

**Pennsylvania Public Utility Commission
American Recovery and Reinvestment Act Investigation
I-2009-2099881**

Working Group Final Report

January 24, 2011

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I. Executive Summary

This report is intended to help the Pennsylvania Public Utility Commission (“Commission”) comply with Section 410(a) of the American Recovery and Reinvestment Act of 2009 (“ARRA”). Section 410(a) of the Recovery Act requires the Commission to consider implementing policies that align electric and gas utility financial incentives with the promotion of energy efficiency and conservation, in order for the Commonwealth of Pennsylvania to receive certain additional Federal stimulus funds.

The report is divided into three major sections. The first section discusses the meaning of Section 410(a) of the ARRA and what it requires the Commission to do. The second section discusses existing policies or laws that address the policy goals outlined in Section 410(a) of the ARRA. The third section discusses additional measures the Commission may consider to address the policy goals outlined in Section 410(a) of the ARRA.

II. Introduction

A. Objective of Investigation Proceeding

This investigation is intended to ensure compliance by the Commonwealth of Pennsylvania with Section 410(a) of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 § 410(a), 123 Stat. 115 (2009) (ARRA). Section 410(a) of the ARRA conditions the allocation of certain federal funds to the Commonwealth of Pennsylvania on a requirement that the Commission consider implementing rate-making policies for electric and gas utilities that align their financial incentives with the promotion of energy efficiency and conservation. The investigation has sought input from interested parties such as Pennsylvania electric and gas utilities, industrial customers, and Statutory advocates regarding potential Commission actions that might be needed to satisfy the requirements of Section 410(a) of the ARRA.

NFG

National Fuel Gas Distribution Corporation (“National Fuel”) credits Commission Staff for administering this proceeding as an open collaborative process encouraging the input of all participants. National Fuel is concerned, however, that in accommodating all viewpoints and input, many of the topics discussed in this final report are off-point from the task at hand.

Regarding elimination of the financial disincentives of natural gas utilities to promote conservation, Pennsylvania simply has not kept pace with other states. This is made abundantly clear when reviewing the American Gas Association’s (AGA) latest update of *Innovative, Non-Volumetric Rates and Tracking Mechanisms: Current list as of August 2010*. See, NFG Attachment 1 (“AGA Report”).

As can be seen from page 3 of the AGA Report, Pennsylvania is now in the minority of states with utility rate structures that create financial disincentives to promote

conservation. Pennsylvania's status as an outlier is even more dramatic when overall natural gas consumption of the state is considered. Of the top 17 natural gas consuming states, Pennsylvania is the only state to not implement one of the innovative rate designs in the AGA Report. *See*, NFG Attachment 1; pages 4 and 5. Indeed, of all the largest natural gas consuming states, Pennsylvania is alone in its refusal, so far, to adopt increasingly commonplace rate designs that promote energy conservation. This fact will likely raise questions regarding Pennsylvania's good-faith commitment to the requirement of the ARRA that the states, in exchange for federal stimulus funding, address ratemaking disincentives to energy conservation.

B. History of Investigation Proceeding

The Commission issued an Order initiating this investigation on May 6, 2009. Parties submitted Comments on July 6, 2009 and Reply Comments on August 6, 2009. Based on the comments, the Commission held a technical conference on November 19, 2009. Based on the discussions at the technical conference, on December 18, 2009 the Commission issued a Secretarial Letter seeking the formation of a working group to further discuss issues regarding ARRA and to prepare a report regarding potential policies that could be implemented by the Commission to ensure compliance with ARRA. The working group was formed on January 18, 2010, and held meetings on March 10, 2010, April 28, 2010, and June 9, 2010. This is the final report of the ARRA working group.

III. Meaning of Section 410(a) of the ARRA

This Section of the ARRA Working Group Report focuses on the meaning of Section 410(a)(1). Section 410(a)(1) of the ARRA states:

The Secretary shall make grants under this section in excess of the base allocation established for a State under regulations . . . only if the governor of the recipient State notifies the Secretary of Energy in writing that the governor has obtained necessary assurances that each of the following will occur:

The applicable State regulatory authority will seek to implement, in appropriate proceedings for each electric and gas utility, with respect to which the State regulatory authority has ratemaking authority, a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and will provide for timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers' incentives to use energy more efficiently.

In response to this requirement, Governor Rendell issued a letter to the Secretary of Energy on March 23, 2009, certifying that he had written to the Pennsylvania Public Utility Commission asking that it ensure adoption of the general policy described in Section 410(a) of

the Recovery Act. On the same day, Governor Rendell issued a letter to Commission Chairman Cawley, asking that the Commission:

[C]onsider additional steps the Commonwealth can take to establish appropriate incentives in electric and natural gas utility rates for energy efficiency programs, consistent with State law, the attached statute and relevant PURPA requirements. These include policies to align interests of utilities to support conservation without raising the cost of conservation and increasing the cost to ratepayers of measurable, verifiable efficiency savings.

To determine the meaning of the above text, a court would rely on canons of construction that are used to interpret legislation.¹ Courts ordinarily start with what is known as the “plain meaning” rule, expressed as follows:

[T]he meaning of a statute must, in the first instance, be sought in the language in which the act is framed, and if that is plain... the sole function of the courts is to enforce it according to its terms.
Caminetti v. United States, 242 U.S. 470 (1917).

Comments submitted by parties representing a range of interests provide a sample of attempts at a “plain meaning” interpretation of Section 410(a). The consumer representatives in this working group have generally taken the position that the Commission’s policies already substantially meet the requirements of Section 410(a) and that, in any case, many of these issues are already explicitly addressed by Pennsylvania statutes that must be reflected in any Commission policies. Here’s one example:

Exactly what the ARRA mandates is a source of significant debate. However, the actual language of Section 410(a) underscores two significant points. First, by specifying that the Commission “seek” to implement a “general” policy, the ARRA has given the Commission substantial latitude. Second, the ARRA specifies that natural gas distribution companies (“NGDCs”) and electric distribution companies (“EDCs”) be given only an earnings “opportunity” rather than an earnings “guarantee.” (*Comments of OSBA*).

On the other hand, the gas and electric utilities in this working group have generally taken the position that the Commission’s policies do not fully meet the requirements of Section 410(a). Here’s one example:

While the Commonwealth’s initiatives over the years are laudable, the fact that all gas companies in the Commonwealth currently have rate structures

¹ This writing provides a brief overview of the rules that govern statute construction and how those rules might be applied to Section 410(a). A full analysis is beyond the scope of this memo and perhaps of little value because it would require speculation as to the outcome of judicial proceedings.

that pit conservation against revenue opportunities belies the conclusion that Pennsylvania's current laws and regulations successfully promote the ARRA objective of ensuring "that utility financial incentives are aligned with helping their customers use energy more efficiently and that provide timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers' incentives to use energy more efficiently." Columbia submits that the Commonwealth may jeopardize its ability to attract all of the grants available under Section 410(a) of the ARRA if it stands pat on its past legislative and regulatory achievements. (*Reply Comments of Columbia Gas*).

The above excerpts and other comments suggest that reasonable minds may differ on the meaning of Section 410(a). As a result, the statutory text is arguably ambiguous on its face. The parties have generally divided themselves into two camps on a key question of whether the Commission needs to do "more" than it is already doing to satisfy Section 410(a). One group believes that the Commission should implement a policy that will facilitate some additional measures to satisfy Section 410(a), and the other group believes that the Commission's existing policies and programs already meet Section 410(a) requirements.

Another key question, if the Commission determines that it should implement a policy that facilitates some additional measures to satisfy Section 410(a), is how should the additional measures be facilitated and what additional measures should be included. As to how to facilitate the additional measures, the group who support additional measures believes that the Commission should indicate, in general terms, what measures the Commission is willing to consider, if proposed in some future proceeding. The specifics of any particular measure could then be fully considered in the future proceeding.

When a court finds that a statute is ambiguous, its job is to ascertain, from other sources, legislative intent that is not discernible from the plain meaning of the statutory text. *United States v. Great Northern Ry.*, 287 U.S. 144 (1932). The analysis begins, however, with an evaluation of the subject language within the larger context of the overall statute:

In analyzing a statute's text, the Court is guided by the basic principle that a statute should be read as a harmonious whole, with its separate parts being interpreted within their broader statutory context in a manner that furthers statutory purpose. The various canons of interpretation and presumptions as to substantive results are usually subordinated to interpretations that further a clearly expressed congressional purpose.²

Ultimately the intent is to effectuate statutory purpose. In other words, no court will interpret a statute in such a way as not to give effect to the purpose underlying the law itself.

² Kim, Yule, Esq., *Statutory Interpretation: General Principles and Recent Trends*, Congressional Research Service (August 31, 2008)(<http://www.fas.org/sgp/crs/misc/97-589.pdf>)

The ARRA was enacted in response to the downturn in the national economy and is considered to be a stimulus bill. Economic stimulus, however, is not its sole purpose. As provided in the text of the law:

The Purposes of this Act include the following:

- (1) To preserve and create jobs and promote economic recovery;
- (2) To assist those most impacted by the recession;
- (3) To provide investments needed to increase economic efficiency by spurring technological advances in science and health;
- (4) To invest in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits; and
- (5) To stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases.

The ARRA includes language designed to promote efficiency in the energy sector of the economy and environmental protection. While the explicit meaning of Section 410(a) might be a subject of debate, the intent of the section is clearly to promote the efficient use of energy. This appears to be recognized by all parties who submitted comments in the instant proceeding.

Although there is language in Section 410(a) that can be read to suggest that the Commission satisfies the legal standard if it merely undertakes an exercise that considers (but does not implement) a “policy that ensures that utility financial incentives are aligned with helping their customers . . .,” that text cannot be read in isolation:

In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.

United States v. Boisdoré’s Heirs, 49 U.S. (8 How.) 113, 122 (1850).

It is also unlikely that the existence of conservation and efficiency programs, without a mechanism to align utility financial incentives, would satisfy Section 410(a), again if the subsection is read as a whole within the larger context of the ARRA. However, “it is significant in terms of legislative construction that the requirement is broadly constructed and does not specifically mandate a particular ratemaking methodology, including “decoupling.” “A “decoupling” policy would fit the description of the ARRA paragraph, but it clearly is not the only available policy that would conform to and meet the necessary assurance.”³ To the contrary, “it appears that it does not mandate decoupling and the language is broad enough to

³ Addendum to the EISA PURPA Standards Manual dated March 17, 2009 (pages3-4).
http://www.naruc.org/Publications/ARRAcorrectiontoPURPAandnote_v3.0.pdf

allow state regulatory commissions a choice of policy options.” American Public Power Association, *The Effect of Energy Efficiency Programs on Electric Revenue Requirements* (undated report).⁴ Nevertheless, even some opponents of a gas revenue decoupling mechanism (gas RDM) in this working group concede that in Pennsylvania, Section 410(a) can be construed as requiring Pennsylvania to become more aggressive regarding gas conservation in order to qualify for federal funding.

Key to the analysis is a Commission determination regarding the current circumstances. If, as some parties contend, current utility rate design produces a utility *disincentive* to help customers use gas and electricity more efficiently, then Section 410(a) would likely require that the Commission do *something* to correct that deficiency if Pennsylvania is to qualify for additional federal funding under this Section.

Another established aid to statutory construction is the rule that courts will defer to an administrative agency’s interpretation of a statute that the agency administers. *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). Assuming that a Department of Energy (“DOE”) agency administers compliance with Section 410(a), there may be some value in reviewing DOE agency writings on aligning utility financial incentives with energy efficiency and conservation. As mentioned above, there is currently no guidance from the DOE on the precise meaning of Section 410(a). However, under the Energy Policy Act of 2005, the DOE recommended, among other things, that state “regulators should consider modifying ratemaking practices to promote energy efficiency among consumers, while recognizing that this goal must be balanced with other ratemaking objectives.” Those recommendations included “addressing the typical utility throughput incentive and removing other regulatory and management disincentives to energy efficiency.” United States Department of Energy, *State and Regional Policies that Promote Energy Efficiency Programs Carried Out by Energy and Gas Utilities: A Report to the United States Congress Pursuant to Section 139 of the Energy Policy Act of 2005* (March 2007).⁵

In conclusion, it is apparent that if the Commission finds that the state’s energy policy, as reflected in utility rate design, produces a utility disincentive to the promotion of conservation, then maintenance of the status quo is not consistent with the language, purpose and intent behind Section 410(a). The statute does not explicitly prescribe qualified policies or rate making changes that would serve to reverse the disincentive and produce any particular, desired incentive regime. Proponents of revenue decoupling, however, assert that if Pennsylvania were to adopt a RDM or similar rate making change, it would readily comply with Section 410(a). On the other hand, opponents of revenue decoupling argue that although Section 410(a) might require Pennsylvania to do *something* with respect to aligning utility incentives with helping customers use energy more efficiently, it does not necessarily mean that Pennsylvania must adopt a RDM solely for the purpose of meeting the federal statutory prerequisite for additional ARRA funding.

⁴ <http://www.appanet.org/files/PDFs/EffectofEnergyEfficiency.pdf>

⁵ http://www.oe.energy.gov/DOE_EPAAct_Sec._139_Rpt_to_CongressFINAL_PUBLIC_RELEASE_VERSION.pdf

Columbia Gas

This section of the Report presents the diverging positions taken by the parties in interpreting the meaning of Section 410(a). Columbia respectfully submits with regard to the following statement— “If, as some parties contend, current utility rate design produces a utility *disincentive* to help customers use gas and electricity more efficiently, then Section 410(a) would likely require that the Commission do *something* to correct that deficiency if Pennsylvania is to qualify for additional federal funding under this Section,”—that (1) utility disincentives currently do exist, and (2), in order for Pennsylvania to be eligible for additional federal grants under Section 410(a), the Public Utility Commission must seek to implement a general policy that ensures utility financial incentives are aligned with the promotion of energy efficiency and conservation measures.

Columbia supports its position with the fact that conservation disincentives are clearly and unarguably produced by utility rate structures that recover a natural gas distribution company’s fixed non-gas costs through volumetric charges.⁶ Similarly, Columbia disagrees with the conclusion in Section III that there is any opportunity for the Commission to find that Pennsylvania’s energy policy, as reflected in utility rate design, does not produce utility disincentives to promote conservation. So long as rate designs are in effect where increases or decreases in energy consumption produce corresponding increases or decreases in utility earnings, a utility will continue to have strong incentives to encourage its customers to consume more. The type of utility rate structures currently set in Pennsylvania pit conservation gains against revenue opportunities. Moreover, Columbia posits that if, as a result of this investigation, the Commission agrees that disincentives exist, it is not only *likely* that Section 410(a) requires the Commission to do *something*, but that Section 410(a) surely requires the Commission to rectify the inequity, and adopt a general policy that does nothing short of aligning utility financial incentives with the promotion of energy efficiency and conservation opportunities for customers.

Columbia further maintains that Section 410(a) cannot be satisfied solely by removing existing disincentives. Instead, as referenced in this Report, Section 410(a) states that “the applicable State regulatory authority will seek to implement, in appropriate proceedings for each electric and gas utility, with respect to which the State regulatory authority has ratemaking authority, a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and will provide for timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers’ incentives to use energy more efficiently.”(Emphasis added). In addition, in Governor Rendell’s letter to Chairman Cawley, the Governor asked that the Commission “[C]onsider additional steps the Commonwealth can take to establish appropriate incentives in electric and natural gas

⁶ Columbia’s comments concerning straight fixed variable and similar rate designs are limited to natural gas distribution charges (“distribution charges”) and are not intended to address the recovery of natural gas supply charges (“gas supply charges”), which Columbia submits must be recovered on a volumetric basis in order to send the proper price signals to customers.

utility rates for energy efficiency programs...” (Emphasis added). It is Columbia’s position that “removing disincentives” and “aligning” or “establishing appropriate incentives” are not one and the same, and consequently Columbia submits that the meaning of Section 410(a) is not only limited to identifying and removing disincentives, but to also ensure that utility financial incentives are aligned with helping their customers to conserve and become more efficient energy users. Columbia acknowledges that while removing utility disincentives can begin to align utility financial incentives with its customers’ energy efficiency and conservation initiatives, removing disincentives alone will not necessarily align utility financial incentives in a manner to provide a timely earnings opportunity for utilities associated with cost-effective energy efficiency savings.

NFG

Section 410 (a) of the ARRA was not enacted in an effort to reward the status quo. On the contrary, the ARRA is a call for States to change their historical ratemaking rules and policies that couple rates to the volume of energy consumed by utility customers. The ARRA expressly requires that Pennsylvania adopt policies that will align utility financial incentives with helping customers conserve energy. While the Commission has long encouraged customers to conserve energy, the Commission has done little to modify its policies to create financial incentives for utilities to actively and aggressively promote energy conservation. Section 410(a) is intended to encourage states, like Pennsylvania, to evaluate and modify their long-standing ratemaking policies that discourage utilities from partnering with their customers to conserve energy.

OCA

The OCA would note at the outset that Section 410(a) of the ARRA does not mandate any specific action by this Commission or by the Commonwealth of Pennsylvania. Rather, this Section sets forth a number of conditions that must be met if the Commonwealth wishes to apply for certain supplemental energy efficiency funding from the federal government. Even then, Section 410(a) does not identify specific policies or programs that must be adopted in order to meet the conditions for this supplemental funding. Rather, it calls for “a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and will provide for timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings.” Importantly, this provision goes on to state that the policy must be conducted “in a way that sustains or enhances utility customers’ incentives to use energy more efficiently.” The Draft Report correctly notes that Section 410(a) does not mandate any particular ratemaking methodology such as “decoupling.”

Section 410(a) does not preempt – nor does it seek to preempt – applicable Pennsylvania law, such as the comprehensive framework that was recently established for the energy efficiency programs of Pennsylvania’s electric distribution companies (EDCs) in Act 129 of 2008. In OCA’s view, the statutory requirements of Act 129 and other provisions of the Public Utility Code are consistent with the policies set forth in Section 410(a) with respect to the appropriate ratemaking and support for energy efficiency programs. But at the end of the day, the Commission is bound by the Public Utility Code and if, for some reason, the Commission concludes that it cannot meet the standards of

Section 410(a) under Pennsylvania law, then that is the end of the inquiry. It is up to the General Assembly, not the Commission, to determine whether it wishes to change Pennsylvania law in order to qualify for supplemental funding under Section 410(a).

As set forth more fully below, however, it is the position of the OCA that the Commission does in fact already have the statutory authority and policies in place to meet the goals of Section 410(a) under current Pennsylvania law.

OSBA

Requirements of Recovery Act

Section 410(a) of the Recovery Act requires the Public Utility Commission (“Commission”) to “*seek* to implement . . . a *general* policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and that provide timely cost recovery and a timely earnings *opportunity* for utilities.” (Emphasis added)

Exactly what the Recovery Act mandates is a matter of significant debate. However, the actual language of Section 410(a) underscores two significant points. First, by specifying that the Commission “seek” to implement a “general” policy, the Recovery Act has given the Commission substantial latitude. Second, the Recovery Act specifies that natural gas distribution companies (“NGDCs”) and electric distribution companies (“EDCs”) be given only an earnings “opportunity” rather than an earnings “guarantee.”

Governor Rendell’s Request

By letter of March 23, 2009, Governor Rendell asked the Commission to “establish appropriate incentives in electric and natural gas utility rates for energy efficiency programs, [which are] consistent with State law.” By requesting that the incentives be consistent with existing law, the Governor recognized that Section 410(a) of the Recovery Act does not provide the Commission with the legal authority to act contrary to a specific state law or to exercise power not granted to the Commission by a specific state law. Although the Governor did not foreclose the possibility of amending existing state law, he neither explicitly nor implicitly indicated that compiling a laundry list of legislative proposals was to be a priority.

The Governor also stated that the incentives established by the Commission *should* include “policies to align interests of utilities to support conservation without raising the cost of conservation and [without] increasing the cost to ratepayers.” By this exhortation, the Governor did not foreclose the possibility that the Commission *could* adopt policies which impose a net cost on ratepayers. However, his request implies a preference for policies which do not increase costs to electric ratepayers beyond those costs which will be imposed under the EDCs’ conservation plans.

Industrials

As made evident in the Report, the meaning of Section 410(a) has been the subject of considerable debate among ARRA WG members. As indicated in the Comments of the

OCA, "Section 410(a) of the ARRA does not mandate any specific action by either the Commission or the Commonwealth." Instead, to qualify for grants under this section in addition to the already-determined base allocation amount, Pennsylvania must establish that: (a) it has a general policy that aligns financial incentives with helping customers use energy more efficiently; (b) its general policy provides timely cost recovery and timely earnings opportunities for utilities associated with cost-effective measurable and verifiable energy savings; **and** (c) the policy satisfying criteria (a) and (b) sustains or enhances customers' incentives to use energy more efficiently. The third prong of the Section 410(a) criteria is especially important given the context of the enactment of the ARRA. At a time when Pennsylvania's business and industry is attempting to recover from a major recession, charging customers additional surcharges to provide utilities with financial incentives or "keep whole" payments to promote energy efficiency and conservation undermines customers' own incentives to be more efficient. Moreover, because the Industrial Customer Groups believe that Pennsylvania already meets all of these criteria through its policy that cost of service is the primary factor in rate design and other Pennsylvania law, no further steps are needed by the Commission at this time for Pennsylvania to comply with Section 410(a).

IV. Present Policies or Laws that Address Policy Goals Outlined in ARRA 410(a)

Industrials

In general, this Section of the Report outlines various ways that the PUC and Pennsylvania law already supports and addresses some of the policy goals in Section 410(a). Specifically, the Report outlines the following policies of the Commission that, when taken together, already meet these goals:

- The unbundling of electric generation and natural gas and the ability of utilities to recover, on a full and current basis, all reasonable costs related to the Provider of Last Resort/Supplier of Last Resort Function;
- The elimination of declining block rates;
- The ability to verify energy efficiency savings and the cost effectiveness of such measures through use of the Technical Reference Manual ("TRM") and the Total Resource Cost ("TRC") Test;
- The inclusion of energy efficiency and demand-side response activities in Pennsylvania's Alternative Energy Portfolio Standards ("AEPS") Act;
- The implementation and requirements of Act 129;
- Public Utility Code Sections that promote weatherization and other energy conservation measures for low-income customers; and
- Public Utility Code Sections that grant the Commission authority to implement conservation measures and recover appropriate costs in rates.

Despite these numerous Pennsylvania policies and laws that already address the policy goals associated with Section 410(a), various utility members of the ARRA working group have indicated that, as long as utility revenues for fixed costs are tied to customers' volumetric charges, there remains a disincentive for utilities to promote

energy conservation. In order to alleviate this perceived problem, the Industrial Customer Groups opine that the best way to achieve energy efficiency goals (in addition to continuation of the various policies and laws summarized in this Section of the ARRA WG Report) is to implement proper cost of service allocations among customer classes, and to implement properly-designed rate structures that follow the results of the cost of service study.

With proper cost allocation and rate design, a customer's rate includes three potential parts: (1) a flat fee to recover any costs that are fixed and do not vary based on the kW or kWh (or Mcf for natural gas) used by the customer; (2) a variable fee based upon energy usage to recover any costs that vary on the amount of kWh or Mcf used; and (3) a demand charge to recover costs that vary based on the kW demand of the customer. Cost-based pricing is simple: the rate structure matches the cost structure.

