Appendix A

U-180907 – WUTC Regulatory Workshop December 10, 2018 1:30 p.m.

RE: Notice of Inquiry into the Adequacy of the Current Regulatory Framework Employed by the Commission in Addressing Developing Industry Trends, New Technologies, and Public Policy Affecting the Utility Sector

Commission Stakeholder Questions / Utility Responses:

1. **How are developing industry trends, new technologies, and public policy in the utility sectors affecting the effectiveness of traditional rate-base, rate-of-return regulation?**

   Investor-owned utilities are buffeted today by varied and rapid changes in the business conditions they face. Customers are requesting new options for service, given fast-paced changes in technology in recent years. In addition, utilities are facing dramatic changes in public policy related to energy generation and distribution, customer privacy, and cyber-security issues, to name a few. Avista for one has been very active in trying to be responsive to these changing conditions, however historical rate-making is an impediment due to instilling a two-year lag or longer period before recovery of utility investment from customers.

   Each of the pressures identified above put operating and financial constraints on the utility, which traditional rate-making treatment (rate-base, rate-of-return regulation) with its built-in regulatory lag, cannot overcome. The effectiveness of traditional regulation is therefore at question, increasing regulatory risk, increasing the costs of maintaining utility systems, and ultimately increasing costs to serve customers (i.e. increases in cost of capital). Given the developing industry trends, current financial incentives of the utility may no longer be aligned with customer needs, nor with the Commission or State policy goals.

   It is important to remember that this Commission recognized that traditional ratemaking treatment was an impediment to the promotion of energy efficiency and distributed generation. In order to allow for the proliferation of those resources, the UTC allowed investor-owned utilities to implement decoupling mechanisms. These mechanisms have, for Avista, removed any impediment towards the promotion of both energy efficiency, as well as distributed generation. While distributed generation in particular could be seen as a threat to the traditional utility model, decoupling for Avista has removed that impediment. It would be a positive step to make mechanisms, like decoupling, permanent mechanisms to protect all stakeholders. It is actions like these that the UTC could undertake to drive utilities towards desired outcomes for customers, communities, and the state. Unfortunately traditional historical test year ratemaking acts as an impediment, rather than a positive driver.

2. What are the advantages and disadvantages of traditional rate-base, rate-of-return regulation under current market conditions?

Advantages of traditional rate-base, rate-of-return regulation under current market conditions are that it continues to provide regulatory oversight, and price changes take place only after extensive, public multi-month processes where utility costs and operations are reviewed, which some believe protects customers and provides safeguards. Under a static environment, and under the right circumstances, healthy regulatory lag caused during this time period can be an essential tool for regulators that can work to the benefit of customers and the utility. This approach matches existing, known and measureable expenses with existing revenues to evaluate the overall needs of the Company.

Disadvantages, however, of traditional regulation, when escalating costs of maintaining the utility systems are outpacing utility revenue growth (growth is outside the control of the utility), is that the unhealthy regulatory lag of recovery of a utility's investment occurs, and can be as much as two years or more. Utility investments are increasingly dedicated to maintaining and replacing small, dispersed facilities like utility poles and transformers, rather than major investments like a new power plant. These smaller level of investments do not fit into the traditional regulatory schema, making these investments more challenging to audit for prudence, and often do not qualify under the modified historical test year approach for inclusion as adjustments.

In addition, there has been a significant increase in the level of utility investment in shorter lived assets (depreciable over 5 to 10 years), that any delay in recovery could mean a significant amount of investment that would go unrecovered from customers. For example, if Avista invested in a software platform related to cyber-security, where the software has a 5-year life, that investment would be excluded from rate base for two years due to regulatory lag. By the time it is included in rates, 40% of that asset may be unrecoverable from customers. Ultimately, the impacts of this level of regulatory lag can place a financial risk on the utility, increasing capital costs that eventually may be passed onto customers. While Avista will always seek to operate a prudent and safe utility system, it would be disingenuous not to state that significant regulatory lag may drive utilities to make decisions counter to the best interest of its system and customers.

