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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)

ADMINISTRATIVE LAW JUDGE'S RULING CALLING FOR COMMENTS ON INCENTIVE REFORM ISSUES

This ruling solicits further comments regarding energy efficiency incentive reforms for the 2013 - 2014 period.[1] A top priority of this proceeding is to implement any revised incentive policies and measures to coincide with the start of the 2013 - 2014 portfolio cycle. In order to impact utility behavior, an incentive mechanism should be in place at the start of a cycle. This ruling is issued to develop the record to meet this goal.

As stated in the Assigned Commissioner's Scoping Memo dated May 16, 2012, this proceeding will examine a range of possible approaches in the design and reform of the "Risk/Reward Incentive Mechanism" (RRIM):

> At this point, we define the scope of potential incentive reforms for 2013 - 2014 quite broadly. Any new incentive mechanism may require significant changes relative to the RRIM used for 2006 - 2008, and for 2009, or wholesale

[1] No further comments are solicited regarding incentive policies for the 2010 - 2012 cycle. Also, no further comments are solicited on the merits of eliminating energy efficiency incentive earnings mechanisms altogether.

> adoption of a new mechanism. Any new or revised RRIM should incorporate the lessons learned from prior RRIM cycles providing incentives for utilities to offer the maximum verifiable and socially-desirable level of energy efficiency programs and services, while protecting ratepayers through necessary cost containment mechanisms.

Accordingly, comments are solicited on incentive reforms to augment the record that has been developed to date. Preliminary proposals for a 2013 - 2014 incentive mechanism were submitted prior to the issuance of Decision (D.) 12-05-015 (in Rulemaking (R.) 09-11-014), which provides policy guidance regarding the 2013 - 2014 portfolio of energy efficiency programs. In D.12-05-015, the Commission directed the utilities to file proposed portfolios of 2013 - 2014 energy efficiency programs by July 2, 2012. Responses to this ruling should address whether parties' previous proposals for a 2013 - 2014 incentive mechanism warrant any changes, clarifications, or further development, in light of the policy guidance and principles in D.12-05-015. Parties should provide supporting rationale for positions, and the basis for any formulas, figures or calculations offered.

The Commission has noted the following in D.12-05-015 regarding problems with the RRIM as applied during 2006 - 2008 and 2009:

> One of the "unintended consequences" of this proceeding is that utilities were encouraged to place greater emphasis on measures with high annual savings levels even if their design lives were relatively short, with the result that the majority of 2006 - 2009 portfolio savings (and a significant portion of projected 2010 - 2012 program savings) derived from one measure – basic Compact Fluorescent Lamps. While flooding the California lighting market with deeply discounted Compact Fluorescent Lamps achieved a significant amount of short-term savings, it was not the intention of the incentive mechanism. The goal of the incentive mechanism is to ensure

> that energy efficiency is viewed through the same financial lens as supply-side investments, to foster creativity within the utilities' engineering and management and to ensure that energy efficiency savings (not merely savings accounting) became a top priority for the utilities.

In D.12-05-015, the Commission also stated the following regarding the relative emphasis on resource versus non-resource programs for 2013 - 2014:

> While we continue to direct the utilities to retain strategic and promising non-resource activities, we also begin to blur this distinction in the 2013 - 2014 portfolio. We direct the utilities to design a portfolio that can both deliver resources savings <u>and</u> transform markets by finding the synergies between these approaches to maximize opportunities for customers and other actors in the market, and take greater advantage of financing tools, the expertise and commitment of third-party implementers and local governments, and the state's growing "green jobs" sector to offer utility customers cost-effective packages of high-quality energy efficiency measures. (D.12-05-015 at 14)

In view of these observations, parties should thus address how a 2013 - 2014 incentive mechanism should be calibrated relative to the different types of programs in the portfolio. For example, programs addressing harder-to-achieve savings might be rewarded at a different incentive rate (or subject to different performance metrics) than programs with easier-to-achieve savings. Parties' proposals should address how to avoid encouraging undue emphasis on short-lived savings programs at the expense of other more important goals, and how to place greater emphasis on programs offering deeper savings, measures with higher up-front costs and longer design lives, and market transformation efforts with correspondingly increased challenges associated with program participation levels.

