STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

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

Comments of the Natural Resources Defense Council, Pace Energy and Climate Center and the Association for Energy Affordability

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INTRODUCTION AND SUMMARY

The Natural Resources Defense Council, Inc. ("NRDC"), Pace Energy and Climate Center ("Pace"), and the Association for Energy Affordability ("AEA") respectfully submit these comments as provided for by the May 30, 2008 "Notice Soliciting Comments" (the "Notice"), in the Energy Efficiency Portfolio Standard Proceeding ("EEPS").

The Notice identifies as "an integral issue" performance-related incentives for utilities. It encourages parties to comment on the importance of incentives, generally, as well as on the set of Guidelines prepared by Department of Public Service ("DPS") Advisory Staff and three incentive models: (1) the DPS Trial Staff proposal, as set forth in their Revised Proposal of November 27, 2007, and their Initial Brief; (2) the Shareholder Risk/Reward Incentive Mechanism adopted by the Public Utilities Commission of California on September 20, 2007; and, (3) the Advisory Staff model outlined in the Notice.

Utilities must play a significant role in the administration of energy efficiency programs in order for New York State to achieve its goal to reduce electricity consumption 15% below forecasted levels for 2015 ("15 by '15"), as their efforts and inherent advantages are critical to scale up energy efficiency to the requisite levels. NRDC, Pace and AEA strongly support Commission adoption of performance-based incentives for energy efficiency programs administered by both electric and gas utilities. Indeed, beginning with our initial filings in this case, we have consistently advocated for the use of both financial incentives and penalties to reward and penalize utilities for their performance in meeting prescribed energy efficiency program targets.

We applaud the Commission's expressed intent to adopt performance-based incentives in this proceeding. By adopting a clear and effective utility incentive structure and tying such structure to aggressive energy efficiency targets for utilities, the PSC will help align utility shareholders' interests with the energy efficiency goals of New York State and ensure that utilities achieve their share of the 15% goal. We concur that the Commission should establish these standards as soon as possible, preferably prior to the submittal by the utilities of their comprehensive energy efficiency plans to implement "15 by '15". In developing their comprehensive efficiency plans, the utilities would greatly benefit by knowing "the rules of the game." We believe that the incentive structure recently adopted by the California Public Utilities Commission provides a good example of an appropriate performance incentive structure for New York State.[1]

A. The PSC Should Adopt an Incentive Structure to Align Utility Shareholders' Interests with the Energy Efficiency Goals of New York State.

The PSC should adopt a clear and effective incentive structure for utilities, to ensure that the utilities assign the requisite corporate management attention and programmatic and fiscal resources to utility efficiency programs, which are an essential component of achieving the 15 by '15 goal. Such a structure must be designed to level the playing field between energy efficiency and supply side resources and maintain the utilities' sustained commitment to energy efficiency over time.

[1] State of California Public Utilities Commission, Rulemaking 06-04-010, Order Instituting Rulemaking to Examine the Commission's post-2005 Energy Efficiency Policies, Programs, Evaluation, Measurement and Verification, and Related Issues, Interim Opinion on Phase 1 Issues: Shareholder Risk/Reward Incentive Mechanism for Energy Efficiency Programs, Decision 07-09-043 (issued September 25, 2007), as modified by CPUC D.08-01-042, Interim Opinion: Joint Petition for Modification of Decision 07-09-043 (adopted January 31, 2008).

Although utilities are required to develop and implement Revenue Decoupling Mechanisms (RDMs) in accordance with the PSC's April 20, 2007 Order Requiring Proposals for Revenue Decoupling Mechanisms,[2] such a mechanism will only *remove* the disincentive for a utility to promote energy efficiency. It will not provide an incentive for a utility to implement such programs. Thus, a RDM must be combined with regulatory incentives to encourage utilities to scale up energy efficiency programs to the necessary levels. As stated in the Judges' Straw Proposal in this proceeding, "utility incentives, properly designed, can serve at least four purposes: (1) to align utilities' financial interests with energy efficiency; (2) to provide through negative performance incentives a mechanism to hold utilities accountable for meeting targets; (3) to encourage control of program costs; and (4) to encourage achievement of increased efficiency gains."[3] Staff has stated that "[p]roperly designed incentives can play a role in aligning the financial interests of a utility for energy efficiency goals."[4]

The award of any incentives should be based on actual verified performance, subject to independent verification, and not based on simply completing certain milestones, such as entering into contracts for reductions or spending a certain amount of money. In addition, the award of incentives should be scaled, with higher incentives for higher achievement, and the opportunity to earn greater incentives for exemplary performance beyond the base target, so as to

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[2] PSC Case No. 03-E-0640, Proceeding on Motion of the Commission to Investigate Potential Electric Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation and PSC Case No. 06-G-0746, In the Matter of the Investigation of Potential Gas Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation, Order Requiring Proposals for Revenue Decoupling Mechanisms (issued April 20, 2007).