Cost of service pricing sends the correct price signals to customers and provides appropriate incentives for customers to engage in energy efficiency and conservation initiatives without impairing a utility's financial condition. Initially, it is important to recognize that electric and natural gas rates have been unbundled. The supply portion of the unbundled service is provided either by non-utility competitive supplies or by the utility under reconcilable rate classes. As a result, only the delivery (*i.e.*, transportation or distribution) portion of the rates could potentially act as a disincentive to utilities in their pursuit of energy efficiency and conservation programs. When transportation or distribution costs are collected through rates based solely on an energy basis (*i.e.*, Mcf or kWh) basis, in addition to providing an alleged disincentive for utilities to encourage conservation efforts, usage fluctuations caused by variables such as weather and economic conditions reduce utilities' ability to cover fixed costs and distort the true cost of delivery service to consumers. Conversely, when rates are properly designed, the only costs collected on a kWh or Mcf basis are those costs that vary based on the number of kWh or Mcf used by customers. As a result, a properly-designed rate structure is aligned to provide both the customer and the utility with an incentive to operate as efficiently as possible. Similarly, with properly-designed rates, costs incurred by the utility that vary based on demand are collected through a demand charge or kW charge. Accordingly, when customers reduce their demand through energy efficiency or conservation, the customers see a cost reduction and the utility is kept whole. Finally, fixed costs that do not vary based on the kWh or kW (or Mcf) used by a customer are collected as a customer charge, thus keeping the utility whole.

The benefits of cost of service-based pricing are especially evident for unbundled services such as electricity and natural gas. With unbundling, a utility may provide only transportation or distribution services to a particular customer. For many large customers, costs of electric generation distribution or natural gas transportation service do not vary based on consumption. The same is true for large customers taking generation service or receiving natural gas service through dedicated facilities. As a result, ensuring these customers have appropriate cost of service based rates and rate designs would insulate utilities from any financial impacts of conservation, thus ensuring that the

financial incentive for the utility to promote energy efficiency and conservation is properly aligned with the policy goals articulated in Section 410(a).

Fortunately, Pennsylvania has already adopted a ratemaking policy in favor of cost-based allocations and rate design. In fact, the Commonwealth Court has declared that cost of service is the "polestar" for ratemaking.⁷ Cost-based pricing allows a utility to charge rates based upon clearly defined fixed and variable costs, so they will require fewer rate adjustments, thus reducing the need for base rate proceedings. Cost-based pricing sends appropriate price signals to customers and ensures that utilities are not harmed by conservation efforts, thus fully meeting the requirements of Section 410(a).

Section 410(a) also requires examination of the timeliness of recovery for costs of programs. The current ratemaking process in Pennsylvania ensures timely recovery for utilities through the opportunity to file for base rate adjustments. To the extent the costs incurred by a utility to implement a conservation program impair its ability to earn a fair rate of return when considered with all other costs and revenues of the utility, it can file for a base rate increase where all costs, revenues and expenses are considered. Utilities also have discretion regarding the timing of any rate case to ensure that recovery begins shortly after program implementation, and can also seek adjustments to its sales forecast to reflect known and measurable impacts of the program. This process provides sufficiently timely recovery for any program costs.

In short, the Commonwealth's current ratemaking process, with an emphasis on cost of service as the "polestar" for ratemaking: (a) constitutes a general policy that aligns utility financial incentives while helping customers to use energy more efficiently; (b) provides timely cost recovery and earnings opportunities for utilities that are associated with cost-effective measurable and verifiable energy savings; and (c) enhances customers' initiatives to use energy more efficiently. Accordingly, Pennsylvania is fully compliant with Section 410(a) and no further action is necessary at this time.

B. Rate Unbundling

1. Supply Portion of Rates Competitively Procured

Pennsylvania has separated the supply costs from distribution and transmission costs. Generation is competitively procured by retail shopping. EDCs must obtain POLR supply by competitive procurement. NGDCs must obtain gas through least cost mechanisms. Least cost mechanisms foster competitive procurement of supply in Pennsylvania, which assists energy users in seeing the actual costs of supply. Competitive procurement of supply also eliminates many problems in aligning ratemaking policies with energy conservation goals, as base rate cases do not include supply costs.

⁷ See *Lloyd v. Pa. Pub. Util. Comm'n*, 904 A.2d 1010, 1020 (Pa. Cmwlth. Ct. 2006).

2. EDC/NGDC Reconcilable Supply Rate Opportunity

Through the implementation of rate unbundling, the movement to enable direct access by customers to competitive supply alternatives and the authorization for utilities to fully recover all reasonable costs related to the Provider of Last Resort ("POLR") or Supplier of Last Resort ("SOLR") roles, Pennsylvania addresses some of the policy goals of Section 410(a).

a. Electricity Unbundling

Historically, local electric utility companies were responsible for generating or purchasing and delivering electricity to customers' premises. The Electric Generation Customer Choice and Competition Act ("Competition Act") required electric distribution companies ("EDCs") to unbundle transmission, distribution and generation rates for retail customers. *See* 66 Pa.C.S., § 2802(14); *see also* 66 Pa. C.S. §2801-2812. Specifically, the Competition Act provided all customers in Pennsylvania with the opportunity to purchase supply from Electric Generation Suppliers ("EGSs"). 66 Pa. C.S. § 2806(a). The rates charged by EGSs reflect the costs incurred by the EGS in the wholesale market to arrange for the customer's supply service. The electric distribution company ("EDC") is responsible solely for delivering electricity to those customers who shop, and for providing POLR (or default service) supply for those customers who do not buy their electricity from an EGS, or whose EGS fails to provide the promised supply. 66 Pa. C.S. § 2809(e); 52 Pa. Code § 54.184(a). When an EDC acquires electricity for customers not served by an EGS, the EDC is functioning as the "default service provider."

Both the default service regulations and Act 129 allow default service providers to fully recover all reasonable costs associated with supply. The default service regulations state that "costs incurred for providing default service shall be recovered through a default service rate schedule....[and that] [t]he rate schedule shall be designed to recover fully all reasonable costs incurred by the DSP...." Similarly, Act 129 provides that default service providers "shall have the right to recover on a full and current basis...all reasonable costs incurred under this section and a commission-approved competitive procurement plan." 66 Pa. C.S. § 2807(e)(3.9).

b. Natural Gas Unbundling

Similar to the Electric Generation Customer Choice and Competition Act enacted in 1996, the Natural Gas Choice and Competition Act ("Natural Gas Competition Act") was enacted in 1999 and unbundled rates for Pennsylvania's Natural Gas Distribution Companies ("NGDCs"). *See* 66 Pa. C.S. § 2201-2212. Larger customers in Pennsylvania have had the right to purchase gas supplies from competitive suppliers and to have the NGDC transport that gas since the mid 1980's.⁸

More specifically, the Natural Gas Competition Act extended the availability of transportation service to all retail natural gas customers, regardless of size; however, in

⁸ In fact, pursuant to a Petition filed by the Pennsylvania Gas Association for an expedited rulemaking regarding gas transportation, on October 16, 1986, at Docket No. L-860016, the Commission adopted uniform transportation regulations governing natural gas transportation service, codified at 52 Pa. Code §§ 60.1-60.9.

recognition of the satisfactory level of supply competition for Large Commercial and Industrial ("C&I") customers, the Natural Gas Competition Act created a supplier of last resort ("SOLR") obligation for NGDCs that was limited to supply service for residential, small commercial, small industrial and essential human needs customers. *See* 66 Pa. C.S. § 2207(a)(1). In that role and in the role of merchant service provider, NGDCs have reconcilable rate mechanisms under Section 1307 of the Public Utility Code that ensure recovery of all gas commodity costs incurred in the application of an acceptable least cost procurement policy. The majority of larger customers purchase natural gas from natural gas suppliers ("NGSs"), with their rates determined based on the costs incurred by the NGS to obtain the supply in the wholesale market.

NFG

Under Pennsylvania's current ratemaking policies and structures, electric and natural gas unbundling has little or no relevance to the goals and objectives of the ARRA. The neutral section of this report indicates that unbundling has "addressed some of the policy goals of Section 410(a)," but the corresponding summaries of electric and natural gas unbundling fail to provide any facts in support of the bald conclusion that unbundling has achieved some of the policy goals of the ARRA. There is no data or analysis that shows unbundling in Pennsylvania has directly resulted in increased customer conservation or that unbundling has in any way eliminated utility financial disincentives to promote customer conservation. National Fuel's opinion on this issue should not be viewed as opposition to unbundling, rather, we simply fail to see how unbundling furthers the goals set forth in the ARRA, particularly the requirement that the State will ensure that utility financial incentives are aligned with customer conservation.

Unbundling does not change a utility's financial incentives to promote conservation. Unbundling merely separates a utility's distribution costs from energy costs. If the volumetric structure of unbundled rates remains in place there can be no change in a utility's disincentive to promote conservation. If unbundled delivery rates maintain the volumetric recovery of a utility's fixed cost the utility will still have a financial incentive to promote customer energy consumption over conservation. Indeed, it is more likely that unbundling will increase customer energy consumption (all else being held constant), since not only will a utility have the financial incentive to increase customer usage, but so too does the energy supplier.

C. Elimination of Declining Block Rates

The elimination of declining block rates has been promoted by the Commission as a policy that enables customers to use energy more efficiently, consistent with Section 410(1)(a). Previously, under cost of service rate regulation, electricity rates were sometimes designed so that per unit charges decreased as a customer's usage increased. Upon implementation of the Electricity Generation Customer Choice and Competition Act in 1996, and the subsequent creation of a policy statement regarding default service in 2007, the Commission determined that declining block rate structures should no longer be implemented or encouraged. The Policy Statement on Default Service and Retail Electric Markets illustrates this point. Specifically, Section 69.1810 of the Policy Statement provides that "[r]etail rates should be designed to reflect the actual, incurred cost of energy and therefore encourage energy conservation. The [price to

compare] should not incorporate declining blocks, demand charges or similar elements." 52 Pa. Code § 69.1810.

OCA

The OCA supports the Commission's policy of elimination of declining block rates, but emphasizes the point that such elimination should be gradual over time. The elimination of declining block rates is consistent with the last portion of ARRA Section 410(a) that the Commission's policy "sustains or enhances utility customers' incentives to use energy more efficiently." At the same time, the OCA is concerned that a "flash-cut" elimination of such rate structures could produce severe rate shock for some customer groups. The Commission has long recognized this concern and has appropriately implemented this type of rate change on a gradual basis.

OSBA

The Commission's earlier decision, reflected in 52 Pa. Code §§54.187(c) and 69.1810, to phase out demand charges and declining blocks for generation service was exactly the type of action encouraged by Section 410(a) to promote the conservation of electricity. Similarly, the fact that (for the most part) purchased gas costs are recovered on a flat, per unit basis is the type of ratemaking incentive intended by Section 410(a) to conserve natural gas.

C. Alternative Energy Portfolio Standards (AEPS)

1. Technical Reference Manual (TRM) & Total Resource Cost (TRC)

Pennsylvania is already positioned to evaluate energy efficiency measures implemented by electric distribution companies ("EDCs") for their cost-effectiveness and to measure and verify efficiency savings, consistent with Section 410(a)(1). First, the Public Utility Commission has adopted and maintained a Technical Reference Manual ("TRM") as a tool to assess standard energy savings measures implemented by EDCs. Second, as directed by statute, the Commission has defined a Total Resource Cost test ("TRC") to be used to determine the cost effectiveness of energy efficiency and conservation ("EE&C") plans filed by Pennsylvania's larger EDCs.

a. Technical Reference Manual ("TRM")

The Commission first adopted the TRM as part of its implementation of the Alternative Energy Portfolio Standards Act of 2004, 73 P.S. §§ 1648.1 – 1648.8 ("AEPS Act"). The AEPS Act requires EDCs and electric generation suppliers ("EGSs") to include a specific percentage of electricity from alternative energy resources in the generation that they sell to Pennsylvania consumers.⁹ The level of alternative energy required gradually increases according to a 15-year schedule, as set by the AEPS Act and the Commission. The AEPS Act defines "alternative energy sources" as including demand side management ("DSM"), energy efficiency ("EE"), and load management technologies. 73 P.S. §§ 1648.2.

⁹ Implementation of the Alternative Energy Portfolio Standards Act of 2004: Standards for the participation of Demand Side Management Resources, Docket No. M-00051865, Tentative Order at 2-3 (Pa. PUC Oct. 3, 2005)(Oct. 3, 2005 Implementation Order).

The Commission worked in 2005 to establish standards for the verification and tracking of such DSM and EE measures. The Commission adopted the TRM as a “a consistent framework for calculating deemed savings for a menu of energy efficiency measures using supported assumptions and customer data as input values in industry-accepted algorithms.”¹⁰ The TRM covers a menu of energy efficiency measures, such as a consumer’s switch to energy efficient appliances or CFL light bulbs, available to reduce residential, commercial and industrial energy consumption. The Commission refers to these energy savings from standard measures as “deemed savings.” “Deemed savings are ranges of energy savings above standard usage ranges from a particular application or equipment over a given period of time.”¹¹

In adopting the TRM approach, the Commission borrowed from comparable protocols implemented by Vermont and New Jersey. However, in 2005 the Commission and interested parties worked through a collaborative process to make the TRM reflect Pennsylvania-specific information.

With the subsequent passage of Act 129 of 2008, 66 Pa.C.S. § 2806.1, the Commission was charged with establishing energy efficiency and conservation (“EE&C”) programs for Pennsylvania. Specifically, Act 129 requires each EDC with at least 100,000 customers to adopt a plan to reduce energy demand and consumption within its service territory, to meet reduction benchmarks over several years. Act 129 set an aggressive schedule for Commission review and approval of each EDC’s individual EE&C plans. Once the EE&C plans have been approved, Act 129 requires the Commission to monitor and verify the data collection, quality assurance and results of each EDC’s EE&C plan as well as the Pennsylvania program as a whole. 66 Pa.C.S. § 2806.1(a). As part of its Act 129 Implementation Order, the Commission recognized that the TRM will serve a role in both the development of the EDCs’ individual EE&C plans and in the ongoing evaluation of the success of the program.¹² The Commission has updated the TRM to reflect additional energy efficiency technologies and new standard measures, to apply prospectively. By Order entered June 1, 2009, the Commission expanded and updated the TRM to address the dual purpose of implementation of EE&C measures required by Act 129 and continued use in identifying DSM/EE alternative credit amounts for AEPS Act and Act 129 compliance.¹³

Through adoption and modification of the TRM, the Commission has shown a commitment to the development and application of tools to allow for measurement and

¹⁰ Oct. 3, 2005 Implementation Order, at 5.

¹¹ Oct. 3, 2005 Implementation Order, at 5.

¹² Energy Efficiency and Conservation Program, Docket No. M-2008-2069887, Implementation Order at 3 (Pa PUC Jan. 16, 2009)(Act 129 Implementation Order)

¹³ Implementation of the Alternative Energy Portfolio Standards Act of 2004: Standards for the Participation of Demand Side Management Resources – Technical Reference Manual Update, Docket No. M-00051865, Order, (Pa PUC June 1, 2009).

verification of energy efficiency savings when Pennsylvania EDCs and customers implement DSM and EE measures.

b. Total Resource Cost (“TRC”) Test

By statute and Commission orders, Pennsylvania employs a Total Resource Cost (“TRC”) test to evaluate the cost-effectiveness of individual EE&C plans implemented by Pennsylvania EDCs and how well those plans work towards Pennsylvania’s goal of reduction in energy consumption.

As part of the Pennsylvania EE&C programs, Act 129 of 2008 requires each of the larger EDCs “to adopt and implement cost-effective energy efficiency and conservation plans to reduce energy demand and consumption” within their service territory. 66 Pa.C.S. § 2806.1(a). Act 129 directs the Commission to analyze “the cost and benefit of each plan submitted under subsection (b) in accordance with a total resource cost test approved by the commission.” 66 Pa.C.S. § 2806.1(a)(3). Each EDC submitting a plan is required to “demonstrate that the plan is cost effective using a total resource cost test approved by the commission and provides a diverse cross section of alternatives for customers of all rate classes.” 66 Pa.C.S. § 2806.1(b)(1)(i)(H). Section 2806.1(m) defines “Total resource cost test” as “[a] standard test that is met if, over the effective life of each plan not to exceed 15 years, the net present value of the avoided monetary cost of supplying electricity is greater than the net present value of the monetary cost of energy efficiency conservation measures.” 66 Pa.C.S. § 2806.1(m).

In its Act 129 Implementation Order, the Commission further described the TRC to evaluate the cost effectiveness of energy efficiency and demand reduction programs proposed and implemented by Pennsylvania’s larger EDCs. The Commission directed that the TRC test “will take into account the combined effects of a program on both participating and non-participating customers based on the costs incurred by the EDCs and participating customers.”¹⁴ Benefits calculated in the TRC test “will include the avoided supply costs, such as a reduction in transmission, distribution, generation and capacity costs valued at marginal costs for the periods when there is a consumption reduction.”¹⁵ The Commission explained that “avoided supply costs” should be calculated using net program savings costs, and that the persistence of savings over time should be included in the net program savings costs.¹⁶ On the costs incurred side of the TRC test, the Commission stated that costs will include program costs paid by the utility and the participants, as well as any increase in supply costs for the periods in which consumption increased.

Although the Commission had used the California TRC test as a model and starting point, the Commission determined that the Societal Test used as part of the California equation cannot be part of the Pennsylvania TRC. As the Commission explained, “the Societal Test is a variant

¹⁴ Act 129 Implementation Order at 15.

¹⁵ Act 129 Implementation Order at 15.

¹⁶ Act 129 Implementation Order at 15.

of the TRC and goes beyond the TRC test in that it attempts to quantify the change in the total resource costs to society as a whole rather than only the service territory.”¹⁷ The Commission based its decision on the language of Section 2806.1(m) which requires consideration of “the net present value of the avoided monetary costs of supplying electricity...”¹⁸ The Commission determined that the Pennsylvania TRC test “will exclude environmental and societal costs that are not otherwise already embedded in the wholesale costs for the generation of electricity.”¹⁹

The Commission clarified that EDCs should express the results of the TRC test “as both a net present value (‘NPV’) and a benefit-cost ratio (‘B/C ratio’).”²⁰ For the NPV calculation, the Commission directed EDCs to use their after-tax weighted average cost of capital as the appropriate discount rate. The NPV will measure the change in the total resource costs due to the EE&C program, such that an NPV above zero would indicate that the EE&C program is a less expensive resource than the supply option upon which the marginal costs are based.²¹ The B/C ratio will assist the Commission in evaluating the merits of EE&C programs by giving an indication of the rate of return of this program to the utility and its ratepayers. For example, a B/C ratio above one would indicate that the EE&C program is beneficial to the utility and its ratepayers on a total resource cost basis.²²

Pennsylvania’s adoption of a Total Resource Cost Test, by statute and Commission order, provides a uniform standard for evaluation of whether EE&C measures proposed and implemented by EDCs are cost effective over the life of the measures in the EE&C plan. Section 410(a)(1) looks for measures that will sustain or enhance utility customer’s incentives to use energy more efficiently. Pennsylvania’s consideration of both the net present value and benefit-to-cost ratio of EE&C measures are consistent with the goals of Section 410(a)(1) that require measuring and verifying efficiency savings.

2. Demand reduction & energy efficiency in Tier II

The Alternative Energy Portfolio Standards ("AEPS") Act, 73 P.S. §§ 1648.1-1648.8, includes demand-side management as a Tier II alternative energy resource. Specifically, the AEPS Act allows the following types of demand-side management activities (consisting of the management of customer consumption of electricity or the demand for electricity), among others, to qualify as Tier II resources:

¹⁷ Act 129 Implementation Order at 15.

¹⁸ Act 129 Implementation Order at 15-16.

¹⁹ Act 129 Implementation Order at 16.

²⁰ Act 129 Implementation Order at 16.

²¹ Act 129 Implementation Order at 16.

²² Act 129 Implementation Order at 16.

- (i) implementation of energy efficiency technologies, management practices or other strategies in residential, commercial, institutional or government customers that reduce electricity consumption by those customers; and
- (ii) implementation of load management or demand response technologies, management practices or other strategies in residential, commercial, industrial, institutional and government customers that shift electric load from periods of higher demand to periods of lower demand.

73 P.S. § 1648.2(12).

Upon rate cap expiration, all Pennsylvania suppliers (both default service providers and EGSs) must demonstrate that a percentage of their supply sold to retail customers is backed by Tier II resources. This creates a potential revenue stream to customers who pursue qualifying projects, consistent with Section 410(a)'s goals.

OSBA

The Alternative Energy Portfolio Standards (“AEPS”) Act requires that a gradually increasing percentage of electricity sold to retail customers in Pennsylvania by an EDC and an electric generation supplier (“EGS”) be derived from alternative energy sources (Tier I and Tier II sources). *See* 73 P.S. § 1648.3. The AEPS Act classified demand reduction and efficiency conservation as a Tier II source. *See* 73 P.S. §1648.2. An option to put more emphasis on demand reduction and efficiency conservation is to move it from a Tier II source to a Tier I source.

E. Act 129

On October 15, 2008, Governor Rendell signed into law House Bill 2200, or Act 129 of 2008 ("Act 129" or "Act").²³ Among other things, Act 129 expands the Commission's oversight responsibilities and sets forth new requirements on EDCs for energy conservation, default service procurements, the expansion of alternative energy sources, and the inclusion of a smart meter program. Act 129 also establishes prescriptive targets for energy conservation, with the ability to recover costs from ratepayers and a potential fine if the targets are not met.

OCA

Act 129 of 2008 represents a comprehensive effort by the Pennsylvania General Assembly to enact energy efficiency and ratemaking standards for EDCs. The recently completed set of Energy Efficiency and Conservation (EE&C) proceedings represent this Commission’s official response to that statute. In OCA’s view, Act 129 and this Commission’s decisions under that Act are consistent with the standards of Section 410(a), but in any case, they represent the current state of the law for electric utilities in Pennsylvania and cannot be altered by this Commission simply in order to qualify for funding under ARRA Section 410(a).

²³ 66 Pa. C.S. §§ 2806.1 *et seq.*

Act 129 contains a series of “carrots and sticks” that explicitly permits recovery of an EDC’s costs through an automatic reconcilable adjustment clause and allows reduced revenues from conservation to be reflected prospectively in the *pro forma* rate calculations presented in base rate cases. Because energy efficiency usage reduction goals are explicitly mandated in Act 129 – and because utilities can be fined up to \$20 million for failure to meet those goals – the interests of the EDCs are clearly and directly aligned with their customers’ interests in using energy more efficiently. The OCA submits that, when coupled with the automatic current rate recovery of conservation costs permitted in Act 129, the mandate and penalty provisions of the Act meet the requirements of Section 410(a).

Because Act 129 applies only to electric utilities, and not to natural gas utilities, we cannot look to Act 129 for policies regarding natural gas utilities in response to Section 410(a). Nevertheless, the OCA submits that, as set forth below, other provisions of the Public Utility Code provide the Commission with adequate tools to meet the policies of Section 410(a) for natural gas utilities as well.

Industrials

Although Pennsylvania is fully compliant with Section 410(a) for both electric and natural gas services due to its use of cost of service principles as the polestar for ratemaking, Act 129 creates further financial incentives for electric utilities to promote energy efficiency by consumers and electric utilities.

The financial incentives for utilities in Act 129 consist of cost recovery mechanisms from ratepayers for the costs of implementing its programs and penalties to the extent certain benchmarks are not met. Act 129 states that utilities are entitled to recover “all reasonable and prudent costs” associated with energy efficiency and conservation programs up to a cap of 2% of revenues.²⁴ The statute allows utilities to reflect lost sales and revenue during their base rate proceedings, but specifically prohibits revenue decoupling to obtain additional compensation between rate cases.²⁵ On the other hand, the statute also includes financial penalties for utilities that do not achieve the efficiency goals.²⁶ A total of 34 states use similar penalties and/or cost recovery programs with great success, finding that through these programs, utilities “become stronger partners with customers in achieving conservation.”²⁷

Act 129 complies with the mandate in Section 410(a) of the ARRA to have measurable and verifiable efficiency savings. Act 129 requires utilities to “explain how

²⁴ See *id.* § 2806.1 (k)(1).

²⁵ See *id.* § 2806.1 (k)(3).

²⁶ See *id.* § 2806.1 (f).

