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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Examine the Commission's Energy Efficiency Risk/Reward Incentive Mechanism.	Rulemaking 09-01-019 (Filed January 29, 2009)

ASSIGNED COMMISSIONER'S RULING TO REFRESH THE RECORD ON OUTSTANDING ISSUES

This ruling provides parties the opportunity to refresh the record regarding the disposition of the Energy Efficiency (EE) "Risk/Reward Incentive Mechanism" (RRIM) for the 2010-2012 cycle and beyond for the qualifying Investor-Owned Utilities (IOUs).

The Commission has concluded the award process for RRIM payments for the 2006-2008 cycle. Disposition of RRIM earnings for 2009 is being addressed in separately filed applications. The only remaining issue in this proceeding is how the IOUs can be provided the appropriate incentives to meet and exceed EE goals for the 2010-2012 cycle and beyond.

Status of the Current Record

Parties have previously provided comments and proposals regarding the problems with the design and functioning of the RRIM as originally adopted in Decision (D.) 07-09-043, and as subsequently modified through a series of decisions adopted through 2010. Parties last filed proposals regarding the prospective changes in the design of the RRIM in comments dated August 7, 2009. An Administrative Law Judge's (ALJ's) Proposed Decision (PD) regarding a prospective RRIM design was filed on November 15, 2010. Comments thereon were filed on December 6, 2010, and reply comments were filed on December 13, 2010.

The methodology for an EE incentive formula in the ALJ's PD, among other things, relied on locked-in *ex ante* measures of EE portfolio cost effectiveness for the 2010-2012 cycle. Relevant issues regarding the prospective 2010-2012 EE portfolio cycle have been addressed in a series of decisions issued in Application (A.) 08-07-021 et al. When the ALJ's PD on the prospective RRIM was issued, however, the Commission had not yet resolved outstanding issues regarding the *ex ante* measures in the 2010-2012 EE portfolio. Pending resolution of those outstanding issues in A.08-07-021 et al. relating to the 2010-2012 portfolio, the ALJ's PD on the prospective RRIM was withdrawn.

The Commission has recently concluded proceedings in A.08-07-021 et al. regarding 2010-2012 program EE cost-effectiveness measures. Since these matters have been concluded, it is now appropriate to move forward to update the record and to issue a new proposed decision concerning the disposition of an incentive mechanism for the 2010-2012 cycle and beyond. The disposition of outstanding portfolio issues in A.08-07-021 et al. provides for more informed consideration of how the Commission should resolve RRIM issues in the context of the 2010-2012 portfolio cycle and beyond.

Assuming that the Commission determined to continue the RRIM, utilizing some variation of the existing shared-savings formula, issues would still need to be resolved concerning how the estimated EE portfolio savings for the 2010-2012 cycle, as determined in A.08-07-021 et al. may apply in updating the RRIM shared savings formula.

In D.09-09-047, the Commission adopted EE portfolios for 2010 through 2012, and concluded that *ex ante* values established for planning and reporting accomplishments for 2010-2012 should be frozen for the duration of the cycle. The Commission and utilities use *ex ante* values for EE measures to determine whether a utility's forecasted EE portfolio is cost-effective. In D.10-12-054, the Commission froze *ex ante* values for DEER measures for purposes of program evaluation based on the 2008 DEER, version 2.05.[1] The Commission adopted *ex ante* figures for non-DEER measures in D.11-07-030, to remain frozen for purposes of program cost effectiveness evaluation throughout the 2010-2012 program cycle.

Scope of Further Comments

For purposes of filing comments to update the record, parties need not repeat remarks previously made regarding how the RRIM should be revised, but parties should focus on any changes in their views or recommendations for prospective RRIM reform since comments were last filed. In filing updated comments, parties should not merely address fine tuning of the existing RRIM, but should also address the broader policy justifications relevant to the continuation of an EE incentive earnings mechanism.

[1] DEER stands for Database for Energy Efficient Resources. This database contains estimated energy savings values for standard energy efficiency measures. Non-standard energy efficiency measures are referred to as non-DEER measures. Non-DEER measures include custom energy efficiency projects designed for a single customer.

Public Utilities Code Section 454.5(b)(9)(c),[2] the Energy Action Plan and past Commission decisions have established a policy to procure all cost-effective conservation and EE resources before adding generation resources. In D.04-09-060, the Commission articulated its goal to pursue all cost-effective EE opportunities in support of the Energy Action Plan. Conservation and energy efficiency are first in the loading order of electricity and natural gas resources. While the Commission remains fully committed to promoting EE as a top priority, it is appropriate to reexamine the premise that an annual RRIM shareholder payment is necessary to secure the IOUs' commitment to EE.

