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VIA HAND DELIVERY

Honorable Jaclyn A. Brilling
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, New York 12223

Re: Case 07-M-0548 - Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard

Dear Secretary Brilling:

New York State Electric & Gas Corporation ("NYSEG") and Rochester Gas and Electric Corporation ("RG&E"), referred to herein as "the Companies", hereby submit this response to the Commission's May 30, 2008 Notice Soliciting Comments regarding performance-related incentives for energy efficiency programs in the above-referenced proceeding.

Introduction and Summary

The Companies have in this case and in other forums expressed their support for the State's energy conservation goals and are prepared to move forward with energy efficiency in accordance with Commission policy and directives in this case.

The Companies believe that there are circumstances in which utility and customer interests can be appropriately aligned through the use of incentive mechanisms. The earnings sharing mechanisms under which the Companies operate is a broad and successful example. It provides an incentive for the Companies to find efficiencies in their cost structures that not only benefit customers and shareholders in the short-term, but can benefit customers in the long run as rate-resetting flows all such efficiencies to customers. Earnings sharing mechanisms work in large measure because the Companies have control over the success of their cost savings and efficiency efforts.

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The Companies greet the prospect of such a structure related to energy efficiency, as outlined by all three of the proposed structures, with some caution. For the near-term, in which fast-track programs are the primary programs under consideration the Companies are concerned with the implementation of an incentive mechanism based on achieved energy savings because Utilities generally have not focused on energy efficiency management. While the utility can design effective programs, implement them well, meet or beat cost budgets, and even achieve appropriate levels of customer awareness, ultimately the decision to participate in the program is entirely the customer's. An incentive mechanism tied to performance measures such as these might be a reasonable approach to apply to the so called "fast-track" programs if the Commission deems an incentive structure should be implemented in the near term. Incentive mechanisms based on verified results might be appropriate for longer-term energy efficiency programs once the Companies have gained experience with energy efficiency program management, collected/analyzed program results, and after the Commission has determined the operational parameters of energy efficiency programs in New York State. At this time, the Companies believe it is premature to adopt a system of incentives and penalties for the fast-track programs based on verified energy savings. While it is true that California has enacted an incentive program with the possibility of symmetric penalties based on verified energy savings, the Companies note two key differences between California and New York. First, and most importantly, California has over 15 years of experience managing energy efficiency programs and 10 years of measurement and verification study results. After such a time the likely responses of the customer base can be more accurately projected. Second, California had a lengthy litigated proceeding solely on the topic of incentives for energy efficiency with a more thorough investigation and resolution of the myriad issues. By comparison, in the present case it would seem there is a rush to enact a mechanism.

The Companies recommend that the Commission consider a performance mechanism based on verified ratepayer net benefits once data has been collected and analyzed on customer responses to fast-track programs and once a full consideration of the many issues associated with implementing an energy efficiency program is complete. Adopting incentives and penalties for the fast track programs, now, tied to achieved energy reduction targets also could create difficulty coming to agreement on how to forecast and measure such savings given the lack of customer response data and the unfamiliarity of NY utilities in managing energy efficiency programs. Having said this, there could be a place for both rewards and penalties for utility performance regarding energy efficiency for the fast track programs, pending the resolution of related details necessary for implementation. A mechanism could, for example, be designed to reward or penalize utilities with respect to implementation of programs, including budget, outreach and education and customer awareness measures. These are components of the overall energy efficiency portfolio for which utilities are responsible and which they can control. Notwithstanding these introductory and summary comments, the Companies will comment below on the specific guidelines proposed by Advisory Staff, the three identified models and briefly on the range of incentive levels.