²⁷ American Gas Association, *Update on Regulatory Approaches to Promoting Energy Efficiency*, NATURAL GAS RATE ROUND-UP, May 2009 at 2.

quality assurance and performance will be measured, verified, and evaluated."²⁸ The PUC will then use these measurements to ensure that utilities are "achieving or exceeding" the required reductions in consumption and demand.²⁹ In addition, Act 129 goes beyond the general requirements of Section 410(a) and mandates efficiency goals for all utilities in Pennsylvania. These efficiency goals consist of a 3% reduction in consumption and a 4.5% reduction in demand by 2013.³⁰

Act 129 contains a key consumer protection in its requirement that the PUC investigate the costs and benefits of an EE&C Program, as well as whether there should be additional required consumption reductions. Specifically, Section 2806.1(c)(3) states:

By November 30, 2013, and every five years thereafter, the Commission shall evaluate the costs and benefits of the Program established under subsection (a) and of approved Energy Efficiency and Conservation Plans submitted to the Program. The evaluation shall be consistent with a total resource cost test or a cost-benefit analysis determined by the Commission. If the Commission determines that the benefits of the program exceed the costs, the Commission shall adopt additional required incremental reductions in consumption.
66 Pa. C.S. § 2806.1(c)(3).

Similarly, Section 2806.1(d)(2) states:

By November 30, 2013, the Commission shall compare the total costs of Energy Efficiency and Conservation Plans implemented under this section to the total savings in energy and capacity costs to retail customers in this Commonwealth or other costs determined by the Commission. If the Commission determines that the benefits of the plans exceed the costs, the Commission shall set additional incremental requirements for reduction in peak demand for the 100 hours of greatest demand or an alternative reduction approved by the Commission. Reductions in demand shall be measured from the electric distribution company's peak demand for the period from June 1, 2011, through May 31, 2012. The reductions in consumption required by the Commission shall be accomplished no later than May 31, 2017.

²⁸ 66 Pa.C.S. § 2806.1 (b)(1)(C).

²⁹ *See id.* § 2806.1 (b)(1)(D).

³⁰ *See id.* § 2806.1 (c), (d).

Id. § 2806.1(d)(2). Thus, at or near the end of the initial plans, the Commission must make a critical determination that the benefits exceed the costs prior to extending either the energy efficiency or demand response plans and establishing new targets.

Act 129 also gives utilities the autonomy and additional resources to create sustainable conservation programs. Although Act 129 given the Commission ultimate approval over the elements of each Plan, utilities have considerable autonomy in the creation of their respective conservation programs. This autonomy will result in programs that are adapted specifically to each utility's respective business models, which will make it easier for utilities to achieve the Commonwealth's efficiency goals. Further, Act 129 provides assistance to utilities through "conservation service providers" to help implement the efficiency programs.³¹

There are several additional provisions of Act 129 that surpass the requirements of Section 410(a). For example, Act 129 mandates the use of smart meter technologies in order to help make energy rates and bills more understandable to consumers, thus increasing customers' ability to actively conserve energy.³² Act 129 also calls for the use of various conservation technologies like solar panels, efficient windows, doors, lighting, and appliances,³³ as well as eventually increasing the use of low-impact hydropower.³⁴

As a result, in addition to Pennsylvania's established policy of using cost of service as the primary factor in ratemaking, Act 129 further buttresses the conclusion that Pennsylvania is fully compliant with Section 410(a).³⁵ Act 129 includes specific conservation and energy efficiency goals, provides cost recovery for utilities and includes significant penalties for utilities that fail to meet Act 129's goals. Further ratemaking gimmicks (such as revenue or rate decoupling) are not warranted for use in Pennsylvania.

1. Energy conservation

Act 129 requires EDCs with more than 100,000 customers to adopt a plan, approved by the Commission, to reduce electric consumption by at least 1% by May 1, 2011, and by at least 3% by May 31, 2013, adjusted for weather and extraordinary loads.³⁶ In addition, by May 31, 2013, peak demand is to be reduced by a minimum of 4.5% of the EDC's annual system peak

³¹ *See id.* § 2806.1 (b)(1)(E).

³² *See id.* § 2807 (f)(1).

³³ *See id.* § 2806.1(m)(2).

³⁴ *See id.* § 2814 (a).

³⁵ Natural gas utilities can rely on Section 1319 of the Public Utility Code for recovery of conservation plan expenses. *See* 66 Pa. C.S. § 1319.

³⁶ 66 Pa. C.S. § 2806.1(c).

demand in the 100 hours of highest demand,³⁷ measured against the EDC's peak demand during the period of June 1, 2007 through May 31, 2008.³⁸ Consistent with the Act, by July 1, 2009, all Pennsylvania EDCs filed with the Commission proposed energy efficiency and conservation ("EE&C") plans.

Act 129 includes cost recovery mechanisms from rate payers for the utilities' cost of implementing Energy Efficiency and Conservation ("EE&C") programs. Act 129 states that utilities are entitled to recover "all reasonable and prudent costs" associated with EE&C programs up to a cap of 2% of revenues. *See* 66 Pa. C.S. § 2806.1(k)(1). However, Act 129 specifically precludes EDCs from recovering decreased revenues due to reduced energy consumption or changes in energy demand via a reconcilable automatic adjustment clause, and instead requires EDCs to pursue recovery of such costs via a base rate case proceeding. 66 Pa. C. S. § 2806.1(k)(2) and (3).

The Commission has interpreted this limitation on the "'total cost of any plan'...as an annual amount, rather than an amount for the full five-year period." Implementation Order at 33. When explaining this expanded interpretation, the Commission continued:

Since the statutory limitation in this subsection is computed based on annual revenues as of December 31, 2006, we believe it is reasonable to require that the resulting allowable cost figure be applied on an annual basis as well. In addition, we note that the plans are subject to annual review and annual cost recovery under the Act, 66 Pa. C.S. §§ 2806.1(h) and (k). Finally, based upon the information presented in the comments and experience in other states, it appears that the statutory goals for consumption and demand savings are not likely to be achievable if the two percent limit was read as applicable to the entire multi-year EE&C program.

Id. at 34 (internal citations omitted).

In accordance with this interpretation, the seven major EDCs' budgets for their respective EE&C Plans are as follows: PPL Electric Utilities Corporation - \$246 million; West Penn Power Company - \$94.25 million; Duquesne Light Company - \$78.2 million; PECO Energy Company - \$341.6 million; Metropolitan Edison Company - \$24.9 million; Pennsylvania Electric Company - \$23.0 million; and Pennsylvania Power Company - \$6.7 million. Pursuant to these plans, these costs will be recovered by a non-bypassable charge, applicable to all ratepayers.

In addition, each of these plans, which have been approved by the Commission, includes a number of programs designed to encourage customers to reduce energy consumption through various incentives. EDCs that do not meet Act 129's targets for energy consumption and/or

³⁷ Consistent with its January 16, 2009, *Energy Efficiency and Conservation Plan Implementation Order* at Docket No. M-2008-2069887 (hereinafter "Implementation Order"), the Commission has adopted the use of 4.5% of the EDC's average of the 100 highest peak hours during the summer months of June, July, August, and September in 2007. Implementation Order, p. 21.

³⁸ 66 Pa. C.S. § 2806.1(d).

peak load demand reductions will be subject to monetary penalties, ranging from \$1 million to \$20 million. *See* 66 Pa.C.S. § 2806.1(f).

With regard to energy conservation, Act 129 also complies with the mandate in Section 410(a) of the ARRA to have measurable and verifiable efficiency savings. Act 129 requires utilities to "explain how quality assurance and performance will be measured, verified, and evaluated." 66 Pa. C.S. § 2806.1(b)(1)(C). The Commission will then use these measurements to ensure that utilities are "achieving or exceeding" the required reductions in consumption and demand. *See* 66 Pa. C.S. § 2806.1(b)(1)(D).

Moreover, Act 129 includes a specific process to determine whether any plan should extend beyond the initial five-year (or 42-month) plans. Specifically, Section 2806.1(c)(3) states:

By November 30, 2013, and every five years thereafter, the Commission shall evaluate the costs and benefits of the Program established under subsection (a) and of approved Energy Efficiency and Conservation Plans submitted to the Program. The evaluation shall be consistent with a total resource cost test or a cost-benefit analysis determined by the Commission. If the Commission determines that the benefits of the program exceed the costs, the Commission shall adopt additional required incremental reductions in consumption.

66 Pa. C.S. § 2806.1(c)(3).

Similarly, Section 2806.1(d)(2) states:

By November 30, 2013, the Commission shall compare the total costs of Energy Efficiency and Conservation Plans implemented under this section to the total savings in energy and capacity costs to retail customers in this Commonwealth or other costs determined by the Commission. If the Commission determines that the benefits of the plans exceed the costs, the Commission shall set additional incremental requirements for reduction in peak demand for the 100 hours of greatest demand or an alternative reduction approved by the Commission. Reductions in demand shall be measured from the electric distribution company's peak demand for the period from June 1, 2011, through May 31, 2012. The reductions in consumption required by the Commission shall be accomplished no later than May 31, 2017.

Id. § 2806.1(d)(2).

Thus, at or near the end of the initial plans, the Commission must make a critical determination that the benefits exceed the costs prior to extending either the energy efficiency or demand response plans and establishing new targets.

NFG

Some parties to this proceeding argue, incorrectly, that Act 129 adequately aligns utility financial incentives with customer conservation. Act 129 requires EDC's to implement an energy conservation plan and in that respect it is consistent with the goals of the ARRA. Contrary to the express goals of the ARRA, Act 129 does not seek to align the financial incentives of EDCs with customer conservation but instead seeks to force compliance upon EDCs under the threat of fines and penalties if target goals are not met. Fines and penalties are not financial incentives, they are pecuniary punishment. They reflect the very status quo ratemaking model that the ARRA seeks to change. Additionally, Act 129 fails to provide for a rate mechanism to allow EDCs to accomplish the goals of the Act in a quick efficient manner. It also fails to align EDC financial incentives with customer conservation initiatives because Act 129 expressly precludes recovery of lost revenue due to reductions in demand (*i.e.*, it precludes a RDM for electric utilities). 66 Pa. C.S. § 2806.1(k)(2). The only conclusion to be drawn from a review of Act 129 in light of the goals of the ARRA is that Act 129 does not comply with ARRA but instead stands as a major obstacle to implementing the ARRA as to electric utilities.

Columbia Gas

Columbia echoes NFG's comments above. While Act 129 may promote energy efficiency measures to be taken by EDCs, it expressly prohibits recovery of lost revenues. This is inconsistent with the ARRA's charge to the Commonwealth in aligning utility financial incentives with customer energy conservation. It has been suggested by at least one party in this report that no incentives for EDCs are needed because Act 129 mandates that EDCs pursue conservation. While this statement is factually true, it is not what the ARRA requires in exchange for federal stimulus funds. Prohibiting recovery of lost revenues flies in the face of aligning utility financial incentives. That being said, recovery of lost revenues is not prohibited for NGDCs, as Columbia and the rest of the stakeholders discuss in future sections of this report.

OSBA

Act 129 of 2008 charges the Commission with establishing an energy efficiency and conservation program. *See* 66 Pa. C.S. §2806.1(a). Act 129 also directs each EDC with at least 100,000 customers to file an energy efficiency and conservation plan ("EE&C plan") with the Commission for review and approval. *See* 66 Pa. C.S. §2806.1(b) and (l).

The following EDCs filed an EE&C plan with the Commission: PPL Electric Utilities ("PPL") at Docket No. M-2009-2093216; PECO Energy Company ("PECO") at Docket No. M-2009-2093215; Metropolitan Edison Company ("Met-Ed") at Docket No. M-2009-2092222; Pennsylvania Electric Company ("Penelec") at Docket No. M-2009-2112952; Pennsylvania Power Company ("Penn Power") at Docket No. M-2009-2112956; Duquesne Light ("Duquesne") at Docket No. M-2009-2093217; and West Penn Power Company d/b/a Allegheny Power ("Allegheny Power") at Docket No. M-2009-2093218. The Commission approved EE&C plans for the above-listed EDCs and is currently reviewing proposed changes in those plans believed (by the EDCs) to be

necessary to achieve the reductions in energy demand and consumption required by Act 129.

Unlike Sections 2806.1 and 2807(f) with regard to electric conservation, the General Assembly has not provided detailed requirements and parameters for gas conservation. Similar to Section 2804(9) for EDCs, Section 2203(8) provides legal authority for energy conservation programs aimed at low-income and payment-troubled residential customers. However, any effort by the Commission to mandate conservation programs for other customers of NGDCs and any effort by NGDCs to establish such programs for other customers on a voluntary basis must rely on Section 523(b)(4), Section 1319, or Section 1505(b) for statutory authorization. Therefore, an NGDC is permitted to implement a conservation plan (for other than low-income and payment-troubled residential customers) only after the Commission has determined that the plan is “prudent and cost-effective” and is permitted to recover only those costs which are “prudent” and “reasonable.” If the Commission is interested in promoting gas conservation, the Commission should establish generic rules for gas conservation plans rather than develop those rules through case-by-case litigation.

2. Smart meters and time-of-use rates

In addition to requiring EDCs to achieve reductions in energy consumption and peak demand by 2013, Act 129 also required jurisdictional electric distribution companies with more than 100,000 customers to submit for approval a smart meter plan. *See* 66 Pa. C.S. §§ 2807(f)(1-4). In addition to availing customers with the information needed in order to directly react to price signals, Act 129 also required that, as part of these programs, EDCs must, "with customer consent, make available direct meter access and electronic access to customer meter data to third parties, including electric generation suppliers and providers of conservation and load management services." *Id.* at §2807(f)(3).

Moreover, while Act 129 generally allows EDCs to recover "reasonable and prudent costs of providing smart meter technology" through base rates or through a reconcilable automatic adjustment clause under Section 1307, *see* 66 Pa.C.S. § 2807(7), Act 129 specifically prohibits the recovery of lost or decreased revenues by EDCs due to reduced electricity consumption or shifting energy demand. *See* 66 Pa. C.S. § 2807(4).

Another policy instituted by the General Assembly that allows for real price signals and direct reaction by consumers to use energy more efficiently is the requirement in Act 129 that all default service providers must submit time-of-use ("TOU") rates and real-time price plans. *See* 66 Pa. C.S. § 2807(f)(5). These TOU rates and real-time price plans must be optional for residential or commercial customers, and the results of these plans must be tracked by EDCs. Specifically, EDCs are required to submit annual reports that document the efficacy of these programs in affecting energy demand and consumption and what effect these programs have on wholesale market prices. *See* 66 Pa. C.S. § 2807(5). Such provisions are in line with Section 410(a)'s goal to have measurable and verifiable energy savings.

OSBA

Each EDC with at least 100,000 customers was required to file a smart meter technology procurement and installation plan (“SMIP”) with the Commission pursuant to Act 129 of 2008. *See* 66 Pa. C.S. §2807 (f)(1).

The following EDCs filed a SMIP with the Commission: PECO at Docket No. M-2009-2123944; PPL at Docket No. M-2009-2123945; Duquesne at Docket No. M-2009-2123948; Allegheny Power at Docket No. M-2009-2123951; and Met-Ed, Penelec, and Penn Power at Docket No. M-2009-2123950. The Commission has approved all EDC SMIP’s except for Allegheny Power. The Commission is now waiting to assess the effect that SMIPs have on energy conservation.

Act 129 also required that by January 1, 2010, or at the end of the generation rate cap period whichever is later, an EDC must submit one or more proposed time-of-use rates and real-time price plans. *See* 66 Pa. C.S. §2807(f)(5).

The OSBA is skeptical about the extent to which real-time pricing would actually change consumption by small businesses. For example, a restaurant needs to operate its heat and its air conditioning during the hours it is serving customers, even if that is the period in which market electricity prices are near their highest. Although real-time pricing might persuade such a small business to invest in more efficient heating and cooling, that business is unlikely to be able to shift consumption off-peak in order to avoid paying higher prices.

Before the Commission extends the real-time pricing requirement to small businesses, it should thoroughly research the possibility that hourly pricing for Large Commercial and Industrial (“Large C&I”) customers of Duquesne, PPL, and Penn Power have not significantly changed consumption patterns but, rather, have simply forced those customers to absorb higher prices or to purchase fixed-price service from an EGS. If hourly pricing has not significantly altered consumption patterns for Large C&I customers, it is unlikely that hourly pricing would alter the consumption patterns of small businesses, which generally have lower total energy costs than Large C&I customers.

3. Reflection in a base rate case of lost revenues from conservation programs

Act 129 allows electric utilities to reflect decreased revenue from reduced energy consumption in the revenue and sales data used to calculate rates in their base rate proceedings, but specifically prohibits lost revenue recovery to obtain additional compensation between rate cases. *See* 66 Pa. C.S. § 2806.1(k)(2) and (3). As noted above, a similar provision is included for utilities' recovery of costs associated with smart meter programs. *See* 66 Pa. C.S. § 2807(f)(4).

NFG

See National Fuel’s comments to Section VII. of this report for a full discussion regarding the use of base rate case filings as the means to recover lost revenues due to the implementation of conservation programs.

E. Low Income Energy Conservation Programs including LIURP

Pennsylvania's Public Utility Code and regulations directly promote weatherization and other energy conservation measures for the benefit of low income consumers. In the 1980s, the Commission established the requirement that each electric and natural gas utility implement usage reduction programs for their low income customers, programs that have become known as the Low Income Usage Reduction Program (LIURP). 52 Pa. Code Chapter 58. Section 58.1 of the Commission's regulations makes clear that such LIURP efforts are to assist low income consumers in conserving energy and to also reduce demand for electricity and gas overall as well as during periods of peak demand. Section 58.1 states:

This chapter requires covered utilities to establish fair, effective and efficient energy usage reduction programs for their low income customers. The programs are intended to assist low income customers conserve energy and reduce residential energy bills. The reduction in energy bills should decrease the incidence and risk of customer payment delinquencies and the attendant utility costs associated with uncollectible accounts expense, collection costs and arrearage carrying costs. The programs are also intended to reduce the residential demand for electricity and gas and the peak demand for electricity so as to reduce costs related to the purchase of fuel or of power and concomitantly reduce demand which could lead to the need to construct new generating capacity. The programs should also result in improved health, safety and comfort levels for program recipients.
52 Pa. Code § 58.1.

Later, as Pennsylvania undertook the restructuring of its electric industry to introduce retail choice for customers, and expanded retail choice for its natural gas customers in 1996 and 1999, respectively, the Pennsylvania General Assembly took care to ensure the continuation of these energy conservation programs and to ensure the full and current recovery of dollars spent on the programs. 66 Pa.C.S. §§ 2802(17); 2804(8) and (9); and 2203(6), (7), and (8). Thus, as part of Pennsylvania's move to competitive markets for electric generation, Sections 2802(17) and 2804(8) continued Pennsylvania's "universal service and energy conservation policies, protections and services, and full recovery of such costs" through a cost recovery mechanism designed to fully recover the electric utility's costs over the life of the programs. 66 Pa.C.S. §§ 2802(17), 2804(8). As part of the natural gas retail choice law, the General Assembly ensured that universal service and energy conservation programs are appropriately funded, are available in the territory of each natural gas distribution company, and operated to help low income consumers reduce energy consumption to make natural gas service more affordable. 66 Pa.C.S. §§ 2203(6), (7), and (8). These programs are to be operated in a cost-effective manner and natural gas distribution utilities are allowed to fully recover these program costs through a cost-recovery mechanism. Id.

As approved by the Commission, electric distribution companies and natural gas distribution companies have implemented LIURP measures to assist consumers with household

incomes below 200 percent of federal poverty guidelines, with the majority of assistance designated for households below the 150 percent of federal poverty level mark. Low income consumers with the highest energy consumption are given priority, as they offer the greatest potential for bill reduction and energy conservation. LIURP measures may address reduction of heating demand, water heating demand or other household energy consumption such as lighting. LIURP assistance is available to consumers, whether homeowners or renters. This way, LIURP assists in reduction of energy consumption and improvement of the quality of housing stock. LIURP measures offer both immediate and long-term benefits to the consumer, the utility, and the public.

A January 2009 study of Pennsylvania's LIURP programs found that since 1988, over \$330 million has been spent on weatherization treatments for more than 292,071 households. Long Term Study of Pennsylvania's Low Income Usage Reduction Program, John Shingler, Consumer Services Information Project, Penn State University (January 2009).³⁹ In the most recent reporting year of 2008, Pennsylvania residential ratepayers have supported the LIURP programs at an annual level of about \$30.5 million, reaching approximately 24,072 low income homes annually with some form of energy efficiency service. 2008 Pennsylvania PUC Bureau of Consumer Services Universal Service Report, pp. 32-34.⁴⁰

Act 129 of 2008 reflects Pennsylvania's continued commitment to aid low income households in reducing their energy consumption and to reduce their energy bills. Section 2806.1(b)(1)(G) requires each EDC's EE&C plan to "include specific energy efficiency measures for households at or below 150% of the Federal poverty guidelines." 66 Pa.C.S. § 2806.1(b)(1)(G). As Act 129 makes clear, these specific energy efficiency measures are to be coordinated with other existing programs designed to assist low income consumers in conserving energy. *Id.* Act 129 specifies that the expenditures to meet this Section 2806.1(b) requirement are in addition to the EDC's expenditures to support LIURP. *Id.*

Pennsylvania electric distribution and natural gas distribution utilities already have cost-effective LIURPs that provide low income consumers with support to allow for weatherization to reduce energy consumption. Additionally, Act 129 of 2008 requires EDCs to implement energy efficiency measures designed to further assist low income consumers in reducing energy consumption. As provided by the Pennsylvania Public Utility Code, full and timely cost recovery for these programs is provided through reconcilable surcharge mechanisms.

NFG

LIURP is consistent with the ARRA in that one of its goals is to achieve energy efficiency/conservation for customers. However, the efficiency and conservation goals of the ARRA are not limited to just low income customers, so LIURP represents only partial compliance with ARRA's goals because the majority of utility residential customers are not eligible to participate in and receive the benefits of the programs. Furthermore, LIURP does nothing to ensure that utility financial incentives are aligned with customer

³⁹ Available at http://www.puc.state.pa.us/general/publications_reports/pdf/PSU-LIURP_Report2008.pdf

⁴⁰ Available at http://www.puc.state.pa.us/general/publications_reports/pdf/EDC_NGDC_UniServ_Rpt2008.pdf

conservation. While it is true that utilities can obtain recovery of prudent program expenses, no aspect of these programs is designed to address the revenue loss utilities will experience from LIURP programs that successfully reduce customer energy consumption. Thus, contrary to the objectives of the ARRA, the end result of LIURP programs is financial harm to the utilities.

F. Existing Authority for Commission to Implement Policies

- **66 Pa. C.S. § 1319 Recovery of conservation expenses;**
- **66 Pa. C.S. § 523(b)(4) Conservation; and**
- **66 Pa. C.S. § 1505(b).**

The Commission's authority to require utilities to implement conservation measures and recover appropriate costs in rates is found in several provisions of the Public Utility Code. Both the Commission and the General Assembly have long recognized the importance of energy conservation and energy efficiency measures to Pennsylvania's future. In 1986, the General Assembly included several provisions in the Pennsylvania Public Utility Code to address the implementation of energy conservation measures by electric and natural gas utilities, to provide for timely cost recovery of any implemented measures, and to provide for performance factor considerations related to actions (or failure to act) to encourage the development of conservation and load management measures. Specifically, through the 1986 amendments known as Act 114 of 1986, the following sections were included in the Public Utility Code:

Section 1505(b) - Authority to order conservation and load management:

This section provides that the Commission may order the utility to establish a conservation and load management program as part of determining or prescribing safe, adequate and sufficient service.

