ORDER NO. 89638

Exploring the use of Alternative Rate Plans or Methodologies to Establish New Base Rates for an Electric Company or Gas Company	*	BEFORE THE PUBLIC SERVICE COMMISSION OF MARYLAND
	*	PC51
In the Matter of Alternative Rate Plans or Methodologies to Establish New Base Rates for an Electric Company or Gas Company	*	CASE NO. 9618

Issue Date: September 29, 2020

ORDER APPROVING PERFORMANCE INCENTIVE MECHANISMS

1. In Order No. 89226, the Commission found that the record developed in Public Conference 51 ("PC51") supported the use of a multi-year rate plan ("MRP") as an alternative to traditional ratemaking methods, and determined that a properly constructed MRP can result in just and reasonable rates and yield public benefits over time.[1] The Commission also found "that aligning state policy goals and utility rate increases is an important objective"[2] and that performance-based rates "can strike a balance between

[1] *Exploring the Use of Alternative Rate Plans or Methodologies to Establish New Base Rates for an Electric Company or Gas Company*, PC51, and *In the Matter of Alternative Rate Plans for Methodologies to Establish New Base Rates for an Electric Company or a Gas Company*, Case No. 9618, Order No. 89226 at 56 (August 9, 2019).
[2] Order No. 89226 at 57.

imposing additional obligations on the utilities that meet State policy goals and obtaining measurable benefits and providing value to customers."[3]

2. To that end, the Commission directed a Working Group of interested parties convened by the Commission's Public Utility Law Judge Division ("PULJ") to "commence discussions on how best to integrate performance-based measures into a multi-year rate plan by identifying goals and outcomes (*e.g.*, integrating more renewable resources and energy efficiency, encouraging peak demand reductions, facilitating storage, supporting grid modernization, and any other State policy goals that may be in place or enacted) that align utility performance with State policy objectives that are not already addressed through existing regulatory measures."[4] The Commission also tasked the Working Group with "evaluating metrics that are clearly defined, verifiable, quantifiable, subject to the utility's control, and be able to be incorporated into a multi-year rate plan."[5]

Background

3. On June 17, 2020, the Chief Public Utility Law Judge submitted the Phase II Report on Performance Based Regulation ("Phase II Report").[6] As it did in Phase I, the Commission's Technical Staff ("Staff") submitted Strawman Positions to the Working Group as a starting point for the discussion on performance-based regulations. The Phase II Report noted that "there was a significant amount of interest and participation in the

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[3] *Id.*.
[4] *Id.* at 58.
[5] *Id.*.
[6] *Exploring the Use of Alternative Rate Plans or Methodologies to Establish New Base Rates for an Electric Company or Gas Company*, PC51, and *In the Matter of Alternative Rate Plans for Methodologies to Establish New Base Rates for an Electric Company or a Gas Company*, Case No. 9618, Phase II Report on Performance Based Regulations, June 17, 2020 ("Phase II Report").

[Working Group], with attendance varying between 25-45 individuals each meeting, with another 5-10 people participating on a conference call each meeting."[7]

4. The Working Group came to consensus on many of the Strawman Positions, but not all, as described below. The Phase II Report also noted that parties were given numerous opportunities to submit written comments during the Working Group meetings and to respond to the Strawman Positions.[8] Additionally, the Phase II Report stated that parties were advised to raise other issues as appropriate and not constrained to the issues identified by Staff.[9] The Working Group held six meeting with the final meeting being held virtually on May 22, 2020.[10]

5. As a preliminary matter, the Working Group agreed that a more appropriate term for this proceeding would be "Performance Incentive Mechanism" ("PIM") instead of "Performance Based Regulation" ("PBR"). Staff explained that "PBR divorces the rates a utility charges from the costs it incurs and moves away from traditional cost of service rates and towards outcome-based determinations based on the performance of the respective utility."[11] The Working Group agreed that a PIM more closely aligns the Commission's intent to retain the cost of service paradigm under an MRP construct as PIMs can be layered over a cost of service-based MRP and work in conjunction with an MRP.

[7] Phase II Report at 1-2.
[8] Phase II Report at 2.
[9] *Id*.
[10] *Id*. at Fn 6.
[11] Phase II Report at 1.