Parties may suggest different incentive designs or performance benchmarks as incentives to pursue resource acquisition versus market transformation programs. In accordance with the Scoping Memo issued on May l6, 2012, the Commission will consider separate treatment for non-resource programs in more detail in a later ruling. Although the detailed development of a separate incentive framework for non-resource programs can be deferred into a later phase of workshops, it may be useful to address issues concerning necessary coordination and segregation of resource versus non-resource programs for purposes of designing incentives for resource programs in the comments in response to this ruling.

Currently, parties' proposals for 2013 - 2014 consist of three possible policy directions with respect to incentives, namely:

1) Make only incremental changes to the existing incentive model;
2) Develop an entirely new, yet to be defined, mechanism or approach; and
3) Terminate further attempts to design an incentive earnings mechanism.

No further comments are necessary regarding proposals to terminate further attempts to design an incentive earnings mechanism. Parties' proposals regarding potential revisions of the incentive mechanism require further comments, as discussed below.

Incremental Changes to the Existing RRIM Shared Savings Model

Comments in response to this ruling should address how the RRIM should be redesigned for 2013 - 2014 assuming the Commission determines only to make incremental changes to the RRIM (with separate incentive treatment of non-resource programs to be addressed in a subsequent ruling). Certain parties have proposed that for 2013 - 2014, the RRIM as applied for 2006 - 2008 and 2009 should continue, with only incremental changes. In particular, such parties agree that (1) non-resource programs should be segregated from resource programs to provide for separate incentive treatment, (2) incentives should be based only on ex ante measures, adjusted for actual installations and administrative costs, and (3) no unit penalties should apply, but a cost-effectiveness guarantee should continue. For non-resource programs, these parties agree to defer development of separate incentives until later in the proceeding, possibly through workshops. Among these parties, recommendations differ in certain details, such as net benefits derivations.

Certain parties advocating this approach have not yet presented recommendations for a shared savings rate or cap on incentive earnings for 2013 - 2014. Also, parties that proposed shared savings rates have not provided adequate rationale for the proposed rate. Further comments are solicited regarding the proposals and rationale for shared savings rates and caps for 2013 - 2014.

To the extent that a shared savings rate is to be based upon supply-side equivalent earnings, the derivation of the rate would depend on the portfolio and resulting Performance Earnings Basis. Since parties are to file their portfolio proposals for 2013 - 2014 on July 2, 2012, those proposed portfolios will form the basis for a revised Performance Earnings Basis. In R.09-01-019, the Investor-owned Utilities (IOU) previously provided calculations of the shared savings rate to reflect supply-side equivalent earnings for 2010 - 2012. Since the 2013 - 2014 period will reflect a different mix of programs with a different net benefits, the Performance Earnings Basis should be updated to reflect 2013 - 2014 portfolio effects. The corresponding shared savings rates can then be recalculated to show the applicable supply-side equivalent earnings in relation to the 2013 - 2014 portfolio. Each IOU shall provide this recalculation of the shared savings rate, updated to reflect the 2013 - 2014 portfolio, to be due by July 16, 2012.

To the extent that parties propose a different RRIM shared savings rate for 2013 - 2014 in comparison the calculated shared savings rate necessary to correspond to equivalent supply-side earnings, the utility should indicate what those differences are, and what rationale is offered to support whatever shared savings rate is proposed.

Option for More Extensive Reforms to Incentive Design

In parallel with consideration of limited incremental changes to the RRIM, the Commission will also consider adopting more extensive incentive reforms for the 2013 - 2014 period.

In its latest comments, Southern California Edison Company (SCE) argues that a shared savings incentive mechanism may no longer be appropriate or consistent with the Commission's current focus on market transformation, and on deeper, long-term energy savings. For 2010 - 2012, SCE calculated that a shared savings rate as high as 77% would be required to produce equivalent supply-side earnings for the 2010 - 2012 portfolio.[2] Given the significant reduction in ratepayer benefits that would result, SCE recognized that this shared savings rate for the 2010 - 2012 period was not appropriate.

