BEFORE THE
DEPARTMENT OF ENERGY
OF THE COMMONWEALTH OF VIRGINIA

***Ex parte*: In the matter concerning**	**)**	
performance-based regulation	**)**	**SCC Case No. PUR-2024-00152**
and alternative regulatory tools	**)**	
for investor-owned electric utilities	**)**	

COMMENTS OF TRAVIS KAVULLA[1]
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I appreciate the Department attention to this important matter, and its work undertaking a stakeholder process to consider input on performance-based regulation. In these comments, I address a handful of topics. First, I assess the status quo of the economic regulation of Virginia's investor-owned electric utilities, contrasting that to performance-based regulation. Remarkably, incentives for the proper exercise of businesslike judgment by utilities have *diminished* in Virginia over time, so the creation of meaningful performance-based regulation would represent a significant turn from Virginia's *status quo*. In that vein, I offer several observations about what the implementation of performance-based regulation in the Commonwealth should look like.

1. Traditional Cost-of-Service Ratemaking and Virginia's Regulatory Status Quo

Traditionally, since the early 1900s, investor-owned utilities in the United States have had their rates established under a model familiarly called "cost-of-service" regulation. Here, utilities' rates are designed to collect a "revenue requirement." This revenue requirement is composed of a representative year's worth of the utility's operating expenses, plus taxes and other government-imposed surcharges, and a return of and on that test year's average "rate base," which is to say the total amount of undepreciated capital investment a utility has dedicated to its regulated service to the public. Formulaically, this may be represented by the following equation.

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Revenue Requirement = O + T + D + r(RB)

- O= Operating Expenses
- T = Taxes
- D = Depreciation (return *of* capital investment to utility)
- r= fair rate of return (weighted cost of capital)
- RB= Rate Base
  - **value of utility plant assets** minus **accumulated depreciation**

Within this equation, the *only* function by which to maximize a utility's profit is to spend more in capital investments. This is true even if less capital spending (or a re-balance between capital and operational expenditures) would more efficiently accomplish the goals of affordable and reliable electric service to customers. Were competition ubiquitous, it would discipline this tendency. But instead the captive customers of Virginia's electric monopolies depend upon sound utility regulation to simulate competition and to tamp down on the perverse incentive for inefficient utility spending that is ingrained in this traditional formula of ratemaking.

It is important to note, from the outset, that Virginia has departed from many traditional protections that the cost-of-service regulatory model afforded. All too often the Virginia State Corporation Commission ("the Commission") faces a significant information asymmetry that imperils its mission or the Commission's work is superseded by legislative prerogative whereby excessive utility capital spending is approved *ipso facto*.[2]

If the Commission cannot reasonably discipline the "rate base" variable in the above formulation, then it would instead need to regulate capital spending by properly establishing the allowed rate of return ('r', in the above equation). But this Commission cannot even do that, because its work is today subject to one of the most highly prescriptive and unusual laws pertaining to ratemaking I have ever seen in my career of utility regulation to date.[3] Without going into the many details of its baroque framework, the statute may be summarized at a high level as requiring the Commission to employ a misleading financial analysis to assess the utility's returns for the purpose of the Commission's rate review. More specifically, the law's required analysis is misleading because of its arbitrary parameters of a preselected peer group and a narrow band of return outcomes that cause the regulatory evaluation of the return to be divorced from prevailing macroeconomic trends, and also because the law's myopia focuses on

[2] Final Order (Nov. 2, 2018), *Petition of Virginia Electric and Power Company for a prudency determination with respect to the Coastal Virginia Offshore Wind Project pursuant to Virginia Code §56-585.1:4F*, Case No. PUR-2018-00121.

[3] Virginia Code §56-585.1.

only a handful of items of the utility's overall balance sheet and income statement, to the exclusion of many other utility costs that customers are obliged to pay. This, again, is a seminal departure from traditional cost-of-service regulation which, in taking account of the utility's books as a whole, in some ways assessed its performance as a whole.

Sometimes, the novel Virginia statute in question is known for the regulatory procedure it creates: a triennial or biennial review of the utility's so-called base rates. What makes this statute particularly ironic—or perhaps cautionary—in the context of the Commission's instant consideration of performance-based regulation is that the law emulates a seminal feature of performance-based regulation, the setting of rates that endure without active governmental intervention for multiple years. In performance-based regulation, this usually would be a good thing, typically constraining inefficient utility spending because it forces utility management to make actual trade-offs between capital and operational expenditures, and disciplines less useful spending in either category. But Virginia's multi-year rates are an Alice in Wonderland version of that, because the law's numerous exceptions, which require annual or even more frequent retroactive rate adustments for certain costs but not others, ultimately pervert the holistic approach that any useful performance-based regulation would take to putting utilities on a budget and holding them to it for multiple years.

