BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Reform the Commission's Energy Efficiency Risk/Reward Incentive Mechanism	Rulemaking 12-01-005 (Filed January 12, 2012)

THE DIVISION OF RATEPAYER ADVOCATES' OPENING COMMENTS IN RESPONSE TO THE PROPOSED DECISION ADOPTING EFFICIENCY SAVINGS AND PERFORMANCE INCENTIVE MECHANISM

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I. INTRODUCTION

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, the Division of Ratepayer Advocates (DRA) submits these comments on the Proposed Decision of ALJ Pulsifer titled *Decision Adopting Efficiency Savings and Performance Incentive Mechanism* (PD). The PD was mailed on July 26, 2013. The PD adopts a newly designed Efficiency Savings and Performance Incentive (ESPI) mechanism to replace the previous Risk Reward Incentive Mechanism (RRIM) for the 2013-2014 energy efficiency program cycle. The original design of the ESPI was presented in the April 4, 2013 *Assigned Commissioner Ruling Regarding Energy Efficiency Savings and Performance Incentive Design for Energy Efficiency 2013-2014 Portfolio* (ACR). The PD makes a couple modifications to the ESPI design presented in the ACR in response to parties' comments.[1]

DRA opposes increasing customer utility bills to reward the utilities with shareholder incentives to administer energy efficiency programs.[2] However, should the Commission decide to continue such awards, the ESPI mechanism in the PD is an improvement over the previous RRIM mechanism. Within these comments, DRA recommends modifications to the EPSI to better protect ratepayer investment and ensure that cost effective energy efficiency portfolios ensue. DRA's recommendations include; 1) adding a cost effectiveness threshold to the lifecycle resource savings component, 2) basing incentive earnings solely on ex post evaluation results as opposed to a combination of ex post and ex ante, and 3) reducing the total award cap from 9.1% to 7% of EE portfolio budgets. The Commission should adopt the PD with DRA's modifications.

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[1] DRA offered extensive comments on the ACR and our positions will largely be restated in this document. Please refer to DRA's Opening and Reply comments on the April 4, 2013 ACR filed on April 26, 2013 and May 3, 2013.

[2] DRA opposes shareholder incentive mechanisms for the following reasons: it is not clear that the utilities are the best suited entities to administer energy efficiency; it is unlikely that any level of incentives will adequately mitigate utility bias towards supply side resources, and the stress that incentive mechanisms put on Commission staff resources. Refer to The Division of Ratepayer Advocates' Comments in Response to Assigned Commissioner's Ruling to Refresh the Record on Outstanding Issues, filed on 9/23/2011 in R.09-01-019.

II. DISCUSSION

A. Background

The argument for energy efficiency shareholder incentive mechanisms is based on a belief that cost-of-service regulation creates a bias in utility planning towards supply-side procurement, making utility investment in demand reduction unfavorable. In order to mediate this asserted bias, the Commission adopted the (RRIM) that allowed the investor owned utilities (IOUs) to earn a return on EE developments in the 2006-2008 cycle (Decision (D.) 07-09-043). This mechanism was aimed at creating a 'win-win' scenario where the IOUs were rewarded when energy savings increased and customers saved money. Incentives were to be sufficient to ensure that the IOUs viewed energy efficiency as a core part of operations, yet were to be based on real and verified savings. Ratepayer's financial investments were purportedly protected.[3] Unfortunately, within a year of D.07-09-043 the Commission and parties acknowledged that the RRIM was not working as intended.[4]

There were three major unintended consequences of the 2006-2008 RRIM. First, it led to a focus of efforts on disputes over process and measurement protocols instead of focusing on greater innovation in program design as it was intended to do. Second, efforts to adapt programs to changing markets were dwarfed by an overriding focus on Evaluation Measurement &Verification (EM&V) disputes. Lastly, The IOUs shifted resources towards shorter-term savings measures to attain higher RRIM earnings as opposed to longer-term savings measures and market transformation programs.[5] As a result, the RRIM was modified in a series of decisions issued through 2010. One of the most significant modifications was the shift from ex post evaluation results to 'locked down' ex ante values as a basis for determining final awards in Decision (D.)10.12.049. It was believed that this would relieve the contention around EM&V results, although this

[3] D.07-09-043, p. 4.

[4] D.12-12-032, p. 3.

[5] *Assigned Commissioner's Ruling To Refresh The Record On Outstanding Issues*, Rulemaking (R.) 09-01-019, issued on August 30, 2011 in R.09-01-019, p. 6.

did not prove to be the case in the 2010-2012 portfolio cycle.

