

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to Reform
the Commission's Energy Efficiency
Risk/Reward Incentive Mechanism

R.12-01-005

(Filed January 12, 2012)

**REPLY COMMENTS OF THE UTILITY REFORM NETWORK ON
ORDER INSTITUTING INVESTIGATION AND IN RESPONSE
TO THE ASSIGNED COMMISSIONER'S RULING**



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Pursuant to Ordering Paragraph 10 of the Order Instituting Rulemaking 12-01-005, the Utility Reform Network (“TURN”) respectfully submits these comments.

1. Response Concerning Scope of OIR
a. Issues and Prioritization

TURN had interpreted the language in Section 10 of the OIR as requesting parties, in their initial comments, to “describe the issues it recommends be considered by the Commission in this proceeding, the priority for taking up these issues, and the party’s preferred schedule for addressing the issues over 18 months.”

However, at least two of the utilities (PG&E and Sempra) and the NRDC submitted fairly extensive substantive comments defending the current shared savings RRIM mechanism and suggesting some specific substantive changes that would increase utility profits. For example, PG&E advocates using only the PAC test to measure cost effectiveness (thereby promoting lower customer incentives), while NRDC advocates using a much lower discount rate to calculate the value of future savings.

TURN has addressed both of these issues in previous filings. We will not repeat our arguments, since we believe the Commission did not intend these comments to address detailed substantive issues concerning modifications to any potential future incentive mechanism.

TURN does agree with SCE that the Commission would best advance the paramount state interest in promoting energy efficiency activities that have profound and lasting impact on energy use by redesigning the incentive mechanism to create a simpler and more straight-forward mechanism. However, TURN strongly cautions that

any incentive mechanism will need to be grounded in some meaningful benchmarks that reflect progress towards actual goals, and we cannot totally divorce incentives from measurement of performance.

b. Response to NRDC Concerning Shared Savings Model

Given the lengthy defenses of the shared savings incentive mechanism, TURN responds briefly to address just one issue – the relationship between “energy savings” and “ratepayer savings.”

NRDC has championed the shared savings incentive structure as a model for the utility industry nationwide, and NRDC again asserts that “a shared savings mechanism is the only type of incentive mechanism that fully aligns shareholder and customer interests.” (NRDC, p. 2) NRDC’s conclusion is based on a false premise concerning the nature of ratepayer benefits. Essentially, there is a disconnect between the “avoided cost” calculations in the E3 model and actual avoided supply-side costs, since the avoided cost model does not take into account utility capital investments in generation capacity driven by resource adequacy requirements.

The nub of the problem is reflected in NRDC’s conclusion that “[e]nergy savings are what displace supply-side resources, and is therefore the correct basis for determining comparable earnings.” (NRDC, p. 6). This conclusion is incorrect. Utility supply-side investments in generation are driven primarily by forecasts of *peak demand*, not annual energy consumption. Utilities build or sign PPA’s to meet annual and monthly capacity (resource adequacy) requirements. They likewise use those generation resources to procure energy, as well as various forms of medium and short-term contracting, as authorized in their bundled procurement plans.

It is entirely true that *energy savings* displace power plant dispatch and running times. NRDC’s focus on energy production is understandable, given that environmental emissions – pollutant and GHG – are directly correlated with energy production. However, it is entirely possible for utilities to spend money on capacity additions even

if energy production does not increase proportionately. In fact, this was exactly the situation in California during the 2000's, when the build out of large homes with air conditioners in the Central Valley resulted in declining load factors, signifying a disproportionate growth in peak demand. The housing market meltdown may have temporarily slowed this growth, but the structural problems persist.

It is entirely true that reduced energy production results in lower variable costs for ratepayers. But it is not true that reduced energy consumption results in a one-to-one reduction in ratepayer costs for supply-side resources. The current avoided cost calculations do not capture this discrepancy.

