

SHIFTING UTILITY INCENTIVES TO REDUCE COSTS

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WHY IT MATTERS

Virginians are facing increasing energy costs, which disproportionately impact low-income households. The current regulatory system governing Virginia's investor-owned utility monopolies (IOUs), Dominion Energy and Appalachian Power Company, lacks incentives for utilities to control spending, lower customer energy bills, and minimize environmental harm.

The profits of utility monopolies are entirely composed of their return on capital investments. In such a regulatory structure, the more utilities spend on capital-intensive projects, the more profit shareholders can earn.¹ This incentivizes utilities to address increasing load growth through expensive investments, including continued reliance on costly and high-risk fossil fuel generation. This approach discourages equally effective and lower-cost alternatives such as solar plus storage, energy efficiency, demand response, customer-owned energy, technologies to maximize existing infrastructure, and buying cheaper energy through power purchase agreements (PPAs).

Simultaneously, the current planning process is not an effective tool for maximizing least-cost solutions. The last three Dominion Integrated Resource Plans or IRPs (2018, 2020, and 2023) have been rejected by the State Corporation Commission (SCC) or by the assigned SCC hearing examiner.² Although the 2024 IRP was deemed "legally sufficient," the SCC directed critical improvements. Improvements,³ however, will not be submitted until 2026. Thus, the utility will continue selecting resources under a flawed plan. Appalachian Power Company is not required to file an IRP.

Finally, utilities can recover many costs through "rate adjustment clauses" (RACs) or riders. Unlike other cost recovery mechanisms, riders permit a utility to adjust customer rates to recover exactly the amount it spent, even if it exceeds projected costs, without impacting shareholder profits, thereby transferring investment risk to customers.^{4,5} Notwithstanding expert advice against the widespread use of riders, more than 71% of utility costs are eligible for rider treatment.^{6,7} The extensive use of this mechanism in Virginia is unparalleled in other states.⁸

Overall, the current regulatory framework reduces incentives to control ratepayer and environmental costs by externalizing them onto customers.

CURRENT LANDSCAPE

Virginia has taken steps toward joining more than 20 other states actively exploring tools to reform the reg-

ulatory structure governing IOUs. In 2023 and 2024, the General Assembly passed two bipartisan initiatives for the SCC and Virginia Energy to study performance-based regulation (PBR). Reforms under the PBR umbrella aim to incentivize cost containment and reward utilities for good performance, rather than exclusively rewarding them based on the size of their capital investments.

The 2023 legislation established an SCC proceeding to implement "performance-based adjustments," also known as "performance incentive mechanisms" (PIMs).⁹ PIMs reward or penalize utilities based on their performance in achieving specific target outcomes. The SCC's draft regulations resulting from this proceeding include metrics to help establish these targets in areas such as distributed energy resource interconnection times, peak load reductions, and savings from demand-side management (DSM) programs.¹⁰ However, the impact of PIMs would be minimal if the monetary compensation for improving specific metrics is eclipsed by the financial compensation received by maximizing capital investments. In this case, PIMs alone would not alter utility incentives to reduce costs and improve performance.

The 2024 legislation established a study process in which the SCC, Virginia Energy, and stakeholders would evaluate further potential reforms to align the current financial incentives of IOUs with state policy goals. The stakeholder report recommended several areas for further analysis, including:¹¹

- An examination of the use of riders, assessing the costs and benefits to ratepayers.
- An evaluation of alternative cost recovery mechanisms, such as multi-year rate plans that more fairly balance risk between shareholders and customers.
- A study of mechanisms that could improve utility spending and performance, such as fuel-cost sharing and expanded use of PIMs.
- An assessment of the current regulatory structure's alignment or misalignment with clean energy and energy efficiency goals.

OPPORTUNITIES

In addition to systemic reforms, other opportunities exist to strengthen utility incentives to decrease costs. For example, improving IOUs' resource planning process is essential during a period when Virginia utilities are experiencing unprecedented load growth. Ensuring large utilities adopt a least-cost, least-regrets plan that is trusted by stakeholders and decision-makers is a step toward meeting energy needs affordably.

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In addition, expanding competitive procurement standards would allow all least-cost resources to compete fairly against proposed fossil fuel facilities. Currently, utilities must use competitive solicitations to select clean energy resources. However, when they propose new fossil fuel infrastructure, there is no requirement for a competitive solicitation to compare the proposed facility with a clean alternative or combination of alternatives that could offer the same services at a lower ratepayer and environmental cost.

Finally, third-party-owned utility-scale projects are another low-cost opportunity that may currently be underused. PPA costs for utility-scale solar have dramatically declined nationwide. However, current law caps PPAs at 35% of utilities' solar energy investments.¹² Thus, utilities limit their use of qualified third-party-owned projects, even when they would be cheaper than utility-owned projects that provide investors with a return. Utilities should be encouraged to consider all qualified and cost-competitive PPAs to reduce energy infrastructure costs.

TOP TAKEAWAYS

Current utility incentives are counterproductive to meeting energy demand affordably and achieving the state's clean energy goals. The current system shifts economic and environmental risk to ratepayers.

Virginia has just begun a process to evaluate and design a different regulatory framework that could enhance cost-containment incentives and reward utilities for performance rather than for the magnitude of their capital investments.

Other utility business reforms, such as expanding the cap on PPAs and expanding competitive procurement processes, could also better align incentives with the state's energy goals and decrease customer costs.

ENDNOTES

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