Due to outstanding issues with ex-ante lockdown process the November 15, 2010 PD adopting a mechanism for the 2010-2012 cycle was ultimately withdrawn. Disputes regarding the ex ante values for the 2010-2012 program were not resolved until July 2011.[6] A ruling issued on August 30, 2011 questioned the justification for continuing an incentive mechanism at all. The Commission's adoption of an incentive mechanism for the 2010-2012 cycle was delayed until December 2012. The 2010-2012 Energy Efficiency Incentive Mechanism ultimately was implemented retroactively and the Commission admitted that the mechanism would not have a 'meaningful effect' on utility behavior.[7]

The instant PD continues shareholder incentive earnings for IOU energy efficiency efforts for the 2013-2014 cycle. The PD states, "We continue to believe that monetary incentives remain important as a means of elevating the importance of EE programs as a core element of the IOU business model."[8] However, building upon lessons learned, the ESPI described in the PD differs quite dramatically from prior mechanisms. A large amount of focus has been placed on mitigating the number of unintended consequences that resulted in the past.

The proposed ESPI would offer a maximum award of $150 million for the 2013-2014 EE portfolio cycle to Pacific Gas and Electric (PG&E), San Diego Gas and Electric (SDG&E), Southern California Edison (SCE), and Southern California Gas Company (SoCalGas).[9] In order to address the diversity of the EE portfolios, the proposed ESPI mechanism has four award components each separately focusing on lifecycle resource savings, codes and standards (C&S) advocacy, non-resource programs, and IOU performance in the ex-ante review (EAR) process. Each component differs in its

[6] PD, pp. 42-43.

[7] D.12.12.032, p. 23.

[8] PD, p. 13.

[9] $150 million amounts to 9.1% of total budget (minus administrative funds and funding for RENs and CCA).

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structure for awarding incentives in order to better address programmatic differences and to diversify risk.

B. Aspects of the Proposed ESPI Mechanism that DRA Supports

DRA appreciates the comprehensive and practical analysis the PD presents. In general, DRA supports the proposed ESPI as it is an improvement from the 2006-2008 and 2010-2012 RRIM and has the potential to encourage the utilities to improve EE performance in a way that is in ratepayers' best interest. Specifically, DRA supports the following aspects of the ESPI:

For non-resource and codes and standards (C&S) programs it is appropriate to award incentives through a management fee approach for the 2013-1014 cycle.

The Commission's Guidance Decision for the 2013 - 2014 EE portfolio (D.12-05-015) stresses the importance of non-resource programs and the market transformation goals put forth in the Strategic Plan.[10] It is essential to align the focus of shareholder incentive mechanisms with the major objectives put forth by the Commission; therefore DRA supports the non-resource program component of the ESPI.

Though DRA has concerns regarding a management fee approach, in this case, DRA supports using this approach for the 2013-2014 cycle. In general, a management fee approach calculates awards based on expenditures and therefore encourages spending (potentially careless and imprudent spending). Also, a management fee approach does not necessarily incentivize successful program implementation or optimal allocation of investment of funds within the programs. Although a management fee approach has these limitations, it may be the best option for programs where performance is difficult to measure. As it is difficult to attribute savings to non-resource programs, a management fee is an appropriate incentive design in this area. In addition, DRA supports the PD proposed management fee of 2% on non-resource program expenditures.

It is also difficult to verify C&S savings so a management fee approach is also

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[10] D.12-05-015, p. 16.

appropriate for incentivizing C&S programs. Again, DRA does not object to a C&S management fee of 10%.

The lifecycle resource savings component should use stretch NTG and EUL values when calculating the incentives earning rate.

The proposed ESPI calculates the incentives earnings rate by dividing the total earnings potential (8% of resource program expenditures) by lifecycle units of resource savings. The lifecycle units of resource savings are calculated by multiplying annualized savings goals by target or 'stretch' Net–to-Gross (NTG) and Expected Useful Life (EUL) values.[11] It is stated that these values may not be achievable for the IOUs within the 2013 - 2014 cycle but that they challenge the IOUs to reach higher levels of performance over time.

