

The Role of Performance Measurement in Rate Cases

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PART I: The Appropriate Use of Benchmarking for Rate Case Support

Benchmarking is a generally accepted and well-developed method for management to diagnose their business by comparing performance and practices against an appropriate peer group. The use of benchmarking in rate cases is quickly gaining popularity as regulators expect or demand proof of relative efficiency. Yet for many management teams the value of this strategy is diminished by lack of clarity on benefits, or perceptions of risk regarding negative results. This first article in a series by UMS Group describes the most advanced current approaches and explores the advantages and risks presented by the use of benchmarking in support of rate cases.

Introduction to Benchmarking

Management generally views benchmarking as a diagnostic tool. Many find it useful for discovering how they compare among their peer groups, learning how others conduct similar work, and developing insights on how to achieve higher levels of performance at lower cost. Some even use it as a report card to track performance over time.

Features of Benchmarking	Benefits of Benchmarking
Comprehensive measurement framework	Yields a complete picture of service level and cost
Consistent best practices descriptions and definitions	Eliminates favoritism and guess-work
Provides systems to track costs at activity level	Enables process, rather than departmental or functional, comparisons
Measurement is formally conducted	Avoids ad hoc approach and/or procrastination
Consistent activity definitions across companies	Provides apples-to-apples comparisons

Essentially, it allows management to set a course for the future by determining the levels and sources of performance improvement that the company should strive to deliver by capturing identified opportunities.

Benchmarking for Regulatory Purposes

The customary use of benchmarking by management is to establish forward looking targets for future performance levels based on what differences in current performance suggest may be possible. But in a regulatory setting, benchmarking is normally used to judge the appropriateness, or prudence of past performance. The application of what was initially designed as a diagnostic and future focused target setting tool requires a very different viewpoint when it is used retrospectively to judge reasonableness in a regulatory setting. Many regulators and managers faced a similar challenge in the 80's and 90's

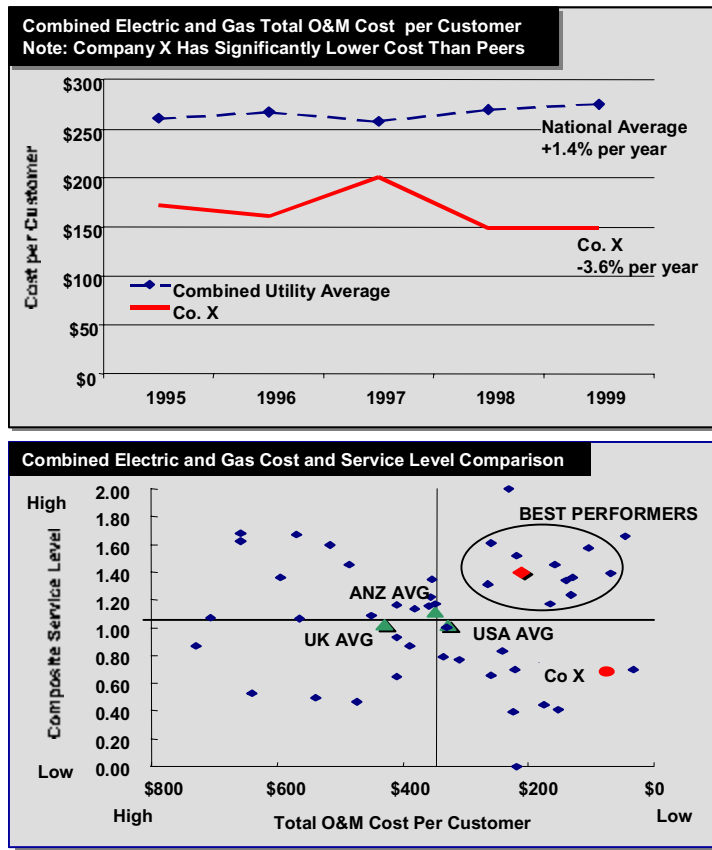
“We are seeing an increase in the use of industry comparisons in rate cases.” – commission staff member

with nuclear and fuel purchase prudence reviews. The standard that seems to have emerged for “reasonableness” is “what would a reasonable manager have decided given the information that was (or should have been) available at the time the decision was made.” The concept of perfection has been uniformly rejected, acknowledging that less than optimum decisions can still be prudent and fall within the band of reasonableness, given the context in which they were made. Regulatory proceedings should adopt a similar

approach with respect to how benchmarking is to be used in determining the reasonableness of costs.