These exceptions principally take the form of Virginia utilities' numerous "adjustment clauses," "riders," or "factors" that sit outside of base rates and are subject to more frequent change. Collectively, one may colloquially call all of these rates "trackers" because they are designed to retroactively track and collect for the utility, through a series of almost constantly changing rates, whatever the utility has happened to spend.[4] In traditional cost-of-service regulation, while a company was guaranteed a recovery of its operating expenses based on sales volumes on a normalized basis, there existed an opportunity to profit when actual utility performance departed from that norm, including because of superior (or inferior) utiltiy performance. If utilities trimmed fat from their actual spending, entered into more advantageous

[4] Notably, there is an important exception to this style of business for certain Virginia energy customers. Those customers allowed to choose a Competitive Service Provider to furnish their generation-supply services may insist on knowing the full price of that service beforehand through the customer's choice of contract with the CSP. In doing so, they are subject to the CSP's up-front, fully stated costs—and not the retroactive changes in the utility's fuel factor, the tracker that usually sees the single most impactful shift in costs.

trading or hedging arrangements for power purchases and fuel, or undertook any number of other efficiencies in the period between rate-setting intervals, they would gain a profit on operating expenditures—just like capital expenditures. The benefit of that performance would be to the advantage of the utilities for the period when rates were in effect and costs were lower than those rates' normalized baseline, but ultimately be captured by customers in the next rate-setting interval. This balanced approach created one of the few ordinary businesslike incentives to exist in traditional cost-of-service regulation.

The trackers employed by Virginia's utilities altogether erase the essential incentive to economize on costs, which virtually every other business in America faces. Over the past two decades in Virginia, riders and adjustment clauses, together with increases in the fuel factor, have made up the vast majority of rate increases residential customers of both Dominion Energy Virginia and Appalachian Power Company have paid for.[5] The practical consequence of this is that the majority of rate hikes in Virginia are being processed through a style of ratemaking that does not subject these rising costs to even the basic incentives of traditional utility regulation. Virginia has thus moved backwards as far as this inquiry is concerned: The cost-of-service ratemaking of 30 years ago is a more performance-based regulation than the *status quo* in Virginia today.

For Dominion Energy Virginia alone, 22 of these trackers exist.[6] I am unaware of any other electric utility in the United States that has more trackers than Dominion. For the costs this diverse set of trackers covers, which in their individual scope are as broad as all the fuel to operate power plants to being as narrow as to cover a single preferred facility's costs, the utility has little or no "skin in the game." Conceptually, just as in a base rate case, a party might contest the prudence or reasonableness of certain spending housed within a tracker. However, by spawning literally dozens of regulatory proceedings each year, these trackers make it easier for the utility to hide the ball, heightening the information asymmetry already latent in the Commission's work and making it practically impossible for interested parties to actively participate, given the resource expenditure such an undertaking would require. They also add procedural and legal complications to the Commission's work, because to other parties it is not

[5] State Corporation Commission, *Status Report on Implementation of the Virginia Electric Utility Regulation Act Pursuant to 56-596B of the Code of Virginia* (November 2024) at 5-7.
[6] *Id* at 6.

always clear in which of the utility's many, inter-related dockets one may legitimately object to certain utility activities and spending.

All of this has sadly brought Virginia to where it is today, where one of the nation's most talented and well-respected regulators is charged with implementing one of the worst systems of economic regulation anywhere in America.

2. Considerations for Performance-Based Ratemaking in Virginia

Ratemaking in Virginia would have to undergo certain fundamental changes in Virginia to accomplish any kind of performance-based regulation worthy of the name. I specifically propose three characteristics that any performance-based regulation should include.

First, all or nearly all costs, including both capital and operating expenditures, would have to be brought into the fold of a single ratemaking mechanism. That is because these costs can trade off against one another. A utility investment in a power plant is a substitute for the operating expenditure of purchased power. A cloud-based information technology ("IT") system is a substitute for the rate-base solution of siting IT systems in-house. The list is nearly endless, and the only way to require the people who should be responsible for evaluating the tradeoffs in the first instance—utility managers—is to include all these tradeoffs within the same practice of ratemaking. This accounting for total expenditures ("totex" as it is known in the United Kingdom's approach to performance-based regulation) replaces the false dichotomy that currently exists in Virginia between operating and capital expenditures, which leads, often inefficiently, to a preference for the latter. As a practical matter, creating the incentive for efficient business decisions necessarily means the elimination of all or nearly all adjustment clauses, riders, and the fuel factor, and their reincorporation into base rates.[7]

Second, once all the relevant cost elements of utility service are reincorporated into a holistic model, one element of Virginia's status quo may be usefully retained: a stay-out period of at least three years during which time the reunified rate does not change unless it is demonstrated that the utility is radically underearning or overearning its previously authorized return. The

[7] One tracker that is practically ubiquitous in utility regulation in American regulation today is the fuel and purchased power tracker, which in Virginia is known as the Fuel Factor and Deferred Fuel Cost Charge. Were this retained even as other trackers are rolled into base rates, then it should be subject to a sharing mechanism that pivots around a baseline of projected costs.

setting of rates that, once adopted, are in effect for multiple years establishes robust incentives for performance around managing costs and executing on the trade-offs described above, because it allows the regulated utility to capture the upside benefits or suffer the downside effects, at least within the three-year term, of its decisions. This style of ratemaking causes utilities to be accountable in a way they are presently not. In the long run, nothing could create so strong an imperative for affordability and the efficiency of utility service as this.