DRA supports the PD's use of 'stretch' portfolio average EUL and NTG values that are set higher than the current portfolio average in order to encourage investment in programs that offer more long-term savings (those with high EUL values) and market transformation opportunities (those with high NTG values). An unintended consequence of the 2006-2008 RRIM was that it encouraged the utilities to pursue only highly cost effective programs (e.g., CFLs or compact fluorescent lamps) which usually are those in which offer short-term savings and have high free ridership levels. The Commission's Guidance Decision for the 2013-14 portfolio (D.12-05-015) stressed that the incentive mechanism objectives should be to capture all cost-effective energy savings with a particular focus on comprehensive projects and longer-term savings. The stretch NTG and EUL values are consistent with this strategy.

Ex post evaluation results are preferred to ex ante 'lock down' values in determining savings estimates and final award amounts.

Ex post evaluation is superior to the use of ex ante values in determining the resource savings component earnings as it more adequately aligns ratepayer and utility interest. In past comments, parties have expressed opposition to the use of ex post

[11] Calculations are explained more fully on pages 33-38 of the PD.

savings estimates as a means for determining incentive earnings. These parties argued that the ex post evaluation timeframe did not allow for IOUs to make timely adjustments, that the uncertainty involved with ex post evaluation hinders the effectiveness of a mechanism, and that ex post evaluation discourages market transformation goals. The PD addresses these parties' oppositions and reiterates the benefits of ex post evaluation in determining incentive earnings. DRA supports the findings explained in the PD. Specifically; 1) the IOUs do not require advance certainty in order for an incentive mechanism to be effective, 2) timing concerns with ex post evaluations do not impede the IOUs' incentive to maximize savings, 3) ex post evaluations do not change the goals applicable to the cycle being evaluated, and finally, 4) that ex post evaluations are not 'retroactive adjustments' but instead confirm what was actually realized from the program.[12] Most importantly, the PD states:

> The IOUs do not require advance certainty as to ex post results in order to have an incentive to manage 2013-2014 EE program savings in an effective manner. In fact, uncertainty as to ex post results will keep the IOUs from becoming complacent in managing EE programs. By being subject to risks of ex post evaluations, an IOU cannot assume the amount of incentive earnings per measure is a foregone conclusion, without regard to actual savings realized. Instead, the IOU will be motivated to actively manage programs to maximize EE savings in order to maximize ESPI earnings.[13]

It is critical that the ESPI earnings mirror the actual savings realized in order to align IOU and ratepayer interests. It is in the ratepayers' best interest for the IOUs to be actively monitoring EE program performance and making timely adjustments in order to maximize energy savings and benefits to ratepayers. An effective incentive mechanism would reward the IOUs for doing just that.

The ex post evaluation plan and dispute process discussed in the PD will help mitigate contention.

DRA appreciates the ex post evaluation plan discussed in Attachment 6 of the PD.

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[12] PD, pp. 48-50.

[13] PD, p. 48.

The plan involves posting reports and statements to a publicly accessible website, multiple opportunities for stakeholder input, and conferences to discuss draft Final Evaluation Reports and draft Savings Performance Statements. DRA also supports the ex post evaluation dispute process explained in Attachment 4 of the PD. The "Dispute Resolution Process" was adopted in D.10-04-029, Ordering Paragraph 7 and may be invoked in order to resolve disputes relating to the 2013-2014 ex post evaluation. The process would only occur after informal attempts are exhausted and would allow the ALJ, assigned Commissioner, or the full Commission to resolve the dispute. DRA believes that the plan and dispute process is transparent, clear, and fair. And further, that this should better guide and/or alleviate potential contention involved with ex post evaluation.

A. DRA's Recommended Modifications to the Proposed Mechanism

Overall, DRA believes that the proposed ESPI mechanism is largely in alignment with Commission goals and has the potential to encourage the utilities to improve performance in a way that is in ratepayers' best interest. However, DRA recommends these three modifications to the ESPI that will better protect ratepayers:

1. The resource savings component should include a cost effectiveness threshold as proposed by DRA in our April 26, 2013 opening comments on the ACR

The PD states, "The reformed incentive program adopted in this decision builds upon the lessons learned from prior program cycles, and offers a <u>cost-effective</u> means of encouraging the IOUs to continue to meet EE goals."[14] The PD also identifies 'prudent use of customer funds' as a criterion used to inform the mechanism design.[15] However, currently there is no incentive within the proposed ESPI for the IOUs to spend ratepayer funds prudently. In fact, two components in the ESPI award the IOUs purely for spending (i.e., the C&S and non-resource management fees). The PD further states:

Consequently, consistent with the priorities stated in D.12-05-015,

[14] PD, p. 12.