Annual rate cases may also be the effect of traditional regulation and extended regulatory lag, thus burdening all stakeholders, including ratepayers, with rate-case fatigue. This regulatory lag, may also cause a delay in sending current price-signals to customers, as increases in customer charges significantly lag behind the actual costs of the utility. Therefore, there is no rate certainty, but rather rate volatility (both actual and perceived).

Finally, traditional regulation does not allow the utility to adjust quickly or flexibly to the changing market conditions, without significant risk of under recovery of its investments and other costs. Mechanisms such as a timely ERF could help circumvent some of these issues in the short-term, while other mechanisms (performance-based, multi-year rate plans, attrition mechanisms, for example) could positively impact stakeholders in the long-term.

3. Would potential alternatives to traditional regulation, including performance-based regulation, multi-year rate plans, and other flexible regulatory mechanisms better align the utility business model with customer interests and public policy objectives?

Yes. Alternative regulation, such as performance-based regulation, multi-year rate plans, and other flexible regulatory mechanisms would better align the utility business model with customer interests and public policy objectives. These regulatory mechanisms could help utilities secure balanced and fair outcomes for their customers and shareholders, and provide the utility an opportunity to earn its authorized rate of return, strengthening utility performance.

For example, Multi-Year Rate Plans feature a moratorium on general rate cases that typically last 3-4 years. Between rate cases, an attrition relief adjustment or separate cost tracker, typically based on multi-year historical or estimated cost trends, industry price and productivity trends, or a combination of, may provide automatic, timely relief for growing cost pressures. These types of alternative regulation may include an earnings sharing adjustment, rate caps or revenue caps. Multi-year rate plans benefit all stakeholders by phasing in increases in rates over time, rather than larger, lumpy changes. Efficiencies can be gained for customers, the Company and the Commission by reducing general rate case filings and providing predictability or price certainty of rate changes and bills, a key ask by industrial and other customers for budgeting purposes. Multi-year rate plans provide a meaningful incentive for utilities to manage its costs to stay within the approved changes in rates, which customers benefit from either through earnings sharing mechanisms or in subsequent rate proceedings that update rates to reflect the efficiencies gained by the utility during the multi-year rate plan. These more gradual rate changes also provide a more current price signal to customers, and most often rates are lower over a multi-year rate plan than annual rate increases through separate annual rate case filings.

Alternative, flexible regulatory mechanisms allows for more creative thinking to cover customer choices, to reflect a new and changing utility. The "Utility of the Future" will be impacted by electric vehicles, demand response, distributed generation, micro-grids, battery storage, solar, cogeneration, need to cover "partial requirement customers" and eco districts, to name a few.

Perhaps another area for Commission consideration would be allowing utilities to earn rates of return on non-wires and/or non-build alternatives. Utilities are incented to invest in its system – it's how utilities make money and it's what they know best. However, there are instances where a bundling of energy efficiency, demand response, and other alternatives may provide equal or better system enhancements (and better grid utilization) than the traditional build approach. A return on such an "investment" could help to lessen the reliance on traditional utility "build" model. Another approach is to allow utilities to earn on purchase power agreements, which may help drive utilities to choose the best option for customers, even if that option is not the traditional utility-built generation model. The Commission could also consider long-term or permanent solutions to cost effective energy efficiency solutions, rather than existing tariff mechanisms, that incent the utility to go further than current cost-based policies do today.

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Regulatory mechanisms, like performance based regulation are designed to encourage better utility performance, created with performance metrics that matter to customers and other stakeholders. Performance based regulation is typically founded on cost-based rates, determined in the same way as a traditional general rate case, however, incentives are then layered on top of the cost-based rates to encourage desired outcomes - by targeting customer service and grid reliability, for example. A targeted performance incentive mechanism therefore, links a utility's revenue to performance appraisals, strengthening utility performance incentives by providing rewards for good performance and/or penalties for substandard performance. This can lead to opportunity for utilities to profit in targeted areas, encouraging better performance, reducing need for prudence reviews, and benefiting all stakeholders.