Comments on Specific Guidelines

1) *The overall objectives of performance incentives in the context of energy efficiency are: (1) Encourage superior performance and deter weak performance; and (2) align utilities' financial interests with energy efficiency as a resource option.*

Comment: For the fast-track programs being considered in the near term, the Companies support the concept of performance incentives to encourage superior performance by utilities. Mindful of New York's mixed history with energy efficiency over the last 30 years, the Companies believe that current high electricity prices, the difficulty in siting new generation, and environmental considerations demand that energy efficiency be a component of a comprehensive solution. The Companies do not believe that utilities should be at risk of penalties due to a failure to meet energy reduction targets that depend ultimately on customer acceptability and action. Failure to meet outreach and education goals, customer awareness goals (e.g., through survey results) and appropriately implement approved programs could reasonably put utilities at risk for penalties. If over time customer receptiveness to energy efficiency initiatives can be demonstrated, as in California, then perhaps such data can be used to construct well-defined measurable targets, for which utilities could be allowed incentives for achieving targets or subject to penalties for failing to meet target levels. The institution of an incentive mechanism based on achievement of a difficult to forecast energy savings target has the potential to invite troubling incentives with respect to setting such targets and subsequently measuring them. The overall objectives of performance incentives should be closely linked to aspects of energy efficiency programs within the control of the utility that are readily measurable.

2) *The maximum amount of money available to utility stockholders from an energy efficiency incentive should account for the size of the utility program portfolio target relative to the jurisdictional goal for the utility's service territory, and should encourage improved utility performance without placing an excessive burden on ratepayers.*

Comment: In concept, the Companies generally agree that over the long-term, maximum incentive amounts should be related to the size of the utility portfolio target. However, the companies believe that the maximum incentive should be based on achievable net benefits created (i.e., the value of electricity -- energy and/or capacity -- or natural gas avoided less program and other direct costs). In addition, the Companies believe that tying incentive payments to realized net ratepayer benefits will improve the chances that utility performance will be encouraged without placing an excessive burden on ratepayers. Also, see comments in response to 1) above.

3) *The formula by which a maximum monetary incentive and intermediate monetary incentives and disincentives are calculated should not induce utilities to increase program costs artificially or to manipulate the program design and implementation inappropriately.*

Comment: The Companies generally agree that the formula by which a maximum monetary incentive and intermediate monetary incentives and disincentives are calculated should not induce utilities to incur unnecessary program costs. However, if a particular program is proving to be successful beyond expectations and creates benefits on the margin, then spending above plan on direct program costs to "buy" additional benefits may be warranted. Therefore, the incentive structure should not artificially discourage expansion of a successful program. To do so would leave ratepayer money on the table, so to speak. As noted in the summary, the existence of a penalty structure based on energy reduction targets, by itself, has the potential to manipulate the program design away from high-risk, high-reward and towards safe programs. The Companies do not believe this necessarily is in customers' interests.

4) *The incentive formula should provide for both positive and negative revenue adjustments.*

Comment: See our previously expressed concerns with penalties related to energy reduction targets.

5) *The effectiveness of a utility's energy efficiency program portfolio, based on measurement and verification results, should be the basis for determining revenue adjustments.*

Comment: As previously stated, the Companies are concerned with mechanisms applied to fast track programs now that would penalize utilities for the failure of customers to participate. A Commission decision to adopt energy savings targets as the basis for incentive and penalty calculations would require decisions on many details including the verification and measurement process and assumptions, the time period over which measurement happens, the value of energy to be used (a forecast at the time, or the actual prices as the program unfolds), and the time period over which incentives/penalties are determined with respect to program rollout. Nevertheless, if the Commission were to adopt incentives and penalties for the fast track programs in the near term, the Companies recommend that they instead be structured to apply to the utility's performance on certain program aspects under its control as discussed above.

6) *The utility must achieve a high percentage of its target before realizing a positive revenue adjustment tied to performance.*

Comment: The Companies agree that however targets are ultimately measured utilities must achieve a high percentage of its target before realizing a positive revenue adjustment for performance.

7) *The primary gauge for determining the effectiveness of a utility's energy efficiency program portfolio should focus on verified MWH savings. For programs that are approved with a specific peak reduction target, the primary gauge should be MW savings.*

Comment: See comments in item 5) above.