Questioning the justification for continuing the RRIM is especially appropriate given the track record during the now completed 2006-2008 RRIM cycle. The most recent revisions in the RRIM design were adopted for the 2006-2008 RRIM true-up in D.10-12-049. Since the RRIM was originally instituted in D.07-09-043, and subsequently modified over succeeding years, serious questions have been raised concerning whether the mechanism can realistically do what it was originally designed to do. Instead of inspiring greater innovation in program design or implementation to realize more aggressive goals and reap the rewards, the RRIM has instead channeled resources largely into procedural disputes over process and measurement protocols. These activities seem to have often overshadowed and distracted efforts to effectively adapt programs to changing markets and new information. The RRIM has fostered unproductive behavior such as intensive preoccupation with disputing Energy Measurement

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[2] Public Utilities Code Section 454.5(b)(9)(c) states: "The electrical corporation will first meet its unmet resource needs through all available energy efficiency and demand reduction resources that are cost effective, reliable, and feasible."

and Verification (EM&V) results and defending what some parties have characterized as high-end *ex ante* estimates. The RRIM has incented shifting resources away from longer-term savings towards shorter-term savings measures that directly produce RRIM earnings.

As the latest attempt to remedy perceived problems with the RRIM design, the Commission modified the RRIM in D.10-12-049 to impute *ex ante* measures instead of relying on verified *ex post* results, as originally intended when the RRIM was instituted in D.07-09-043. RRIM awards for the 2006-2008 true-up were finalized by allocating as shareholder earnings a 7% share of estimated net benefits of the portfolio (portfolio benefits minus portfolio costs).

Yet, this latest attempted fix raises additional problems in terms of prospective RRIM design. For example, awarding incentive earnings based on *ex ante* measures effectively neutralizes much of the inherent point of having a incentive mechanism in the first place (i.e., as a tool to motivate the IOUs to be innovative and continuously improve their programs towards achieving higher EE saving). Designing an RRIM based on *ex ante* measures with no *ex post* accountability means that an IOU receives the same incentive earnings irrespective of whether actual results for any given EE program are inferior or superior relative to an *ex ante* assumption. Thus, parties should comment on whether a prospective RRIM based on *ex ante* assumptions serves its intended purpose in terms of motivating superior performance.

It is also appropriate to reexamine the premises underlying the RRIM in view of the changing focus of the approved budget of EE portfolio programs for 2010-2012, with an increasing emphasis on longer term strategic programs rather than short term savings. Under the current RRIM, earnings are awarded as a percentage of net benefits calculated using the Total Resource Cost and Program

Administrator Cost methodology. The present-valuing of future savings and the emphasis on first-years savings embedded in these methodologies provide higher net benefits for measures with higher short-term savings, which encourages the utilities to shift portfolio resources away from market transformation programs and more comprehensive measures designed to produce long-term savings (i.e., insulation of existing buildings) in favor of programs and measures that produced shorter-term savings that increased RRIM earnings (such as compact fluorescent lights (CFLs)) and refrigerator rebates. Based on the changing emphasis toward longer term strategic market transformation goals, an RRIM premised on rewarding short-term savings may no longer be the most effective tool to promote the Commission's goals. Comments are thus solicited on whether the RRIM, as currently configured based on a percentage of shared savings from resource acquisition programs (rebates, etc., that induce purchases of more efficient "widgets"), is inconsistent with EE program goals that are moving toward market transformation activities.

The RRIM is also not currently designed to facilitate the provision of incentives for customized projects. Because customized projects require unique calculations for each project, the Commission did not adopt *ex ante* values for the portion of the 2010-2012 portfolio budget related to custom projects. Instead, the Commission adopted a review process for individual projects on a case-by-case basis and a default realization rate for projects that are not reviewed. Since a significant portion of 2010-2012 portfolio is anticipated to include customized programs, parties should comment on how an RRIM shared savings percentage be calculated that incorporates all relevant portfolio programs, including custom measures.

Additional Questions

To refresh the record on outstanding RRIM issues, in addition to the general issues outlined above, comments are also solicited on the following questions:

1. Apart from the RRIM, do other existing regulatory measures help ensure that the utility remains committed to EE goals? For example, does access to risk-free capital through ratepayer funding of EE budgets help ensure that programs will be implemented in a cost-effective manner? By providing public scrutiny on the success of EE programs, does the Commission's EM&V process help ensure that the IOU will be motivated to pursue cost effective achievement of EE goals for the 2010-2012 cycle as a core part of regulated operations.