Clean Energy plans, for example, are a mounting concern for the environment and metrics monitoring environmental impacts have been pertinent areas of consideration. Relevant metrics that could be considered include generation mix, emissions from generation and truck fleets, and growth of electric vehicle and green power loads.

The following areas or metrics, to name a few, <u>are examples</u> of performance based regulation metrics:

- Reliability – indicates the extent to which service is reliable and interruptions are remedied quickly (e.g., SAIDI and SAIFI);
- Customer Service – ensures that the utility is providing adequate levels of customer service;
- Plant performance – indicates the operating of specific generation resources (e.g., availability factor);
- Cost – indicates the cost of service (e.g., rates, unit cost and productivity);
- Employee Safety – ensures that employees are not subjected to excessive safety risks;
- Public Safety – ensures that the public is not subjected to excessive safety risks;
- System Efficiency – indicates the extent to which the utility system as whole is being operated efficiently – e.g., in terms of load factor;
- Customer Engagement – utilities have an opportunity to provide customers information on energy efficiency products, demand side management tools and techniques, renewable energy, and provide them with new products and service;
- Customer Experience – indicates the extent that the utility is meeting customer expectations, utilities need to present themselves as a progressive partner, not a regressive monopoly; (provide: ease, convenience, proactive and personalized)
- Network Support Service – indicates the extent to which customers and third-party service providers have access to the network; and
- Environmental Goals – indicate the extent to which the utility and its customers are reducing environmental impacts, including climate change.

Formula rate mechanisms use pre-specified formulas to calculate automatic rate adjustments to keep the utility's actual rate of ROE within or near a specified band around the authorized ROE. Earnings surpluses or deficits occur when revenue and costs are not balanced. These plans have earnings true up mechanisms that adjust rates mechanically to substantially reduce or eliminate earnings variances. Again, this can encourage better performance, requiring the utility to manage its costs to stay within an approved ROE band, reducing the need for annual

prudence reviews, and benefiting all stakeholders. Widely used with formula rate plans, reliability and customer service factors, may be used to measure or impact service quality measures, DSM, grid modernization, accommodation of third party providers, distributed generation and storage.

Other flexible regulatory mechanisms may incent the utility to react by providing for more cost-effective non-traditional deployment of resources to address utility measures, such as non-wire solutions or other advanced utility systems. Furthermore, cost trackers, such as conventional trackers or capital trackers, and Expedited Rate Filings (ERFs), are also alternative regulatory mechanisms that may provide an expedited recovery of specific utility costs through a separate tariff rider, allowing utilities to recover prudently incurred costs between general rate cases. These tools benefit utilities by modifying the timing and certainty of capital cost recovery for new investments, while providing opportunity for prudence review of costs to ensure customers pay for only those costs that reflect prudently incurred investments.

Lastly, alternative regulation may allow utilities to partner with other agencies to address such areas as energy burden of its customers, providing an opportunity to further address programs such as Avista's Low Income Rate Adjustment Program (LIRAP). As the utility is able to create mechanisms that lesson the energy burden of certain customers, this reduces the overall impact on all customers.

Examples of existing Regulatory models that could be considered:

- California Model - 3 year rate plan models. 18 month regulatory process. Utilities stagger timing of cases so that multiple utilities are not in at the same time. Incremental rate increases each year of rate plan.
- Alaska Model – rate cases are filed with an 18 month regulatory process. Interim rates at a discounted amount from filed is in place 45 days after filing, subject to refund.

These existing models allow for a rigorous fully vetted review process by the Commissions, balances Staff workload, and protects customers, as initial increases are subject to refund, while maintaining opportunity for the utility to recover its costs without significant delay or regulatory lag.