Summary of Strawman Positions

6. The Phase II Report reflects wide agreement and consensus on seven of the Strawman Positions as well as four areas where Working Group participants could not reach agreement. Those items are summarized below:

1. Consensus Items

7. Utility-specific PIMs - The Working Group reached general consensus that the PIMs should be individually tailored to the specific requesting utility.[12] The Working Group believes that "the specific details and parameters of PIMs, especially performance standards, should be utility-specific due to each utility's own characteristics and historic performance."[13] Both the Maryland Office of People's Counsel ("OPC") and the Apartment and Office Building Association ("AOBA") agreed that utility-specific PIMs should reflect the costs and benefits of achieving a PIM and that rewards for meeting or exceeding a particular goal should reflect the costs and benefits associated with achieving that goal. In addition, parties suggested that asymmetric awards or penalties may be appropriate in certain cases.[14]

8. Regarding performance standards or targets for utility-specific PIMs, Staff asserted that performance standards and targets for each metric should be set for the entire MRP period as part of the MRP proceeding in order to avoid annual litigation of targets. Targets will be unique for each utility and the metrics should be designed so they are not met easily.[15] AOBA noted that the issue is not whether the target is easy or hard

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[12] *Id*. at 3.
[13] *Id.*
[14] *Id*.
[15] *Id*.

but whether the utility will achieve the target without an incentive.[16] Further, the parties agree that to avoid the risk of gaming, metrics should be "clear and well-defined, because the more complex the metric and corresponding data, the more difficult to evaluate/measure, and allegedly easier to manipulate."[17]

9. The Phase II Report noted that the Working Group "envisioned that the Commission would determine which State [p]olicies were appropriate for a PIM and metrics for each respective policy goal, thereby creating a 'menu' option for utilities to select for inclusion in an MRP."[18] Staff proposed that, for each goal, the Commission establish mandatory metrics that a utility must address in relation to a policy goal; Staff did not support an "optional menu" where utilities could pick and choose what metrics to pursue.[19] Additionally, the Working Group recommended that the Commission should determine whether utilities can propose PIMs not on the Commission's menu, and whether third parties should be able to propose PIMs and tracking metrics in addition to those proposed by the utility.[20]

10. Gate Mechanism - The Working Group agreed that a PIM design must include a "gate mechanism," which "would permit the Commission to suspend a PIM related to positive or negative revenue adjustment for good cause, pending a review of the utility's performance."[21] Staff clarified that the gate mechanism could also be used to suspend negative revenue adjustments if the circumstances warranted. Staff anticipated the gate mechanism would be rarely exercised by the Commission and would be initiated by an

[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] *Id*. at 4.
[21] *Id*. at 5.

order providing the rationale for a PIM suspension, the length of the suspension, the PIM revenue adjustments required, and a requirement that the utility make a tariff filing implementing the adjustment.[22]

11. Parties generally agreed with the use of a gate mechanism, but some cautioned that the proposal could discourage utilities from seeking PIMs, or it could increase regulatory risk. Further, parties stated that a gate mechanism should rarely be employed and should be symmetrical for both penalties and rewards, especially when events or forces are outside the utilities' control.[23] Staff noted that the Commission already has the authority to suspend a PIM pursuant to Public Utilities Article, *Annotated Code of Maryland* ("PUA") § 2-112.

12. Maintain the PIM Work Group - The Working Group recommended that the Commission should "continue [the PIM Work Group] as a standing group to update the PIM framework based on new or revised policies."[24] None of the parties opposed this Strawman Position but some questioned whether it was necessary and proposed that the Working Group could simply reconvene in the event that unforeseen events or issues arise.

13. Performance Standards – The Working Group agreed that performance standards should not be developed and that PIMs would be developed on a case-by-case basis.[25] The parties agreed that this will provide the utilities with flexibility to address changes and new State policies.

[22] *Id*.
[23] *Id*.
[24] *Id*. at 6.
[25] *Id*. at 6-7.

14. Reward/Penalty Structure - The parties agreed generally that "a graduated reward/penalty cap shall be implemented from 2021 through 2023."[26] However, the parties varied on how the graduated structure would be implemented. For instance, Staff recommended a gradual increase to the ROE incentive adjustment range with caps associated with each year of the MRP, *i.e.*, +/- 5 basis points in 2021, +/- 15 basis points in 2022, and +/- 25-basis points in 2023.[27] However, Columbia Gas recommended a phase-in based upon performance levels in PIMs rather than by year. Similarly, the Exelon utilities and Washington Gas Light Company ("WGL") also found that a phase-in may be appropriate, but that the utility should be permitted to propose specific caps within its MRP.[28]

15. PIM Filing Requirements - The parties agreed generally that "a PIM design proposal will require additional information to be included under the minimum filing requirements of an MRP."[29] Staff explained that an MRP filing containing a PIM proposal must specify the target State policy objective and the associated PIM metrics and performance standards for each year of the MRP. Staff noted that utilities shall propose PIM performance standards for metrics that justify the proposed maximum performance ranges that are a "stretch challenge" on the higher performance range and a credible risk on the lower performance range.[30] OPC supported Staff's proposal that PIMs should present a "stretch challenge" but also recommended that the performance data going forward should be audited. No one opposed the recommendation that the

[26] *Id*. at 13.
[27] *Id*.
[28] *Id*.
[29] *Id*.at 14.
[30] *Id*.at 14.