2. Absent the prospect for RRIM earnings, would the utility be motivated (or able) to increase its supply-side investment for the 2010-2012 cycle to meet expected load growth? If so, explain how any supply-side investment growth would be necessary or justified given the IOUs' existing generation reserve margin surplus. For example, the California Independent System Operator 2010 Summer Loads and Resources Operations Preparedness Assessment, May 10, 2010 at 4 shows that the IOUs' service territory generation resources are 30-40% in excess of peak demand, representing an excess of 13-25% of the required planning reserve margin.

3. Since the shared savings percentage currently is based on assumed equivalent supply-side resource savings, and if no new supply-side resources are necessary during 2010-2012, what other sorts of objective benchmarks could be used to calculate the appropriate RRIM shared savings percentage?

4. EE savings also helps the IOUs to meet their targets for the 33% Renewable Portfolio Standard (RPS) under SBx1 2 by reducing total energy sales (the denominator in the RPS ratio). Given this strong motivation to pursue EE, why would RRIM earnings be necessary as a further incentive?

5. In D.07-09-043, the Commission estimated for the 2006-2008 EE portfolio that achieving 125% of savings goals would produce Performance Earnings Basis (PEB) savings of $3.9 billion, equating to shareholder earnings from avoided supply-side investments of between $450 million and $700 million. (*See* D.07-09-043 at 102). Based on the EE portfolio for 2010-2012, what would be the comparable earnings from avoided supply-side resources by implementing EE measures covered by the approved programs for the 2010-2012 cycle assuming the achievement of 125% of adopted savings goals?

6. In the RRIM adopted in D.07-09-043, the Commission applied a 12% shared savings rate based on a formula dividing the estimated supply-side savings of $450 million (at 125% of goals) by *ex ante* total resource savings of $3.9 billion (*see* Table 1 of D.07-09-043). Using this same formula, but substituting the estimated supply-side savings for 2010-2012, as referenced above, and substituting the estimated total PEB resource savings calculated based on *ex ante* values approved in A.08-07-021 et al., what shared savings percentage would result for the 2010-2012 cycle?[3]

7. In D.10-12-049, the Commission reduced the shared savings percentage down to 7% to reflect perceived risk reduction due to the elimination of the *ex post* true-up. What corresponding adjustment to the shared savings percentage would be appropriate to reflect reduced risk for the 2010-2012 cycle, and also assuming the earnings penalty component of the current RRIM were to be eliminated.

8. Since a natural gas distribution utility experiences no avoided supply-side earnings that result from implementation of EE

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[3] In D.11-07-030, the IOUs were granted 60 days in which to make any energy efficient portfolio program design changes consistent with the Commission-adopted *ex ante* measures. Those updated program changes are due by September 12, 2011. Once those updates are filed, PEB net benefits scenarios for 2010-2012 can be calculated consistent with the updated program changes.

measures, what rationale, if any, exists for basing gas department incentive earnings on electric utility supply side earnings. Alternatively, what rationale exists to justify continued payment of EE incentive earnings for a natural gas distribution utility?

9. What are the financial ramifications of the continuation or possible elimination of the RRIM? Based on 2006-2008 awards, how significant are RRIM earnings to the IOUs relative to overall utility-regulated earnings? What threshold level of RRIM earnings are necessary to motivate IOU management to maintain a commitment to EE as a core part of regulated operations? Do ratepayers receive additional benefits beyond the benefits of the EE programs by giving this incentive to utility shareholders?

10. In its current format, to what extent does the RRIM create a bias in favor of measures which produce short-term EE savings, as opposed to helping to stimulate longer-term market transformation? How could the RRIM be modified to further encourage and reward market transformation or other goals set forth in the Energy Efficiency Strategic Plan?

11. Given that this decision will be issued well into the current program period of 2010-2012, to what extent, if any, is the RRIM incentive signal at all relevant for the construction and execution of the portfolio for the current cycle?

12. Since a significant portion of 2010-2012 portfolio is anticipated to include customized programs, how can an *ex ante* RRIM shared savings percentage be calculated that incorporates all relevant portfolio programs, including custom measures?

IT IS RULED that an updated round of comments shall be filed, to be due on September 23, 2011, addressing the issues outlined in this ruling relating to the Risk/Reward Incentive Mechanism applicable to the 2010-2012 cycle and beyond. Reply comments shall be due on October 7, 2011.

Dated August 30, 2011, at San Francisco, California.

/s/ MARK J. FERRON
Mark J. Ferron
Assigned Commissioner