[15] PD, p. 20.

> our adopted ESPI gives greater weight to programs designed for deeper savings, measures with higher up-front costs and longer design lives, and market transformation efforts (with correspondingly increased challenges associated with participation levels and achieving savings from these programs). Net economic benefits will be lower, however, because portfolio design will focus more towards achieving the longer-term policy vision, capturing all savings up to where the portfolio is not cost-effective.[16]

However, the proposed ESPI does *not* encourage the IOUs to 'capture all savings up to where the portfolio is not cost-effective.' The resource savings component encourages the IOUs to pursue long term savings and market transformation opportunities but it does not encourage them to keep resource programs cost effective as a whole. Costs do not enter the equation. Therefore, the ESPI mechanism allows for the IOUs to maximize incentive earnings by implementing a non-cost effective portfolio. The PD claims that the stretch goals in the ESPI send signals that encourage cost effective investment:

> We note that we adopt a series of 'stretch' goals for the IOUs in the ESPI, which sends a very similar signal as a cost-effectiveness multiplier and it is unclear what, if any, interactive effects there may be between the two similar components. Therefore, we decline to adopt a cost-effectiveness multiplier at this time but will consider adding it to the ESPI in future iterations.[17]

However, the NTG and EUL stretch goals within the resource savings component do not adequately encourage cost effective investment. Solely encouraging the IOUs to increase portfolio NTG and EUL values (i.e., net lifecycle savings) only encourages the IOUs to focus on *one* side of the cost effectiveness equation (the benefit side of the benefit/cost ratio). It is extremely important to not only encourage the IOUs to seek opportunities to maximize savings but also to encourage the IOUs to seek opportunities to reduce costs in doing so.

DRA does not support the cost effectiveness multiplier presented in the April 4,

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[16] PD, p. 36.

[17] PD, p. 68.

2013 ACR, and instead proposes another method for encouraging cost effective EE investment.[18] In DRA's April 26, 2013 opening comments on the ACR, DRA recommended the use of a cost effectiveness threshold, a Total Resource Cost (TRC) test of 1.0.[19] A cost effectiveness threshold ensures that the EE portfolio is cost effective in order for the IOUs to earn the resource savings component of the ESPI. It protects ratepayers from funding incentives while incurring losses from non-cost effective resource programs. The proposed ESPI mechanism with a cost effectiveness threshold will encourage the utilities to maximize lifecycle savings while keeping resource programs cost effective as a whole. This result would be more aligned with D. 12-05-015, which stressed the goal of capturing *all* cost-effective energy savings, something that the 2006-2008 RRIM did not effectively encourage.

Further, DRA does not propose a "penalty" when cost effectiveness falls below the cost effectiveness threshold (i.e., TRC of 1.0), or require that shareholder earnings be included within the TRC calculation. DRA also recommends that the shareholder earnings from the ex ante review (EAR) process and from the non-resource and codes and standards management fee awards still be awarded if the TRC falls below 1.0. This way the utilities do not risk losing the *entire* award. This is a balanced approach that will minimize contention that may result from using a cost effectiveness threshold.

While it is unknown how likely it is that a portfolio will become non-cost effective, ratepayers should not face *any level* of risk of funding incentives to IOUs for implementing non-cost effective energy efficiency programs. Even if it is unlikely that the resource program's TRC would drop below one, ratepayers must be assured that their investment is protected.

[18] See the April 4, 2013 ACR for a description of the cost effectiveness multiplier and DRA's April 26, 2013 Opening Comments for DRA's opposition to the multiplier.

[19] DRA's April 26, 2013 Opening Comments on the ACR, p. 10.

2. The resource savings award component should include *only* ex post savings values as originally proposed in the April 4, 2013 ACR

The ESPI mechanism should award earnings based solely on ex post verified results as was originally proposed in the ACR. The PD proposes calculating the resource savings award component based on a mixture of ex post and ex ante values. The mixture would be determined by identifying the amount of uncertainty surrounding each measures savings estimates. Those that are deemed to be highly uncertain will be subject to ex post evaluation while those that are not will use ex ante values with an ex post 'true up' adjusting for actual measured installed. All custom projects will be subject to ex post evaluation. The PD states:

> We recognize that a significant portion of the portfolio consists of "deemed" measures with savings parameters for which there is a great deal of certainty, and it does not seem warranted to defer payment for these savings until all evaluation activities are completed.[20]