The appropriateness of costs is a fundamental issue for regulators to address. Benchmarking is a technique that lends itself to demonstrating objectively how a utility's costs, as well as its service quality, compare over time and with other utilities. Examples of these results are shown in Figure A. The use of benchmarking results as evidence of the reasonableness of costs is generally appropriate.

Figure A: The Use Of Benchmarking Results As Evidence Of Reasonableness Of Cost Is Generally Appropriate



This can be done at the overall utility level, or for each of the component businesses within the utility (e.g., generation, transmission, distribution, customer service, etc.) However, regulators are often tempted to look deep within these businesses, delving into benchmarking results at the sub-functional or individual activity level. Sub-functions are groups of activities within each business that are managed together because of the specialized nature of the work or because similar skills are required to execute the work. For example within the transmission business, construction, maintenance, and operations can each be considered a sub-function. Meter reading, billing, and field services would each be considered sub-functions within customer service. In some US jurisdictions, these are called “Classes of Service”.

Because of interdependencies between areas across the business, caution must be exercised when

utilizing benchmarking results to determine reasonableness of cost. Management must have the discretion to manage the business and optimize it as a whole. They should be accountable for business performance but must be allowed to make the necessary tradeoffs in order to achieve optimal overall business results. Regulatory pressure to minimize costs within each isolated class of service is likely to lead to sub-optimization and higher overall costs than would otherwise be necessary.

Confidentiality & Regulatory Discovery: Benchmarking Catch-22 ?

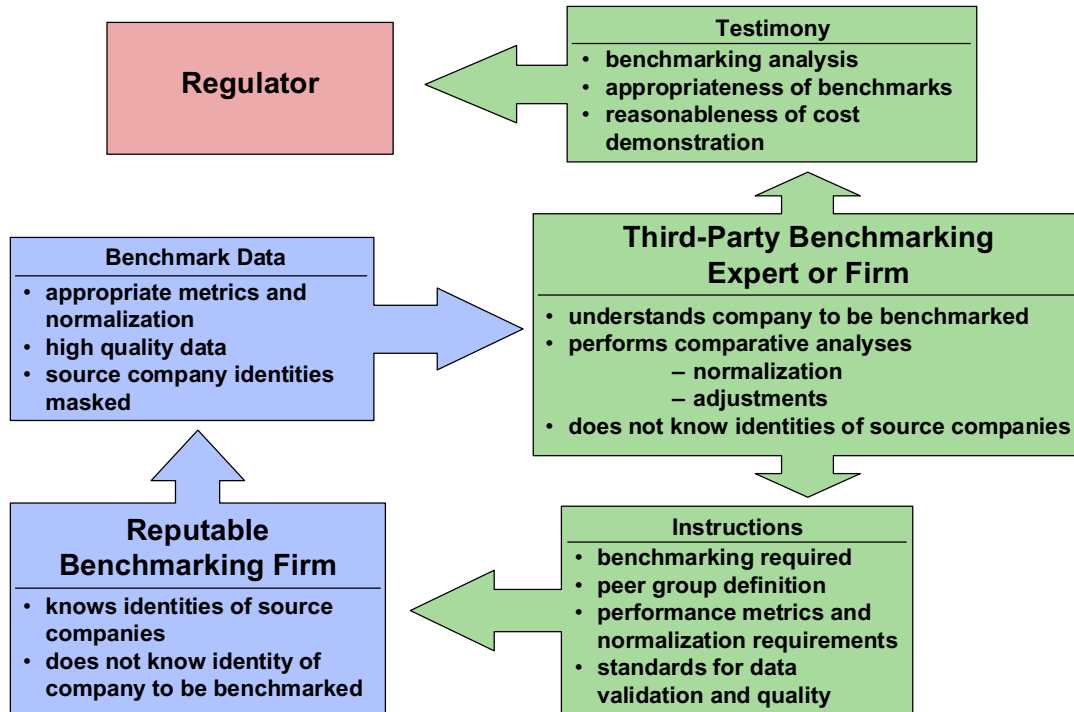
Benchmarking is an approach that offers great promise in the regulatory arena for determining the reasonableness of costs proposed by a utility. This is especially true now, in a dynamic market where all participants are under pressure to continually reduce costs and improve their performance. Regulator statements and actions in various jurisdictions have suggested that they see value in benchmarking. However, the confidentiality requirements that almost always attend other companies' agreements to provide proprietary information on their performance are truly an intractable problem for regulators.