Section 1319 - Financing of energy supply alternatives (specifically conservation and load management programs): This section provides for the recovery of prudent and reasonable costs of conservation and load management programs.⁴¹

Section 523(b)(4) - Performance factor considerations related to conservation and load management: This section provides for consideration for actions or failure to act to encourage the development of

⁴¹ The PUC may allow recovery of prudent and reasonable costs for developing, managing, financing and operating conservation programs through a surcharge. Pursuant to Section 1319 of the Public Utility Code, 66 Pa. C.S. § 1319, the Commonwealth Court held that capital costs of construction or expansion of facilities may not be recovered through a surcharge. Instead, under Section 1319, such capital costs and additions to utility plant must be determined to be used and useful in the course of setting just and reasonable base rates. Pennsylvania Indus. Energy Coalition v. Pa. P.U.C., 653 A.2d 1336, 1346-47, *aff'd per curiam*, 670 A.2d 1152 (Pa. 1996) (PIEC), citing 66 Pa.C.S. §§ 1315, 1319.

cost effective conservation and load management programs when determining just and reasonable rates.⁴²
66 Pa. C.S. §§523(b)(4), 1319, 1505(b).⁴³

The Commission implemented its Chapter 58 LIURP regulations based in part on its Section 1505(b) authority. More recently, in implementing the provisions of Act 129, the Commission reminded EDCs that “it continues to have all the powers provided it by the Public Utility Code to regulate jurisdictional utilities' management practices, including the management of any program related to an energy efficiency and conservation plan,” citing Section 1505(b) as an example.⁴⁴

Columbia Gas

Section IV primarily deals with electric distribution companies (“EDCs”), the Alternative Energy Portfolio Standards (“AEPS”) and Act 129. Columbia offers its position on Subpart F only—“Existing Authority for Commission to Implement Policies.”

Columbia agrees that the court in PIEC did not address the issue of recovery of lost revenues and, therefore, no legal precedent exists that would preclude the Commission from reviewing/approving an RDM or similar ratemaking change for gas utilities under 66 Pa. C.S. §1307(a). However, Columbia respectfully submits that in PIEC, the Court opined the issue of lost revenue recovery was not yet ripe for determination and remanded that portion of the December 12, 1993 order to the Commission for reconsideration. No subsequent consideration has occurred. Although there is little guidance on the issue of lost revenue recovery from prior case law, the December 12, 1993 order set forth that lost revenues would appropriately be recovered through a balancing account included in a base rate proceeding rather than through a surcharge mechanism, providing little confidence in potential Pa. C.S. §1307(a) recovery.

⁴² Rate adjustments allowed by Section 523(b)(4) to reflect utility management’s performance in implementing of energy efficiency and conservation plans are addressed in setting just and reasonable base rates, not through a surcharge mechanism. PIEC, 653 A.2d at 1351. However, for purposes of implementing the objectives of ARRA, we note that the court in PIEC did not address the issue of recovery of lost revenues and therefore there is no legal precedent that would preclude the Commission from reviewing/approving an RDM or similar ratemaking change for gas utilities under 66 Pa. C.S. § 1307 (a). Id. at 1352.

⁴³ The OCA would also note that Section 524 requires electric utilities to supply data to the Commission on, among other things, the potential for promoting and ensuring the full utilization of all practical and economical energy conservation and how the utility has integrated demand-side measures in its resource mix. 66 Pa.C.S. §524(a)(3) and (4). While many of the requirements of Section 524 have become inapplicable as a result of restructuring, these reports are still required to be filed with the Commission. Additionally, Section 511.1 authorizes the Commission to apply for the use of federal funds related to energy conservation research and development. 66 Pa.C.S. §511.1.

⁴⁴ Re Implementation of Act 129 of 2008, Phase 2 – Registry of CSP Providers, Docket No. M-2008-2074154, Final Order at 10 (Pa PUC Feb. 5, 2009).

Conversely, there are no provisions in 66 Pa. C.S. §1308 that preclude the Commission from adopting rate designs that remove the link between a utility's allowed revenues and earnings and its customers' energy consumption levels. Because utility revenues and earnings are linked to energy consumption, current rate structures typical in Pennsylvania encourage utilities to promote energy consumption and send perverse price signals to customers regarding the cost of delivering energy. As society's goals regarding the consumption of energy has changed, and as the utility industry itself has transformed and unbundled over the last several decades, so must the application of rate policies by regulators. In order to encourage the most efficient use of energy, rate structures differentiating the *service* of delivering the energy to the consumer from the *product* that is being delivered must be established.

Columbia submits that rate structures differentiating the *service* of delivering the energy to the consumer from the *product* that is being delivered are readily recognized by credit reporting agencies and investors. The reporting agencies understand the importance of revenue certainty and non-volumetric rate structures to a utility's financial health, and that the lack of opportunities for timely and more certain recovery of costs can discourage investors from investing. Without adequate ratemaking mechanisms that address these issues, utilities such as Columbia are forced to file more frequent base rate cases to reflect new investments and the effects of continuing energy efficiency and conservation by its customers. The investment community takes note of these financial hurdles as evidenced by the comments provided to the Commission by Richard Cortright, Managing Director in the Utilities & Infrastructure Practice of Standard & Poor's Ratings Services during the Commission's November 19, 2009 Technical Conference in this docket. At the technical conference Mr. Cortright stated "we as a rating agency will be closely focused on the various recovery mechanisms that regulators establish to enable utilities to recover their costs—in particular those costs over which they have little to no control—on a timely basis."⁴⁵ Mr. Cortright continued: "To the extent that a commission has established recovery mechanisms such as the various trackers noticed on this slide, as well as decoupling mechanisms, we would view a commission as being supportive of and attentive to the creditworthiness of a utility."⁴⁶

Rates for delivery service should reflect the fact that a utility's delivery service costs are fixed and do not vary by the level of consumption, while rates for the commodity product should reflect the fact that the commodity costs are variable and therefore should continue to be priced to customers on a volumetric basis.

⁴⁵ *American Recovery and Reinvestment Act Technical Conference* ("ARRA Technical Conference"), PUC Docket No. I-2009-2099881 (Nov. 19, 2009) (Standard & Poors Comments at 3; Transcript of Record at 99).

⁴⁶ *ARRA Technical Conference*, (Standard & Poors Comments at 3; Transcript of Record at 100).

NFG

66 Pa. C.S. § 1319, Recovery of Conservation Expenses

Section 1319 of the Code grants utilities the right to voluntarily establish conservation or load management programs and it also grants the Commission the authority to order a gas or electric utility to implement a conservation or load management program. However, the Commission's authority is not without limitations. The plain language of the statute indicates that cost recovery for these programs is not limited to base rates.

Following is the complete statutory provision:

66 Pa. C.S. § 1319. Financing of energy supply alternatives

(a) RECOVERY OF CERTAIN ADDITIONAL EXPENSES.--

If:

(1) a natural gas or electric public utility elects to establish a conservation or load management program and that program is approved by the commission after a determination by the commission that the program is prudent and cost-effective; or

(2) the commission orders a natural gas or electric public utility to establish a conservation or load management program that the commission determines to be prudent and cost-effective:

the commission shall allow the public utility to recover all prudent and reasonable costs associated with the development, management, financing and operation of the program, provided that such prudent and reasonable costs shall be recovered only in accordance with appropriate accounting principles. Nothing in this section shall permit the recovery of costs in a manner prohibited by section 1315 (relating to limitation on consideration of certain costs for electric utilities). Nothing in this section shall permit the recovery of the cost of producing, generating, transmitting, distributing or furnishing electricity or natural gas.

(b) OPTION FOR RECOVERY.-- The commission may consider allowing the recovery of those costs permitted to be recovered by subsection (a) through charges to those persons who are participants in the financing program.

Subparagraphs (a)(1) and (a)(2) of the statute grant utilities the right to voluntarily implement conservation or load management programs and grants the Commission the right to order gas and electric utilities to implement such programs. However, conservation or load management programs, whether voluntary or involuntary, must be "prudent and cost-effective" and as long as a program is prudent and cost-effective, the

Commission is required to allow the utility to recover its costs. Id. Regarding the method for recovering the costs of such programs, the statute states nothing about base rates being the sole vehicle for recovery. Actually, the plain language of the statute infers that the opposite is true.

Subsection (b) of the statute states that the Commission may allow recovery through “charges” to the participants in the program. So in subsection (b) the legislature is addressing cost recovery and had the opportunity to expressly state that these charges could only be recovered in base rates, but instead it opted for the more vague term “charges.” This indicates that the legislature intended to grant the Commission broad discretion to allow for various ratemaking designs to accomplish full cost recovery under the statute. Had the legislature intended to limit recovery to a base rate proceeding, it would have expressly stated that these costs could only be recovered via base rates. However, as is clear from the plain language of the statute, no such limitation exists, and therefore, the Commission is free to allow cost recovery for conservation programs implemented pursuant to § 1319 via a surcharge mechanism rather than requiring implementation only through a base rate proceeding. See, PIEC v. Pa.PUC, 653 A.2d 1336, 1349 (Pa.Cmwlth. 1995).

66 Pa. C.S. § 523(b)(4) Conservation

The plain language of 66 Pa. C.S. § 523(b)(4) does not require that the costs of conservation and load management programs be recovered only through base rates. Following is the complete language of the statute:

66 Pa. C.S. § 523. Performance factor consideration

(a) **CONSIDERATIONS.**-- The commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.

(b) **FIXED UTILITIES.**-- As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:

- (1) Management effectiveness and operating efficiency as measured by an audit pursuant to section 516 (relating to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.
- (2) Action or failure to act pursuant to section 514 (relating to use of coal) to upgrade capability to use coal for electric utilities.
- (3) Efficiency and cost-effectiveness of generating capacity for electric utilities.
- (4) Action or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management, cogeneration or small power production for electric and gas utilities.
- (5) Action or failure to act to encourage cost-effective conservation by customers of water utilities.
- (6) Action or failure to act to contain costs of constructing new generating units consistent with sections 515 (relating to construction cost of electric generating units) and 1308(f) (relating to voluntary changes in rates).
- (7) Any other relevant and material evidence of efficiency, effectiveness and adequacy of service.

The plain language of § 523 makes absolutely no reference to “base rates” and it certainly does not state that base rates (or any other rate design) is the only means by which a utility may recover costs related to conservation or load management programs. Certain parties to this proceeding will argue that the Court’s ruling in *Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission* (“*PIEC*”) precludes cost recovery, for at least conservation program incentives, outside of a base rate proceeding. *PIEC v. Pa.PUC*, 653 A.2d 1336, 1353 (Pa.Cmwlth. 1995). However, due to certain flaws in the Court’s decision in *PIEC*, the ruling should be narrowly construed.

The Court in *PIEC* failed to review and analyze § 523 in accordance with the rules of statutory construction. When analyzing a statute, the Court is guided by the *Statutory Construction Act*, 1 Pa. C.S. § 1501 *et seq.* *Com. v. Walls*, 926 A.2d 957, 962 (Pa. 2007). The goal of statutory construction is to “ascertain and effectuate the intent of the General Assembly.” 1 Pa. C.S. § 1921 (a). When interpreting a statute, the Court cannot ignore the plain words in the statute, so the language employed by the General Assembly is the best indication of its intent. *See, Milk Control Commission v. Penn Fruit Co.*, 188 A.2d 705, 708 (Pa. 1963) and *Com. v. Walls*, 926 A.2d at 962. When the letter of the statute is clear and unambiguous, the Court is not free to engraft additional verbiage upon it in a

supposed effort to pursue its spirit. In re: Incorporation of the Borough of Bear Creek Village, 616 A.2d 111, 117 (Pa. Cmwlth. 1992) citing 1 Pa. C.S. § 1921 and In re Estate of Fox, 431 A.2d 1008 (Pa. 1981). Therefore, the Court will only consider other aspects of the statute and the statutory process when the words of the statute are not explicit. Com. v. Walls, 926 A.2d at 962; see also, 1 Pa. C.S. § 1921(c).

The brief legal discussion regarding § 523 in the *PIEC* decision is void of any statutory construction analysis. Although the Court emphasized the phrase “when determining just and reasonable rates” in its discussion, it did not explain the legal grounds for concluding that this language in § 523 somehow limits the establishment of conservation incentives to base rate proceedings. Clearly the Court did not arrive at that conclusion based on the plain language of the statute because the plain language makes absolutely no reference to base rates. This would infer that the Court, following rules of statutory construction, must have determined that the language was ambiguous and required consideration of matters beyond the plain language of the statute. However, no such analysis exists in the Court’s opinion. Aside from the plain language of the statute the only other documentation considered by the Court is discussed briefly in footnote 18, where the Court acknowledged that it had not previously addressed § 523 but that the Commission had previously granted incentives in rate cases. PIEC, at 1351. So, the Court appears to be giving deference to Commission precedent.

It is well settled that “the construction of a statute by those charged with its execution and application is entitled to great weight and should not be disregarded or overturned except for cogent reasons, and unless it is clear that such construction is erroneous.” Spicer v. Com. Dept. of Public Welfare, 428 A.2d 1008, 1009 (Pa.Cmwlth. 1981) *quoting* Longo Liquor License Case, 132 A.2d 899, 901 (Pa. Super. 1957). Although it attempted to apply this legal maxim in *PIEC*, the Commission precedent relied upon by the Court does not address the issue that was before it. The Court cited to two decisions of the Commission in support of its conclusion that § 523 requires that conservation incentives can only be established via a base rate case. However, in reviewing one of those decisions, Pa. PUC v. Met. Ed. Co., 141 P.U.R. 4th 336 (1993), nowhere does the Commission interpret § 523 as being applicable only in the context of a base rate proceeding.⁴⁷ Similarly the Commission makes no general statement that conservation incentives can only be raised within the context of a base rate proceeding. Simply stated, there is no discussion by the Commission about the rate mechanisms that § 523 applies to. The Commission’s discussion involves only the formulation of performance criteria that would facilitate implementation of § 523 and the evidence presented regarding Met-Ed’s performance. Id. at 405-406. As there is no discussion about rate mechanisms in the decision, the Court’s reliance on the Met-Ed decision is questionable.

The flaws in the Court’s analysis and the limited discussion regarding incentives indicate that the *PIEC* decision may be distinguished from future cases and should be narrowly construed. The Court’s decision in *PIEC* was limited to conservation program

⁴⁷ The other decision, Pa. PUC v. West Penn Power Co., (Dkt. No. R-000922378, filed May 14, 1993) was not available electronically.

incentives under § 523, and the Court did not rule on the recovery of lost revenues, which clearly remains an open issue.

66 Pa. C.S. § 1505(b)

Section 1505(b) is a statutory provision granting the Commission authority to order utilities to establish a conservation or load management program, however, the statute is silent as to cost recovery and methods of cost recovery. Following is the complete statutory provision:

66 Pa. C.S. § 1505. Proper service and facilities established on complaint;
authority to order conservation and load management programs

(a) GENERAL RULE.-- Whenever the commission, after reasonable notice and hearing, upon its own motion or upon complaint, finds that the service or facilities of any public utility are unreasonable, unsafe, inadequate, insufficient, or unreasonably discriminatory, or otherwise in violation of this part, the commission shall determine and prescribe, by regulation or order, the reasonable, safe, adequate, sufficient, service or facilities to be observed, furnished, enforced, or employed, including all such repairs, changes, alterations, extensions, substitutions, or improvements in facilities as shall be reasonably necessary and proper for the safety, accommodation, and convenience of the public.

(b) AUTHORITY TO ORDER CONSERVATION AND LOAD MANAGEMENT.-- In determining or prescribing safe, adequate and sufficient services and facilities of a public utility, the commission may order the utility to establish a conservation or load management program that the commission determines to be prudent and cost-effective.

Although § 1505 does not expressly mention cost recovery or methods for cost recovery, it does require the Commission to determine that a conservation or load management program implemented by a utility is “prudent and cost-effective.” This language implies that cost recovery is permitted but provides no guidance regarding the ratemaking methods that may be utilized to recover costs. The fact that the statute is silent as to cost recovery indicates that the Commission has broad discretion to allow cost recovery outside of a base rate case in order to achieve the purpose of the statute.

OSBA

Section 410(a) of the Recovery Act does not provide legal authority for the Commission to implement conservation measures and associated cost recovery mechanisms unless those conservation measures and cost recovery mechanisms are authorized by existing state law. Sections 523(b)(4), 1319, 1505(b), 2802, 2804(9), 2806.1(k)(2) and (3), and 2807(f)(4) of the Public Utility Code, 66 Pa. C.S. §§ 523(b)(4), 1319, 1505(b), 2802, 2804(9), 2806.1(k)(2) and (3), and 2807(f)(4), address conservation measures and utility cost recovery under existing state law.

Section 523(b)(4) provides for performance factor considerations related to conservation and load management. Specifically, this section provides for consideration of an action or a failure to act to encourage the development of cost-effective conservation and load management programs when determining just and reasonable rates.

Section 1319 authorizes NGDCs and EDCs to establish conservation or load management programs, either voluntarily or upon order of the Commission. Before implementation, the Commission must determine that the program is “prudent and cost-effective.” If the Commission makes such a determination, the Commission is to allow recovery of “prudent and reasonable costs.” However, the NGDC or EDC may not recover Construction Work in Progress or costs of producing, generating, transmitting, distributing, or furnishing electricity or gas.

Cost recovery must be “in accordance with appropriate accounting principles.” Arguably, that means (at least) that costs must be recovered on a class-specific basis in accordance with the principle of cost causation. In addition, the Commission is explicitly permitted to “consider” imposing the costs on only participating customers. Therefore, by implication, the Commission is also permitted to impose the costs on non-participating customers.

Section 1505(b) authorizes the Commission to order any utility (including an NGDC or an EDC) to establish a conservation or a load management program. Although Section 1505(b) does not set as many parameters as Section 1319 does, Section 1505(b) contains the same requirement that the Commission determine that the plan is “prudent and cost-effective.”

Section 2802 states the General Assembly’s findings and declares the General Assembly’s intent in enacting the Electricity Generation Customer Choice and Competition Act (“Electric Competition Act”). Although Section 2802 is a guide to determining legislative intent in interpreting the other sections of the Electric Competition Act, Section 2802 arguably does not provide independent legal authority for establishing conservation programs.

Section 2802(17) does state the General Assembly’s intent that energy conservation programs should be continued if they were in existence when the Electric Competition Act was enacted, but it is Section 2804(9) which puts that intent into action. However, even if Section 2802(17) can be construed as substantive authority, it does not empower the Commission to order EDCs to establish *new* conservation programs. Furthermore, because of the definition of “universal service and energy conservation” in Section 2803 of the Public Utility Code, 66 Pa. C.S. §2803, any conservation programs continued by authority of Section 2802(17) are available only to low-income customers.

Section 2804(9) requires the Commission to “ensure that universal service and energy conservation policies, activities and services are appropriately funded and available in each electric distribution territory.” The requirement in Section 2804(9) constitutes authority for energy conservation programs without regard to whether or not they

preceded the enactment of the Electric Competition Act. However, because of the definition of “universal service and energy conservation” in Section 2803, those programs must be limited to low-income customers.

Section 2804(9) preserves for the Commission the authority to determine what level of funding is “appropriate” and requires the Commission to ensure that the programs are “cost-effective.” Section 2804(9) also authorizes the Commission to impose the costs of such energy conservation programs on both shopping and non-shopping customers.

Section 2806.1 requires EDCs to establish conservation plans. In view of the explicit and detailed requirements and parameters in Section 2806.1, there is no apparent reason for the Commission to rely on other sections of the Public Utility Code as authority for electric conservation programs. In fact, the detailed provisions in Section 2806.1 are evidence of the General Assembly’s intent that electric conservation plans adhere to Section 2806.1 (and the Commission’s orders entered pursuant to Section 2806.1) to the extent those plans (and related cost recovery mechanisms) might conflict with plans (and cost recovery mechanisms) established under any other section.

Section 2806.1(k)(1) provides for the EDC’s full recovery of the costs of its conservation plan, provided that those costs are “reasonable and prudent.” Section 2806.1(k)(2) and (3) prohibit revenue decoupling but allow an EDC to reflect any anticipated conservation-related sales decline in the forecast used to calculate the revenue requirement in its next distribution base rate case.

Section 2807(f) requires EDCs to phase in smart meters and to offer time-of-use rates and real-time price plans. The detailed provisions in Section 2807(f) are evidence of the General Assembly’s intent that the requirements in Section 2807(f) supersede any requirements for smart meters and time-of-use/real-time pricing implemented under the authority of any other provision of the Public Utility Code.

Similar to Section 2806.1(k)(2) and (3), Section 2807(f)(4) prohibits revenue decoupling but allows anticipated revenue losses to be included in calculating an EDC’s claimed revenue requirement in a distribution base rate proceeding.

Unlike Sections 2806.1 and 2807(f) with regard to electric conservation, the General Assembly has not provided detailed requirements and parameters for gas conservation. Similar to Section 2804(9) for EDCs, Section 2203(8) provides legal authority for energy conservation programs aimed at low-income and payment-troubled residential customers. However, any effort by the Commission to mandate conservation programs for other customers of NGDCs and any effort by NGDCs to establish such programs for other customers on a voluntary basis must rely on Section 523(b)(4), Section 1319, or Section 1505(b) for statutory authorization. Therefore, an NGDC is permitted to implement a conservation plan (for other than low-income and payment-troubled residential customers) only after the Commission has determined that the plan is “prudent and cost-effective” and is permitted to recover only those costs which are “prudent” and “reasonable.”

Furthermore, in view of the General Assembly's express disallowance of revenue decoupling in the case of EDCs, it is reasonable to infer that the legislature would impose a similar prohibition on revenue decoupling for NGDCs if it were to mandate NGDC conservation plans statutorily. Therefore, revenue decoupling should not be approved as part of any NGDC conservation plan under Section 523(b)(4), Section 1319, or Section 1505(b).

V. Additional Measures to Consider to Address Policy Goals Outlined in 410(a)

A. Broad Principles

There are a variety of additional means to remove disincentives utilities may have to promote customer energy efficiency. Specific methods that utilities can use to address these disincentives are explained in Section V.B. Depending on the specific circumstances for each utility, some methods may be better than others for achieving the elimination of potential disincentives for utilities to promote energy efficiency. From an overall perspective to determine what method may work best for a particular utility the following broad principles should be considered: (1) flexibility to approve various approaches, (2) use of pilot programs, and (3) use of "opt-in" or "opt-out" methodology.

Columbia Gas

Columbia agrees that the application of broad principles will likely produce the most benefits in terms of providing utilities with the appropriate financial incentives to promote conservation. Columbia maintains that the Commission should be flexible so that companies can design rates and formulate conservation programs that are tailored to their particular situations. Columbia urges the Commission to consider the practical experience achieved in other jurisdictions in its review and approval of ratemaking proposals that are considered novel relative to the historical application of traditional ratemaking approaches in Pennsylvania. The goal of aligning the financial incentives of a utility with successful conservation measures does not have to equate to a guarantee that the utility will earn its authorized rate of return. The introduction of revenue decoupling mechanisms, Straight Fixed-Variable (SFV) rate design or flat rates does not guarantee that a utility will earn its authorized rate of return, but rather only provides the utility with an *opportunity* to achieve a reasonable rate of return.

While all of the rate design options reviewed herein have merit, Columbia particularly endorses the application of SFV rates. Columbia maintains that a SFV rate structure sends proper price signals to customers regarding the cost of delivery service, contains a significant volumetric component (reflecting purchased gas supply costs) to encourage energy efficiency, and aligns utility financial incentives such that utilities are not disadvantaged by actively encouraging their customers to pursue energy efficiency and conservation measures. At the same time, this rate design approach will not overcharge customers for delivery service in colder-than-normal time periods, as is the case under traditional volumetric delivery charges, and it will provide over time a greater degree of stability to customers' gas utility bills.

1. Flexibility to approve various approaches

There are a number of ways to remove a utility's disincentive to promote energy efficiency initiatives. The specific approaches that can be utilized will be provided in greater detail later in this report. This section addresses the issue regarding the benefits of providing utilities with the flexibility of offering one of the specific methods of removing a utility's disincentive to provide energy efficiency measures to customers. The American Gas Association has identified three basic rate making methods that remove a utility's disincentive to promote customer energy efficiency efforts: (1) flat monthly fees, (2) earnings stabilization mechanisms, and (3) revenue decoupling mechanisms. The American Gas Association has stated that eight of the top ten natural gas consuming states employ one of these mechanisms. Gas and electric utilities assert that they should be provided with the flexibility to employ the methodology best suited for their service territories.