8) *Incentives should be calculated over aggregated portfolio performance rather than by specific programs; however, a mechanism must be in place to assure that individual program targets are not sacrificed to maximize incentives.*

Comment: The Companies agree that incentives should be calculated over aggregated portfolio performance rather than by specific programs. However, the Companies don't understand the second part of this guideline related to individual program targets. If the Companies interpret this guideline as suggesting that each program must meet a minimum percentage of target in order for any incentive to be paid even if a portfolio of programs in aggregate would otherwise earn an incentive, we disagree. The State is embarking on energy efficiency anew and does not have a track record to know how individual programs will ultimately be received. Again, to encourage high-risk high-reward programs, potential awards should not need to meet program-by-program minimum thresholds. If a particular program turns out in practice to be poorly received, it should be suspended, and sacrificed. This makes logical economic sense. Utilities should not be encouraged to throw good money after bad in order to satisfy an individual program target.

9) *Incentives would not be available for programs in which a utility transfers funds from ratepayers to NYSERDA (this principle would not preclude a utility from obtaining incentives for a program that it undertakes that was previously conducted by NYSERDA with ratepayer funds transferred by the utility).*

Comment: The Companies agree.

10) *Consistent statewide incentive principles based upon overall program performance are necessary for ease of administration and to prevent confusion among potential market participants.*

Comment: The Companies agree.

11) *Incentives (assuming performance at 100% of the utility's proposed program target) must be included in the cost estimates of program proposals.*

Comment: Yes, see discussion in item 2) above.

Alternative Incentive Models

Summary of Alternative Incentive Models

The Notice included an Advisory Staff incentive model as well as links to Trial Staff's Initial Brief in Case 07-M-0548, which contained an incentive model for fast-track programs, and the risk/reward incentive mechanism for energy efficiency programs adopted by the California Public Utilities Commission in Rulemaking 06-04-010. It should be pointed out upfront that the California model was adopted after a lengthy and extensive process that included: a detailed scoping ruling by an Administrative Law Judge (ALJ) for multiple phases of the rulemaking, identification of Phase 1 as the forum for addressing and implementing a risk/reward incentive mechanism, and encouragement of informal discussions prior to workshops and submission of pre-workshop written comments including preliminary incentive proposals. In addition four days of workshops on the Phase 1 issues were held and facilitated by an assigned ALJ. Post-workshop comments and final comments were filed by several parties to the case. The ALJ asked for the submission of additional comments on certain matters and provided for reply comments on submitted material. It was determined that evidentiary hearings were necessary to address disputed factual material and as a result, opening and reply testimony was submitted culminating in four days of evidentiary hearings. Finally, opening and reply briefs were filed by the parties to the case.

Neither Trial Staff's nor Advisory Staff's model has been subjected to anything close to the level of scrutiny the California Commission applied in developing its incentive risk/reward model. Trial Staff has provided sufficient detail on its model construct to allow the Companies to offer comments on its design and operation. However, Advisory Staff's model is a formative conceptual construct, lacks detail necessary for a thorough understanding and omits or is silent on certain protocols/processes that are necessary for implementation. As a result, our comments set forth below recognize the differences in these models.

California Risk/Reward Model

Trial Staff's initial brief accurately points out that an extensive process was followed by California in developing its incentive based model for energy efficiency. They also properly note that the California utilities have had a long uninterrupted period of administering energy efficiency programs, have extensive experience in measuring and verifying program performance. In fact, California utilities have had 15 years experience with managing energy efficiency programs and have 10 years of measurement and verification study results. Importantly, in 2002, the California Commission restored the utilities to their traditional energy procurement responsibilities which is in contrast to New York where primary responsibility for supply procurement remains with unaffiliated energy suppliers. These facts clearly influenced the risk/reward incentive mechanism ultimately adopted by the California Commission.

The California model contains opportunities for incentives and risks of penalties for deviations from target amounts. The incentive opportunities accrue only when utility portfolio managers produce positive ratepayer net benefits as measured by the difference between avoided costs for generation, transmission, and distribution and energy efficiency program costs. Shareholders earn incentives once net ratepayer benefits exceed 85% of the portfolio target net benefit amount and a target of 80% for individual kWh, kW, and therms. If, for example, achieved portfolio savings are 100% of target but only 75% of the kWh savings target, no pay-out would accrue to the benefit of shareholders. It should be noted that in contrast to Trial Staff's proposal (discussed below) these individual targets are not energy efficiency program-specific targets but more general targets based on usage determinants thereby providing the California companies flexibility in allocating resources across specific programs to meet individual target amounts for kWh, kW, and therms. Specifically, assuming individual targets are met, California utilities earn 9% of verified net ratepayer benefits if they achieve 85-100% of the portfolio goal and 12% of the net benefits once savings exceed 100%. Incentives are capped at a level that represents the earnings they would have otherwise achieved from displaced supply side investments, provided they achieve 125% of the portfolio target amount.

