection process and innovations such as managing power quality and constraint in the distribution

[5] Lowry, M. Recent Trends in Electric Utility Regulation, September 12, 2017, Workshop, Docket 17-3142-PET.

network. Where there are PIMs, recommended practices include the following: there should be an upper bound for awards in any given category so that the other categories are not ignored or excluded from utility attention. The award should be calculated so that it is linked or keyed to the utility ROE. In other words, a utility should not be rewarded above a normal return for the high standards of performance that should be expected of the utility. Standards of service below that traditional high standards of service should then correspond to an ROE that is reduced by an equivalent amount so that conventional high standards of performance results in the utility, overall, earning its allowed ROE. Superior performance could improve earnings by some small but relevant amount above allowed ROE. A *penalty* could apply to inferior performance. Multi-year rate plans should include at least basic PIMs for service quality and reliability which could simply incorporate utility's service quality and reliability plans. The establishment of PIMs could be phased in over time to help gauge the quality of the performance measure and the ability to the utility to perform ably in relation to the metric without unintended consequences, likely gaming. Utilities could phase in performance incentives by first measuring and tracking desired outcomes, then later attaching financial rewards or penalties for performance.

d. Fuel or power adjustment clause.

There appears to be widespread agreement that fuel adjustment clauses are desirable and have the effect of lowering the utility's cost to borrow. However, these clauses should include only components that meet the following three standards for inclusion: (1) the costs should be largely outside the utility's control; (2) the costs should be material in their character; and (3) the costs should be volatile to a degree that would place undue risks on the utility in relation to its financial performance. It may be appropriate for the Commission to revisit the list of items

included in prior alternative regulation plans to determine whether they actually satisfy these three standards. Specifically, if any future alternative regulation plans include fuel or power adjustor clauses, it will be necessary to evaluate whether some items included in the clause could be managed by the utility through normal physical or financial hedges.

e. Exogenous Adjustments

Exogenous adjustments typically make provision for cost recovery for large unexpected and extreme events outside company control, like costs associated with storm recovery. Exogenous adjustments may also include events that may be largely outside utility control, but within the control of government or industry generally. These events may include tax changes, changes to accounting standards, or other government or industry change for which the company has little control. However, like with the power adjustor, it will be necessary to carefully review any proposed exogenous adjustment mechanisms in proposed future plans to include only those events that are beyond a utility's control. Storm events, for example, can be managed in advance through well-designed regiment of tree-trimming. Provisions for accountability and suitable incentives should be part of the plan.

f. Earnings Sharing

The Department believes that some form of earnings sharing is appropriate for plans that are filed by investor-owned utilities for the immediate future. The Department recognizes that an earnings sharing mechanism may limit a utility's financial incentives to manage costs and improve service, which should be one of the primary goals of alternative regulation. However, as noted above, the Department believes that it is possible to develop effective incentives that would allow above normal earnings for utility performance that yields effective cost containment

and/or exceptional performance. However, earnings sharing guardrails are needed to ensure that ratepayers are not unduly harmed by unexpected events or poor utility performance. Such guardrails should be designed with an emphasis on consumer protection from extraordinary utility returns. It is important and fair to impose on the utilities, and not the customers, the obligation to foresee, design for, and manage downside risks to the utility are not available on the customer side. Accordingly, earnings sharing mechanisms may be appropriate where a utility can be compensated for strong performance, but downsides risks that can be controlled by the utility should be borne by the utility.

g. New Businesses and Third-Party Access.

The Department believes that the next generation of alternative regulation plans should be designed with the future in mind. It is becoming apparent that solar providers, load aggregators, customers themselves, and potentially storage providers can offer services comparable or even better than that which is likely to emerge from a single entity. Nevertheless, the entry of these services and providers can be committed to either a slow or fast track depending on barriers or incentives to their participation. The form of regulation provides one of the many tools available to regulators to help motivate the utility to perform as a cooperating partner. The Department recommends that plans for alternative regulation be designed with these ambitions in mind.

V. Conclusion

The Department appreciates the Commission's decision to issue a draft proposal, and looks forward to engaging in substantive dialog with the Commission and other interested parties regarding the proposal. The Department recommends that the Commission allow all interested

parties an opportunity to comment on the draft proposal in writing as well as by way of a workshop to follow written comments.

Dated at Montpelier, Vermont this 4th day of December, 2017.

Vermont Department of Public Service

By: /s/ Daniel C. Burke

Daniel C. Burke, Special Counsel
Vermont Department of Public Service
112 State Street
Montpelier, VT 05620-2601
(802) 828-4019