NFG

A number of parties⁴⁸ cited a need for flexibility in designing programs that remove existing financial disincentives to a utility's promotion of customer conservation. National Fuel agrees that flexible program design is important to meeting the various needs of the diverse utility service territories in Pennsylvania. Many distinctions should be recognized when establishing programs that effectively remove current financial disincentives to utility encouragement of customer conservation efforts. First and foremost, a distinction needs to be made between EDCs and NGDCs. While both have important roles to play, there are differences in the existing disincentives that each type of utility faces in promoting customer conservation. Distinctions also need to be made within industries, including: regional differences (*e.g.*, between eastern and western NGDCs) and differences between types of customers (*e.g.*, residential, small commercial, and large commercial/industrial). Recognition of the varying requirements of urban/suburban/rural customer needs should also be considered. Also important is the consideration of whether a specific utility's customer base is growing or shrinking, based on regional demographics.

i) Differences between NGDCs and EDCs.

There are a number of differences between NGDCs and EDCs that need to be considered when designing effective conservation programs that eliminate disincentives to support effective conservation programs.

First, there are legal differences in the treatment of lost revenues. As some parties⁴⁹ have identified, current Pennsylvania law (*i.e.*, Act 129) does not allow for the recovery

⁴⁸ See, the Initial Comments of: PECO Energy Company ("PECO"), p. 2; and Energy Association of Pennsylvania ("EAPA"), p.3.

⁴⁹ See, Initial Comments of: Office of Small Business Advocate ("OSBA"), pg. 5; Office of Consumer Advocate ("OCA"), pg. 6; and Comments of the Industrial Customer Groups, pg. 10.

of EDC lost revenues through a surcharge mechanism such as a revenue decoupling mechanism (“RDM”). However, there is no law in place prohibiting lost revenue recovery for NGDCs.

Second, customer energy consumption profiles differ significantly between NGDCs and EDCs. For example, both NGDCs and EDCs serve residential households, however, the number of electric appliances in a given home almost always exceeds the number of natural gas appliances. While there are usually far fewer natural gas-fueled appliances in a residential household, the total combined energy consumption of those appliances is often greater than total combined energy consumption of the more numerous electric powered appliances. This fact alone illustrates that the energy usage profile of electric and natural gas is very different.

The differences in energy usage profiles would have a profound effect on the design of energy efficiency programs between NGDCs and EDCs. For example, NGDCs are better suited to conservation programs that target a limited number of appliances (e.g. furnaces and water heaters) and can achieve significant total energy savings from those few appliances. Data regarding average consumption by energy end uses for residential customers compiled by the Energy Information Agency (“EIA”) supports this proposition. The following table summarizes the average residential household energy consumption for the climate zones⁵⁰ that occur in Pennsylvania.

Energy End Uses						
Million BTU of Consumption per Household						
Source: EIA						
Climate Zone	Total	Space Heating	Air Conditioning	Water Heating	Refrigeration	Other Appliances and Lighting
Greater Than 7,000 HDD	117.9	68.1	3.1	20.6	4.9	24.9
	100%	57.8%	2.6%	17.5%	4.2%	21.1%
5,500 to 7,000 HDD	115.0	63.8	4.8%	20.3	4.6	24.4
	100%	55.5%	4.2%	17.7%	4.0%	21.2%
4,000 to 5,499 HDD	101.7	47.6	7.4	19.6	4.8	24.6
	100%	46.8%	7.2%	19.3%	4.7%	24.2%

⁵⁰ HDD = Heating Degree Days. See: http://www.eia.doe.gov/emeu/cbecs/climate_zones.html

What this table illustrates is that the major natural gas residential appliances (space heating and water heating) represent approximately 66% to 75% of residential household energy usage, depending on climate zone.

Data regarding residential space heating by fuel type for Pennsylvania from the US Census Bureau is summarized in the table below:

House Heating Fuel		
Pennsylvania Occupied Housing Units		
Source: US Census Bureau		
	Households	%
Utility Gas	2,502,769	51.5
Bottled, Tank, or LP Gas	179,066	3.7
Electricity	867,879	17.9
Fuel Oil, Kerosene, etc.	1,116,071	23
Other Fuel	183,778	3.8
No Fuel Used	8,946	0.2
Total	4,858,509	100.0

What this table shows is that there is heavy market saturation for natural gas for house heating, which is due to its relatively low cost and efficient consumption characteristics. The benefits of natural gas in residential applications were provided in UGI’s Initial Comments.⁵¹ National Fuel supports those comments and believes that the conversion of applications to natural gas from other fuel sources (including electricity) would be an effective component of any Pennsylvania energy efficiency program.

As can be seen from the tables above, no energy efficiency program targeting residential households can afford to ignore natural gas appliances. Speaking from our own experience National Fuel has seen consumption reductions of approximately 11.5% for residential customers installing high efficiency furnaces in National Fuel’s New York service territory.

⁵¹ See, Initial Comments of UGI Distribution Companies (“UGI”), pgs. 4-5.

ii) Intra-industry Distinctions.

Flexibility in program design, as recommended by a number of parties in this proceeding, is reasonable when developing programs within specific industries (*i.e.*, natural gas utility industry) for a number of reasons.

a. Regional Differences.

Pennsylvania has a varied mix of fuel sources utilized by customers across the State. An example of the diversity of energy utilization by region within Pennsylvania is provided in the table below that summarizes the house heating fuels used by Pennsylvania households as reported by the U.S. Census Bureau.

Heating Fuel % Used by Pennsylvania Households						
Source: U.S. Census Bureau						
	Pennsylvania Total	Erie Metro	Pittsburgh Metro	Scranton Metro	Philadelphia Metro	Remaining Pennsylvania
Utility Gas	51.5	82.8	76.8	50.9	59.1	32.7
Bottled, Tank, or LP Gas	3.7	4.0	1.9	4.5	2.7	5.1
Electricity	17.9	6.6	10.8	16.3	16.9	22.6
Fuel Oil, Kerosene, etc.	23	2.4	8.6	24.3	20.3	32.6
Other Fuel	3.8	3.9	1.7	4.0	0.9	6.8
No Fuel Used	0.2	0.2	0.1	0.1	0.2	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

This data illustrates that western metropolitan regions in Pennsylvania clearly have a greater proportion of households utilizing natural gas than eastern metropolitan households. Because the majority of residential household energy consumption is in

space heating and water heating and the high percentage of households in western Pennsylvania using natural gas, energy efficiency programs sponsored by natural gas utilities are likely to be more effective in achieving energy savings in western Pennsylvania than in the eastern region of the Commonwealth. Furthermore, given the high saturation of natural gas usage in western Pennsylvania, the growth opportunities from customer conversions from heating fuel sources other than natural gas are much less likely in the western part of the state than in the eastern part. Stated simply, if utilities are required to implement aggressive conservation plans for their customers, the natural gas utilities in western Pennsylvania will have basically the same customer base, but that customer base will be consuming much less energy. The consequence of this conservation under Pennsylvania's current ratemaking structures and policies is that western Pennsylvania natural gas utilities are much more likely to be financially harmed by reduced customer consumption than other utilities in the State. Hence, the financial disincentive to promote energy efficiency is likely the greatest for natural gas utilities in the western part of the state.

b. Urban/Suburban/Rural Customer Distinctions.

The table presented in the previous section also demonstrates the difference in energy usage characteristics by households in urban/suburban or rural areas. As shown in the table above, households in the urbanized regions of the State are more likely to use natural gas than those in more rural regions. The four metropolitan areas identified in the table above represent 57% of all households in the State. The high concentration of households served by a limited number of gas utilities supports the argument that there is greater potential for success when utilities are actively involved in providing customers with an energy efficiency initiative.

c. Differences between Residential, small Commercial, and Large Commercial/Industrial Customers.

Differences within customer classes also need to be recognized. For example, large customers' (particularly large industrial customers) energy usage is much more likely to be sensitive to economic conditions than smaller or residential customers. More care needs to be taken in designing and timing the implementation and cost recovery from large volume customers. Savings achieved from smaller volume customers are more likely to be consistent and sustainable over the long term and can be used to justify the energy efficiency investments needed to achieve these savings than for large customers. This is not to say that large industrial customers should be ignored when designing energy efficiency programs. Recognition, however, should be given to the fact that, relative to smaller customers, energy consumption patterns of large industrial customers are much more likely to be influenced by factors such as economic conditions, fuel switching or availability of alternative energy sources. The mix of customer usage by customer class will also vary across the State. The diversity of consumption by customer class across the State supports the concept of maintaining program design flexibility.

OCA

The OCA agrees that the Commission should have substantial flexibility to select approaches that are best suited to meet the goals of Section 410(a) and the terms of the Public Utility Code. But that flexibility and discretion must lie with the Commission, not with each individual utility. It is up to the Commission to determine which approaches will maximize energy efficiency in a manner that will produce rates that are just and reasonable for the utility and its customers. That task cannot be delegated to the utility alone.

To use an example, some types of rate programs will benefit the shareholders of utilities whose sales are growing between rate cases (as has been true for most electric utilities), while other types of programs will benefit the shareholders of utilities whose sales are declining (like many natural gas utilities). If left to the sole discretion of the utility, each utility will understandably select the type of program that most benefits its shareholders, even if that program is not necessarily the most cost-effective or beneficial to customers. The Commission, on the other hand, is obligated to balance the interests of utility shareholders and consumers and to approve only those programs that the Commission determines best serve the overall public interest.

As such, the OCA submits that this section of the Draft Report should be modified to make it clear it is the Commission, not each individual utility, that should be given the flexibility to determine the programs that are best suited to meet the goals of Section 410(a) for each electric and natural gas utility.

Industrials

The Industrial Customer Groups agree with and adopt herein, the September 30, 2010 Comments of the OCA on this topic.

4. Use of pilot programs

As the Commission begins its efforts to address a utility's disincentive to promote energy efficiency, it may find that the use of utility pilot programs could be an effective means of testing the usefulness of the specific methods discussed in this report. Pilot programs to test utility program designs have been used in the Commonwealth previously. Pilot programs have been effectively used to test the design of low-income residential customer assistance programs as well as small customer transportation programs. Pilot programs to test the most appropriate method for removing a utility's disincentive to promote energy efficiency programs may prove useful as well.

Industrials

Because the Industrial Customer Groups believe that proper cost-based pricing and rate design would effectively address utilities' disincentives to promote energy efficiency, there is no need for any sort of pilot program as a result of this proceeding or the information contained in this Report.

5. Use of “opt-in” or opt-out” methodology

Energy conservation programs offered by utilities can require customers to “opt-in” to utilize the program, or could be designed so that a customer must “opt-out” of the program if the customer does not want utilize the program. There has been considerable discussion regarding these methodologies.

UGI: The Commission may choose to provide a number of program methodologies for utility consideration and allow utilities to either opt-in or opt-out of specific methodologies. The opt-in opt-out approach is consistent with the principle of providing flexibility in using specific methods for removing a utility’s disincentive to promote customer energy efficiency.

Industrials

The Industrial Customer Groups oppose mandatory conservation programs, preferring an "opt-in" approach for customers. The ability to implement energy efficiency measures varies for larger customers. Large Commercial and Industrial customers should not be penalized through a mandatory conservation program when they increase energy use due to expansion of their operations or business opportunities. In many instances, increased energy usage is a sign that a Large Commercial or Industrial user is recovering from the effects of the recession. Pennsylvania needs a vibrant manufacturing base to compete in the global marketplace.

In addition, the Industrial Customer Groups want to ensure that sensitive customer information is adequately protected. As a result, to the extent that conservation programs are created that would, in any way, release or publicly make available commercially sensitive information such as a large industrial customer's load data, safeguards must adequately protect customer information. Specifically, an affirmative consent procedure must ensure that industrial customer information will not be released without explicit customer authorization.

B. Rate Design

NFG

This report presents a summary of a number of rate design alternatives. National Fuel is concerned that this itemization of various rate design methods has lost track of the purpose of this proceeding; *i.e.*, to explore methods that will allow Pennsylvania regulatory policy to achieve the goal of ARRA that utility financial incentives be aligned with helping customers to conserve energy. While formula based rates, decoupling, straight fixed-variable, and annual rate adjustments can be designed in such a manner as to remove a utility’s disincentive to promote conservation, the remaining methods addressed in this report (modified straight fixed-variable, inclining block rates, flat block rates, time of use rates, seasonal rates, and base rate case adjustments for lost revenues) do not and cannot in and of themselves meet the overall objective of aligning a utility’s financial incentives with customer conservation. Simply put, in each of these non-

compliant rate design methods, a utility stands to maximize its financial benefit only through *increases*, not decreases, in customer consumption. Such an incentive is the polar opposite of the requirements of the ARRA.

As cited by Equitable in its comments,⁵² there are a variety of ways to remove the disincentives to utilities to promote customer energy efficiency. National Fuel would agree with this observation and add that each of the rate designs discussed in this report has strengths and weaknesses. The American Gas Association (AGA) has identified three basic rate making methods that remove a utility's disincentive to promote customer energy efficiency efforts: (1) flat monthly fees, (2) earnings stabilization mechanisms, and (3) revenue decoupling mechanisms. As stated earlier and demonstrated in Attachment 1, sixteen (16) of the top seventeen (17) natural gas consuming States employ one of these mechanisms. It is worthwhile to note here that Pennsylvania is the largest natural gas consuming state in terms of residential, commercial, and industrial consumption *not* to employ at least one of these mechanisms. Also, each of the sixteen (16) States referenced here has effectively concluded that these recovery mechanisms are necessary to provide an incentive for conservation in addition to utility rate cases.

An earnings stabilization mechanism is a rate mechanism that is not discussed in this report. Under this mechanism, a utility's earnings are effectively reconciled within a predetermined band where earnings below a certain level are recovered through a subsequent adjustment to customers and earnings above a certain level are subsequently refunded to customers. By providing an earnings band that automatically reconciles to within a predetermined band a utility can avoid significant earnings erosion through the successful promotion of conservation efforts. Earnings stabilization mechanisms, however, do not completely eliminate financial disincentives to promote customer energy efficiency efforts since, under a volumetric rate design, it is always in the utility's financial interest to be above the top earnings band.

Industrials

As explained more fully above, the Industrial Customer Groups assert that proper cost-based pricing and rate design would effectively address utilities' disincentives to promote energy efficiency, while also sustaining or enhancing customers' incentives to use energy more efficiently. As such, the Commission should reject any attempt to pursue revenue decoupling or utilities' attempts to guarantee awarded returns (rather than an opportunity to earn a return), as well as providing additional incentives for utilities (such as Performance target incentives, shared energy savings between utility and customer, awarding higher Rates of Return for utilities if meeting energy conservation

⁵² Comments of Equitable Gas Company ("Equitable"), Appendix A, p. 3.

goals or allowing full recovery of costs for assets retired due to energy conservation) as a result of successfully engaging in energy conservation.

While the Industrial Customer Groups recognize that Section 2806(i) of the Competition Act gives the Commission authority "to use performance-based rates as an alternative to existing rate base/rate of return ratemaking, subject to the restrictions pertaining to rate caps in Section 2804(4)," (see 66 Pa. C.S. § 2806(i)), if electing this option, the Commission should carefully balance the interests of ratepayers and utilities in designing performance based rates. Such balancing could include appropriate measurable goals, with incentives if goals are met and disincentives if goals are not achieved. Regardless of the actual structure, the ultimate purpose of such rates, if utilized, should be to incentivize customers while addressing utilities' needs; not simply providing economic windfalls for utilities.

1. Formula-based rates

A formula rate mechanism is a fixed method for calculating the rate that utilities may charge customers by application of a pre-approved formula, which contains variables corresponding to multiple cost and sales elements.⁵³ A formula rate is distinguishable from a more traditional stated or standard rate, which is a fixed charge or rate set in a rate case and which does not change until another rate case is concluded. Under a formula rate mechanism, the formula itself is the rate, so periodic adjustments made in accordance with the approved formula do not constitute changes in the rate itself and do not require rate cases.⁵⁴ Charges to customers may be updated periodically using data from public sources (such as FERC Form 1), and the recalculation of charges is done pursuant to a set of protocols specified by the regulator. In contrast to a decoupling mechanism which adjusts only for changes in sales volume, a formula rate mechanism adjusts for changes in both sales and costs on an annual basis.

The Federal Energy Regulatory Commission ("FERC") has been accepting formula rates in the wholesale transmission context since the 1970s.⁵⁵

⁵³ See, Manuel and Vogt, Formula Rates Lessons Learned, Presentation, Edison Electric Institute, March 17, 2010 (<http://www.eei.org/meetings/Meeting%20Documents/2010-03-17-rrac-Formula-Rates-Ackerman.pdf>).

⁵⁴ See *Public Utilities Com'n of State of California v. F.E.R.C.*, 254 F.3d 250 (C.A.D.C. 2001).

⁵⁵ The Federal Power Act authorizes the use of an automatic adjustment clause in the computation of utility rates when the use of such a clause would result in the "efficient use of resources" and the "economical purchase and use of fuel, electric energy, and other items." See 16 U.S.C. § 824d(f) (1976). Courts have approved the use of formulas in establishing wholesale electric rates, see *Louisiana Public Service Commission v. FERC*, 688 F.2d 357, 360 (5th Cir.1982), cert. denied, 460 U.S. 1082, 103 S.Ct. 1770, 76 L.Ed.2d 343 (1983).

OCA

The OCA submits that formula-based rates should generally be limited to discrete cost elements that are substantial, volatile, and are outside of the utilities' control. An example of the appropriate use of formula-based rates is fuel adjustment clauses that have traditionally been permitted under Section 1307 of the Public Utility Code. As noted below, however, the OCA acknowledges that automatic adjustment clauses for energy efficiency expenses are permitted pursuant to Act 129 and Section 1319 of the Public Utility Code.

Industrials

As noted in the summary, formula-based rates have been accepted by the FERC. The FERC formula rates include extensive protocols to ensure that all stakeholders have sufficient time and information to review the rate changes. An additional complicating factor in the use of formula rates on a state level is the need to ensure that rates and allocations reflect cost of service. Although a formula based rate is more appropriate than a revenue decoupling mechanism because it takes into account all changes in the utility's costs and revenues, there are significant issues that would need to be considered and addressed before pursuing this option.

2. Decoupling

Under current rate design used by most electric and gas utilities in the Commonwealth, a utility's overall earnings are directly linked to the units of energy used by a customer. That is, as customers' energy consumption increases, all else being equal, so too, do the earnings of the utility increase. The purpose of revenue decoupling is to end this link between increased customer energy consumption and increased profit and thereby remove the financial disincentive to a utility promoting energy efficiency programs.

To the extent that the costs incurred by utilities in delivering energy to customers are fixed, the idea of decoupling is that the recovery of those costs should not be linked to the amount of energy used by customers. Once the link between utility earnings and customer unit energy consumption is broken, utilities will not be harmed financially from providing conservation services to customers.

The specific mechanism employed to eliminate the link between earnings and consumption can take a number of forms. Revenue decoupling can be designed around a specific annual revenue target or it can be designed around annual volumetric targets. Decoupling can be based on total annual targets or based on per customer targets. Decoupling that is designed around total targeted delivery revenues will ensure that a utility recovers no more or no less than that targeted delivery revenue amount. Since a utility's total targeted delivery revenue will not vary based on customers' usage, a utility will have no disincentive to promote customer conservation efforts. A total delivery revenue target may present an issue for natural gas utilities since a decoupling mechanism designed around total delivery revenues may also make a utility indifferent to the number of customers that it connects to its system. This can be remedied by designing a decoupling mechanism around average usage or revenue per customer. Decoupling mechanisms designed around changes in average revenue per customer

maintains a utility's incentive to connect additional customers to the system and eliminates a utility's disincentive to promote customer conservation.

NFG

A number of parties suggest that revenue decoupling mechanisms (RDM) are not their preferred ratemaking mechanisms to remove utilities' financial disincentives to promote customer energy efficiency and conservation. Some parties referenced the public opposition to a RDM mechanism experienced by National Fuel in its last Pennsylvania base rate case filing. These parties suggest that the experience accurately reflected the public's sentiment regarding a RDM. However, these critics consistently fail to recognize that National Fuel's proposed RDM did not include, at the time, a sufficiently detailed companion conservation program that, had it been included, would have shown customers that real savings were achievable, even with the RDM. There is no substantive evidence that customers in National Fuel's service territory are, among gas customers across the nation, somehow uniquely opposed to a RDM as a component to a meaningful conservation program.

National Fuel's experience in its neighboring New York service territory illustrates that customers are willing to accept and can benefit from a RDM when the full scope of the program is made known and widely available to them. Soon after its Pennsylvania RDM filing, National Fuel filed for a RDM in a rate case in its New York division. Unlike the Pennsylvania proposal, the New York filing included a detailed and comprehensive Conservation Incentive Program ("CIP") for its customers. As observed by the editors of *The Buffalo News* when the CIP was filed, "the [RDM is a] structural change that would not only provide a firmer base for the utility's cost recovery but encourage it to launch conservation incentives that would be a long-term plus for the community." "Paying for heat," *Buffalo News*, February 8, 2007. The CIP, now with a proven track record, has been well received by both the New York Public Service Commission and National Fuel's customers.

A RDM is no longer a novel or untested rate mechanism. It is a proven and effective tool in eliminating a utility's financial disincentive to promote conservation and it is widely used in States that are aggressively and proactively confronting their energy challenges. Contrary to the comments of certain parties in this case, National Fuel can demonstrate that those customers that implement energy efficiency initiatives promoted under National Fuel's CIP will incur savings greater than any associated RDM rate. To suggest, as these critics do, that the RDM is a sham ratemaking mechanism that provides no customer benefits is absolutely inaccurate. Because the cost of fuel is by far the most significant component of a customer's natural gas bill the consumer benefits from usage reduction are obvious. Further, utilities can be effective providers of both conservation services and information to customers. If they were not, Congress would have had no interest in making it a requirement under the ARRA that the States remove the financial disincentives to utilities to provide energy efficiency services to their customers.

In support of their opposition to a RDM, Industrial Customer Groups cite to some jurisdictions that, according to the Industrial Customer Groups, had a bad experience with RDMs. The two leading examples supplied by the Industrial Customer Groups are Maine

and Montana.⁵⁶ While a thorough analysis requires a review of the experiences of Maine and other jurisdictions, that analysis should also include jurisdictions where RDM is considered to be a success. For example, California, a state with more electric and gas customers than the entire populations of Maine and Montana, credits RDMs with enabling that State's significant energy savings. In 2008 the AGA said:

Natural gas RD has not failed in a single instance and electric and gas decoupling has been successful in California for more than two decades. Since 1974, California has held its per-capita consumption essentially constant, while energy use per person for the United States overall has jumped 50 percent. Revenue decoupling made possible the successful energy efficiency programs in California. As of March 2008, electric decoupling is being used by utilities in California, Idaho, Maryland, and Delaware, and is pending in several additional states.⁵⁷

PECO

PECO notes that although a decoupling mechanism delinks a company's revenues from its sales volume, it does not address costs at all. Under traditional cost of service ratemaking, utilities in a positive sales growth period were able to use incremental revenues to offset increases in costs and avoid rate cases. Employing a decoupling mechanism in a positive sales growth environment may lead to more frequent rate cases as compared to the traditional ratemaking.

OCA

Whatever the merits or objections to the use of decoupling, the issue is essentially moot in Pennsylvania, particularly with respect to electric utilities. Act 129 of 2008 expressly states that, while EDCs may utilize an automatic adjustment clause between base rate cases to recover the costs of energy efficiency and demand response programs, such costs may not include "decreased revenues of an electric distribution company due to reduced energy consumption or changes in energy demand." 66 Pa.C.S. §2806.1(k)(2). Under Act 129, such decreased revenues may only be reflected "in revenue and sales data used to calculate rates in a distribution-base rate proceeding" under Section 1308. A parallel prohibition for automatic recovery of decreased revenues between base rate cases is included in the "smart meter" provision of Act 129 at 66 Pa.C.S. §2807(f)(4).

