National Fuel

June 20, 2008

VIA HAND DELIVERY

Hon. Jaclyn Brilling
Secretary
Public Service Commission
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case No. 07-M-0548 – Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard

Dear Secretary Brilling:

Enclosed please find an original and 5 copies of the Comments of National Fuel Gas Distribution Corporation in Response to the May 30, 3008 Notice Soliciting Comments in the above-captioned proceeding.

Thank you for your attention to this matter.

Respectfully submitted,

Michael W. Reville JF

Michael W. Reville

cc: All Parties

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
NATIONAL FUEL GAS DISTRIBUTION CORPORATION

On May 30, 2008 the Commission issued a Notice Soliciting Comments ("Notice") in the above-captioned proceeding. The Notice states that the Commission is "considering the issuance of an Order in June, 2008 that would, among other things, initiate a process for the submittal, review and approval of proposed energy efficiency programs to be administered by electric utilities." The Notice queries "whether, and to what extent, financial incentives based on the extent to which performance exceeds or falls short of targets should be established prior to the submittal of proposals by utilities." Notice at 1. To aid the Commission in its analysis, the Notice requests comments regarding "a number of concerns related to utility incentives." The Notice further provides, "to facilitate consideration of this issue," the parties are invited to comment in particular on various proposals and guidelines for incentive mechanisms. For its response, National Fuel Gas Distribution Corporation ("Distribution" or "the Company"), a gas-only local distribution company ("LDC"), submits the following comments.

I. General Comment on the need for financial incentives for gas utilities

It is generally recognized that "existing rate designs still may discourage utilities from actively promoting energy efficiency." Cases 03-E-0640 and 06-G-0746, Order Requiring Proposals for Revenue Decoupling Mechanisms (issued April 20, 2007)

("RDM Proceeding") at 2. The regulatory solution to the rate design disincentive has been to authorize a revenue decoupling mechanism ("RDM") to protect utilities from revenue erosion caused by customer conservation. Id. at 2-3. Distribution agrees with the Commission and industry observers that an RDM provides the most effective mechanism for the removal of disincentives for utilities to develop an effective energy efficiency program. Distribution recognizes the need for direct utility involvement in encouraging customers to utilize natural gas in an efficient manner. Indeed, Distribution's customer surveys show that a majority of customers believe the utility is the most credible source for information about the efficient use of natural gas**.** Certainly at this very early juncture in utility efforts to design and implement conservation programs, there is no need for additional financial incentives and, in fact, they can be counterproductive.[1]

As more fully described below, the Company believes that financial incentives for conservation programs are unnecessary because the financial awards being contemplated are not of sufficient materiality to capture management's attention beyond the level that currently obtains. The small size of conservation programs[2] relative to the other, day-to-day operations of New York's gas utilities suggests that an incentive mechanism is not likely to produce any meaningful effect. In addition, owing to the limited scope of natural gas efficiency programs, financial incentives – beyond removal of the existing disincentive in rate design - are not likely to have a meaningful effect. Furthermore,

[1] Distribution's comments are confined to the appropriateness of establishing financial incentives for the management of energy efficiency programs of natural gas local distribution companies. Distribution is not commenting on the need for incentives for electric utilities.

[2] Distribution's current Commission-approved conservation incentive program consists of residential and small non-residential appliance rebates, a low-income usage reduction program and a general energy efficiency outreach and education program.

incentive mechanisms in New York often evolve over time into penalty-only mechanisms, the result being to convert the utility from a partner in achieving the objectives of the mechanism, to an adversary.

The Company finds it difficult to imagine how additional utility efforts beyond those involved in operating an energy efficiency program developed collaboratively by utilities, Staff, New York State Energy Research and Development Authority (“NYSERDA”), Consumer Protection Board (“CPB”), and other interested parties, would be of such positive (or negative) effect, that additional incentives would be justified. Instead additional incentives beyond any standard prudence requirement would more than likely lead to additional administrative, legal, and measurement and verification overhead costs for all parties involved.

The primary function of a natural gas LDC is to provide safe and reasonably priced natural gas delivery service to customers. In order to meet this primary role, utilities should be permitted to earn a fair return on the facilities installed to provide customers with that access to natural gas service. Currently utilities are required to focus on that primary mission plus a plethora of other obligations, some directly related and many only tangentially. An improperly structured energy efficiency incentive mechanism is likely to distract management not only from that primary goal, but also from other programs – consumer programs, retail competition; there are many - that consume limited utility resources.