Given the high shared savings rate that would be required to approximate supply-side earnings (as calculated by SCE), and given the continuing controversy surrounding measurement of load impacts, either on an ex ante or

[2] *See* SCE Comments dated February 2, 2012, at 8.

ex post basis, the Commission may decide to adopt an entirely different incentive approach. Moreover, various parties dispute the premise that supply-side earnings correspond to the cost savings from energy efficiency programs. The Utility Reform Network (TURN), for example, notes that utility supply-side investments in generation are driven primarily by forecasts of *peak demand*, not annual energy consumption. Utilities build plants or purchase power to meet capacity (resource adequacy) requirements, and they receive a return on the capital investments they make on their owned plants. They then use available generation resources, owned or procured from independent power producers, to provide energy their bundled customers, but they receive no earnings on their delivered energy, regardless or its source. Therefore, reduced energy consumption does not result in a one-to-one reduction in ratepayer costs for supply-side resources. Current avoided cost – and, in turn, shareholder earnings - calculations do not capture this discrepancy.

In addition, a number of facts suggest that there may not be a strong correlation between the replacement of utility-owned generation earnings opportunity of new power plant construction with energy efficiency measures at this time. It is widely recognized that he primary driver of new power plant authorizations in California for some time to come will be the integration of renewable resources and local, transmission-constrained areas where once-through-cooling plants are being retired or repowered. These are not resources that utility-wide energy efficiency (EE) programs can displace (i.e., there are no "transmission-constrained EE" programs in the utilities' EE portfolios), and consequently likely that a significant portion of this new generation will be required regardless of the utilities' EE success.

Based on these observations, further analysis is warranted to determine whether supply – side equivalent earnings continues to be an appropriate proxy for incentive earnings, and to address how an effective, yet simplified, incentive mechanism can be designed and implemented for 2013 - 2014.

SCE believes that an entirely new mechanism could remove "the level of dysfunction and unproductive acrimony" associated with past RRIM controversies. In order for program administrators to focus on market change programs in addition to energy savings from resource acquisition programs, SCE proposes movement to a simpler, more straight-forward mechanism that rewards implementation of the portfolio approved by the Commission and which reflects the three cornerstones of California's energy policy.

The Commission has taken steps to reduce controversy relating to the measurement of net benefits by utilizing ex ante measures rather than ex post updates for incentive earnings for 2006-2008 and 2009. In D.12-05-015, the Commission recognized, however, that shifting the emphasis from ex post to ex ante measurement did not eliminate controversy and potential delay in resolving disputes concerning load impacts of energy efficiency measures for 2010-2012. The Commission noted in this regard:

> Given the challenges associated with the ex post results of the 2006-2008 portfolio cycle, and in particular the impact of the evaluated results on the utility Risk Reward Incentive Mechanism earnings, the Commission has expressed the desire and intent to develop a process of freezing the parameters used by the utilities to plan their portfolios and the savings calculations embedded in them. As we learned in trying to implement this approach in the 2010-2012 portfolio cycle, in which the ex ante parameters were not frozen until July 2011 (nearly two-thirds of the way through the portfolio cycle), the ex ante freezing process can be every bit as contentious as the use of ex post evaluation results. Simply

> put, the shift from ex post to ex ante only shifts the debate to a different point in the process. (D.12-05-015 at 25)

Principles and Criteria to Guide Incentive Reform

As a framework for analysis of alternative approaches to the reform and redesign of incentive mechanisms, the Commission's Energy Division previously issued on April 1, 2009, its: "White Paper: Proposed Energy Efficiency Risk-Reward Incentive Mechanism and Evaluation Measurement & Verification (EM&V) Activities" (White Paper). The White Paper identified the following criteria to serve as a framework for designing an effective incentive mechanism:

> **Effective and Strategic**
>
> The mechanism must uniformly and effectively achieve the Commission's energy efficiency policy goals of producing reliable energy savings, accomplishing the California Energy Efficiency Strategic Plan objectives, and reducing energy consumption necessary to achieve Greenhouse Gas emissions reduction goals.
>
> **Feasible**
>
> The mechanism must be feasible to design and implement with current CPUC, IOU, party, and consultant staffing levels and workload.
>
> **Timely and Broadly Accepted**
>
> The mechanism should be designed so that the determination of incentive payments can be accomplished in a reasonable time frame and be broadly accepted by all stakeholders.
>
> **Fair and Cost--Efficient**
>
> The mechanism should provide sufficient, but not excessive, financial awards to utilities to motivate excellent program design and implementation, with sufficient protection against unreasonable costs and poorly managed programs. The mechanism should minimize the total cost to ratepayers of

implementing, evaluating, and incentivizing energy efficiency programs.