If it was thought necessary for utility rates to adjust within a longer period of pre-established base rates (such as five years) due to changes in the macroeconomic environment (e.g., an inflationary cycle), then an appropriate approach would not be to tie any changes within the interval to the utility's cost of service, but instead to the kind of pressures that other businesses throughout the economy were experiencing. Adjusting the "totex" revenue requirement annually on an indexed basis where it is multiplied by the difference between the inflation and productivity indexes could provide an objectively measured benchmark for this purpose.[8]

Third, when the basic structures of ratemaking are re-established to convey holistic, businesslike performance incentives to the utility, and only once that happens, one may turn to establishing more targeted incentives for utility performance that ride atop this system. These are sometimes called performance incentive mechanisms ("PIMs"). These PIMs should not duplicate incentives inherent in the model of ratemaking—managing costs and growing sales—but should target considerations principally involving customer service and be objectively measurable. In a world where consumers now have the potential to self-supply energy or make other arrangements, a PIM that focuses on the latent incentive of the utility to monopolize this space should be established. While Virginia's electric utilities usually are thought of as "vertically integrated" or monopoly entities, to the exclusion of alternatives, Virginia law does provide for limited retail competition and for customer self-supply—both of which rely on timely facilitation of meter data and grid access that are still in the control of the utility. In that vein, a worthwhile PIM would revolve around the timeliness and accuracy of the provision of data to competitive

[8] Modern readers will be familiar with the concept of inflation, which can be measured through the GDP price index recorded by the federal government. Productivity, too, is also monitored and is a measurement of the efficiency of the utilization of capital and labor, which typically is an offsetting factor to inflation.

service providers, and the timeliness of distribution-level and home interconnections of third-party or customer-owned resources.

There should be only a handful of PIMs and performance on them to the Commission's expectations should make up a significant portion of the utility's authorized return. Otherwise, the incentive to act to achieve the performance outcome will be diluted, especially if a PIM runs contrary to ordinary but noxious utility incentives, like the instinct for monopolization.[9] Incremental performance around acceptable performance should have both upside and downside, with docked or surplus profits for poor or exceptional performance.

In certain quarters, there appears to be some confusion about what performance-based regulation means, or should mean. Proposals in certain states and by the federal government have suggested that the underlying ratemaking structure for utilities should be left intact, and that "performance-based regulation" should consist simply of paying bonuses to the return on equity for achievement of certain outcomes, including those outcomes that should be table stakes for a properly run utility. The Federal Energy Regulatory Commission has adopted various "incentives" under this confused rubric, and an alumnus of the Virginia Commission, now FERC Commissioner Mark Christie, has humorously and accurately lampooned these ratemaking treatments as "FERC candy."[10] So it bears repeating here, that meaningful performance-based regulation should take care to create broad-based incentives for businesslike conduct by a utility, and only then create targeted bidirectional incentives for a limited set of additional, objectively measurable outcomes.

3. Conclusion

Finally, I would be remiss not to observe that the Joint Resolutions requiring this instant proceeding expressly call for the inclusion of Competitive Service Providers in the Department of Energy stakeholder process that is part of this study process, and the consideration of "the

[9] An especially worthwhile elaboration of this observation is included in a recent report on performance-based ratemaking. LeBel *et al*, Improving Utility Performance Incentives in the United States, (Regulatory Assistance Project, October 2023), at 41-44. https://www.raponline.org/wp-content/uploads/2023/10/rap-improving-utility-performance-incentives-in-the-united-states-2023-october.pdf

[10] Johnson and Hung, "FERC again proposes incentives for voluntary cybersecurity investments," (Akin Gump, Sept. 26, 2022). https://www.akingump.com/en/insights/blogs/speaking-energy/ferc-again-proposes-incentives-for-voluntary-cybersecurity-investments

impact of Competitive Service Providers in the Commonwealth."[11] As described above, I have offered a style of performance-based utility regulation that is compatible with the role of CSPs under current Virginia law. While the Commission engages in the close economic regulation of electric utilities, it remains important that CSPs are invited, heard, and listened to through stakeholder processes and through comments like these. The Commission itself has recently noticed one other stakeholder gathering that, even while it concerns the business model of CSPs, nevertheless features no CSP representative.[12] The Commission should be attentive to the fact that Virginia law and its own regulatory structure contemplates an environment that allows at least some limited degree of customer choice, and that such customers make up nearly 40% of the generation supplied to the industrial class of Virginia's largest utility.[13] Neglecting CSPs leaves out an important voice to the important conversations that various parts of the Commonwealth's government have lately convened.

I thank the Department and the Commission for their time and attention to this important matter, and for your public service. Any questions about these comments can be directed to me directly at the e-mail below.

Respectfully submitted,

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[11] House Joint Resolution 30 (2024).
[12] Agenda, "Data Center Load Technical Conference," (issued Nov. 18, 2024) Case No. PUR-2024-00144.
[13] U.S. Energy Information Administration, *Annual Electric Power Industry Report*, Form 861 (data release Oct. 2023). https://www.eia.gov/electricity/data/eia861/