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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking Concerning Energy Efficiency Rolling Portfolios, Policies, Programs, Evaluation, and Related Issues.	Rulemaking 13-11-005

ASSIGNED COMMISSIONER AND ADMINISTRATIVE LAW JUDGE'S RULING SEEKING COMMENT ON REFORMING OR ELIMINATING THE EFFICIENCY SAVINGS AND PERFORMANCE INCENTIVE MECHANISM

Summary

This ruling grants the December 27, 2019, Motion of the California Public Advocates Office (Cal Advocates) for review of the Efficiency Savings and Performance Incentive (ESPI) mechanism originally established in Decision (D.) 13-09-023.

Parties are invited to provide comments responding to questions included in Section 6 of this Ruling by no later than April 29, 2020. Reply comments are invited by no later than May 15, 2020.

1. Procedural Background

On December 27, 2019, Cal Advocates filed a motion to review, or preferably eliminate, the ESPI mechanism.

Responses to the Cal Advocates motion were filed on January 13, 2020, by San Diego Gas & Electric Company (SDG&E) and Southern California Gas Company (SoCalGas) jointly, SoCalGas separately, Southern California Edison Company (SCE), and the Natural Resources Defense Council (NRDC).

Cal Advocates replied to the responses to its motion on January 23, 2020.

2. Cal Advocates' Motion

The Cal Advocates' Motion recommends that the Commission consider modifying or eliminating the ESPI based on four specific changes that have occurred since the mechanism was developed:

- The increasing use of a statewide management structure in energy efficiency program delivery, the result of which is that the investor-owned utilities (IOUs) not managing individual statewide programs have minimal ability to impact program design or the amount of savings these programs achieve;
- The shift from utilities managing energy efficiency programs to procuring third-party programs transfers much more control over program design and implementation to third parties who are selected through a request for offer process, which is similar to the role IOUs play in supply-side procurement (for which they receive no shareholder incentives);
- ESPI payments are included in (and therefore reduce) portfolio cost-effectiveness tests, which exacerbates the significant cost-effectiveness challenges that the energy efficiency portfolios are facing; and
- Given that the Commission has ordered SoCalGas to not participate in statewide codes and standards advocacy programs (besides contributing their proportional share of funds for the programs), Cal Advocates asks the Commission to review whether SoCalGas should receive shareholder incentives for codes and standards programs in which it has no substantive role.

The Motion requests that the Commission seek input from parties on two factual questions and nine policy questions, shown below.

Factual Questions

- Is there empirical evidence that ESPI has motivated utility investors and managers to prioritize energy efficiency? Please provide specific factual evidence showing that ESPI has

improved the performance of energy efficiency portfolios, if such evidence is available.

- How does ESPI affect the cost of obtaining energy savings? How do the costs associated with ESPI affect the cost-effectiveness of energy efficiency portfolios?
  - [For utilities] For each program year from 2015-2017, state how much you have received or expect to receive in ESPI awards. Calculate the reported and evaluated Total Resource Cost (TRC) test ratio and Program Administrator Cost (PAC) test ratio of your portfolio, with and without ESPI costs.
  - [For utilities] For program year 2018, state how much you have requested in ESPI awards. Calculate the reported TRC test ratio and PAC test ratio of our portfolio, with and without ESPI costs.

Policy Questions

- Given the current management structure of energy efficiency programs, are shareholder incentives still necessary to ensure the achievement of energy savings? Should the Commission eliminate shareholder incentives for energy savings?
- Are shareholder incentives the best use of ratepayer resources dedicated to obtaining energy savings?
- If the commission continues to authorize incentives to utility shareholders, how should the incentive mechanism be structured to strike the balance between motivating performance and protecting ratepayers?
- If the Commission continues to authorize incentives to utility shareholders, how should incentives be structured for statewide energy efficiency programs?
- If the Commission continues to authorize incentives to utility shareholders, should the utilities be eligible for incentives when their role is limited to transferring funds?
- If the Commission modifies or eliminates ESPI, when should the changes take effect?