4. What conditions should determine whether the Commission applies these alternative mechanisms?

While Avista does not believe there should be any conditions applied to alternative mechanisms, the Commission could consider alternative forms of rate-making under the following conditions, to name a few: 1) to allow a utility to recover its costs, if its increased costs are associated with meeting public policies and interests, and customer initiatives and requests, as the utility needs to be able to nimbly respond; 2) when the utility can provide support that use of alternative regulation (i.e. a multi-year rate plan, etc.) is in its stakeholders' best interest to approve; 3) when traditional rate making will not allow the utility an opportunity to earn its allowed returns during the rate period.

The utility should bear risk from factors that are within management control but should not bear the risk from factors that are outside its control. Performance based plans, for example, should not incorporate elements of cost that are outside management control, such as fuel prices or changes in taxation. They should incorporate sales decoupling so that management does not have a conflict between the policy goals of energy conservation and promoting distributed energy resources and the fact that lower retail sales will lower profits. Targets should be realistic and attainable, and consistent with funding levels, and measurement of results should be objective, providing the utility with a reasonable opportunity to earn a fair rate of return.

5. Does the Commission have sufficient authority to implement alternatives to traditional regulation?

It is unclear as to whether the Commission has sufficient authority. The recent Court of Appeals decision in Avista's 2015 General Rate Case[1] has limited the Commission's ability to exercise regulatory flexibility by narrowly interpreting the Commission's authority to determine the value of utility property (capital) for ratemaking purposes. The Court held that the "used and useful" standard in RCW 80.04.250 requires that rates only include the value of utility property that is used and useful for service "at the time the inquiry as to rates is made." This narrow interpretation requires the Commission to set future rates based only on historical levels of utility property that do not always reflect the levels of property benefiting customers at the time the rates are in effect. Moreover, the decision compromised the Commission's ability to consider forward-looking ratemaking mechanisms, like multi-year rate plans that would benefit the utility and its ratepayers.

Legislation is therefore needed to acknowledge the transformational changes affecting the utility industry, to provide context for the amendment to RCW 80.04.250, to confirm the Commission's statutory grant of authority for ratemaking includes consideration and implementation, where appropriate, of performance and incentive-based regulation, multi-year rate plans, and other flexible regulatory mechanisms, to achieve fair, just, reasonable and sufficient rates and accomplish its public interest objectives.

6. What rulemaking or policy guidance from the Commission could help make rate regulation more efficient and effective?

A rulemaking or policy guidance from the Commission that would make regulation more clear, more efficient and more effective, would include a process that allows for open dialogue amongst all parties, sets how to evaluate Company rate base during a multi-year rate plan, opportunities for trackers that would allow the utility the ability to defer costs for later recovery after prudence review and approval of said costs, and guidance on filing alternative mechanisms supported by the Commission that would allow for formula based, performance or incentive based mechanisms, as well as multi-year rate plans.

[1] *Wash. State Attorney General's Office, Public Counsel Unit v. Wash. Utils. & Transp. Comm'n and Avista Corp.*, COA No. 48982 -1 – II

As noted above, alternative regulation would provide consumers with greater certainty and transparency into the utility investments they pay for, and protect consumers by reducing the need for frequent and substantial rate increases related to utility property investments. Alternative regulation would allow utilities to try new and innovative things, be open to market transformational technologies, while protecting the utility by allowing for recovery of prudent investments in a timely manner.

7. What is the appropriate scope and order of priorities for a rulemaking or policy statement on this subject?

The appropriate scope and order would be:

1. In the short-term fix the Court of Appeals decision in Avista's 2015 General Rate Case, perhaps in Q1 or Q2 of 2019.

2. As it relates to new or alternative mechanisms, the Commission should act in a deliberate manner and pace. Customer demands are evolving quickly, and the Commission, utilities and other stakeholders need to be nimble in pace and supportive in nature.