Simple and Transparent

The mechanism should be simple, thoroughly understood by all parties, and replicable. A structure that is highly complex and based upon parameters with high uncertainty or the probability of significant variation over time will create high levels of contention and consume valuable resources to implement and litigate.

Technical integrity

The mechanism should maintain the technical integrity of all EM&V research, savings estimates, and energy efficiency forecasts. The incentive process should not dominate EM&V expenditures and effort.

In addition, in D.07-09-043, in adopting the RRIM, the Commission stated that an incentive mechanism should exhibit the following characteristics:

- Provides a meaningful earnings opportunity based on supply-side comparability and other factors;

  Earned only to the extent that the utility portfolio produces positive net benefits for ratepayers, that reach to meet and surpass the Commission's goals;
- Based on calculations of net benefits are independently evaluated and verified;
- Ratepayers receive the vast majority of economic benefits;
- The opportunity for shareholder "reward" is balanced by the risk of financial penalties for substandard performance in achieving the Commission's savings goals;
- Ratepayers are protected against financial losses on their investment in energy efficiency. If portfolio costs exceed the verified savings, shareholders absorb the negative net benefits dollar for dollar; and

- Overall <u>level of potential earnings and penalties is capped</u> to symmetrically limit ratepayers' and shareholders' exposure to risks, while encouraging superior performance.

Status of the Record on Alternative Incentive Models

To date, only a limited record has been developed on possible alternatives to the RRIM. In its White Paper, the Energy Division offered preliminary ideas for new approaches to the design of incentives. The Energy Division suggested, for example, partitioning incentives into (1) "base incentive earnings" for resource programs based on simplified and more broadly defined performance standards and (2) "bonus incentive earnings" for selected non-resource programs, market transformation programs, and strategic initiatives, based on superior accomplishment of more specifically defined and rigorous performance standards.

Among the alternative approaches, the White Paper suggested that a base level of incentive earnings could be designed in the form of "management fees typically paid in the energy and financial sectors." The White Paper suggested that management fees could be calculated as a percentage of portfolio funds spent by the IOU and/or of net participant expenditures on energy efficiency measures. (White Paper at 13)

Following up on this idea, TURN proposed that the Commission could require the utilities to include energy efficiency goals in their utility employee bonus programs (for example, the "results sharing" programs which provides bonuses based on a variety of performance measures), to provide a management fee-type shareholder incentive for utility performance, analogous to incentive mechanisms adopted for safety, reliability, and customer service.

As another option, the Energy Division White Paper suggested that base incentive earnings could be tied to achievement of consumption – based targets. While measuring changes in consumption and energy intensity indicators might be somewhat more straightforward than load impact evaluations of individual energy efficiency measures, such an approach could raise new questions regarding the attribution of consumption changes to utility programs versus other factors (weather, macro-economic trends, demographic changes in utility service territories, etc.)

In earlier rounds of comments filed in R.09-01-019, various parties commented on these proposals in broad terms. While parties generally agreed with the need for reforms, they disagreed concerning what specific reforms were warranted. The White Paper, together with comments filed in R.09-01-019 in response, laid a starting point for considering possible reforms. Further record development is required, however, to formulate an incentive program that could be adopted, possibly using one or more of these suggested alternative approaches.

In the latest set of comments in this proceeding, SCE proposed that parties collaborate in workshops to develop a new incentive mechanism for 2013 - 2014 to transition away from the shared savings mechanism while meeting reliability, affordability, and environmental protection goals.

Next Steps in Development of the Record

Consistent with the broadly defined scope of this proceeding, any new ideas or concepts for innovative reform of energy efficiency incentive programs may be raised in comments in response to this ruling. At the same time, any proposals for new innovations in the design of incentives need to be formulated with sufficient clarity and specificity to enable the Commission to develop and adopt a reformed mechanism no later than the beginning of 2013. Moreover, if a party supports an incentive approach that has previously been proposed, such as those noted above, then parties' comments should not simply rehash assertions presented in previous comments, but should offer new ideas or responses addressing previous objections.