⁵⁶ Initial Comments of the Industrial Customer Groups

⁵⁷ American Gas Association, *Response of AGA to ELCON 2007 Revenue Decoupling Policy Brief* (May 2008) at 4. As of May, 2009, fifteen (15) states have approved an RDM for gas utilities. *See*, <http://www.aga.org/legislative/ratesregulatoryissues/ratesregpolicy/issues/decoupling>.

The Public Utility Code is silent on the issue of lost revenue recovery or decoupling with respect to natural gas utilities. However, the Commission will recall that National Fuel Gas Distribution Company's request to implement a decoupling mechanism in 2006 was voluntarily withdrawn after it resulted in the filing of 1267 formal complaints, testimony of 168 public input hearing witnesses, and the introduction of legislation in the Pennsylvania House of Representatives that would have required the PUC to "disallow any proposed rate, rate increase or rate surcharge based in whole or in part on the utilization of a revenue decoupling mechanism." House Bill 2594 of 2006; see Pa. PUC v. National Fuel Gas Distribution Company, R-00061403, Recommended Decision of ALJs Corbett and Hoyer (Oct. 31, 2006), Statement of Chairman Wendell F. Holland (November 30, 2006), and PUC Final Order (December 4, 2006).

Unless and until some form of revenue decoupling is authorized by the General Assembly, the OCA submits that this is not a fruitful avenue for the Commission to explore in this context.

OSBA

General Statements on Revenue Decoupling

Section 410(a) of the Recovery Act does not require the Commonwealth to allow decoupling as a condition for receiving stimulus funds. Furthermore, to this point, Congress has not mandated revenue decoupling in any other energy-related enactments. In addition, the General Assembly has expressly prohibited revenue decoupling for EDCs and has provided no explicit statutory authority for NGDC revenue decoupling. Without statutory authority, the Commission may not implement revenue decoupling for EDCs or NGDCs.⁵⁸

At most, the absence of revenue decoupling in the Commonwealth might inhibit utilities from implementing conservation plans on a *voluntary* basis. However, because of the legislatively-mandated requirements on EDCs (with both cost recovery from ratepayers and penalties on EDCs for non-compliance), the lack of revenue decoupling should have no impact upon achieving electric conservation. Similarly, a Commission *mandate* that NGDCs establish conservation plans should be sufficient to overcome any hypothetical inhibitions related to the absence of revenue decoupling.

Because an EDC (and presumably an NGDC) may reflect anticipated sales declines in the future test years in upcoming distribution rate cases, the only "loss" to the utility (due to the absence of revenue decoupling) would arise from the lag between the point at

⁵⁸ The General Assembly has expressly prohibited EDCs with at least 100,000 customers from retroactively recovering revenue losses attributable to energy conservation. At the same time, the General Assembly has expressly permitted those EDCs to reflect such revenue losses on a prospective basis in a distribution base rates case. See Sections 2806.1(k) and 2807(f)(4) of the Public Utility Code, 66 Pa. C.S. §§2806.1(k) and 2807(f)(4).

which conservation measures begin to impact sales and the implementation of new distribution rates. Given a utility's freedom to file distribution rate cases whenever it deems necessary, there is no reason to search for ways to implement revenue decoupling through the back door.

Single-Issue Ratemaking

Implementing revenue decoupling through a surcharge under Section 1307(a) of the Public Utility Code, 66 Pa. C.S. §1307(a), would interfere with traditional base rate regulation and would constitute single-issue ratemaking. Even though Section 1307 allows single-issue ratemaking in certain circumstances, there is a general prohibition against single-issue ratemaking. "Single issue ratemaking is similar to retroactive ratemaking and, in general, is prohibited if it impacts on a matter that is normally considered in a base rate case" except when the utility's costs are extraordinary and nonrecurring.⁵⁹

Revenue decoupling does not fall within the exceptions to the prohibition against single-issue ratemaking for non-recurring and extraordinary expenses. Revenue losses sought to be recovered by a decoupling mechanism will be recurring, since the Commission is trying to incorporate energy conservation as a long-term policy. Revenue losses sought to be recovered by a decoupling mechanism are also not extraordinary. A utility cost is considered extraordinary if it is not only "unanticipated but also a substantial, one-time expense or a substantial item that will not appear as a continuing expense and could otherwise never be recovered in rates."⁶⁰ That same principle is applicable to the type of revenue losses which revenue decoupling mechanisms seek to enable the utility to recover. "Although cases have not clearly defined the extraordinary exception by example, we know a weather-related expense caused by what is commonly referred to as an 'act of God' is considered extraordinary."⁶¹ The losses sought to be recovered through a revenue decoupling mechanism are not caused by an "act of God."

⁵⁹ *Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission*, 653 A.2d 1336, 1350 (Pa.Cmwlt. 1995); *See, e.g., National Fuel Gas Distribution Corp. v. Pennsylvania Public Utility Commission*, 464 A.2d 546, 567 (Pa.Cmwlt. 1983)(holding that the consideration of expense and revenue items in isolation could result in confiscatory rates); *Philadelphia Electric Co. v. Pennsylvania Public Utility Commission*, 93 Pa.Cmwlt. 410, 502 A.2d 722 (Pa.Cmwlt. 1985)(holding that there should be no line-by-line examination of items in a rate case and "an isolated item of revenue or expense may or may not be, without more, the subject of a refund or recovery.")

⁶⁰ [*Popowsky v. Pennsylvania Public Utility Commission*, 869 A.2d 1144, 1153 \(Pa.Cmwlt. 2005\).](#)

⁶¹ *Popowsky v. Pennsylvania Public Utility Commission*, 642 A.2d 648, 652-653 (Pa.Cmwlt. 1994).

Furthermore, revenue decoupling may also be a violation of Section 1301 of the Public Utility Code, 66 Pa. C.S. § 1301. Specifically, Section 1301 states in pertinent part that:

Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be *just and reasonable*, and in conformity with regulations or orders of the commission.

(Emphasis added)

Under the revenue decoupling proposals, the NGDCs would essentially be allowed to reconcile distribution revenues, eliminating both weather and conservation effects on volumes, but there would be no reduction in the return on equity an NGDC would be awarded. This type of selective regulation would not result in reasonable rates.

Revenue decoupling would also compromise the role of lower prices as an incentive to conserve. Specifically, revenue decoupling would reduce the risk for utilities but produce higher rates for consumers. As Electricity Consumers Resources Council (“Elcon”) Executive Director John Anderson wrote, “The belief that consumers will undertake conservation or energy efficiency efforts without being rewarded with lower bills is somewhere between counterintuitive and ludicrous. If a utility’s earnings are held constant and consumption is reduced, that translates into higher rates for consumers. The utility doesn’t care how much power it sells, but decoupling dampens the incentive for consumers, large or small, to engage in energy efficiency if such efforts do not result in lower electricity bills.”⁶²

Industrials

The Industrial Customer Groups agree with and adopt herein, the September 30, 2010 Comments of the OCA on this topic; however, to the extent that the Commission decides, as a result of reviewing this Report, that further exploration of revenue decoupling is necessary, the Industrial Customer Groups submit the following Comments:

Revenue decoupling would not help Pennsylvania achieve its energy efficiency goals or compliance with Section 410(a), and is contrary to both Pennsylvania law and precedent. Moreover, revenue decoupling is not only costly to implement and maintain, but also has little positive effect upon conservation.

The Commission has a fundamental duty to ensure that the rates charged to customers are just and reasonable.⁶³ The primary vehicle for ensuring that rates are just and reasonable is a rate proceeding filed pursuant to Section 1308 of the Public Utility

⁶² *Elcon Paper Criticizes Decoupling for Eliminating Utility Risk*, Greenwire, March 1, 2007.

⁶³ *See id.* § 1301.

Code.⁶⁴ Certain costs are required to be reviewed through a Section 1307 automatic adjustment mechanism, such as gas supply costs; however, for most categories of costs, especially those that relate to electricity distribution or natural gas transportation service, a rate proceeding pursuant to Section 1308 is the only vehicle to review a utility's costs and adjust the rates paid by customers. This review is accomplished using a historic and future test year approach that examines multiple variables, including expenses, utility plant, expected customer sales and an appropriate return on rate base (reflecting the reasonable cost of debt, an appropriate capital structure and a reasonable return on equity). Rates are calculated and designed to provide a utility with an opportunity to earn a fair return, but there is not a guarantee for the utility of earning an authorized return each year.⁶⁵

Apart from specific costs recovered through automatic adjustment charges, Pennsylvania has followed the generally accepted ratemaking prohibition against single issue ratemaking.⁶⁶ Single issue ratemaking occurs when only one element of the general ratemaking equation is examined between rate cases and the customers' rates are adjusted to reflect only changes in that element. Single issue ratemaking is fundamentally unfair and inequitable because it does not permit the Commission to examine other savings or expense adjustments that may favor consumers. Under single issue ratemaking, the Commission reviews only a limited portion of the overall ratemaking equation and, in effect, assumes that a single variable such as a reduction in sales translates into reduced profits for the utility. If all other elements of the equation remain consistent from the future test year, revenue decoupling essentially guarantees the utility an awarded return, rather than just ensuring the opportunity to earn an awarded return. Sales may decrease due to conservation efforts; however, if the utility's cost of borrowing also is reduced, or if its distribution or transportation costs decrease commensurate with the reduced sales because customers' rates have been properly designed (as explained earlier), the utility's profit or return is unaffected. Implementing single issue ratemaking schemes such as revenue decoupling deprives the Commission of the ability to examine those types of offsets.

Act 129 itself expressly prohibits revenue decoupling for energy efficiency and conservation plans. Specifically, Section 2806.1 (k)(2) & (3) state:

(2) Except as set forth in Paragraph (3), decreased revenues of an electric distribution company due to reduced energy consumption

⁶⁴ See *id.* § 1308.

⁶⁵ See *In re Pa. Power & Light Co.*, 1998 WL 417435, 3 (Pa. P.U.C. 1998) (citing *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("...[U]nder the just and reasonable standard pursuant to traditional regulation, a utility was never entitled to a guaranteed recovery of revenues. Under traditional regulation, rates were set to provide a reasonable opportunity for the utility to earn an anticipated revenue requirement, including an authorized rate of return on its investment.")).

⁶⁶ See, e.g. *Pa. Indus. Energy Coalition v. Pa. Pub. Util. Comm'n*, 653 A.2d 1336, 1350 (Pa.Cmwlth. 1995).

or changes in energy demand shall not be a recoverable cost under a reconcilable automatic adjustment clause.

(3) Decreased revenue and reduced energy consumption may be reflected in revenue and sales data used to calculate rates in a distribution-base rate proceeding filed by an electric distribution company under Section 1308 (relating to voluntary changes in rates).⁶⁷

In essence, revenue decoupling guarantees a utility a specified return regardless of the rate of energy consumption with the hope that utilities will be more inclined to promote conservation. Many have concluded, however, that revenue decoupling makes energy companies indifferent to conservation efforts—it does not promote them.⁶⁸ The National Association of Regulatory Utility Commissioners recently noted that no major study exists that connects revenue decoupling with increased energy efficiency.⁶⁹ The AARP echoed that sentiment when stating, "decoupling mechanisms increase rates or add surcharges to bills without any direct link to the utility's provision of energy efficiency programs."⁷⁰ In short, revenue decoupling is the promise of utility revenues without the promise of conservation.

Revenue decoupling also would not, in the language of Section 410(a), "sustain or enhance" customers' incentives to conserve. Instead, revenue decoupling would have a negative financial impact on consumers. First and foremost, it results in rate increases for customers, which acts as a disincentive to conserve. Revenue decoupling also distorts market prices, and decreases a consumer's incentive to be efficient, because regardless of how efficient customers are, their monthly bills essentially remain constant.

Section 410(a) of the ARRA requires efficiency measures to be "cost-effective." Revenue decoupling, however, is expensive for consumers and regulators. In addition to creating higher rates for consumers, revenue decoupling also increases costs for regulators. Decoupling requires constant "true-ups" (rate adjustments). Specifically, this mechanism must be sufficiently detailed to segregate changes in revenues that occur due to energy efficiency and conservation from decreases due to other factors, such as weather, economic downturns and plant closures. Such true-ups will engage time,

⁶⁷ 66 Pa. C.S. § 2806.1(k)(2),(3).

⁶⁸ See generally, *Report on Revenue Decoupling for Transmission & Distribution Utilities*, Presented to the Maine Utilities & Energy Committee, January 31, 2008 (statement by the Maine Public Utilities Commission, Office of Public Advocate and Office of Energy Independence & Security); see also *Decoupling: The Vehicle For Energy Conservation?*, STANDARD & POOR'S RATING DIRECT, February 19, 2008.

⁶⁹ See *Report on Revenue Decoupling for Transmission & Distribution Utilities*, Presented to the Maine Utilities & Energy Committee, January 31, 2008 (statement by the Maine Public Utilities Commission, Office of Public Advocate and Office of Energy Independence & Security).

⁷⁰ Industry Comments before Oklahoma Corporate Commission, Comment 165:35-41-11 (comment by AARP).

money, and personnel resources from regulatory bodies and consumer parties such as the Industrial Customer Groups who would seek to participate in the true-ups in order to ensure that the resulting rates are just and reasonable.⁷¹

The experiences of Maine and Montana illustrate that revenue decoupling programs are difficult to maintain and can add little to conservation efforts.⁷² In 1991, Maine instituted a revenue decoupling policy for Central Maine Power ("CMP"); a project that ended in failure.⁷³ At that time, the New England economy slipped into a recession, thus reducing CMP's earnings in 1991 and 1992. By the time of CMP's first rate adjustment, it sought \$52 million in deferred earnings.⁷⁴ Experts concluded that revenue decoupling merely served to insulate CMP from the recession and had little effect upon conservation efforts.⁷⁵ The revenue decoupling program in Montana met a similar fate, and the state abruptly ended the program after its first attempt to reconcile deferred earnings.⁷⁶ Given the fragile state of the current economy, and particularly of manufacturing, Pennsylvania may encounter similar difficulties if it implements revenue decoupling.

Several other states have reviewed and subsequently rejected decoupling proposals. The Florida Public Service Commission recently undertook a comprehensive study of decoupling policies, but concluded that the conservation policies already in place would achieve their conservation goals without having to incur "the cost and difficulties associated with design, implementation and maintenance of a . . . decoupling mechanism."⁷⁷

Additionally, in early 2009, the Rhode Island Legislature found that even though decoupling may reduce a utility's disincentive to conserve, there was no evidence that it would promote conservation beyond other extrinsic factors, e.g., economic pressures and technology improvements.⁷⁸ The Rhode Island Legislature also noted that Rhode Island utilities would have earned an additional \$34 million in payments during the previous four years, while increased time between rate cases would serve to reduce public

⁷¹ See *Aligning Utility Incentives with Investment in Energy Efficiency*, U.S. Environmental Protection Agency, November 2007, at Table 5-3.

⁷² Like Pennsylvania, Maine employs active electricity restructuring. See *Status of Electricity Restructuring by State*, U.S. Energy Information Administration, May 2009, available at www.eia.doe.gov.

⁷³ See *supra* note 23.

⁷⁴ See *supra* note 25 (The first adjustment was scheduled for 1991, but it was deferred due to the lagging economy).

⁷⁵ See *id.*

⁷⁶ See *Decoupling and Other Mechanisms to Address Utility Disincentives for Implementing Energy Efficiency*, State EE/RE Technical Forum, May 19, 2005, available at www.epa.gov.

⁷⁷ *Florida Report to Legislature On Revenue Decoupling*, Florida Public Service Commission, Submitted 2008.

⁷⁸ See *id.*

oversight.⁷⁹ Similarly, Arizona policymakers have recently concluded that guaranteed revenue to utilities shifts too much market risk onto consumers while, at the same time, decreasing consumers' incentive to conserve.⁸⁰

In sum, other states, under the similar environmental, economic, and regulatory pressures as Pennsylvania, have concluded that there are more effective ways to promote energy efficiency than revenue decoupling. Revenue decoupling is contrary to Pennsylvania law, and otherwise constitutes bad public policy. Accordingly, revenue decoupling should not be pursued at this time or at any time in the future.

3. Straight fixed-variable

To the extent that certain costs are fixed over time, Straight Fixed Variable (SFV) rate design aligns the recovery of costs with the nature of the costs, i.e. recovery of costs that do not fluctuate with usage is accomplished through a static monthly charge and costs that are driven by usage are recovered through volumetric charges. A strict assignment of fixed cost recovery to fixed charges and variable cost recovery to volumetric charges provides the customer with a price signal that most accurately depicts the fixed cost of delivering the energy—delivery, distribution, and service— and requires each customer to carry his “share” of the allocated fixed costs.

The application of SFV rates addresses revenue erosion caused by persistent weather-normalized declining sales. While the SFV rate structure can mitigate the impact of weather fluctuations and conservation efforts on utilities' revenues and earnings, it does not immunize them from the realities of cost inflation or economic downturn, nor does it relieve them from the responsibility of careful management of resources and the burden of proof that rates are just and reasonable.

NFG

National Fuel would agree that perhaps the most appropriate way to eliminate a utility's disincentive to promote customer energy efficiency is to recover costs in a similar manner to how they are incurred. That is, National Fuel would agree with the Industrial Customer Groups⁸¹ that fixed costs (*i.e.*, those that do not vary directly with customer usage) should be recovered through fixed charges (*i.e.*, charges that are billed to the customer regardless as to how much natural gas or electricity is used during the billing period) and variable costs (*i.e.*, costs that change with the actual amount of energy used during the billing period) should be charged on a unit consumed basis. Should such a ratemaking design be adopted, it would be a fundamental change in how customers are billed for utility services. National Fuel would welcome such a change where non-gas costs are predominantly recovered on a fixed basis through monthly customer charges.

⁷⁹ *See id.*

⁸⁰ *See In Brief: Natural Gas Rates*, PUR UTILITY REGULATORY NEWS, February 6, 2009.

⁸¹ Comments of Industrial Customer Groups, p. 4.

OCA

While the OCA agrees that straight-fixed variable (SFV) rate design may reduce the disincentive that a utility has to promote conservation, the OCA submits that this rate design has exactly the opposite effect on the consumer. By increasing the fixed monthly customer charge, and decreasing the per Kwh or Mcf usage charge, the effect of SFV rate design is that the customer sees less benefit from his or her own conservation efforts. The OCA submits that SFV rate design is precisely the type of policy that ARRA Section 410(a) is intended to discourage when it states that the desired regulatory policy must be accomplished “in a way that sustains or enhances utility customers’ incentives to use energy more efficiently.” SFV rate design produces a negative impact on the customers’ incentive to conserve energy. That is because the more costs that are reflected in the fixed monthly customer charge, the less benefit that the customer receives from conserving energy.

SFV rate design is also contrary to a long line of Commission decisions – and particularly the consistent Statements of Chairman Cawley – that warn against high fixed customer charges because of their negative impact on customer conservation. As noted by Chairman Cawley, for example, in an August 27, 2009, Statement regarding the base rate case settlements of UGI Penn Natural and UGI Central Penn Gas Companies: “From a policy perspective, allocating costs to variable distribution charges, instead of allocating them to a fixed customer charge, provides a stronger incentive for customers to conserve....” Pa. PUC v. UGI Penn Natural Gas Pa. PUC v. UGI Central Gas, R-2008-2079660, R-2008-2079675, Statement of Chairman Cawley (August 27, 2009). See also, Pa. PUC v. PG Energy, Docket No. R-00061365 (Order entered November 30, 2006) (Statement of then Vice Chairman Cawley noting that “the significant reduction in residential customer service charges from those in the case as filed, combined with the reduction or elimination of declining block charges for certain Honesdale customers, should help to provide strong incentives and rewards for energy conservation for these customers.”); Pa. PUC v. Duquesne Light Company, Docket No. R-00061346 (Order entered November 30, 2006) (Statement of then Vice Chairman Cawley regarding the reduction or elimination of declining block charges as an incentive for conservation).

The OCA submits that the use of SFV rate design is inconsistent with ARRA Section 410(a) as well as the longstanding pro-conservation policies of this Commission. As such, the OCA would recommend against its implementation at this time.

OSBA

According to some parties, conservation would be enhanced if all (or at least most) of a utility’s fixed distribution costs were recovered through a fixed charge on customers.

Although this recommended change in rate design might remove a disincentive for utilities to promote conservation, it would also undermine the incentive for customers to conserve. Specifically, the savings to customers from reducing consumption would be greater under the current rate design than it would be under a rate design which makes a customer’s overall distribution rate less sensitive to the customer’s level of consumption.

Furthermore, recovery of most (if not all) of the utility’s fixed costs through a uniform, flat charge on all customers within a class would likely create intra-class

subsidies. Specifically, the proposed rate design is based on the assumption that a customer's load profile does not materially affect the cost to provide distribution service to that customer. Admittedly, there is disagreement about how the cost of mains or wires should be allocated to customer classes. However, there appears to be little (if any) disagreement that not all of those fixed costs are customer-related. Therefore, under the proposed rate design, the smaller customers within an existing class would likely be subsidizing the larger customers within that class.

Industrials

As discussed above, the Industrial Customer Groups support proper cost allocation and rate design. Properly implemented straight fixed-variable rate design can send proper price signals to customers regarding their use of the utility's distribution system, which leads to efficient decisions by the customer.

4. Modified straight fixed-variable

Modified straight fixed-variable (MFV) is descriptive of the energy industry rate structures currently in place in Pennsylvania, whereby a portion of fixed costs are recovered through fixed customer charges and the balance through volumetric rates. The balance between fixed and volumetric recovery has been loosely driven by the qualification of costs as "customer direct" and "customer indirect" costs, as well as a historical practice of the Commission to keep monthly residential customer charges low. Since rates are calculated based on average billing determinants, there will always be disparity among the members of a specific rate class whose usage patterns vary from the average. Recovering a greater portion of fixed costs through variable rates exacerbates that disparity and creates a subsidy of low-use customers by high-use customers; it may also provide a greater relative incentive to conserve.

MFV can result in some revenue stream volatility associated with weather fluctuation and high volumetric rates. Extreme weather can result in periodic windfalls to the utilities and a corresponding burden placed on consumers. Alternatively, negative financial indicators from under-recovery of costs in milder than "normal" weather periods could impede a utility's ability to earn a Commission authorized rate of return.

Some definitions of MFV specify that all fixed costs, except for return on equity and income taxes are recovered through fixed charges, with those two items added to the commodity charges.

Equitable Gas

Traditional Pennsylvania rate design principles provide utilities with the opportunity to recover the majority of fixed delivery service costs (costs of providing distribution service) and natural gas supply costs via commodity or throughput based rates. Within Equitable's total residential delivery service revenue requirement, for example, approximately 27.5% is recovered through a fixed monthly service charge while 72.5% is recovered through a throughput based delivery service charge. Through the application of existing rate design principles, increased customer usage enhances return, whereas

decreased customer usage negatively impacts return. At a minimum, the Commission should review reversing the revenue recovery mechanisms so that a majority of revenue is recovered through fixed monthly charges.

OCA

The OCA's comments regarding straight fixed variable rate design are also applicable here. To the extent that the goal of the Commission (and the goal of ARRA Section 410(a)) is to promote conservation by electric and natural gas **consumers**, then the Commission should adopt a policy that sharply limits the types and amounts of costs that are reflected in the fixed monthly customer charge, as opposed to the Kwh and Mcf charges. Customers will only benefit from conservation to the extent that reductions in usage result in reductions in monthly bills.

Industrials

As discussed above, the Industrial Customer Groups support proper cost allocation and rate design. Properly implemented straight fixed-variable rate design can send proper price signals to customers regarding their use of the utility's distribution system, which leads to efficient decisions by the customer.

