SUMMARY OF CPUC RULING ESTABLISHING A PILOT TO ADDRESS UTILITY INCENTIVES AND THE ROLE OF DERS IN PROVIDING DISTRIBUTION SERVICES

On April 3, Commissioner Michael Florio issued a ruling in the Integrated Distributed Energy Resources proceeding, formally kicking off the CPUC's inquiry into utility incentives and ways to address the current bias in the utility business model for making capital intensive investments in infrastructure rather than contracting with third party service providers.

The ruling proposes a potential mechanism to address this bias, and proposes a pilot program whereby this mechanism would be applied to some real world projects, to be determined, with the utilities ultimately issuing RFOs to procure services from DER providers. Key elements and ideas from the Ruling are summarized below.

- The utilities' incentive to deploy investor capital is determined by the opportunity to earn a return in excess of the cost of capital. Thus, in circumstances where the rate of return (r) is greater than the cost of capital (k), utilities are motivated to deploy additional capital, i.e. build additional infrastructure. Conversely, if the rate of return is less than the cost of capital, utilities would be averse to deploy additional capital. And in circumstances where the rate of return is equivalent to the cost of capital, utilities should be indifferent to opportunities to deploy additional capital/invest in additional infrastructure.
- Importantly, in recent times, the Ruling posits that the utilities have generally faced strong incentives to deploy additional capital given that their regulated rate of return has been approximately 10% while the cost of capital has been approximately 7-8%.   The delta between these two values is the investment opportunity that is forgone should investments that could be made by the utility be instead displaced by third-party owned providers or solutions.
- To overcome this bias, the Ruling suggests that the Commission, on a pilot basis, allow the utilities to earn a return, set as a fixed percentage of the payments a utility makes to a third party provider in lieu of making a utility investment.
- A key issue in the proceeding will be determining both the level of the incentive, which the ruling suggests setting at 3.5% as well as which projects are eligible to be included in the pilot. Regarding project eligibility, the ruling indicates that application of this mechanism, through which utilities would contract for services from third party DER providers, only makes sense in instances where it is cost effective to do so (i.e., the net-present value of the payments plus the incentive is less than the net present value of the investment, including the rate of return on that investment, that would otherwise be made).
- The Ruling lays out a proposed process for pursuing the pilot. This process would begin with the utilities identifying opportunities where DERs may offer a cost effective alternative to what the utility would otherwise invest and then, following significant stakeholder vetting, issue an RFO to actually procure the services from DER providers. Once projects are selected via the RFO, the utilities would submit applications seeking approval for the contracts selected in the RFO. The Ruling envisions the above process would be in place for a two year period, with actual project deployment taking place over a longer time horizon.

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