In designing its shareholder incentive mechanism the California Public Utilities Commission (“CaPUC”) noted that “there is an inherent utility bias towards supply-side procurement under cost-of-service regulation, namely, that investor-owned utilities can generate earnings for shareholders when they invest in 'steel-in-the-ground' supply-side resources, but not when the utilities are successful in procuring cost-effective energy efficiency."[3] While this may be true for certain electric utilities that may own and operate electric generation facilities, it is not true for New York's natural gas LDCs where the natural gas procurement is a pass through cost and not an activity that contributes to earnings.[4] Further, a fully implemented RDM completely eliminates any incentive for an LDC to promote increased consumption since under an RDM, a utility's earnings do not increase with increases in customer consumption.

II. Advisory Staff Incentive Guidelines

Staff's purported objective in establishing energy efficiency incentives for utilities is to (1) encourage superior performance and deter weak performance; and (2) align utilities financial interests with energy efficiency as a resource option. These are laudable objectives, but Distribution believes that they can be achieved without an incentive mechanism. Indeed, an incentive mechanism based on Staff's guidelines would be redundant, inasmuch as a well-designed conservation program will not be "enhanced" by the utility's reaction to an incentive mechanism. At worst, the incentive mechanism would shift management's focus from operating a conservation program in a manner consistent with its purpose, to achieving the incentive targets without regard to the ultimate objective.

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[3] 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. pp. 3-4.

[4] Some may argue that energy efficiency will lead to lower natural gas distribution plant and system investments. This is doubtful, however, since the vast majority of natural gas distribution system costs are incurred to physically connect customers to the natural gas distribution system. It is unlikely that energy efficiency initiatives would have a meaningful impact on such costs.

The Commission has the ability to encourage superior performance and deter weak performance for natural gas utility efficiency programs through a typical utility prudence standard. The limited number of natural gas efficiency programs coupled with the likely direct involvement of NYSERDA in managing a number of those programs would allow the Commission to review a utility's performance using the standard prudence review. The development of incentive mechanisms, however, will be complicated, time-consuming and potentially litigious.[5] For natural gas utility conservation initiatives, the time and effort required to establish such incentive mechanisms would not be well spent.

It also bears mention that for the most part, the public has accepted utility energy efficiency programs and a RDM as reasonably necessary to encourage energy efficiency efforts in utility service territories. While industry insiders and regulators certainly understand the idea that utility rate design can discourage utilities from embracing conservation efforts, public acceptance of an RDM is no mean feat. A recent editorial in the Buffalo News highlights the difficulty in extending such acceptance to additional incentive mechanisms.[6] The Commission needs to carefully weigh the perceived benefits

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[5] At page 19 of Staff's Revised Proposal filed on November 27, 2007, Staff stated:

> Developing an effective incentive program is a complex undertaking. For example, the California Public Utilities Commission recently devoted nearly 18 months to a rulemaking proceeding, culminating in a 227 page decision that provides a new system of incentives and penalties to encourage California's utilities to meet or exceed California's energy saving goals.

[6] "The idea of paying for an energy-efficiency program has been a tough sell to the public, but if the utility is being asked to reduce sales it is fair to find other ways to cover implementation and infrastructure costs.

More questionable is National Grid's additional request to recapture a share of its own incentives. The utility wants to be able to keep 10 percent of the savings if it meets more than 75 percent of its energy conservation target, and 15 percent of the savings if it reaches at least 100 percent of its target. That overreaches, and the Public Service Commission should take a hard and skeptical look at that request.

Overall, though, the economic and environmental benefits of energy conservation are worth pursuing. Utilities have been offering customers energy conservation and efficiency programs for several years but, as National Grid points out, energy companies are still businesses. Decoupling revenue from energy use needs careful balancing, but if it is done well it allows companies to promote energy conservation more of financial incentives – benefits that are highly speculative, at best – against the very real risk that customers may not share that view.