2. Response to Issues in the Assigned Commissioner's Ruling

a. Response to SDG&E Concerning Risk Reduction due to use of *ex ante* values

In our opening comments TURN calculated how the use of *ex ante* versus *ex post* parameter values for the 2006-2008 program results causes more than a doubling of the electricity savings and the avoided cost benefits. TURN concluded that removing the risk of using *ex post* values, as originally intended for the RRIM mechanism, results in a risk adjustment of at least 55%. Using this risk adjustment results in an illustrative sharing rate of 6.2% and an earnings cap of \$90 million based on estimates of 2010-2012 results provided in NRDC's filings.

SDG&E was the only utility that directly addressed this issue. Interestingly, SDG&E concludes reaches almost exactly the same result as TURN. SDG&E explains that *ex post* values will always produce lower savings results, primarily due to the inherent downward trajectory of NTG values due to market transformation. SDG&E states that “[t]o account for the expected decline in *ex post* savings estimates compared to *ex ante* values, the shared savings rate can be reduced in the same proportion of the expected decline in *ex post* savings compared to *ex ante* to keep ratepayers neutral as far as incentive payments.” (SDG&E, p. 14).

This is exactly the type of calculation TURN performed, using the results from the final Evaluation Report for the 2006-2008 programs. TURN's calculation resulted in a sharing rate of 6.2%, or just a little lower than the 7% adopted in D.10-12-049.

Of course, TURN believes that the shared savings rate should be further adjusted due to the financial benefits to the utilities due to the fact that some extra capital will be available if supply-side investments are really avoided due to energy efficiency. We calculated that benefit would result in a maximum sharing rate of 3.4% back in 2007.

Again, only SDG&E addresses this issue directly, concluding that it is not "productive" to debate the financial risks and rewards comparison, which the Commission considered extensively in D.07-09-043. As TURN discussed in our opening comments, we believe the Commission failed to make an adjustment due to the complex nature of this corporate finance issue, as the Commission's decision was based on a false premise.

b. Calculations of a Shared Savings Rate Using the Updated Numbers

TURN's calculations in our opening comments were based on a model developed by NRDC back in December 2010. The model started with the "earnings opportunity" of \$323 million adopted in D.07-09-043 (before changes were made to the RRIM mechanism reducing risk), and adjusted that "opportunity" by the ratio of net energy savings.

The utilities provide forecasted gross GWh savings at 100% goals in their filings, with a total of 9004 GWh forecast for 2010-2012. However, even if converted to 'net' using the 0.63 portfolio-average NTGR, these numbers are not entirely consistent because they reflect achieving 100% of the MW demand reduction goal. It is apparent from the utility filings that they reach the energy goals prior to reaching the MW goals (most likely due to the high amount of CFLs, which provide disproportionately more energy than capacity savings).

Nevertheless, using these numbers as a conservative estimate of the relative savings, results in a new earnings target of \$277 million.¹ Adjusting this number by TURN's proposed 55% risk adjustment yields an earnings target of \$125 million.²

The utilities calculate lost 'supply-side' earnings of about \$1.075 billion³ and a PEB at 100% of \$1.88 billion. These numbers are significantly higher than the numbers calculated by NRDC, presumably due to the "current assumptions" for avoided cost analysis. Avoided capacity costs have increased by about 25%, while utility-specific avoided T&D costs have just about doubled.⁴

Using TURN's earnings target of \$125 million and the PEB of \$1.88 billion results in a sharing rate of 6.6%. As TURN explained in our opening comments, the 55% risk adjustment accounts only for the reduced risk due to using *ex ante* values. To account for the additional reduced risk of no per-unit penalties and no 'claw-back' or any overpayments, it would be appropriate to reduce the sharing rate to 5%.

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Respectfully submitted,

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¹ \$277 million = \$323 million * (9,004 GWh * 0.63)/6,599 GWh.

² See pages 3-4 and 10 of TURN's opening comments for an explanation of the calculation. The detailed explanation is provided on pages 12-13 of the December 6, 2010 Comments of NRDC in R.09-01-019.

³ PG&E, Table 5 at p. 17 (\$465mm); SCE, p. 7 (\$510mm); Sempra, p. 12 (\$62+\$38mm).

⁴ At this time, TURN has not investigated the validity of these new assumptions, especially the avoided T&D costs.