While workshops may offer opportunities to exchange ideas and information on RRIM reform, it is premature to schedule a workshop until or unless parties present more specific proposals or workshop topics. To make productive use of a workshop, a meaningful outline of issues or subject matter to be covered must be identified in advance. It would be wasteful to use workshop time for attendees merely to listen to general oral presentations or high-level platitudes with no advance notice of specific topics to be discussed.

With advance notice of topics, participants with the requisite subject matter expertise can engage in meaningful dialog and exchange. A well-defined agenda can also help guard against diversions into tangential or peripheral issues.

As a framework for possible workshop topics, the following questions are suggested as a starting point:

> What alternative approaches, performance metrics, and related formulas could be utilized to derive incentive earnings in a more transparent, streamlined, and less controversial manner while promoting energy policy goals?
>
> Based on the performance metrics and formulas identified in the preceding question, what level of (and limits on) incentive earnings should be established for such metrics, both individually and collectively? What governing principles and empirical data should be applied to determine relevant performance metrics and formulas?

> What threshold level of earnings is necessary to motivate IOU management to maintain a commitment to EE as a core part of regulated operations? What relevant metrics or financial measures identify the appropriate limits on RRIM earnings to meet this threshold? (e.g., parity with earnings from supply-side resources, percentage of operating earnings or earnings per share, etc.)
>
> What limits or caps on earnings are appropriate to ensure that ratepayers are protected in terms of just and reasonable rates and that they receive appropriate benefits to justify payment of incentives?
>
> Is supply-side equivalent earnings an appropriate proxy for the magnitude of incentive earnings levels, considering both peak load and energy consumption load impacts separately and the anticipated medium-term need for generation to integrate renewable resources and replace once-through-cooling plants in load pockets, rather than generation to meet system-wide peak? Do other measures better represent the avoided costs and net benefits of energy efficiency to ratepayers?
>
> What degree of ex post independent evaluation and verification is warranted as the basis for the Commission to determine the amount of, or timing of, payment of incentives under a revised mechanism? Should metrics be limited to verifying the actual number of installations and total costs? (The primary focus of this question is on resource acquisition programs. A later ruling will explore metrics for non-resource programs in more depth).

Based on review of comments to this ruling, further guidance will be provided for either a further round of written comments and/or development of a potential agenda for a workshop. Depending on progress at an initial workshop, subsequent workshop sessions may be useful.

As one possible approach to reform, SCE has suggested exploring how energy efficiency can be explicitly made part of the solution to other policy mandates and goals. For example, a mechanism that increases the ability to satisfy some Renewable Portfolio Standard requirements through lower-cost energy efficiency could have the effect of lowering overall costs and rates, while meeting the policy objective of environmental protection. SCE also offers the suggestion of a mechanism that utilizes greenhouse gas allowance credits as an incentive.

Parties' comments in response to this ruling may follow up on SCE's suggestions, may develop the ideas advanced in the Energy Division White Paper, or may propose entirely new innovative ideas and approaches.

IT IS RULED that:

1. Comments are due on July 16, 2012 to address the issues identified in this ruling regarding energy efficiency incentives for the 2013 - 2014 period.
2. Based on the guidance provided in Decision (D.) 12-05-015, comments are solicited as to whether (or how) previous incentive proposals warrant changes, clarifications, or further development, consistent with the policy guidance and principles for 2013 - 2014 programs as set forth in D.12-05-015.
3. Each of the Investor-owned Utilities (i.e., Pacific Gas and Electric Company, Southern California Edison Company, San Diego Gas & Electric Company and Southern California Gas Company) shall provide updated calculations of shared savings rates for 2013-2014. The updated calculations shall be provided in comments due on July 16, 2012, and shall incorporate the relevant net benefits impacts of the 2013 - 2014 portfolios as reflected in the filings due on July 2, 2012, in Rulemaking 09-11-014. Parties should include supporting rationale and calculations for assertions and conclusions, as appropriate.

4. Proposals are solicited regarding the design of new incentive formulas and metrics to meet and surpass energy efficiency goals (to replace the existing shared savings incentive model) for use during the 2013 - 2014 period, and based on the principles and criteria outlined above. The rationale for any proposals offered should be fully supported.

5. Once comments are reviewed, further guidance will be provided concerning the next steps (e.g., further comments or workshops, etc).

Dated June 15, 2012, at San Francisco, California.

/s/ THOMAS R. PULSIFER
Thomas R. Pulsifer
Administrative Law Judge