An RDM establishes a link between a natural gas utility's financial interest and energy efficiency as a resource option. The encouragement of the efficient use of natural gas by customers of an LDC will strengthen the comparative advantage of natural gas to other fuel options as well as enhance the wealth and competitiveness of a natural gas utility company's service territory vis-à-vis other service territories. Indeed, an incentive based on a total resource perspective would need to provide for the *expanded* use of direct fired natural gas wherever such applications can improve the overall energy efficiency goals of the state. As observed by the American Gas Foundation, "increased direct use of natural gas in residential and commercial applications can increase the productivity of available energy supplies, reduce overall energy costs and reduce related CO_2 emissions in all scenarios considered." American Gas Foundation, Direct Use of Natural Gas (April 2008) ("Major Findings"). A financial incentive mechanism to encourage gas conservation, through rewards or penalties, is simply too blunt of an instrument to address the appropriate use of natural gas, in all applications, for New York.

The guidelines recommended by Advisory Staff include a recommendation that such incentives should, "encourage improved utility performance without placing an excessive burden on ratepayers." It is unlikely that any reasonable incentive established for energy efficiency incentives would place an "excessive burden on ratepayers." For

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aggressively without too adversely affecting the bottom line. That's a worthwhile goal, at a reasonable price."

Encouraging Conservation: Utility's Decoupling, Incentive Plans Deserve Careful State Consideration , published on May 19, 2008, © *The Buffalo News Inc*.

example, a one-time incentive award of 200 basis points on Distribution's system would result in an overall bill increase to customers of less than 1.5 percent. Although Distribution is not recommending a 200 basis point incentive, the example serves to demonstrate that a concern over customer impact is overstated. Inasmuch as Staff's proposal would contemplate a smaller reward, the concern begins to look altogether misplaced.

On the other hand, while incentive mechanisms would have limited impacts on ratepayers, they could have significant impacts on shareholders. Too large of an incentive mechanism would likely distract a natural gas distribution utility from its primary mission, as described above. The prospect of a sizable penalty would likely provide more encouragement for utilities to undertake efforts to terminate conservation programs as a distraction and potential threat to earnings.

The establishment of an incentive mechanism for natural gas utility programs and the requirement for precise measurement and verification will undoubtedly lead to higher administrative costs for natural gas utility energy efficiency programs. Effective natural gas energy efficiency programs have been provided for years by utilities, state agencies (such as NYSERDA), and other organizations dedicated to energy efficiency (such as the American Council for an Energy-Efficient Economy). These initiatives include time-tested programs such as appliance rebates, weatherization, and energy efficiency outreach and education. The savings potentials for these types of programs are well established. It is doubtful that incentive mechanisms would yield any additional results beyond the historical experience.

III. Strength and Weakness of the Three Incentive Models

Distribution believes that all three models cited in the Notice suffer from the same flaws described above. Despite good intentions, the incentives are not likely to produce enhanced performance on the part of natural gas LDCs offering a combination of utility- and NYSERDA administered programs. To the contrary, Distribution believes that financial incentives of any kind – positive and particularly negative – will produce distractions that may serve to become counterproductive.

IV. Alternative Consideration

Instead of establishing potential administratively burdensome and costly incentive mechanisms that are likely to distract natural gas utilities from their primary responsibility, the Commission may wish to entertain proposals from utilities that allow them to earn on investments in energy efficiency applications in its service territory. Such proposals could include investments in on bill financing systems and customer equipment purchases such as natural gas engines, distributed generation facilities, micro-turbines, etc. Utility investments in energy efficiency applications could be promoted by providing a greater rate of return for such investments than would otherwise be achieved for typical utility plant investments or provide for opportunities to share savings with customers that install energy efficiency applications with the help of the utility.

V. Conclusion

Distribution supports the Commission's objective to aggressively promote energy efficiency and conservation programs for New York's utilities. By adopting a statewide RDM and approving utility-specific conservation programs, including Distribution's, and by encouraging utility partnerships with NYSERDA and other program administrators, the Commission has established a sound platform to timely meet the state's energy efficiency goals. For gas LDCs in particular, however, the financial incentives referenced in the Notice are not a necessary part of the mix of programs in place and contemplated to meet statewide objectives. To the contrary, Distribution believes that for the reasons stated above, such financial incentives for gas utilities may be redundant at best, and might even be counterproductive, at this state of the proceedings. If upon a later review of LDC programs the Commission determines that more encouragement is necessary, then the issue of financial incentives can be re-examined in light of changed circumstances.

Respectfully submitted,

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Buffalo, New York