[3] PSC Case No. 07-M-0548, Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard, Corrected Ruling Presenting Straw Proposal (issued February 13, 2008) ("Straw Proposal"), at 16.

[4] PSC Case No. 07-M-0548, Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard, New York Department of Public Service Staff Preliminary Proposal for Energy Efficiency Program Design and Delivery, August 28, 2007, at 28.

maintain the utilities' incentive to pursue cost-effective efficiency beyond the targeted level. It is also essential that penalties be included for poor performance on utilities' savings goals.

Incentives should be awarded for cost-effective energy efficiency, and thus should be based on total resource net benefits. In addition to metrics that support the achievement of the 15 by '15 target, additional metrics tied to other criteria, such as low income participation, should be set, as well, to avoid utilities focusing only on savings to the potential detriment of considerations such as equity and comprehensiveness. Though incentives can be annual or multi-year, the advantages of multi-year goals (e.g. based on a three-year cycle) include providing utilities with the flexibility to modify their programs as needed over time to make the most efficient and effective use of resources, as well as allowing goals for programs that may not demonstrate results for multiple years.

It is critical that incentives are tied to aggressive energy efficiency targets for utilities that will ensure that the utilities' share of the State's 15 by '15 goal is reached. Therefore, we recommend that the PSC adopt the 6,126 GWh investor-owned utility target, as well as the utility-specific targets, set forth in our Initial Brief filed in this proceeding on April 10, 2008:

Central Hudson Gas & Electric Corporation	302 GWh
Consolidated Edison Company of New York, Inc.	2,619 GWh
New York State Electric & Gas Corporation	787 GWh
Niagara Mohawk Power Corporation	1,820 GWh
Orange & Rockland	227 GWh
Rochester Gas and Electric Corporation	370 GWh

B. Incentive Guidelines Set Forth by DPS Advisory Staff in the Notice Are Generally Balanced, Reasonable and Workable.

NRDC, Pace and AEA believe that the Advisory Staff Incentive Guidelines set forth in the Notice represent balanced, reasonable and workable guidelines for the adoption and implementation of a performance-based system of incentives and penalties for utility-administered energy efficiency programs.

While it may seem self-evident, it needs to be emphasized that the primary purpose of a performance-based incentive system is to promote **performance**, not to encourage unnecessary and wasteful spending (Guideline 1). By promoting performance and by aligning this performance with utilities' financial interests, the Commission will encourage both programmatic and operational efficiencies to the benefit of ratepayers. By implementing a structure including scaled incentives for higher achievement and concurrent penalties for poor performance, the PSC will encourage superior performance and deter weak performance. NRDC, Pace and AEA agree that the Commission should be mindful not to place an excessive burden on ratepayers (Guideline 2). However, a properly structured and administered performance-based incentive system - one that is based on total net benefits - will produce financial benefits for both ratepayers and utilities, which should be New York's goal.

We agree with Guideline 3. However, while the specific formula is certainly important, its success will also depend on the Commission and its staff exercising its regulatory responsibility. We fully expect that in its initial review and approval of utility efficiency plans, the Commission and its staff will closely scrutinize utility-administered efficiency programs to assure the reasonableness of program costs and the integrity of program design. This responsibility would be strengthened if the Commission were also to incorporate into program development and review the consultative role of other Program Administrators, as contemplated in the Governance Structure model that NRDC, Pace, AEA and other parties have previously proposed in this proceeding.[5] Again, we emphasize that any incentive payment or penalty should be based on **performance**, not program costs.