The presumption is typically that since benchmarking information is acquired by the utility for the purpose of demonstrating that its costs are reasonable, it is an advocacy position and must be validated independently before acceptance by the regulator. But the confidentiality commitments made by the benchmarking company and agreed to by the utility normally preclude such independent validation. This is a classic "Catch-22" situation. Without the confidentiality agreements, high quality benchmarking data cannot be acquired. But with the confidentiality agreements, some may argue that the constraints imposed greatly diminish the credibility and usefulness of that data for regulatory purposes.

"...a big issue with detailed performance benchmarks is our inability to validate data... due to its proprietary nature." –
commission staff member

There is a path that the regulator can take past this difficult problem as show in Figure B. It entails some compromise, but produces simple and easy-to-apply guidelines, and most importantly, delivers a reasonable level of confidence that information provided by the utility and its advocates is valid and accurate.

Figure B: Using Double-Blind Data To Avoid The Regulatory Benchmarking Catch-22



This proposed path includes four steps. First, confidential benchmarking information should only be accepted from reputable benchmarking service providers. The benchmarking industry is sufficiently mature that assessments can readily be made of a firm’s reputation, work quality and capabilities. Typically, there are several respected firms in each business function who have developed specialized benchmarking capabilities and aggressively compete to market their services to companies across the country. These are credible firms who live or die on the quality of the work they deliver and the reputation it produces. Those with the best reputations have installed stringent quality controls and rigorous data collection, validation and analytic processes.

Second, the regulator should insist on independence between the utility and the benchmarking company. If confidentiality constraints prevent independent validation of the analysis, then ensuring the impartiality of the firm conducting the work is imperative. This can best be accomplished through the double blind use of an intermediary – typically use of a third party benchmarking expert. This expert can serve as a screen to specify the benchmarking data and analyses required, to answer any questions about circumstances requiring adjustments or normalization, and to ensure that the benchmark data provider does not know for which company the data and analysis is being provided. The data provided in response to the expert’s requests is therefore high quality data, free of any potential advocacy biases.

Third, evidence must demonstrate the appropriateness of the expert’s instructions to the benchmark

provider with respect to peer groups, performance metrics, and normalization. It is important that these instructions and the assumptions embedded within, are rigorous, appropriate to the purpose and intended use of the comparisons, and free of potential advocacy biases.

Finally, and perhaps most importantly to achieving the regulatory outcome of continual cost improvement, the regulator must confirm that the resulting cost targets at every level of comparison are at least as aggressive as the total cost target suggested by overall analysis. This final test should provide the regulator with confidence that the benchmark cost targets are reasonable and in aggregate, sufficiently aggressive to drive the utility to an overall performance level that is significantly better than average. In the next article of this series I will discuss the development of appropriate regulatory targets for determination of prudent costs.

Benchmarking Sources

FERC

The FERC provides a publicly available source of data. While FERC Form 1 includes all electric IOUs and is published in a reasonably timely manner, it suffers from inconsistent application of data definitions and lack of rigorous data validation. Third party FERC data source services provide some level of data validation but the problem of inconsistent definitions limits the usefulness of FERC data for regulatory benchmarking to high-level or broad-brush analyses.