PIMs represent stretch goals; however, Potomac Edison ("PE") recommended that any audit expenses be fully recoverable as a rate case expense.[31] While the Working Group generally agreed to the audit proposal, they suggested that the Commission determine whether utilities must provide an independent auditor certification of both the historical baseline data and review of any PIM metrics and attainment of goals during the evaluation phase.[32]

16. PIM Modification - Finally, there was Working Group consensus that the PIM designs cannot change outside of the approved MRP, barring a force majeure event affecting the plan as a whole or a change in legislation.[33] This proposal had no significant opposition; however, PE pointed out that an incentive mechanism could go beyond three years—the current MRP lifecycle—to accommodate programs that take longer than three years to complete.[34] In such instances, the parties suggested that the Commission determine whether PIMs should be limited to the same duration as the underlying MRP.[35]

2. Non-Consensus Items

17. PIMs Limited to MRP cases – The Working Group failed to reach consensus on whether PIM proposals and designs will only be available through an approved MRP application.[36] Several of the parties such as WGL, Potomac Edison, and Columbia Gas support the Strawman Position of limiting the PIM proposal to MRPs. However, parties including the Maryland Energy Administration, Prince George's County, and AOBA

[31] *Id*. at 14.
[32] *Id*. at 16.
[33] *Id*.
[34] *Id*.
[35] *Id*.
[36] *Id*. at 2.

believe that PIMs should also be permitted in traditional, historic test year base rate cases. These parties noted that MRPs are optional and argue that allowing PIMs in a traditional base rate case will create an incentive mechanism to encourage all utilities to pursue State policy objectives. OPC noted that PIMs can be used in conjunction with traditional ratemaking and that 29 states have some form of PIM in place under the traditional approach.[37] The Exelon utilities asserted that adopting the Strawman Position was neither necessary nor advisable at this time, and utilities should be able to propose PIMs outside of an MRP.[38] Overall, the Working Group recommends that the Commission clarify whether it intended to allow PIMs in traditional rate cases.

18. ROE versus Monetary Reward Incentive - The Working Group had significant disagreement on the Strawman Position that rewards and penalties should be carried out through an adjustment in the affected utility's return on equity ("ROE").[39] Staff proposed a 50-basis point range, +/- 25-basis points, from the Commission-authorized ROE in the applicable MRP as an award/penalty structure.[40] Staff asserted that this approach provides a consistent application for all utilities and that the overlay of PIM awards/penalties, on top of an MRP, will ensure there is a cost basis to the rates that customers will ultimately pay.[41] Several parties stated the 50-basis point range was reasonable but disagreed on how the award/penalty should be applied.[42] Still others

[37] *Id*..
[38] *Id*.
[39] *Id*.at 7.
[40] *Id*.
[41] *Id*.
[42] *Id*.

argued for converting the ROE penalty into a monetary figure that could be either credited to customers or earmarked for projects in the penalty areas.[43]

19. PIM Award/Penalty Determination - The Working Group did not reach consensus on a PIM review process for the reward/penalty determination; however, consensus was reached that a review should be conducted annually. Staff proposed that intervenors be permitted 60 days to conduct discovery and submit recommendations related to achievement of PIM metrics against MRP-approved PIM performance standards.[44] Staff also provided guidelines to determine whether a utility will receive PIM awards or penalties.[45] MEA and OPC supported Staff's position generally on PIM awards or penalties; however, the Exelon utilities proposed that each metric under each goal be treated individually, and the treatment of awards and penalties should be symmetrical. PE opposed Staff's proposal and argued OPC's approach is one-sided while WGL proposed not to set a general rule.[46]

20. PIM Implementation Time Period - The Working Group failed to reach consensus on the Strawman Position indicating that "No PIM design shall be proposed until 2021 in order to allow time for the Commission's MRP and PIM implementation orders and the initial MRP case."[47] Staff proposed a one-year delay to allow the Commission to fully process the pilot MRP and avoid overburdening the Commission.[48] MEA supported Staff's position. OPC, on the other hand, suggested waiting until after the first MRP fully

