

Utility Rate Proposals: Are We Aligning Compensation With Performance?

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July 2013

This month, a break from this year's series on mergers (begun in February 2013) to address an old wine appearing in new bottles: "incentives."

To Enforce the Utility's Obligation to Serve, Condition Compensation on Performance

The purpose of regulation is to align private behavior with the public interest. That public interest imposes two chief obligations. The first obligation is the utility's obligation to serve the public. This obligation must be defined by commission-established standards for performance. The second obligation is the commission's obligation to compensate the utility. This compensation must be based on the utility's performance.

These two obligations yield three main guidelines when addressing utility requests for incentives. First, the commission *defines* the obligation to serve, by establishing performance standards. Those performance standards include more than quantitative standards like cost levels, and more than qualitative standards like "average," "above average," "best practices" or "excellent." Merely keeping electric current flowing at reasonable rates is only one component of the obligation to serve. Performance standards also should include factors like product diversity, innovation, customer education and customer empowerment. Second, the commission *designs* rate plans that condition compensation on the utility's performance. This step involves (a) establishing the level of revenues necessary for a prudent utility to produce the necessary performance, and (b) designing the compensation scheme so that the utility's profit depends on its performance. Third, the commission *conditions* compensation on performance. Alert commissions performs this role continuously, inside and outside rate cases.

Those who argue that incentives are necessary to align rates with costs miss the central purpose of utility regulation. That purpose is not to align rates with cost, but to align compensation with performance.

How Well Do Typical "Incentives" Relate Compensation to Performance? Five Flaws

Compensation exceeding performance: Typical incentive proposals do not align compensation with performance because they do not define performance. They often propose "sharing" formulas that allow supra-normal returns without committing to supra-normal performance. This can happen only in a regulated, monopoly market. In a competitive market, sellers must match returns with performance or lose their customers. When a utility's return outpaces its performance, it is monopoly rent.

Rewards for cost-cutting: Performance-based rate plans often reward cost-cutting with profit, because for a specified period the rate stays constant while costs decline. But cost-cutting is not a proxy for performance. There is risk that the utility will favor short-term cost cuts over long-term performance investments.

Regulatory gamesmanship: Because the utility knows more about its cost structure than the commission, it can design the incentives to reward behavior that would have occurred anyway.

Worker-reward gap: What enhances performance is people: people who work at jobs, not people who wait for dividends. The typical incentive goes to shareholder profit, not employee paychecks. If the incentive went to employee paychecks, it would be above-line expense, not below-the-line profit. I have yet to see a utility executive assert that his company's workers refuse to excel unless the shareholders earn higher returns.

Test year distortion: A test year revenue requirement is a prediction of what the costs will be in the rate year. Some of those costs, like the ones embedded in rate base or existing contracts, are fixed in advance. But for other costs, the predictions placed in the test year revenue requirement are often wrong. The theory behind a test year is that the over-estimates balance out the under-estimates, so that the return on equity actually earned resembles the level authorized. A surcharge, rider, passthrough clause or similar incentive mechanism removes costs from the test year revenue requirement and recovers them from ratepayers separately. Doing so upsets the test year balance, i.e., the assumption that over- and under-predictions will likely cancel each other out. The imbalance is asymmetrical if the costs recovered through the rider are the type that tend to increase rather than decrease. Those types are, of course, the types that cause utilities to seek riders. (The book value of rate-based assets declines each year with depreciation, but I have never seen a rider that tracks this rate-decreasing effect.) Commissions should restrict riders to special cases: costs that themselves upset the test year balance because they are large and non-routine.

Recommendation: Generic Proceedings on the Value and Design of Incentives

Generic proceedings could address four questions.

How does a commission pick the level of performance? Defining performance is about defining the customer experience. It is not only about choosing among "average," "above average," "excellent" or "first quartile"; it involves placing a value on creating new products and services, and empowering consumers, and incurring "insurance" costs by investing in infrastructure to reduce the effects of natural and human-caused disasters.

How might we reduce the time tension between rate cases and productivity investments? A rate case deals with a limited future period. The length of that period depends on factors unrelated to performance: the utility's decision to seek a rate increase, a consumer

representative's decision to seek a rate decrease, or a commission's decision to investigate. A rough average for the gap between rate cases is three-four years, although there are utilities who ask more frequently and those who “stay out” for decade. The problem is that the time dimension for performance is different from the one for rate cases. Payback periods vary depending on the investment. New meters, purchases of renewable energy, nuclear plant protection: None of these have performance time periods matching rate case time periods. This creates a mismatch between the period in which expenditures are recovered from customers, and the period in which customers benefit from the expenditures. While this type of mismatch is common in society, it grinds the gears of commission decisionmaking.

What procedures will best examine compensation–performance alignment? The general rate case is only one place where compensation is sought but performance ignored. There also are proceedings on power purchase contracts, energy efficiency investments, heat rate incentives and other measures. Are we prescribing too many drugs without studying their interactions?

Who should perform which services? The utility-driven focus on utility compensation for utility costs distracts from the more important question: Is the utility always the necessary actor for every action, or can someone else do some things better?