- If the Commission eliminates ESPI, will the four percent budget set-aside for evaluation, measurement, and verification (EM&V) still be necessary? Would a smaller figure be appropriate?
- If the Commission eliminates ESPI, should it also change the policy that Energy Division manages impact evaluations of energy efficiency programs?
- How should the Commission resolve SoCalGas' request for ESPI payments for its funding of codes and standards advocacy during the period (2018-2025) when it is prohibited from participating in these activities?

3. Responses to Motion

Most parties responding to the Cal Advocates motion either support it or do not oppose it.

SoCalGas and SDG&E generally agree that there have been numerous changes to the role of utilities in managing the energy efficiency portfolios in recent years and that a review of the ESPI mechanism is warranted. They do not agree, however, that the review should be inclined towards total elimination of the incentive mechanism. SoCalGas and SDG&E comment in support of mechanisms that provide utilities incentives to effectively and efficiently meet the State and the Commission goals, including encouraging utilities to prioritize investments and holding them accountable.

SoCalGas and SDG&E particularly emphasize re-looking at the original objectives of the mechanism, which include sustained and long-term commitments to energy efficiency, as distinct from a natural utility bias toward supply-side investment. They point out the original concept also focused on generating meaningful earning for utility shareholders. Finally, they argue that the Commission's desire to set "aggressive yet achievable" energy savings goals continues to support the offering of some financial rewards.

In support of their arguments, SoCalGas and SDG&E recommend the Commission take four steps:

1. Open a new rulemaking to review the ESPI mechanism and re-examine if it will continue to be effective and aligns with the State's and Commission's goals;
2. Issue a ruling soliciting stakeholder ideas and opinions, including innovative ideas for new mechanisms;
3. Develop new metrics for a different or revised mechanism; and
4. Consider the timing for implementation of a new mechanism, in light of the multiple transitions occurring in the energy efficiency portfolios.

SCE's comments largely agree with SDG&E and SoCalGas that the utilities remain accountable to meeting the energy efficiency portfolio goals, even as their role as program designers is being transitioned to other parties. SCE points out that they retain the role of the portfolio manager. Therefore, they argue there continues to be merit in an incentive mechanism that recognizes the continued role for the utilities in (1) achieving overall savings, budget, and cost-effectiveness goals; (2) technical review targeting quality energy efficiency savings; and (3) overall portfolio investment including codes and standards and non-resource activities with additional benefits.

SCE also argues that any reconsideration of the ESPI mechanism should be appropriately prioritized given the other moving parts in the overall energy efficiency landscape, including new business plan filings expected this year. Thus, SCE argues that the timetable requested by Cal Advocates is premature and too aggressive.

Finally, SCE offers several more general questions for the Commission to seek input from parties, rather than the more specific questions included in the Cal Advocates motion. Those are:

- Have the policy and/or goals outlined in D.13-09-023 as the justification for ESPI changed since the Decision was issued?
- Is ESPI aligned with meeting the State's objectives and should ESPI be modified?
- What modifications to ESPI could make it more effective in achieving its goals?
- Is the shift toward third-party designed and implemented programs and statewide program models sufficient to justify a change to the ESPI mechanism adopted by the Commission?
- What metrics, if any, should be used to measure the success of non-resource activities?
- How can the ESPI review process be revised to reduce administrative burden?

SoCalGas' individual comments are focused on the characterization of its role in codes and standards advocacy, given that in D.18-05-041, SoCalGas was prohibited from an ongoing role in the management of codes and standards advocacy. SoCalGas objects to the characterization of SoCalGas' role by Cal Advocates in its motion, as well as reference to SoCalGas effectively "requesting a shareholder incentive merely for transferring funds to PG&E for the statewide codes and standards program."[1]

SoCalGas points out both that there is an ongoing Order to Show Cause (OSC) portion of this proceeding that is addressing its activities around codes and standard advocacy that should not be mixed with the ESPI issues here. In addition, SoCalGas also points out that there are other aspects of codes and

[1] Cal Advocates' December 27, 2019 motion at 10.

standards activities besides those dedicated to advocacy, and that they remain involved in those other sub-programs.