There is a dead band range between 65-85% of target amounts where neither incentives nor penalties apply, even if ratepayers realize positive net benefits from the energy efficiency programs.

Penalties accrue once verified savings fall below 65% of target and are assessed on a per unit basis for each kWh, kW, or therm below goals or based on a payback of negative net benefits. The intent is to insure customers are no worse off from the implementation of energy efficiency programs. Maximum penalties are capped at the same dollar amount as incentive payments.

The California incentive model was the result of an in depth process which examined alternative models in the context of informal and formal collaborative sessions and litigated hearings. The particular model adopted by California was guided by two key factors not present in New York:

a utility industry with 15 years experience managing energy efficiency programs and having 10 years of measurement and verification study results, and a utility industry that has supply resource portfolio management responsibilities. Moreover, many of the associated administrative and ratemaking issues were decided at the time the incentive model was approved by the California Commission. The California model clearly reflects that state's policy of aligning customer and shareholder interests in developing cost-effective energy efficiency programs. However, it is not at all clear that New York should embrace such a model for its utilities, at this time, given the current de-regulated structure of our electricity and gas markets, the lack of recent New York utility experience managing energy efficiency programs, and the absence of measurement/verification protocols.

Trial Staff Model

Trial Staff proposed an incentive model limited to the so-called fast track programs and recommends that the Commission consider the issue of incentives for the longer term in the context of a generic proceeding or in the context of the EPS proceeding. (As explained above, the Companies agree with the need to consider longer-term incentives either as a separate matter in this case or in a generic proceeding.) They describe the proposal as being one that is straightforward and a balance of ratepayers and utility interests that stresses superior performance. Trial Staff advocates for incentives as well as penalties. Incentive payouts would be based on achieved annual energy savings starting once utilizes achieved 85% of the MWH savings goal. Companies could earn up to 5% of the program budget as a reward for meeting between 85-100% of program target savings. The incentive would increase up to 9.5% for achievement levels between 101-110% of target and up to 12% of program budget costs for achievement levels between 112-122% of target. Penalties would begin when utilities failed to achieve at least 60% of target amounts. The penalties would be assessed in two parts: an initial fixed penalty component equal to 1/3 of the maximum incentive amount and a variable component based on the remaining 2/3 that increases for each MWh not achieved. Penalties would be capped at the same dollar amount as the incentives (12% of program budget).

As explained in more detail above, it is not clear that incentive/penalty arrangements for fast track programs should be adopted at this time. The Companies believe incentives should be worked out in the context of a more formal proceeding that considers various alternative model structures, the establishment of specific goals for each utility, the protocols for measurement/ verification, mechanisms for determining incentive pay-outs, and other associated ratemaking issues like cost allocations. The Companies do not support the establishment of Trial Staff's incentive/penalty mechanism for fast-track programs at this time because it would tie utility penalties and incentives to results (i.e., energy efficiency savings by customers) over which it has no control, because of the lack of utility experience in managing energy efficiency programs, and lack of detail on the ratemaking procedures necessary to implement the incentive arrangement.

Notwithstanding our previous concerns regarding the adoption of an incentive/penalty structure for the fast track programs, if Trial Staff's incentive/penalty model is adopted, the Companies would ask the Commission to consider changes to two aspects of the model: individual program targets and the maximum incentive amounts. Individual program targets could unnecessarily constrain the utilities from directing program resources to the most effective energy efficiency programs. The Companies would rather see the establishment of a portfolio target. If the goal is to maximize ratepayer benefits then it would seem unwise to constrain utilities from diverting program budget dollars from an underperforming to a high performing program. Individual targets would encourage utilities to meet target levels to avoid a penalty assessment even where the high performing programs provided for higher net ratepayer benefits.