5. Annual rate adjustments between rate cases to reflect energy conservation effects

An annual rate adjustment mechanism is a variation on the concept of a formula rate. An annual rate adjustment mechanism pairs periodic base rate cases with an annual adjustment mechanism. Under this method, a Pennsylvania utility would file a base rate case under section 1308 of the Public Utility Code⁸² at specified intervals, perhaps every 3-5 years. Between base rate cases, all costs as well as all revenues are trued up through an annual adjustment mechanism, with some cap on the permitted annual increase (perhaps tied to inflation). This adjustment arguably would be possible without the filing of a new rate case provided that the change were sufficiently modest not to constitute a "general rate increase" as defined by section 1308(d).⁸³ Section 1308(d) thus effectively places a cap on the amount of the increase that could be made without a new rate case. The Commission could arguably institute this mechanism using existing statutory authority.⁸⁴

PECO

PECO suggests that the Commission seriously consider this annual adjustment mechanism because, in contrast to a decoupling mechanism, it adjusts both costs and revenues. That is, while a decoupling mechanism delinks a company's revenues from its

⁸² 66 Pa.C.S. § 1308.

⁸³ "[A] general rate increase means a tariff filing which affects more than 5% of the customers and amounts to in excess of 3% of the total gross annual intrastate operating revenues of the public utility." 66 Pa.C.S. § 1308(d).

⁸⁴ See 66 PA.C.S. § 501; 1308(d); 2806(i).

sales volume, it does not address costs at all. Under traditional ratemaking, when sales are increasing, a utility can use the additional revenues to address increases in costs, rather than requiring a rate hike. A decoupling mechanism, where all costs are tied to a fixed charge, will not permit that flexibility. In an annual adjustment mechanism (or a formula rate, for that matter), changes in costs as well as changes in revenues can be adjusted to reflect the current economic circumstances.

OCA

This section of the draft report suggests that it may be possible under current Pennsylvania law to permit annual “true-ups” for all costs and revenues between base rate cases, as long as those true-ups do not produce rate increases that exceed the level for a general base rate increase under Section 1308(d) of the Public Utility Code. The OCA does not agree that such general true-ups would be permitted under the Public Utility Code. The OCA would also oppose such annual adjustment clauses as a matter of policy.

As noted above with respect to formula-based rates, the OCA submits that automatic true-up mechanisms should be limited to discrete cost elements that are substantial, volatile, and are outside of the utilities’ control. Again, an example of the appropriate use of this type of recovery mechanism is fuel adjustment clauses that have traditionally been permitted under Section 1307 of the Public Utility Code.

While base rate increases that are below the percentage levels that trigger the general rate increase requirements of Section 1308(d) may be permitted under Section 1308(a) and (b), those filings are still subject to notice and due process requirements and must be found by the Commission to result in just and reasonable rates. The OCA submits that there is nothing in the Public Utility Code or Pennsylvania case law that would support the type of automatic annual rate adjustment clause for all costs and revenues envisioned in this section of the draft report.

Industrials

The Industrial Customer Groups agree with and adopt herein, the September 30, 2010 Comments of the OCA on this topic.

6. Inclining block rates (opposite of declining block rates)

Inclining block rates are structured with price intervals that increase with increased usage. The first “block”, or specifically defined level of usage, is billed at one rate per unit, and incremental units or blocks of units are billed at a higher rate. Inclining block rates send a price signal to the customer that greater consumption is more costly on a per unit basis and provides incentive for conservation where feasible. Where marginal costs are higher than average costs, reduced usage in that case will benefit both the consumer and the provider. If, however, the inclining block rates are not cost-based, then the use of such rates can create a revenue deficiency for the provider because non-marginal costs included in the inclining block rate recovery will go unrecovered unless made up by increasing customer base or increased usage in lower rate blocks.

OCA

The OCA agrees that inclining block rates, where cost-justified, can serve as a valuable tool to encourage conservation by customers. At the same time, care must be exercised so that steeply inclining rates do not impose hardships on low-income households with heavy energy burdens due to poor housing conditions. As the Commission is aware, PECO had inclining block rates for residential customers during the summer months for many years.

Industrials

As Pennsylvania's largest consumers of energy, the Industrial Customer Groups do not, as a general matter, support or encourage the use of an inclining block rate structure. Instead, as explained above, the Industrial Customer Groups support appropriate cost-based pricing and rate design, which both removes utilities' disincentives for participating in energy conservation while sustaining or enhancing utility customers' incentives to use energy more efficiently.

7. Time-of-use rates (higher rates for on-peak usage)

Time-of-use (TOU) rate structures incorporate varying prices applicable to usage based upon the time period in which the energy is consumed. By sending clear price signals to the consumer of the wholesale cost of purchasing electricity depending on the time of day, time-of-use (TOU) rates provide incentive to shift demand and usage from peak price periods to lower price periods or reduce consumption overall. The success of TOU rates can contribute to the social and environmental goals of conservation and responsible energy demand management. Implementation of TOU rate structures requires more sophisticated metering and communications infrastructure than simple kWh meters, the cost of which can offset the savings to be achieved through usage reduction or load shifting. Additional consumer education costs must also be incurred so that consumers can understand how to benefit from such rate designs. The mandates of Act 129, with respect to the deployment of smart metering and appropriate cost recovery and the availability of TOU rates position this rate design to be a potentially effective conservation and demand reduction tool. TOU rates send relevant price signals to the consumer regarding the cost of the commodity being purchased.

OCA

The OCA supports time-of-use rates, as long as they are offered to customers on a voluntary basis. Under Act 129 of 2008, electric default service providers “shall offer” time-of-use and real-time price plans to all customers with smart meter technology; and residential and commercial customers “may elect” to participate in such pricing plans. 66 Pa.C.S. §2807(f)(5). The OCA would oppose any effort to impose time-of-use rates on a mandatory basis, particularly on residential consumers.

Industrials

As indicated above, the Industrial Customer Groups support appropriate cost-based pricing and rate design, which both removes utilities' disincentives for participating in energy conservation while sustaining or enhancing utility customers' incentives to use

energy more efficiently. Accordingly, the Industrial Customer Groups do not have specific comments on the use of Time-of-use rates.

8. Seasonal rates (higher rates for seasonal peak usage)

Similar to TOU rates, seasonal rates reflect the varying nature of the cost of energy production, but over the year as opposed to within a day. Typically, the seasons are structured as summer/winter or non-heating/heating seasons although shoulder periods can be included as well. Application of seasonal rates does not require the same level of technology as does a TOU rate structure.

Industrials

As indicated above, the Industrial Customer Groups support appropriate cost-based pricing and rate design, which both removes utilities' disincentives for participating in energy conservation while sustaining or enhancing utility customers' incentives to use energy more efficiently. Accordingly, the Industrial Customer Groups do not have specific comments on the use of seasonal rates.

9. Flat block rates (one rate)

A flat block rate structure is alternately defined as an all in fixed fee rate design or a flat per unit fee.

A purely fixed charge for distribution service completely removes any impact from changes in usage on the recovery of distribution costs. The customer pays the same amount regardless of whether he uses zero units of the commodity or service or 1,000 units. Similar to the pricing structures for cable and internet service, flat block rates provide budget certainty for customers. At the same time, however, such a fee eliminates any distribution rate incentive for the customer to conserve. For the SOLR or POLR customer who obtains his commodity from the LDC or EDC, changes in the price of the commodity will be the only component of the bill that will fluctuate.

Aside from changes in customer base, flat block rates ensure service providers a stable revenue stream. The extent to which that revenue stream translates into earnings will be dependent upon the utilities' ability to manage cost variances from ratemaking test year levels.

A flat per unit fee regardless of usage level creates the inner-class disparities for customers that were discussed in Section V. B (4), along with the revenue volatility and potential for deficiency for distribution service providers.

OCA

To the extent that this section refers to customers paying a single fixed monthly rate, regardless of usage, this type of rate would clearly eliminate all incentives for customers to conserve energy and would therefore be inconsistent with both ARRA Section 410(a)

and longstanding Commission policy as noted above. As such, the OCA would not support such a proposal.

Industrials

As indicated above, the Industrial Customer Groups support appropriate cost-based pricing and rate design, which both removes utilities' disincentives for participating in energy conservation while sustaining or enhancing utility customers' incentives to use energy more efficiently. Accordingly, the Industrial Customer Groups do not have specific comments on the use of flat block rates.

10. Reflecting EDC Lost Revenues Associated with Energy Conservation Programs in the Context of Base Rate Cases

Absent the presence of a reconcilable surcharge mechanism to decouple sales and revenues, lost revenues associated with decreased kWh sales due to the implementation of energy conservation programs may be recovered through base distribution rates in accordance with Act 129. There is considerable discussion regarding how such lost revenues can be recovered in a base distribution rate proceeding in accordance with Act 129.

Allegheny Power

Allegheny Power believes that this can be accomplished in the context of a Section 1308 distribution base rate proceeding by adjusting test year revenues downward to reflect an amortization of the total lost revenues, including carrying costs, since the prior base rate case. Lost revenues could be calculated either by multiplying energy conservation program savings in kWh by the distribution rate or by other means such as calculating the difference in allowed and actual distribution revenue per customer. The amortization period would be the anticipated rate effective period, which is typically 3-5 years.

OCA

As noted in the discussion of “decoupling” above, Act 129 of 2008 does not allow for recovery of lost revenues due to conservation between rate cases through an automatic adjustment clause. 66 Pa.C.S. §2806.1(k)(2). Act 129, however, does state that: “Decreased revenue and reduced energy consumption may be reflected in revenue and sales data used to calculate rates in a distribution-base rate proceeding filed by an electric distribution company under Section 1308.” 66 Pa.C.S. §2806.1(k)(3).

Under this provision, the OCA submits that an EDC may reflect the impact of conservation and energy efficiency measures on a prospective basis by considering such impacts in determining pro forma energy sales and revenue estimates. In other words, for example, if a utility were projecting future test year sales of 1,000,000 Mwh under a “business-as-usual” scenario; and if the utility was implementing energy efficiency programs under Act 129 that were expected to reduce annual energy sales by 100,000 Mwh; then the utility would be permitted to set rates prospectively at a projected sales level of 900,000 Mwh. This would result in a higher per kilowatt hour rate level than if the Act 129 energy efficiency programs were not reflected in prospective rates.

What the EDC cannot do, in OCA's view, is to seek retroactive recovery of revenues that may have been lost due to energy efficiency programs between base rate cases. This would have the same effect as allowing automatic adjustment recovery of those revenues, which is explicitly prohibited under the Act.

Industrials

The Industrial Customer Groups agree with and adopt herein the September 30, 2010 Comments of the OCA on this topic.

C. Financial Incentives – Positive and Negative

1. Act 129 penalties and their effects on energy conservation

Act 129 subjects EDCs to penalties if they do not meet the energy conservation goals of their Act 129 plans. These penalties provide a negative incentive to promote energy conservation and should be considered as a Pennsylvania policy that satisfies Section 410(a) of the ARRA, as EDCs have a great incentive to meet their Act 129 conservation goals.

OSBA

Act 129 does penalize EDCs for failing to file EE&C plans and failing to achieve specified reductions in consumption. See 66 Pa. C.S. §2806.1(f). All major EDCs have complied with the filing requirements and are administering EE&C plans. The Commission will have to determine in the future what type of effect the penalties have on the EDCs' success in achieving the specified reductions.

2. Positive incentives to utilities to promote energy conservation

Positive incentives provide benefits to utilities when they succeed in energy conservation efforts. At the present time Pennsylvania does not provide any such positive incentives to utilities. As utilities generally receive greater earnings when they sell more energy, energy conservation efforts can hurt their bottom line. Providing positive incentives can cushion the impact on earnings and "put utilities in the conservation business."

NFG

As implementation of ARRA objectives proceeds and Commission policies re-evaluated or replaced, National Fuel urges the Commission to maintain flexibility to allow various incentive programs. A "one size fits all" approach to incentives and conservation will not work in Pennsylvania. As discussed earlier in National Fuel's comments, each utility is unique in terms of its internal organization/structure and the market it serves. As a result, each utility will face certain challenges in implementing energy conservation programs that are specific to its rates, operating systems, service territory, climate and customers. What works as a financial incentive for National Fuel may not work at all for UGI or PGW. Differences among the utilities must be recognized

and accounted for if conservation programs are to align utility financial incentives with customer conservation as required by ARRA. Any new statutes or regulations that are adopted to comply with the ARRA must avoid establishing rules that dictate the design of financial incentives and conservation programs. The better alternative is for financial incentives and conservation programs to be established via a collaborative effort between utilities and the Commission so that each utility establishes programs that will work to the benefit of that utility and its customers.

PECO

PECO notes that mere removal of disincentives through one of the mechanisms described above will not cause companies to go above and beyond the minimum statutory efficiency requirements. Only positive incentives can accomplish that. It is clear that the ARRA and Act 129 were intended to encourage utilities to go above and beyond the minimum mandated reductions in energy usage. Act 129 requires the Commission's energy efficiency and conservation programs to include "[s]tandards to ensure that each plan includes a variety of measures that will enable an electric distribution company to improve its plan and exceed the required reductions in consumption[.]"⁸⁵ Moreover, the ARRA's requirement that utility financial incentives should provide "a timely earnings opportunity for utilities" also suggests a desire to incentivize behavior above and beyond the minimum statutory requirement.⁸⁶

Existing law authorizes the Commission to consider innovative ratemaking and incentive structures. Therefore, in keeping with the spirit of Act 129 and the Recovery Act, PECO encourages the Commission to consider positive incentives that recognize exemplary behavior as a way to stimulate innovation and quicken the industry's movement toward real energy savings.

Further, in keeping with the discussion of flexibility above, PECO suggests that the Commission consider various types of positive incentives as different mechanisms may be appropriate in different situations.

**a. Performance target incentives
(Reward utilities meeting conservation targets)**

Utility conservation programs generally provide energy conservation targets to enable the utility to carry out the program, and for the Commission to gauge the effectiveness of the program. If a utility does meet the energy conservation targets, the program should provide a benefit to the utility. This incentive will motivate the utility to carry out the program effectively,

⁸⁵ 66 Pa.C.S. § 2806.1(a)(6).

⁸⁶ ARRA § 410(a)(1).

and will provide a means to cover the costs of the program as well as lost earnings from decreased energy sales.

Equitable Gas

Equitable supports performance target incentives as a means to encourage utilities to undertake energy conservation programs.

PECO

Performance target incentives provide a financial reward to utilities for meeting or exceeding the goals of approved energy efficiency or demand reduction programs. The utility can be awarded a smaller, pro-rated amount for falling short of the goal, the full amount for meeting the goal, or a larger amount for exceeding the goal. Minimums and maximums are often set. For example, a utility may not be able to earn a reward for meeting less than 70% of the goal but their reward is capped once they achieve 130% of the goal. Awards are usually calculated as either a percentage of the overall program budget or a fixed amount per approved program. In this way, the provider is given the incentive to not just meet minimum energy efficiency standards, but to make efficiency programs as successful as possible. These rewards are often paid for through a surcharge to ratepayers the following year.

OSBA

Act 129 already *mandates* that EDCs pursue conservation. Therefore, no *incentive* for EDCs to pursue conservation is needed.

b. Shared energy savings between utility and customer

One method to provide a positive incentive to utilities for implementing their energy conservation programs is to share the energy savings between the utility and the customer. If the customer saves on their utility bill due to the customer's participation in the utility's energy conservation program, the utility would receive a portion of that savings. Generally the way that such a program is implemented is that the customer would not receive the full reduction in their utility bill due to the energy savings. This way the utility is not losing as much revenue as it would otherwise lose from the energy conservation program.

Equitable Gas

Equitable supports shared energy savings as a means to encourage utilities to undertake energy conservation programs.

PECO

Under shared savings programs, the utility receives a percentage share of the savings from an energy efficiency investment or demand reduction program. Typically, the utility receives an increasing percentage of the savings as the utility or consumer conserves a greater amount of power or more consumers participate. This gives the utility an incentive to increase participation and energy savings rather than only meet minimum standards. As with performance target incentives, these benefits are often paid for through a surcharge the following year.

c. Rate-of-return adder (higher ROR based on meeting energy conservation goals)

A rate-of-return adder is a form of positive incentive to a utility that meets energy conservation program goals. If the utility meets the program goals, it can ask for an adder to its rate of return in its next base rate case. The adder could be from 0.1% to 0.5%, depending on the amount of energy conservation that was achieved. The rate-of-return adder provides a strong incentive for utilities to offer greater energy conservation programs.

Equitable Gas

Equitable supports rate of return adders as a means to encourage utilities to undertake energy conservation programs.

PECO

A rate-of-return adder would allow utilities to capitalize their energy efficiency and demand-side reduction programs and possibly earn a rate-of-return slightly higher than traditional supply-side investments. The costs of the energy efficiency investments or demand reduction programs become regulatory assets just as if the money was invested in new equipment or infrastructure. The utility can then recover these costs during its next rate case. A small percentage, such as .5% to 5% may be added onto the rate-of-return that normally would be given to supply-side investments. The utility can then earn a profit on energy efficiency investments and demand reduction programs through its rate base and can meet customers' needs through either demand or supply side investments.

OSBA

Some parties believe that the Commission should reward utilities which exceed the conservation mandates of Act 129 with a higher rate of return on equity.

This proposal ignores the fact that Section 2806.1(c) and (d) provide *minimum* levels by which overall and peak demand are to be reduced. Furthermore, those paragraphs expressly allow the Commission to direct an EDC to implement additional conservation measures which are cost-effective. Similarly, Section 2807(f)(2) establishes *deadlines* for an EDC to deploy smart meter technology but does not prohibit an EDC from deploying the technology earlier.

In short, Act 129 provides detailed parameters (including limitations on cost recovery) and specific procedures to govern the design, review, and implementation of EDC conservation plans. However, this recommendation would require that an EDC's "baseline conservation" be addressed in Act 129 proceedings and that the EDC's "extra conservation" be addressed in other rate proceedings (presumably with rules different from Act 129). By providing for multiple tracks for evaluating an EDC's conservation,

this recommendation would increase litigation expenses, make it more difficult to assure that the EDC's overall conservation efforts are integrated and cost-effective, and reduce the accountability contemplated by the reporting requirements under Section 2806.1(i). Therefore, the Commission should reject this recommendation.

d. Allow for full recovery of costs for assets retired due to energy conservation.

As energy conservation programs succeed in reducing energy usage, it is likely that utilities will retire assets to reflect the usage reduction. In addition, utilities may seek to install more energy efficient equipment and then seek to retire less energy efficient equipment that might otherwise be useful in providing utility services. In these situations, the utilities would not be as financially impacted if they were able to obtain full cost recovery for such assets. By allowing full cost recovery of such assets, the utilities would have a greater incentive to undertake such energy conservation efforts.

D. Other Methods to Align Incentives for Energy Conservation

1. Third-party conservation rules

Commercial, industrial, and residential customers may undertake energy conservation efforts in the absence of a utility energy conservation program. Providing rules regarding the inclusion of such third-party conservation in a utility's energy conservation program will be necessary to ensure that the utility's energy conservation efforts are measured correctly. In addition, it may be worthwhile to allow third-party conservation efforts to receive a benefit under a utility energy conservation program, as it would leverage the spending of third parties to obtain more energy conservation than would otherwise be possible in a utility's energy conservation program.

2. Utility energy conservation programs

a. Relation to different rate structures

Utility energy conservation programs will necessarily be different under various rate structures. For example, a utility's revenues may be greatly affected by a utility energy conservation program under one rate structure, but not nearly as affected under a different rate structure. The impact on a utility's revenues by a utility energy conservation program must be considered based upon the utility's rate structure, rather than any more general measurement.

b. Recovery of lost revenues

Section 410 (a) of the ARRA is designed to encourage through appropriate proceedings, general state ratemaking policies that align financial incentives with the efficient use of energy and which provide timely cost recovery and timely earnings opportunities for both natural gas and electric utilities. Prior to the enactment of the ARRA, the Commonwealth of Pennsylvania enacted Act 129 of 2008, requiring electric utilities to implement specific energy efficient and

conservation plans, and establishing certain load reduction targets that electric distribution companies must meet, as well as requiring electric utilities to deploy smart meter technology to all customers within 15 years.

EDCs are committed to conforming to the requirements of Act 129 and Section 410 (a) of the ARRA, and have actively explored opportunities to comply with the energy reduction requirements set forth in Act 129. It is the position of EDC members of the Working Group that certain provisions of Act 129 are not consistent with the directives and policy set forth in Section 410 (a) of ARRA. As a result, there is conflicting opinion on how electric distribution companies are supposed to comply with Act 129 in conjunction with the standards set forth in Section 410 (a) of the ARRA.

Specifically, section 410 (a) requires the Governor of the State to notify the Secretary of Energy, in writing, that:

The applicable State regulatory authority will seek to implement, in appropriate proceedings for each electric and gas utility, with respect to which the State regulatory authority has ratemaking authority, *a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and that provide timely cost recovery and a timely earnings opportunity for utilities associated with cost effective measurable and verifiable efficiency savings*, in a way that sustains or enhances utility customers' incentives to use energy more efficiently. (Emphasis added.)

The ARRA conditions the receipt of certain federal funds on the assurances that electric distribution companies be allowed timely recovery of their costs associated with the implementation of energy efficiency programs. Act 129 allows for recovery of costs through an automatic adjustment clause, but specifically excludes from such an automatic adjustment mechanism the recovery of decreased revenues of an electric distribution company due to reduced energy consumption by use of an automatic adjustment mechanism or changes in energy demand resulting from the implementation of energy efficiency and conservation plans. 66 Pa. C.S. § 2806.1 (k) states:

- 1) An electric distribution company shall recover on a full and current basis from customers, through a reconcilable adjustment clause under section 1307, all reasonable and prudent costs incurred in the provision or management of a plan provided under this section. This paragraph shall apply to all electric distribution companies, including electric distribution companies subject to generation or other rate caps.
- 2) Except as set forth in paragraph (3), *decreased revenues of an electric distribution company due to reduced energy consumption or changes in energy demand shall not be a recoverable cost* under a reconcilable automatic adjustment clause.
- 3) Decreased revenue and reduced energy consumption may be reflected in revenue and sales data used to calculate rates in a distribution-base rate proceeding filed

by an electric distribution company under section 1308 (relating to voluntary changes in rates)

66 Pa. C.S. § 2806.1 (k). (Emphasis added).

Further, in the smart meter technology section of Act 129, the recovery of any lost or decreased revenues of an electric distribution company due to reduced electric consumption or shifting energy demand is also strictly prohibited outside the context of a prospective base rate proceeding. 66 Pa. C.S. § 2807 (f)(4)(ii). Section 2807(f)(4) specifically states:

4) *In no event shall lost or decreased revenue by an electric distribution company due to reduced electricity consumption or shifting energy demand be considered any of the following:*

- i. *A cost of smart meter technology recoverable under a reconcilable automatic adjustment clause under section 1307(b), except that decreased revenues and reduced energy consumption may be reflected in the revenue and sales data used to calculate rates in a distribution rate case proceeding filed under section 1308 (relative to voluntary changes in rates).*
- ii. *A recoverable cost.*

66 Pa. C.S. § 2807 (f)(4). (Emphasis added).

According to the EDC members of the Working Group, the resulting impact of Act 129 from an EDC revenue perspective is that an EDC is faced with whether it will receive timely cost recovery of lost revenue as stipulated in Section 410 (a) of the ARRA or whether the EDC is able to recover the lost revenue from energy efficiency programs. Lost revenue for an EDC that is caused by the implementation of mandated energy efficiency programs can be defined as revenue that an EDC will not receive in a current year because distribution charges that are tied to energy usage are reduced due to the reduced consumption. In the current regulatory environment, if the lost revenue is not recovered through a base rate case proceeding, then the EDC would not recover those revenues, hence causing the EDC to be faced with a disincentive of losing those revenues forever by implementing energy efficiency programs.