NRDC's comments support the Cal Advocates motion to consider the elimination of the ESPI. NRDC argues that the mechanism is not suited to the reality of today where the majority of energy efficiency programs will be implemented either on a statewide or third-party basis. Moreover, NRDC argues, if the ESPI is not structured to improve the efficacy of current energy efficiency programs then it becomes a cost without a resulting benefit, potentially becoming an obsolete mechanism that serves to transfer public funds to utility shareholders.

NRDC also offers two new policy questions for the Commission to seek input:

- Given that the EM&V process is set-up in part to provide inputs necessary to determine the ESPI, what changes should be made to the EM&V process if the ESPI is eliminated or modified?
- Are there other related items to the ESPI that the Commission should consider as part of this review?

Finally, NRDC offers modifications to one of the Cal Advocates' questions, as follows (with NRDC additions in italics and deletions in strikethrough):

- Given the current management structure of energy efficiency programs, are shareholder incentives still necessary to ensure the ~~achievement of energy savings~~ *the planning and delivery of robust energy efficiency programs*? Should the Commission eliminate shareholder incentives for *related items such as net* energy savings?

4. Cal Advocates Reply to Motion Responses

In reply to the responses to the original December 27, 2019 motion, Cal Advocates agrees that the additional questions recommended by the utilities and NRDC should be included in the scope of the review of ESPI.

Cal Advocates disagrees with SCE, however, that the ESPI review should be considered only after the energy efficiency landscape has settled down, for example when third-party contracts are further along and the Commission review of cost-effectiveness policy is complete. Cal Advocates argues there is no need to wait.

Cal Advocates also opposes the suggestion that the Commission open a new rulemaking to consider ESPI changes or elimination, arguing that it is more efficient to undertake the review in this existing proceeding.

Finally, Cal Advocates disagrees with SoCalGas that the issues raised in its motion should be covered instead in the OSC portion of this proceeding devoted to its 2016-2017 codes and standards activities. Cal Advocates points out that their request is with respect to activities in 2018 and beyond.

5. Discussion

The Commission has authorized the award of payments to shareholders of IOUs for investing in demand-side resources for several decades. The most recent mechanism in place to reward successful energy efficiency investments by IOUs is the ESPI, adopted in D.13-09-023, as a replacement to the Energy Efficiency Risk/Reward Incentive Mechanism (RRIM).

The RRIM had been structured to reward the IOUs for achieving high levels of evaluated savings, but also penalized the IOUs for under-achieving savings and included a wide “dead band” of savings for which no incentives would be awarded. The RRIM also incorporated the IOUs’ portfolio

cost-effectiveness levels into their rewards, by multiplying a Commission-set earnings rate by the "performance earnings basis," which was calculated as two-thirds of each IOU's TRC test results plus one-third of their PAC test result.

These features of the RRIM structure resulted in the Commission's efficiency portfolio evaluation results, which are developed by consultants under Energy Division direction, being extremely contentious and highly litigated. The ESPI structure was explicitly intended to reduce the amount of contention in the process and variability in the shareholder awards by: (a) removing any dead band or penalties; (b) not factoring cost-effectiveness into the award calculus; (c) shifting a significant portion of the award basis to *ex ante* savings estimates and to rewarding IOUs for making concerted efforts to improve their *ex ante* estimates; (d) basing the savings payments on net life-cycle rather than first-year savings; and (e) providing IOUs with management fees for codes and standards advocacy and for non-resource programs that support the efficiency portfolio through activities such as marketing or improved access to training and education. The resulting structure consisted of the following four components of the new ESPI:

1. <u>Energy Efficiency Resource Savings</u>: A performance award for *ex-ante* locked down and *ex-post* verified net lifecycle energy savings;
2. <u>Ex-Ante Review Process Performance</u>: A performance award for conformance with *ex-ante* review best practices;
3. <u>Codes and Standards</u>: A management fee award for codes and standards activities; and
4. <u>Non-Resource Programs</u>: A management fee award for implementing non-resource programs.