[43] *Id*.
[44] *Id*. at 11.
[45] *Id*. *See* chart entitled Guideline for PIM Award/Penalty Determination
[46] *Id*. at 12.
[47] *Id*. at 13.
[48] *Id*.

concludes in 2024. The utilities opposed any delay and argued that such delays harm ratepayers.[49]

Summary of PIM Goals & Metrics

21. In Part III of the Phase II Report, the Working Group presented possible PIMs as well as competing viewpoints for and against different aspects of each. Each proposed PIM attempted to address a state policy concern, including the following issues: renewable energy; grid modernization; energy storage; grid reliability and resilience; energy efficiency; electric vehicles; gas safety; damage prevention; competitive supply; diversity; customer satisfaction and billing; and greenhouse gas reduction.

22. None of the proposed PIMs received a consensus favorable recommendation. In several cases, the Working Group concluded a PIM might be inappropriate because of a possible conflict with an existing Commission program. The Working Group recommended that the Commission direct utilities in some cases to begin collecting data on specific metrics in anticipation of future PIMs.

Commission Decision

23. Under PUA § 4-102,[50] the Commission is responsible for setting just and reasonable rates that fully consider, and are consistent with, the public good. The statute affords the Commission discretion to determine rates in any manner that is consistent with this standard. To that end, the Commission finds that exploring and potentially

[49] *Id*.
[50] Per PUA § 4-101, the term "just and reasonable rate" means a rate that: (1) does not violate any provision of this article; fully considers and is consistent with the public good; and except for rates of a common carrier, will result in an operating income to the public service company that yields, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return on the fair value of the public service company's property used and useful in providing service to the public.

implementing PIMs is consistent with the public good, can be beneficial for ratepayers and utilities, and offers opportunities to advance state policy goals and objectives.

24. Going forward, the Commission finds it reasonable to consider PIM proposals in any newly-filed rate case, whether MRP or traditional. The ability to file a MRP rather than a traditional rate application is at the discretion of the utility and the Commission cannot, and will not, prevent utilities from filing for PIMs because they elected to file a traditional rate case. The Commission finds that allowing PIMs to be proposed in a traditional base rate case will provide an opportunity to align the interests of both the utility and the ratepayer while simultaneously advancing State policy objectives.

25. At this time, for administrative efficiency, only the utility filing a rate case may propose a PIM. In the Phase II Report, the utilities cautioned, and the Commission agrees, that intervenor-sponsored PIMs within the MRP context would have implications for an MRP overall and the ultimate rates, which could make consideration of the filing difficult.[51] However, interested parties participating in any such rate case may propose modifications to the proposed PIM and present both evidence and argument in support thereof. The Commission also notes that a party seeking to modify the utility-proposed PIMs would have the burden of proving that the modification would result in just and reasonable rates.[52]

1. PIM Design

26. Although the Working Group requested that the Commission determine which State policies and goals are appropriate and create a menu of PIMs, the Commission finds that utilities have the most information about their business activities and capabilities.

[51] Phase II Report at 4.
[52] *Id*.

Therefore, the utilities are in the best position to determine their ability to advance a particular state policy goal through a PIM. Therefore, at this time, the utilities may propose any PIM that supports any recognized Maryland policy goal (including but not exclusively ratepayer benefits) beyond historic baseline standards.[53] The Commission will evaluate each proposal individually based on the filings and information available at that time. Given the unique constraints and opportunities available for each utility, the Commission expects each utility's PIM proposal to be individually tailored.

2. Contents of a PIM filing

27. In order for the Commission to have a sufficient record to evaluate each PIM, the Commission expects the following criteria to be included in any PIM filing.

a. Metrics, Milestones, and Reporting

28. The Working Group proposed that each PIM proposal should identify specific proposed metrics that will serve as a measurable proxy for progress in the public and/or ratepayer interest. The Working Group also recommended that each PIM proposal contain progress milestones, with the utility earning a predetermined financial reward if it achieves a given milestone within the timelines set. The Commission finds that this framework is reasonable since it provides sufficient certainty to both the utilities and other parties on how the PIM will be evaluated over its lifecycle. The Commission will not set specific performance standards at this time. Rather, proposed performance

[53] State policies are constantly evolving, and the Commission urges utilities to work toward continued innovation in the development of the most cost-effective ways to bring benefits to Maryland ratepayers and the public at large. Additionally, the Commission recommends that utilities consult the Working Group and state agencies like MEA and OPC who can provide useful guidance in the development of PIMs supporting state policies.

standards for PIMs will be considered on a case-by-case basis.[54] This framework will provide the utilities with flexibility to address future changes and new State policies.