As mentioned above, NRDC, Pace and AEA also agree that any incentive formula should provide for both positive and negative revenue adjustments (Guideline 4). We had proposed both of these concepts in the Initial Brief we filed in this proceeding on April 10, 2008. Revenue adjustments should be scaled to ensure that a utility has a consistent incentive to improve performance. We concur that a utility should have achieved a high percentage of its target before it realizes a positive revenue adjustment tied to its performance (Guideline 6). We have proposed that this threshold be set at 85% of a utility's base energy savings goal. (*See* Section C, below).

Guideline 5 is critical and should be strengthened. NRDC, Pace and AEA agree that the effectiveness of a utility's energy efficiency program portfolio should be the basis for determining revenue adjustments. Guideline 5 should be clarified to make explicit that which seems implicit, namely that the "effectiveness" of a utility's efficiency program portfolio is based on its **performance** in meeting its energy savings target. We also agree that this "effectiveness" should be based on measurement and verification results. However, the importance of **independent** measurement and verification should be emphasized, as well, and Guideline 5 should reflect that.

While we agree that MWh savings should be the primary gauge for determining the effectiveness of a utility's energy efficiency program portfolio, and that MW savings should be a

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[5] PSC Case No. 07-M-0548, Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard, "EPS Administration Consensus Recommendation of Natural Resources Defense Council, Pace Energy Project, City of New York, Association for Energy Affordability, Inc., Consolidated Edison Company of New York, Inc., KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island, National Fuel Gas Corporation, Niagara Mohawk Power Corporation d/b/a National Grid, New York State Electric & Gas Corporation, Orange and Rockland Utilities, Inc., Rochester Gas and Electric Corporation, and New York Power Authority", January 11, 2008.

gauge when dealing with programs that address peak savings, these measures should not be the only criteria established (Guideline 7). Performance criteria, such as those based on comprehensiveness and equity, that balance some of the undesirable incentives utilities would have if the sole criteria are MWh and MW (e.g., cream skimming, etc.), should be adopted, as well. (*See* Section A, above). Otherwise, there could be a strong incentive to ignore markets such as low income or longer term market transformation in favor of quick, cheap savings.

The Advisory Staff Incentive Guidelines are silent as to what timeframe should apply to these revenue adjustments. We recommend that a three-year timeframe is adopted. As discussed in Section A, above, such a multi-year timeframe gives utilities more flexibility to modify their programs as needed and allows them to implement programs that might take a few years to excel. Annual metrics, on the other hand, tend to focus utilities on short-term resource acquisition at the expense of longer term investments in things like market transformation that may have better long-term results.

We appreciate what we believe the point of Guideline 8 is, namely to provide utilities with some flexibility in program administration. We support such flexibility, especially the flexibility to respond to unforeseen problems or unanticipated opportunities and agree that incentives should be calculated over aggregated portfolio performance, rather than by specific programs. In doing so, the Commission can avoid the undesirable situation where utilities are focusing solely on the quickest, easiest and highest performing programs, rather than sufficiently diversifying the nature and reach of their program portfolio to ensure that the full range of utility customers is well-served and that a greater variety of worthwhile programs is implemented. We also agree that a mechanism must be in place to assure that individual program targets are not sacrificed to maximize incentives. The best mechanisms to assure that this does not happen are the establishment of specific criteria such as equity and vigilant regulatory oversight of these programs by Commission staff.

We agree that utilities should not be given incentives for programs where funding is transferred to NYSERDA (Guideline 9). However, there needs to be greater clarity regarding how savings and spending would be allocated between a utility and NYSERDA to avoid the situation where both entities claim savings, effectively resulting in double counting.

Finally, we concur that consistent statewide incentive principles regarding overall program performance are both necessary and desirable to ease program administration and to prevent public confusion (Guideline 10) and that incentives should be included in the cost estimates of program proposals (Guideline 11).

C. The PSC Should Adopt an Incentive Structure Similar to That Recently Adopted by the California Public Utilities Commission.

The incentive structure included in the recent California Public Utilities Commission (CPUC) decision regarding Rulemaking 060-04-010 provides a good example of an appropriate performance incentive structure for New York State.[6] This structure provides a sound, balanced approach in terms of incentives and penalties that maximizes energy savings and cost-effectiveness.[7] In order to properly motivate the utilities, the goal should be to establish an incentive system under which the utilities benefit the most when they procure the least cost and most preferred resources for customers: the California model accomplishes this goal. It includes both a

[6] CPUC Decision 07-09-043 (issued September 25, 2007).