The maximum incentives available for shareholders should be based on net ratepayer benefits and not program budget costs. The ultimate objective of an incentive program for energy efficiency programs should be maximization of net ratepayer benefits. As such, utility incentives should be tied to the amount of net ratepayer benefits in order to properly align shareholder and ratepayer incentives. Moreover, basing incentives on program funding levels could lead to perverse incentives to spend unnecessary amounts on certain programs. Trial Staff recognizes this potential problem and proposes a remedy that would exclude from eligible incentive payments, any energy savings achieved with spending above the original program budget. This solution does not appear workable and likely to lead to unnecessary disputes as to what dollars created the eligible energy savings. For example, how much of the energy savings were produced by the first dollar versus the last dollar of program expenditures? Moreover, did the over expenditure produce net ratepayer benefits and if so why should the utility be denied an opportunity to share in the benefits? These questions and disputes can be entirely avoided by basing utility incentive payments on net ratepayer benefits.

Advisory Staff Model

The Advisory Staff sets forth a conceptual framework for comment that appears in some ways to be similar to the California and Trial Staff models with some important differences. They would provide for increased incentives and penalties based on achieved MWh and MW savings. Advisory Staff would require that savings achieve at least 90% of the target amount before incentives were triggered which is a higher threshold than California adopted or Trial Staff recommends. Advisory Staff's model also provides for a higher incentive rate for savings achieved between 90 and 100% than it does for savings above 100% in contrast to California and the Trial Staff. Similarly, Advisory Staff would assess penalties for failure to achieve less than 75% of targeted amounts which is more penal than either California (65%) and under the Trial Staff proposal (60%). Incentives would be set on the basis of a percentage of statewide program costs necessary to reach the Commission's jurisdictional MWH goal and then expressed as in terms of return on equity. What is assumed but not totally clear is that Advisory Staff would establish the same basis point incentive for each jurisdictional utility using total statewide costs divided by total statewide equity as opposed to deriving separate basis point standards based on individual program budgets and equity levels.

Aside from the graphical illustration, there are no numerical values contained in the Advisory's Staff model making it difficult to determine the upside potential and the downside risks associated with its proposal. In addition, it is not clear whether the maximum penalty is set equal to the maximum incentive amount as in the California model and Trial Staff's proposal. Advisory Staff is silent on whether its model would apply to the so called fast-track programs, longer term programs, or both. Finally, it would appear that Advisory Staff is recommending that targets be established on a portfolio basis as opposed to a program by program basis as recommended by Trial Staff but it is not totally clear from the material.

Because Advisory Staff's model leaves unanswered many basic questions, the Companies would request that the Commission ask Advisory Staff to provide additional detail on its proposed incentive model so the Companies can conduct a more thorough examination. At a minimum, Advisory Staff should address the questions we have raised above. Finally, we request that the Commission allow the Companies an opportunity to offer supplemental comments once the Staff Advisory has provided its response to our request for additional detail.

Range of Incentive Levels

The Companies observe that there are precedents for the range of incentive levels for this effort in retail access mechanisms and gas procurement savings incentives, and in service quality and reliability penalties. The relative importance the State and this Commission attach to achievement of energy efficiency goals as compared with these other priorities could inform the decision on the absolute level of incentive and penalties.

Conclusion

The Commission should not adopt incentive/penalty mechanism for fast track programs at this time, based on verified energy savings given the lack of recent utility experience in managing energy efficiency programs, uncertainty regarding the measurement and verification processes that will be employed to determine verified savings, and because of the need for Commission findings regarding the ratemaking details necessary for implementation.

Nevertheless, if the Commission adopts incentives/penalties for fast track, the Companies recommend they be based on factors within the Companies control as discussed in our comments above.

The Companies would consider incentive/penalties based on verified ratepayer net benefits for the longer-term energy efficiency programs after the Companies have gained experience with energy efficiency program management, after measurement and verification protocols have been established and ratemaking and other administrative details have been developed.

Finally, the Companies support establishing a new generic proceeding or a separate part to this proceeding to develop an incentive/penalty mechanism, the necessary ratemaking, and administrative procedures for long term energy efficiency programs.

Respectfully submitted,

James A. Lahtinen

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