29. Although the Phase II Report contains discussion about a possible set of timelines for review of progress toward milestones, an individualized review of the timelines may be necessary for each PIM because of the different types of actions taken to achieve a PIM and the subsequent time it will take to measure the effectiveness of such actions. In the Phase II Report, Staff suggested a PIM Implementation Reporting Schedule[55] based on a multi-year rate case lifecycle. For these reasons, the Commission finds that Staff's proposed PIM reporting schedule is reasonable for an MRP rate case, though a given PIM proposal may deviate from the proposed schedule where appropriate. The Phase II Report does not contain a proposed timeline for a traditional rate case, so any utility submitting a PIM with a traditional rate case must develop and propose an appropriate timeline. The Commission will determine a timeline for each PIM on a case-by-case basis.

30. The Phase II Report also recommended that the Commission require utilities to begin tracking and reporting certain data for use as metrics in future PIMs. At this time, since only a utility may initiate a PIM, the Commission will not require utilities to collect and report data based on its potential value for future PIMs. However, a utility should be mindful that any PIM will require sufficient baseline data to demonstrate success based on the approved metrics. The Commission finds that any proposed metrics, milestones and reporting of PIMs should be clear and well-defined, unique for each utility, designed so they are not easily met, and benefit ratepayers.

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[54] *Id*. at 6-7.
[55] *Id*. at 15.

b. PIM awards and penalties

31. The Phase II Report reflected disagreement among the Working Group members regarding two questions related to the form of award/penalty that a utility could receive based on performance. First, should PIMs contain penalties where the utility failed to achieve certain milestones, and how should milestones for awards and penalties be set relative to each other? Second, should awards/penalties be structured in terms of ROE or in a monetary amount? As to both questions, the Commission will consider arguments on a case-by-case basis for each PIM proposal. Without knowing the needs of the utility, the design of the PIM, and the associated State policy, it would be premature to decide the best method to motivate and incentivize a given utility. The Commission finds that any proposed PIMs award/penalty structure should incentivize utilities to stretch beyond their current capabilities to achieve measurable results.

c. Terminating a PIM

32. The Commission finds that each PIM proposal must include a sunset provision to indicate when the PIM will terminate. If the utility anticipates that the PIM will extend beyond the rate case to which it is tied, then the utility must explain why the extension is appropriate. This requirement ensures that each PIM will be a self-contained measure and will avoid any continued compensation without frequent, targeted review.

33. Regarding the proposal that each PIM contain a "gate mechanism," which could suspend a PIM in whole or in part, the Commission declines to set firm parameters for a gate mechanism at this early stage because there is insufficient information in the record as to how such a mechanism would operate. As noted above, this too will be part of the review associated with a proposed PIM. The Commission notes, however, that it has the

authority to suspend a PIM at any time pursuant to PUA § 2-112 *sua sponte* or upon request by a party to the underlying rate case for good cause.

3. Conclusion

34. Performance incentive mechanisms can serve as a valuable regulatory tool, with the potential to provide measurable benefits to both Maryland's ratepayers and utilities, while advancing State policies and interests. As discussed above, the Commission does not specifically endorse or eliminate any particular PIM option discussed in the Phase II Report. Nonetheless, the Commission expects that any utility PIM proposal, in accordance with this Order, must be tethered to a recognized State policy, accelerate the policy goal beyond the current utility's capabilities, show measurable benefits to ratepayers, and contain metrics which show baseline data over a specific timeframe. Additionally, the Commission directs the Working Group to reconvene as necessary to address common issues, develop lessons learned from any PIM filings, and propose further refinements to the PIM process. The Commission expects to initiate a rulemaking on PIMs after it has gathered sufficient information and experience to inform the development of regulations that would apply in a uniform manner to utilities across the State.

35. Individual PIM proposals showing the policy goals and metrics to be achieved, proposed rewards and penalties, and an expected timeline of performance may be filed in accordance with this Order.

IT IS THEREFORE, this 29th day of September, in the year of Two Thousand Twenty, by the Public Service Commission of Maryland,

ORDERED: (1) That utility companies in Maryland may submit, as part of a rate case, proposals for Performance Incentive Mechanisms as discussed herein; and

(2) That the working group shall reconvene on an as-needed basis.

/s/ Jason M. Stanek

/s/ Michael T. Richard

/s/ Anthony J. O'Donnell

/s/ Odogwu Obi Linton

/s/ Mindy L. Herman
Commissioners