[7] Our support for this model is in keeping with the Straw Proposal's inclination "toward a benefit-based approach similar to that adopted by the California Public Utilities Commission (CPUC)." Straw Proposal at 17.

"carrot" and a "stick", with rewards and penalties based on two aspects of a utility's performance: how well it meets the energy savings targets established by the CPUC, and the economic benefits generated from its energy efficiency portfolio. Thus, this incentive mechanism provides a win-win for utilities and customers, since utilities are rewarded only for saving customers' money, rather than spending their money.

Similar to the California structure, the PSC should establish scaled incentives for utilities, starting at a minimum performance standard ("MPS") of 85 percent of the base energy savings goal. The establishment of such a threshold level before incentives are earned, tied to a robust energy efficiency program, sets a high bar for performance and ensures that consumers receive significant benefits at the point when utilities begin to receive rewards.

The PSC should establish appropriate, sufficient and effective shared savings levels for utilities that are as financially attractive as supply-side rates of return. Under the California model, utilities earn an incentive of 9 percent of net benefits at the MPS level, which is increased to 12 percent of net benefits if utilities achieve 100 percent or more of their goals. Assuming an overall utility portfolio benefit/cost ratio of 2, we think this is a good starting point for New York, as well, which could be adjusted as necessary. Thus, consumers retain the vast majority of net benefits, at 91 and 88 percent of net benefits, respectively. Therefore, the more energy efficiency utilities achieve and the more rewards they receive for increasingly higher levels of performance, the more customers benefit in terms of lower energy bills.[8] While the

[8] DPS's Initial Brief in this proceeding compares the amount of money utilities would earn by administering Staff's bridging programs using, among others, the California and Trial Staff incentive approaches, but neglects to reflect the monetary benefits that customers would retain pursuant to the California approach, which would be quite large relative to the utilities' incentives. PSC Case No. 07-M-0548, <u>Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard</u>,

utility may indeed get an even larger financial benefit if it performs well, the vast majority of any benefit of better performance remains with the ratepayer. Such a structure provides utilities not only with an incentive to meet their goals, but also to pursue as much efficiency as possible, even if it is clear that they will not reach their targets. It is critical, of course, that such incentive levels are tied to aggressive energy efficiency goals, such as the targets we have outlined in Section A, above.

The California model also contains an appealing approach with respect to the assessment of meaningful penalties, which should be similarly adopted in New York. Penalties are assessed per kWh, kW or therm for each unit below the goal if a utility's performance falls to or below 65 percent of the base goal. Penalties are the larger of either the summed per-unit penalty below the energy savings goals or any positive net costs (negative net benefits) to the energy efficiency portfolios. Such a penalty ensures that utilities will have a consistent incentive to improve performance. Rather than developing the details of penalty levels and other issues in individual rate cases, we believe the specific details should be developed at the same time as final utility programs are approved.

The aggressive energy efficiency goals established by California, in addition to the fact that incentives are based on performance regarding the entire program portfolio, ensures that utilities do not simply go after "low hanging fruit" with respect to energy efficiency opportunities. In addition, tying incentives to net benefits, rather than program budgets, ensures that utilities implement cost-effective programs at least cost and that both utilities and consumers benefit.

Initial Brief of the Staff of the Department of Public Service on Bridging Programs and Issues, April 10, 2008, at 28.

D. While Advisory Staff's Incentive Model Contains Appealing Elements, the Model Raises Various Concerns.

The model set forth by DPS Advisory Staff contains appealing elements, including scaled incentives, negative revenue adjustments, and a "deadband" where neither positive nor negative revenue adjustments would be made. Pursuant to this model, utility incentives would be provided as a "bonus" on utility rates of return. However, utilities earn their rates of return on their "rate base", through supply side capital investments (power plants, T & D infrastructure, etc.). This model, therefore, could result in a perverse incentive for utilities to expand their rate base through increasing such investments, which is an outcome not in line with the 15 by '15 goal. It is counterintuitive to give utilities an incentive for energy efficiency that increases in dollar value if they increase their supply side resources.

Rather, we believe that the best approach is to adopt an incentive structure that is performance-based, with incentives tied to net benefits. Such a structure rewards utilities for saving customers' money and provides customers with the opportunity to retain substantial benefits. It is also important that incentives are calculated based on aggregated portfolio performance.