Industry Groups

Industry groups such as EEI collect data from members on a voluntary participation basis. Generally this data is more detailed and better validated than FERC data, and definitions are more consistently applied. However, discovery and independent validation of analyses by regulatory staff can be problematic for member utilities that assumed confidentiality when providing their data.

Independent Benchmarking Firms

In some companies, benchmarking is considered an integral part of their performance management process and internal staff conduct benchmarking on an on-going basis. However, such programs are resource intensive or costly and require cooperation from participating companies or reliance on publicly available data. For competitive reasons, companies often refrain from sharing their data directly with other companies. Consequently, many companies have found it more practical to participate in industry-wide benchmarking programs where confidentiality is maintained, a large group of companies are participating and the resulting shared costs of benchmarking are much lower. In addition, such industry-wide benchmarking programs provide companies with a forum to discuss performance drivers and case studies to improve their understanding of specific operational processes and industry best practices.

Choosing a Benchmarking Firm

There are many firms who have the expertise to undertake benchmarking. However, firms tend to specialize in specific industries and functions. For example, there are several firms such as the Saratoga Institute that are well known for their benchmarking expertise in the field of Human Resources. There are also large general management consulting practices that routinely conduct benchmarking as a part of their business performance analysis for clients. These benchmarking exercises tend to be issue-specific and generally limited in scope to a specific functional area, such as finance or legal. Other firms have focused their efforts within a specific industry, such as automotive,

petrochemicals or utilities.

The primary consideration in selecting companies to conduct benchmarking in specific business areas should be their ability to provide accurate, relevant and timely data from a utility industry peer group and/or a broad cross-functional industry peer group.

In selecting a benchmarking firm, it is important to evaluate six factors:

- **Reputation**
- **Experience**
- **Scope of their benchmarking process and services**
- **Existence of a rigorous data validation process**
- **Relevance, currency and size of their database**
- **Integrity of their data**

One of the major factors that must be taken into account in selecting a consulting firm is prior experience and reputation. The consultant's grasp of the benchmarking discipline as well as the application of a sound benchmarking methodology is extremely important. Given the highly specialized nature of many utility-operating functions, knowledge of the industry and prior experience with utility operations can be very helpful. Finally, there can be no substitute for

verifying the integrity, expertise and credibility of a consulting firm than from references solicited from current and previous clients.

When Benchmarking Fails...

When benchmarking data is unavailable, there are several accepted alternative paths for demonstrating prudent cost management. These include: performance or cost trend analysis, documented success of improvement programs, and price analysis and comparisons. In assessing historical cost trends, key factors such as: changes in workload, inflation, technology investments, one-time expenditures, or unplanned events (e.g., hurricanes or ice storms) must be taken into account to accurately assess the reasonableness of costs. If, after making appropriate adjustments, it can be shown that costs have declined over time, this is one indication that costs are reasonable. Even when costs are flat or keeping up with inflation, if it can be demonstrated that management has been diligent in controlling costs and capturing improvement opportunities, this may be another indicator that costs are reasonable. In assessing management's commitment to reducing costs, initiatives which are aimed at improving performance such as re-structuring, re-engineering, outsourcing, new budget control mechanisms and practices, and the rigor of management decision making for expenditure control can also be important evidence.

Summary

Benchmarking is quickly gaining popularity in rate cases as a response to regulator demands for proof of relative efficiency, reasonableness of costs and demonstration of prudence in management decision-making. Methods for delivering quality benchmarking for these purposes are well developed and proven, as are public and third-party data sources that can be selected as appropriate to specific rate case strategies. Selection of a benchmarking firm for regulatory support should be based on reputation, experience, scope of services, process rigor, database relevance and client references.

A key success factor in the overall process of using benchmarking for regulatory purposes is setting

appropriate performance targets. Correctly setting the performance standards that regulators will use to judge comparative analyses is crucial, and entails such elements as ***scaling, normalization, and the portfolio performance effect***. The science behind performance targets for regulatory use will be the topic of the next paper in this series.