The ESPI decision (D.13-09-023) acknowledged that these changes could have material impacts on the portfolios in a number of ways.

For instance, the decision indicated that the *ex ante* review component of the ESPI would be expected to result in a much narrower range between *ex ante* savings estimates and *ex post* evaluated results over time. Consistent with this expectation, between the 2010-12 portfolio and 2017, the ratio of evaluated megawatt hour savings to *ex ante* estimates increased from 77 percent to 91 percent, the ratio of evaluated megawatt savings to *ex ante* estimates increased from 72 percent to 94 percent, and the ratio of evaluated Therm savings to *ex ante* estimates increased from 92 percent to 95 percent.

Decision 13-09-023 also noted that the combination of the shift away from first-year savings to life-cycle savings and removing cost-effectiveness as a component of the incentive mechanism would likely result in reduced portfolio cost effectiveness over time.[2] In acknowledging this potential outcome, the Commission determined that focusing more on deeper and longer-lasting savings should be prioritized over maximizing net economic benefits, even though "achieving the longer-term policy vision results in a shift in the portfolio towards a higher percentage of future savings, which receive less value in today's dollars when present-valued using the utilities' cost of capital, per our adopted cost-effectiveness tests."

Consistent with the direction in D.13-09-023 and as noted in the Cal Advocates' Motion, for a variety of reasons that have been identified and discussed at length in the record of this proceeding, the cost-effectiveness of the energy efficiency portfolio has been in a steady decline over the past decade.

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[2] Removing cost-effectiveness from the incentive calculus has both a direct impact, by not providing a financial incentive for IOUs to maximize portfolio cost-effectiveness overall, but also it does not serve as a counter-weight to the shift to life-cycle savings basis, since the time value of money inherently biases short-term savings over long-term savings in cost-effectiveness tests.

What may be less obvious to some parties but highly germane to the ESPI mechanism design is that the lifecycle savings of the portfolio have trended upwards across this timeframe as well, also consistent with the ESPI decision's prediction and intent, from an average portfolio measure effective useful life (EUL) of 10.59 years in the 2010-12 portfolio cycle to 11.06 years in 2017. This upward trend has occurred despite a decrease in custom projects, which typically install longer EUL measures, and a statutorily directed increased emphasis on behavioral, retro-commissioning, and operational measures, which currently have a two-year EUL.

While many factors affected these changes and we are unable to state with certainty whether and to what extent the ESPI mechanism influenced them, it is reasonable to conclude that the mechanism had some influence, directionally, or at least did not create an incentive against them. One focus of the ESPI mechanism that has not resulted in a material change is the focus on increasing program influence by rewarding net savings. The ESPI decision established "stretch" net-to-gross (NTG) goals "…to guide longer term transitions in program design, and we are confident that through careful program design that reduces free ridership and focus on cost-effective, longer life measures, the IOU portfolios could achieve the higher portfolio savings associated with the target…NTGs." However, the evaluated portfolio NTG ratios remain virtually unchanged since the ESPI mechanism was put in place.[3]

[3] The Commission anticipated that the IOUs would take steps to embed improvements in program influence into their program designs and potentially into employee compensation structures. However, we do not have evidence that the ESPI mechanism has resulted in changes in IOU program designs or employee compensation structures.

Aside from the lack of improvement in NTG ratios, the above informal summary indicates that the ESPI mechanism has performed largely consistently with many of the intentions articulated in the ESPI decision. It has reduced contention associated with Commission-evaluated savings and resulting award payments, improved *ex ante* savings estimates, encouraged a shift in the portfolio towards measures with longer-lasting savings, and rewarded IOUs for codes and standards advocacy and administering non-resource programs.