E. Though DPS Trial Staff's Incentive Model Contains Certain Strengths, it is Not an Appropriate Model for New York State to Adopt.

DPS Trial Staff's incentive proposal contains various positive elements, including scaled incentives, the incorporation of a penalty, and a "deadband" where no incentive is received nor penalty assessed. However, we do not recommend the adoption of this model, due to key weaknesses associated with it.

Trial Staff's proposal is applicable only to Fast Track programs and thus is very limited in scope. Any incentive structure should be consistently applicable to Fast Track and long-term programs adopted pursuant to this proceeding to provide the necessary certainty to utilities regarding investment in energy efficiency programs.

In addition, Trial Staff has proposed that incentives be tied to energy efficiency program budgets. The point of incentives is to optimize energy savings and cost-effectiveness, and thus discussing incentives in terms of percentage of DSM program budget is irrelevant and misses the point. Rewards should be based on outcome and results and not input, such as the amount of money spent on a program, since such amount does not necessarily correlate to the results achieved by a program. The critical issue is what a sufficient level of incentive is to ensure that "utility investors and managers view energy efficiency as a core part of the utility's regulated operations that can generate meaningful earnings for its shareholders."[9] The focus should be on the savings needed to achieve the 15 x '15 goal in as cost-effective a way as possible and incentives should be structured to achieve that outcome.

Trial Staff's proposal would also apply to programs on an individual basis, rather than a whole program portfolio. As mentioned above, we do not think this is the best approach for New York to adopt, since it does not provide utilities with flexibility, nor does it encourage them to implement a diversity of energy efficiency programs that target a wide range of customers.

Trial Staff's model also does not appear to contain incentives for utilities that achieve energy efficiency beyond 122% of their goals. It is unclear why the model would stop at this point, thus creating a disincentive for utilities to achieve even greater amounts of energy

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[9] CPUC Decision 07-09-043 (issued September 25, 2007), at 4.

efficiency, if possible. Finally, we recommend that the threshold below which utilities start to be assessed penalties be 65% of the base energy savings goal, which is slightly higher than the 60% threshold set forth by DPS Trial Staff.

CONCLUSION

For the reasons stated above, NRDC, Pace and AEA respectfully submit that the Commission should adopt a clear and effective incentive structure for utilities, in conjunction with aggressive energy efficiency targets, to align utility shareholders' interests with the energy efficiency goals of New York State and to ensure that utilities achieve their share of the 15 by '15 goal. This incentive structure should incorporate the following elements and should follow the approach which has been recently adopted by the California Public Utilities Commission:

· The award of any incentives should be based on actual verified performance, subject to independent verification, and not based on simply completing certain milestones, such as entering into contracts for reductions or spending a certain amount of money;

· Incentives should be awarded for cost-effective energy efficiency, and thus should be based on total resource net benefits, in which utilities are rewarded only for saving customers' money, rather than spending their money, and the vast majority of any benefit of better performance remains with the ratepayer;

· Incentives should be calculated over aggregated portfolio performance, rather than program-by-program, to ensure that the full range of utility customers is well-served and that a greater variety of worthwhile programs is implemented;

· The award of incentives should be scaled, with higher incentives for higher achievement, and the opportunity to earn greater incentives for exemplary performance beyond the base target, so as to maintain the utilities' incentive to pursue cost-effective efficiency beyond that point;

· A minimum performance standard of 85% of the base energy goal should be established for utility incentives, to ensure that consumers receive significant benefits at the point when utilities begin to receive rewards. This MPS should be tied to the aggressive utility energy efficiency targets recommended herein to ensure that the 15% goal is met and to secure substantial net benefits for customers;

· It is essential that penalties be included for poor performance on utilities' savings goals, which should be assessed per kWh or therm below 65% of the target, which would ensure that utilities will have a consistent incentive to improve performance;

· In addition to goals that support the achievement of the 15 by '15 target, additional goals tied to other criteria, such as low income participation, should be set, as well, to avoid utilities focusing only on savings to the potential detriment of considerations such as equity and comprehensiveness; and

· A three-year goal should be adopted, which provides utilities with the flexibility to modify their programs as needed over time to make the most efficient and effective use of resources, as well as allowing goals for programs that may not demonstrate results for multiple years.

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