The rational for implementing this process is not convincing. The method for splitting up measures into ex ante and ex post groupings and awarding earnings at different times is confusing, time consuming, and creates another opportunity for contention. Implementing this practice to avoid the deferral of earnings payments does not seem worthwhile. The proposed schedule for awarding earnings based on ex post savings is two years after the program year. Switching to ex ante savings moves the award disbursement up a year, but it does not change the regularity or continuity of award disbursements. Also, if savings estimates have a great deal of certainty then the award amount should not differ dramatically if ex ante or ex post values are used. Therefore, using ex ante values for the more certain savings estimates will not greatly reduce the risk of large swings in incentive amounts resulting from ex post evaluation as the PD asserts.[21]

The process set for determining which estimates will be subject to ex post

[20] PD, p. 50.

[21] PD, p. 54.

evaluation and which will not lacks sufficient detail. Attachment 3 lists the deemed measures to be subject to ex post evaluation for the 2013 program year. But, within the attachment, only a short description is provided as to how the determination was made. The criteria used for determining which measures are 'sufficiently uncertain' are unclear and appears to be largely subjective. This could create an opportunity for contention. Controversy over the ex post evaluation will not be averted if the debate is just moved to this process.

Ratepayers should only fund incentives based on savings that actually occur. While many of the deemed measures may have savings parameters that are fairly certain, there is a risk that ED and/or stakeholders will not be able to judge this certainty to a very accurate extent. Measures deemed to be fairly certain might actually realize substantially less savings. Therefore placing risk on ratepayers of funding incentives based on savings that did not actually occur and limiting the incentive for utilities to recognize and act on changes in market conditions.

The Commission should not implement this process as it is not clearly defined and has not been presented previously or vetted by parties. As the PD recognizes the value of ex post verified savings and the disputes of those who oppose its use, the Commission should award incentives simply based on ex post verified savings estimates.[22]

3. The overall award potential should be capped at 7% of the portfolio budget

The PD proposes an overall award cap of 9.1% of EE budgets. The PD bases this proposal off of a variety of information including incentives in other states, the risk to the IOUs and ratepayers, and stringency of the award design. Ultimately, the PD states that the decision is a matter of judgment based on available facts. However, as the final recommendation of 9.1% is largely a matter of judgment, DRA draws a different conclusion from the available facts.

DRA agrees that other jurisdiction's award caps should be used as a benchmark

[22] PD, pp. 48-50.

for setting one in California. DRA also agrees with the PD conclusion that a cap of 7% of EE budgets is the most accurate measure of comparison with other jurisdictions.[23] However, the PD justifies setting a higher award cap because the stretch NTG and EUL values within the resource savings component make the cap hard to reach (as seen in the low 'business as usual' award projection). The PD states, "Setting more ambitious EUL and NTG values is a reasonable trade-off for setting higher potential earnings on resource programs with no a priori risk of penalty as previously applied under the RRIM."[24] The PD appears to assume that mechanisms in other jurisdictions have caps that are, on average, easier to reach thus justifying that the ESPI cap be set higher. As it is unsupported to make such an assumption, DRA does not believe that the stretch NTG and EUL values justify setting an award cap above the national average of 7% of portfolio budget.

In order to cap the total incentive award at roughly 7% of the EE budgets, DRA proposes adjusting the resource savings component cap down from 8% to 5.5% of the authorized resource program funds and keeping the other component caps the same.[25]

III. CONCLUSION

In conclusion, the ESPI (as modified by DRA) has the potential to encourage the IOUs to pursue energy efficiency investment in a way that achieves Commission goals and aligns with ratepayer interest. The Commission should therefore adopt the PD with DRA's modifications. They include, 1) adding a cost effectiveness threshold to the lifecycle resource savings component, 2) basing incentive earnings solely on ex post evaluation results as opposed to a combination of ex post and ex ante, and 3) reducing the total award cap from 9.1% to 7% of EE portfolio budgets.

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[23] PD, p. 26.

[24] PD, p. 40.

[25] Resource savings component of **8**% of resource program expenditures + EAR process performance cap of 2% of resource program expenditures + 10% C&S management fee + 3% non-resource program management fee = total award cap of **9.1%** of EE budgets.

Resource savings component of **5.5**% of resource program expenditures + EAR process performance cap of 2% of resource program expenditures + 10% C&S management fee + 3% non-resource program management fee = total award cap of roughly **7%** of EE budgets.

Respectfully submitted,

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