As Cal Advocates explains in their motion, however, over the past several years the Commission has authorized significant changes in the manner in which the energy efficiency portfolio is designed and administered, and these changes impact the manner and degree to which IOUs influence program designs and portfolio savings. These changes include requiring a significant portion of the portfolio to be administered on a statewide basis, mandating third-party design and implementation of a majority of the budget, and increasing the use of normalized metered energy consumption (NMEC) as a measurement and verification method for energy savings.

In addition, the IOUs have struggled to file Annual Budget Advice Letters (ABALs) that are cost-effective and meet energy savings goals, as required by D.18-05-041.[4] While ESPI focuses on long-term savings, the current incentive

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[4] D.18-05-041, at 57, states: "We expect the PAs [program administrators] to optimize their portfolios based on three high-level objectives: meeting or surpassing energy savings goals, cost-effectively, and within budget, as indicated by the triggers we identified for PAs to file revised business plans, which are:

1. A PA is unable to adjust its portfolio in response to goal, parameter, or other updates to:

a. meet savings goals,

b. stay within the budget parameters of the last-approved business plan, or

Footnote continued on next page.

structure does not encourage IOU performance in delivering cost-effective portfolios that can also meet goals. Consequently, a review of the ESPI mechanism and the need for reforms — or whether a shareholder incentive will continue to be a useful policy tool in light of these changes — is warranted at this time. Thus, we grant the Cal Advocates December 27, 2019 motion.

Further, we agree generally with the scope and sequencing suggested in the Cal Advocates motion. In particular, we seek to evaluate whether the ESPI mechanism should remain in place at all, and if so, what changes are warranted to account for the modifications to the energy efficiency portfolio and the utility role in the past few years.

We also agree with Cal Advocates that a new rulemaking is not necessary at this time. While it is the case that in the past, the shareholder incentive mechanism has, at times, been handled in a separate rulemaking, there is no particular administrative efficiency to be gained by separating out these ESPI-related issues at this time from the general energy efficiency rulemaking. Therefore, we will address the ESPI issues herein, and the scope will be as discussed in this ruling, and specifically the questions laid out in Section 6.

We are also modifying the scope slightly from the specific questions in the Cal Advocates motion, with respect to the issues associated with SoCalGas and its codes and standard advocacy activities. Specifically, we will include in the scope of this ESPI-related portion of the proceeding the questions about how ESPI or shareholder incentives should be awarded based on statewide program

c. meet the Commission-established cost effectiveness (excluding Codes and standards and spillover adjustments);

2. The Commission calls for a new application as a result of a decision in the policy track of the proceeding (or for any other reason)."

responsibilities; we will keep any SoCalGas-specific issues related to their conduct in codes and standards advocacy activities (currently, or in the past) in the scope of the OSC portions of this proceeding.

We also will include the questions suggested by SCE and NRDC, some in slightly modified form, or subsumed within other related questions.

With respect to the question of how the modification or elimination of the ESPI mechanism would impact evaluation activities or funding, we note that evaluation funds are used for a variety of purposes to support the energy efficiency portfolio that are unrelated to evaluating program savings. Those include energy efficiency potential and goals studies, process evaluations to inform program efficacy, impact studies to measure actualized energy savings, market characterization studies, saturation studies, *etc*. The primary purposes of evaluation funds directed at determining programs are also (1) to provide confidence to demand forecasters and grid planners that savings from efficiency programs are real an additional, and can be relied upon to materialize in place of authorizing more supply-side resource investments; and (2) to identify the efficiency of programs to aid in administrator decisions regarding portfolio composition. Parties commenting on the impact on evaluation funding and role should bear these points in mind, along with the emerging trend toward embedded measurement and verification within program designs.

The questions in the next section have been revised accordingly.

6. Questions for Parties

This ruling seeks comments from parties on the following questions. Utilities must respond to the first question. All other parties are invited to respond to some or all questions, as they see fit.

Utilities shall file and serve their answer to question 1 below by no later than April 15, 2020. All interested parties may file and serve comments on all questions no later than April 29, 2020. Reply comments may be filed and served by no later than May 15, 2020. Thereafter, next steps will be determined in this proceeding.

Questions for Utilities Only

1. For utilities only: For each program year from 2015 to 2018, state how much you have received or have requested to receive in ESPI awards, broken down by each of the four individual award categories. Calculate the reported TRC and PAC test ratio of your portfolio, with and without ESPI costs.

Questions Related to Whether the ESPI Mechanism Should Be Retained or Eliminated

2. Provide empirical evidence that ESPI has motivated utility investors and managers to prioritize energy efficiency differently from what priorities would have been absent ESPI, or has improved the performance of energy efficiency portfolios overall. Alternatively, provide your comments on the outcomes summarized in Section 5 of this ruling.
3. Have the policy and/or goals outlined in D.13-09-023 as the justification for ESPI changed since that decision was issued? If so, how? In identifying such changes, be specific as to the categories of ESPI awards relevant to each policy change.
4. Is ESPI still aligned with meeting the State's or the Commission's objectives? If not, be specific as to what award categories of ESPI are no longer aligned with which Commission objectives.
5. Are shareholder incentives an appropriate and effective use of ratepayer resources dedicated to obtaining energy savings?
6. Given the current management structure of energy efficiency programs, are shareholder incentives, in any form, necessary to ensure the achievement of energy savings? Should the Commission eliminate shareholder incentives for energy

savings completely? Should individual ESPI award categories be eliminated? Why or why not?

7. Are shareholder incentives still necessary to ensure the planning and delivery of robust energy efficiency programs, apart from specific achievement of net energy savings? Why or why not?

Questions Related to Potential Modifications to the ESPI Mechanism

8. What should be the goals of shareholder incentives for utilities for energy efficiency now, if different from those outlined in D.13-09-023?
9. If the Commission continues to authorize incentives to utility shareholders, how should the incentive mechanism be structured to make it more effective in achieving its goals? Should the overall dollar level of ESPI award potential, as a motivation factor, be reevaluated?
10. Should the Commission connect utility performance relative to the ABALs in terms of goal attainment and cost-effectiveness to the ESPI awards? If so, how?
11. How should the incentive mechanism be structured in light of the shift toward more third-party designed and implemented programs?
12. How should the incentive mechanism be structured for the new, more centralized management of statewide energy efficiency programs?
13. Should utilities whose ratepayers are funding, but who are not managing, statewide programs, continue to receive an incentive payment for those contributions? Why or why not?
14. How should the incentive mechanism be structured in light of the shift towards NMEC as a measurement and verification method?
15. What metrics, if any, should be used to measure the success of non-resource activities?
16. What metrics, if any, should be used to measure the success of codes and standards activities?

17. How can the ESPI review process be revised to reduce administrative burden?
18. Provide any other recommendations for changes to the ESPI mechanism.

Other ESPI-Related Questions

19. How should your recommended changes to, or elimination of, ESPI affect the EM&V budget and Commission staff and/or evaluator activities? Be specific in your answer.
20. If the Commission modifies or eliminates ESPI, when should the changes take effect?
21. Are there other related items to the ESPI that the Commission should consider as part of this review?

IT IS RULED that:

1. The December 27, 2019 Motion of the Public Advocates' Office is granted, consistent with the scope discussed in Sections 5 and 6 of this ruling.
2. Pacific Gas and Electric Company, San Diego Gas & Electric Company, Southern California Edison Company, and Southern California Gas Company shall file and serve their responses to Question 1 in Section 6 of this ruling by no later than April 15, 2020.
3. Interested parties may file and serve comments on this ruling and its questions in Section 6 by no later than April 29, 2020.
4. Interested parties may file and serve reply comments in response to this ruling and its questions in Section 6 by no later than May 15, 2020.

Dated March 18, 2020, at San Francisco, California.

/s/ LIANE M. RANDOLPH	/s/ JULIE A. FITCH
Liane M. Randolph	Julie A. Fitch
Assigned Commissioner	Administrative Law Judge