In contrast, the consumer parties in the Working Group contend that the EDCs are fairly compensated by immediate automatic recovery of all the costs of the Act 129 programs and are permitted to reflect reductions in revenues due to Act 129 prospectively if and when they file a base rate case. Section 410(a) requires the ratemaking policies to "provide timely cost recovery and a timely earnings opportunity for utilities associated with cost effective measurable and verifiable efficiency savings"; Section 410(a) does not necessarily require absolutely certain revenue neutrality. No additional incentives are needed because the Act 129 requirements are mandated as a matter of state law and the EDCs are subject to explicit monetary penalties if they do not meet those mandates. In any case, the Pennsylvania General Assembly has spoken clearly and directly on this subject and it is not the role of the Commission to disregard that policy in an attempt to secure federal funds.

Equitable Gas

Equitable Gas Company supports consideration of new and innovative rate design principles and policies consistent with Section 410(a) of the ARRA. The principles and policies considered should provide a vehicle for utilities to recover the cost of energy conservation programs provided by and through NGDCs and lost revenues resulting from the programs and customer conservation. The principles and policies considered should encourage a partnership between NGDCs and their customers promoting energy conservation. With existing principles and policies, there is a disconnect between the programs and utility revenue. As an example, current Pennsylvania regulations mandate the submission of a low-income usage reduction program to assist low-income customers conserve energy and reduce residential energy bills. While the cost to provide to LIURP programs may be recovered, lost revenue due to customer conservation is not. The Commission might consider revenue stabilization mechanisms which would provide for Commission review and approval of periodic utility rate adjustments based on a comparison of achieved versus approved rate of return.

OCA

The OCA's position on this issue is accurately set forth in the last paragraph of this section of the Draft Report that addresses the contentions of the consumer parties of the Working Group. The OCA would also reiterate the comments made in Section V.B.2 above with respect to the issue of "decoupling." That is, the General Assembly has spoken clearly with respect to electric utility recovery of lost revenues in Act 129 of 2008. In OCA's view, ARRA Section 410(a) does not mandate the automatic recovery of lost revenues between base rate cases or any form of decoupling as a condition for receipt of ARRA Stimulus funds. But if Section 410(a) is interpreted by the Commission to include such a requirement, then the Commission's inquiry is at an end because such recovery is simply not permitted – at least for electric utilities -- under Pennsylvania law.

As to natural gas utilities, the Public Utility Code is silent with respect to the issue of lost revenue recovery, but as noted in Section V.B.2 above, it appears unlikely that the General Assembly would endorse such an approach.

Industrials

The Industrial Customer Groups agree with and adopt herein the September 30, 2010 Comments of the OCA on this topic.

c. Timely cost recovery

Section 410 (a) of the ARRA requires that, as a general policy, timely cost recovery and a timely earnings opportunity must be provided for utilities. Some members of the Working Group believe that a base rate case proceeding does not allow for timely recovery of costs resulting from energy efficiency programs. This position is due to the regulatory lag that is an inherent part of a base rate case which causes utilities not to be able to recover the lost revenues on a current basis, but instead one or two years after the fact. As a result, utilities would be subject to reduced cash flow from distribution revenues, causing an interest cost of the reduced cash flow.

OCA

Act 129 permits timely recovery of electric utility conservation costs through an automatic adjustment clause and such clauses have been established for each EDC in the recent PUC Act 129 proceedings. As set forth more fully below, the OCA submits that a similar type of recovery for natural gas costs may be permitted for natural gas utilities under Section 1307 of the Public Utility Code to the extent that such costs meet the requirements of Section 1319 of the Public Utility Code and the standards for cost recovery set forth in the Commonwealth Court's decision in Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission, 653 A.2d 1336, 1348 (Pa.Cmwlth. 1995) ("PIEC"). The PIEC decision is discussed in Section VI of the Draft Report.

Industrials

The Industrial Customer Groups agree with and adopt herein the September 30, 2010 Comments of the OCA on this topic.

d. Positive incentives

Positive incentives provide benefits to utilities when they succeed in energy conservation efforts. At the present time Pennsylvania does not provide any such positive incentives to utilities. As utilities generally receive greater earnings when they sell more energy, energy conservation efforts can hurt their bottom line. Providing positive incentives can cushion the impact on earnings and "put utilities in the conservation business."

e. Potential conflicts between gas and electric utilities over "credit" for conservation activities

For a utility implementing an energy conservation program that has performance measures, receiving credit for the proper amount of energy conservation will be crucial. There may be instances where a customer has both electric and gas service, and participates in both utilities' energy conservation programs. In such circumstances, it may be necessary to devise appropriate energy conservation measurements for the efforts of both utilities.

f. Impact on customers' incentives to use energy efficiently

Utility energy conservation programs should incentivize customers to reduce energy consumption. Many of the electric utilities' Act 129 plans provide rebates to customers who utilize energy conservation equipment such as energy efficient hot water heaters, low energy light bulbs, or energy efficient heat pumps. In these programs, the utilities receive "credit" for the energy conservation resulting from these rebates, in order to satisfy Act 129 requirements. This system provides for flexibility for utilities in crafting such programs, as well as customer control regarding participation in such programs.

g. "Cost effective" requirement in Section 410(a)

Section 410(a) of the ARRA refers to cost effective energy conservation. Therefore the cost effectiveness of a particular energy conservation initiative in a utility energy conservation program should be considered. Energy conservation initiatives that are not cost effective should be avoided.

3. Act 129 interplay with Section 410(a)

a. Timely earnings opportunity for utilities

Section 410(a)(1) of the ARRA provides that the Commission seek to implement “a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and will provide for timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers’ incentives to use energy more efficiently.” (Underling added). As indicated in Section 410(a)(1) of the ARRA, the Commission should seek to implement a policy that will provide utilities financial incentives that will provide them a timely earnings opportunity. In other words, Section 410(a)(1) of the ARRA does not advocate (or require) Commission policies that would interfere with utilities having a timely earnings opportunity. This issue has some bearing on Pennsylvania’s Act 129. Act 129 allows electric utilities to reflect lost sales and revenue due to energy conservation resulting from Act 129 programs during their base rate proceedings, but specifically prohibits recouping such lost sales and revenues between base rate cases.⁸⁷ Given that utilities may reflect lost sales and revenues due to energy conservation resulting from Act 129 programs in future base rate proceedings, it appears that Act 129 does provide a timely earnings opportunity to the utilities. In such base rate proceedings, proper and factually supported determination of lost sales and revenues due to Act 129 programs in the future test year will be an important issue to ensure that utilities have a timely earnings opportunity. Making such a determination will likely become easier over time, because the utilities will develop a historical record regarding the lost sales and revenues due to their Act 129 programs.

b. Cost effectiveness

Section 410(a)(1) of the ARRA provides that the Commission seek to implement “a general policy that ensures that utility financial incentives are aligned with helping their customers use energy more efficiently and will provide for timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measurable and verifiable efficiency savings, in a way that sustains or enhances utility customers’ incentives to use energy more efficiently.” (Underling added). Act 129 states that utilities are entitled to recover "all reasonable and prudent costs" associated with energy efficiency and conservation programs up to a cap of 2% of revenues.⁸⁸ Act 129 requires utilities to "explain how quality assurance and

⁸⁷ See *id.* § 2806.1 (k)(3).

⁸⁸ See *id.* § 2806.1 (k)(1).

performance will be measured, verified, and evaluated."⁸⁹ The Commission will then use these measurements to ensure that utilities are "achieving or exceeding" the required reductions in consumption and demand.⁹⁰ In addition, Act 129 mandates efficiency goals as a result of Act 129 programs that will ensure that Act 129 program funds are cost-effective. These efficiency goals consist of a 3% reduction in consumption and a 4.5% reduction in demand by 2013.⁹¹ Therefore it appears that Act 129 complies with the mandate in Section 410(a) of the ARRA to have cost-effective measurable and verifiable efficiency savings.

c. Lack of positive incentives

Act 129 includes financial penalties for utilities that do not achieve the efficiency goals, but does not include any positive incentives for the utilities if they meet the Act 129 requirements.⁹² In addition, Act 129 allows electric utilities to reflect lost sales and revenue due to energy conservation resulting from Act 129 programs during their base rate proceedings, but specifically prohibits recouping such lost sales and revenues between base rate cases.⁹³ It appears that Act 129 does not prohibit the Commission from approving positive incentives to utilities for meeting Act 129 requirements in base rate cases. Approving positive incentives to utilities for meeting Act 129 requirements outside base rate cases may also be possible under Act 129, however doing so is more problematic given Act 129's prohibition from recouping lost sales and revenues due to Act 129 programs outside of a base rate case. For example, if the Commission were to approve a positive incentive for a utility for meeting Act 129 requirements outside a base rate proceeding, parties may assert that the approved incentive is really just another means to recoup lost sales and revenues due to the Act 129 program, which is prohibited under Act 129 outside of base rate cases.

OSBA

Act 129 already *mandates* that EDCs pursue conservation. Therefore, no *incentive* for EDCs to pursue conservation is needed.

d. Penalty for "independent movers" – those who adopted EE&C measures pre-Act 129

Act 129 requires the Commission to establish "[s]tandards to ensure that each [EE&C] plan includes a variety of energy efficiency and conservation measures and will provide the measures equitably to all classes of customers." 66 Pa. C.S. § 2806.1(a)(5). In its Implementation Order, the Commission interpreted this mandate as requiring that "EDCs should develop plans to achieve the most energy savings per expenditure" under the overarching

⁸⁹ 66 Pa.C.S. § 2806.1 (b)(1)(C).

⁹⁰ *See id.* § 2806.1 (b)(1)(D).

⁹¹ *See id.* § 2806.1 (c), (d).

⁹² *See id.* § 2806.1 (f).

⁹³ *See id.* § 2806.1 (k)(3).

principle that EDCs employ "the most cost effective use of resources so that benefits can accrue to all customers, even if only by virtue of more reasonable energy market prices." *Energy Efficiency and Conservation Plan Implementation Order* at Docket No. M-2008-2069887 (Jan. 16, 2009) (hereinafter "Implementation Order").

From this analysis, the Commission determined that "EDCs must offer a well-reasoned and balanced set of measures that are tailored to usage and to potential for savings and reductions for each customer class" in order to "ensure that offerings will not be skewed toward or away from any particular class." *Id.* at 22. The Commission reasoned that a "general approach" to energy efficiency and demand response programs provides the best benefit to all customers by presenting the "best potential to impact future energy prices." *Id.* While the Commission's Implementation Order leaves the initial EE&C plan design and program allocation to the discretion of the EDCs and, therefore, does not require a specific distribution of programs among classes, the Commission did determine that EDCs must offer through their EE&C plan "at least one energy efficiency and one demand response program" for each customer class. *Id.* at 23.

This design presupposes that each customer class and all customers within a class can benefit from EE&C programs. In addition, by imposing rate recovery from all EDC customers, it assumes that all customers will be able to participate in either an energy efficiency and/or demand response program. Some members of the Working Group contend that such design overlooks the fact that customers who have previously implemented energy efficiency and conservation measures may be unable to participate meaningfully in the EDCs' EE&C programs and are now forced to pay for other customers (including competitors) to implement EE&C measures through the collection of an EE&C surcharge. In addition, the EE&C programs also overlook customers whose next step to become more efficient may be a complete overhaul of processes and equipment, which amounts would exceed the available incentive amounts under the program.

OCA

The OCA would only note that while the primary beneficiaries of each EDC's Act 129 programs are those customers who actively participate in the programs, Act 129 also includes a cost/benefit test, the Total Resource Cost Test, that is designed to ensure that the net present value of the benefits of the programs will exceed the cost of the programs. As a result, all customers in the aggregate should benefit as a result of the Act 129 programs if they are properly designed and implemented. As such, even customers who do not directly participate in Act 129 programs or who have funded their own conservation measures may benefit as a result of a well-constructed, cost-effective utility-wide program under Act 129. In addition, a well-designed portfolio of utility programs could introduce new and improved efficiency measures even to those customers who have already taken some steps on their own initiative.

Industrials

Some parties' positions in this Working Group are that with the use and reliance on a cost/benefit test (the Total Resource Cost Test), utilities' Act 129 programs should, in theory, provide some benefit to all customers in the aggregate if Act 129 programs are properly designed and implemented, this point ignores the reality that customers (in many

cases, large industrial customers) who adopted EE&C measures pre-Act 129 are now being forced to pay significant amounts so that other customers (including competitors) can "get up to speed." In some instances, the energy efficiency measures that a customer pays for through the Act 129 surcharge will subsidize its competitors to enhance their ability to compete. This is fundamentally unfair. As noted in the WG Report, while the costs associated with Act 129 programs are capped at 2% of 2006 utility revenues, customers are being forced to pay hundreds of millions of dollars to support Pennsylvania utilities' Act 129 Plans.⁹⁴

While the Industrial Customer Groups applaud and support Act 129's overall policy goal of reducing energy consumption and increasing energy efficiency in Pennsylvania, the Industrial Customer Groups do not believe that customers who were "ahead of the curve" or spend significant amounts of their own money should have to subsidize the improvement of other customers' operations. For some industries, the only way to "improve" efficiency is through major improvement projects or equipment replacements that cannot be funded by the Act 129 programs. Being forced to subsidize other customers (and competitors) through mandatory EE&C surcharges after spending significant amounts of their own funds pre-Act 129 or to self-fund major improvement projects does nothing to sustain or enhance these customers' incentives to use energy more efficiently.

4. Gas DSIC interplay with Section 410(a)

Gas Distribution System Improvement Charges ("DSIC") are mechanisms approved in a number of states that can provide a means between base rate cases to compensate utilities between rate cases for certain capital improvements, such as replacing cast iron or bare steel mains. To the extent that gas DISCs facilitate the replacement of old cast iron or bare steel pipeline infrastructure, NGDC members of the Working Group contend that they can (i) enhance the efficient delivery of gas and reduce the amount of lost-and-unaccounted-for gas to provide overall energy efficiency, (ii) improve the safety and reliability of NGDC pipeline systems, and (iii) improve the ability of NGDCs operating in gas producing regions of the Commonwealth to take new supplies of Pennsylvania gas, encourage the continued development of Pennsylvania's rich natural gas resources, stimulate the growth of the natural gas and related industries, and promote the production and the use of natural gas. On the other hand, consumer members of the Working Group contend that the relationship between Gas DSICs and energy conservation is tenuous at best and that, in any case, such charges are not permitted under current Pennsylvania law.

OCA

As set forth in the Draft Report the consumer parties to the Working Group – including the OCA – see little or no relationship between the Gas DSIC and the subject of

⁹⁴ As stated in the ARRA WG Report, the seven major EDCs' budgets for their respective EE&C Plans are as follows: PPL Electric Utilities Corporation - \$246 million; West Penn Power Company - \$94.25 million; Duquesne Light Company – \$78.2 million; PECO Energy Company - \$341.6 million; Metropolitan Edison Company - \$24.9 million; Pennsylvania Electric Company - \$23.0 million; and Pennsylvania Power Company - \$6.7 million.

this Report. In any case, no member of the Working Group has suggested that a Gas DSIC is permitted under current Pennsylvania law and as such, there is no point in considering this issue as part of a Commission response to ARRA Section 410(a).

OSBA

The OSBA does not support a Distribution System Improvement Charge (“DSIC”) for NGDCs. A DSIC is an automatic adjustment method that would enable NGDCs to recover the fixed costs (depreciation and pre tax return) of certain non-revenue producing projects completed and placed in service between base rate proceedings. There are numerous reasons not to allow a NGDC to use a DSIC.

First, NGDCs claim that one of the benefits the DSIC provides is a reduction in the frequency of the Company’s general base rate cases. Less frequent base rate proceedings are not necessarily beneficial to ratepayers. Allowing companies to circumvent the comprehensive review inherent in the base rate case process is harmful and biased toward ratepayers since it creates single-issue ratemaking. Specifically, the DSIC surcharge would provide companies the opportunity to recover *select* cost increases without the need for a base rate case, and the comprehensive review such a case entails. As a result, any increase in the surcharge would be fully reflected on ratepayers’ monthly bills. In contrast, a base rate proceeding would allow the Commission to address *all* areas of a utility’s cost structure (rather than just the single area covered by a surcharge mechanism) for the purpose of setting just and reasonable rates.

Second, allowing a DSIC, along with less frequent rate cases, would exacerbate interclass subsidies, thereby requiring some rate classes to provide subsidies to other classes for a longer period of time. A DSIC is charged to all customers via an across-the-board revenue surcharge. However, this type of assignment is not cost-based. If the Commission approves a DSIC for NGDCs and the utilities file less frequent rate cases (as they claim), the combination of the two will aggravate any degree of class cross-subsidization that exists on the company’s system.

Third, allowing an NGDC to recover distribution investments through a surcharge would not guarantee that the company would actually increase spending on its distribution system. Instead, the surcharge would simply guarantee that the company would collect from ratepayers more quickly. If an NGDC is to receive a Gas DSIC, then the NGDC should receive a reduction in the company’s authorized rate of return to reflect reduced risk stemming from reduced regulatory lag.

Fourth, NGDCs have a legal obligation to fix their pipes in order to reduce lost and unaccounted for gas. NGDCs claim that a DSIC would provide them with resources and incentive to address the problems presented by their distribution systems. However, NGDCs have a legal duty to “furnish and maintain adequate, efficient, safe, and

reasonable service and facilities” and a legal duty to “make all such repairs, changes, alterations, substitutions, extensions, and improvements in or to such service and facilities as shall be necessary or proper for the accommodation, convenience, and safety of its patrons, employees, and the public.”⁹⁵ Therefore, denying a DSIC would not diminish NGDCs’ duty to provide adequate, efficient, safe, and reasonable services. NGDCs would continue to have other means to recover their DSIC-eligible expenses in order to carry out that duty, *i.e.*, through a base rate proceeding.

Industrials

The Industrial Customer Groups agree with and adopt herein the September 30, 2010 Comments of the OCA on this topic. Notwithstanding, to the extent that the Commission may accept and consider arguments by other ARRA WG members in support of instituting a Gas DSIC, the Industrial Customer Groups respond below.

A proposed DSIC for NGDCs raises significant concerns by allowing a NGDC to increase customers' rates up to a certain cap without having to undergo the full review of revenues and expenses that occurs in the course of a base rate proceeding. As such, a DSIC suffers from similar fundamental "single issue ratemaking" flaws that revenue decoupling proposals exhibit, which are detailed above in the Industrial Customer Groups' comments to Section IV(B)(2). For example, although the NGDC's level of system replacements may increase, those expenses may be offset by other expense reductions for items such as their cost of debt. In addition, a DSIC rewards NGDCs that may have inappropriately delayed or ignored system repairs that are necessary to provide safe, adequate and reliable service. Finally, depending on how rates are designed for a DSIC, it could place a disproportionate burden on larger customers. As such, the Industrial Customer Groups oppose any proposal that seeks to consider a NGDC DSIC as part of this proceeding.

5. Policies to promote full fuel cycle efficiency

Energy efficiency is using less energy to provide the same level of energy service, and is appropriately measured on a source-to-site basis that considers losses incurred in production, transport and transformation. These losses are determined by physical laws and current technology, and for certain end-uses some energy sources are clearly more efficient than others. For example, on a source-to-site basis the direct end use of natural gas for heating purposes or combined heat and power is approximately three times more efficient than the use of electricity for heating purposes given the current generation base in the grids serving Pennsylvania.

⁹⁵ See Section 1501 of the Public Utility Code, 66 Pa. C.S. §1501

It is the position of certain NGDC members of the Working Group that the Commission can promote energy efficiency not only by adopting policies which encourage increases in energy efficiency within the specific industries it regulates (e.g., rebates on higher efficiency electric or gas appliances), but by also adopting policies which encourage the use of the most efficient energy sources for particular uses (e.g., rebates encouraging the use of the most efficient energy source). Moreover, NGDC members suggest that the Commission can maximize efficiency gains by ensuring conservation programs allocate resources on a fuel neutral basis – that is that funds are spent on those programs that will achieve the greatest efficiency gains regardless of fuel source, as measured by a uniform non-discriminatory test such as the Total Resource Cost (“TRC”) test. If conservation programs are not fuel neutral, efficiency gains may not be optimized as funds are spent to achieve incremental gains in efficiency for a particular energy source, when larger gains could have been achieved by encouraging the use of an alternate energy source.

Since electricity is often used in Pennsylvania for heating purposes where significant energy efficiency gains could be realized through the direct end use of natural gas or propane, it is likely that a successful fuel neutral energy efficiency program would lead to less electricity generation for heating purposes, decreased electric distribution throughput for heating purposes, decreased overall use of natural gas as gas is more efficiently used for direct end use purposes rather than being used for electric generation, and increased gas distribution throughput as more gas is distributed for direct end user applications. Thus, a successful fuel neutral energy efficiency program could be consistent with natural gas distribution company shareholder interests under existing volumetric natural gas distribution rate structures, but could be contrary to electric distribution shareholder interests under current volumetric rate structures. A fuel switching program would also have varying impacts on the rates charged to electric and natural gas ratepayers.

Recently, in a May 21, 2010 Secretarial Letter at Docket No. M0051865, the Commission recognized that:

Cost-effective fuel switching measures should be available to EDCs and their stakeholders when considering the best means of achieving EE&C plan goals. However, fuel switching programs should not be mandated.

EDC shareholder interests are probably not currently aligned with achieving energy efficiency gains through effective fuel substitution programs, given existing volumetric rate structures and Act 129 restrictions regarding recovery of lost distribution revenues. It is the position of certain NGDC members of the Working Group that it is likely that the Commission’s decision to delegate to EDCs the choice of whether to spend energy efficiency dollars on fuel substitution will likely lead to less energy efficiency gains than could be achieved through a fuel neutral non-discriminatory energy efficiency program.

UGI

The UGI Distribution Companies (“UGI”) believe that the Commission, in evaluating possible policy options to align shareholder and customer interests with the promotion of cost-effective energy conservation, should focus on policies to promote the direct end use of gas where it is cost-effective under the total resource cost test because:

- The scale of potential savings is very significant – A recent study by GRI, which can be accessed at <http://www.aga.org/NR/rdonlyres/6D433449-68DE-47F1-B4BS-CE861FED0082/0/0709DIRECT.PDF>, utilizing the National Energy Modeling System (NEMS) utilized by the Energy Information Agency, concluded that policies to promote the direct end-use of natural gas could, by 2030:
 1. Provide nationwide energy savings of 1.9 Quads per year;
 2. Reduce CO2 emissions by 96 metric tons per year;
 3. Provide \$213 billion in consumer savings;
 4. Reduce electric consumption by 200,000 Gwh per year.
 5. Reduce the need for electric generation capacity additions by 50 GW, with avoided capital expenditures of \$110 billion at \$2,200/kW.
 6. Would provide more cost effective energy savings than expenditures to promote more efficient electric energy measures.
- Pennsylvania is blessed with abundant natural gas supplies and is likely to be a net natural gas exporter in the near future. It also has many homes and businesses where natural gas is available but electricity is used for water or space heating. Adopting policies to promote the direct end use of natural gas where it is cost effective under the Total Resource Test would provide a means to both promote energy efficiency while utilizing an in-state resource that does and will provide many ancillary benefits to the Commonwealth.
- California is generally viewed as a leader in energy efficiency, and has long had policies in place to promote fuel substitution where appropriate, and incorporated standards for evaluating fuel substitution in its TRC test model that was largely adopted by the Commission. The Commission has also recognized through its fuel substitution working group that fuel substitution measures meeting the TRC test is an acceptable means of meeting Act 129 goals.

UGI believes that the current docket is a particularly appropriate forum considering this issue because UGI believes that EDC interests are not properly aligned with promoting the most cost-effective means of achieving efficiency, and are instead aligned with pursuing measures that will preserve electric usage for many uses where the direct end use of natural gas would clearly be more efficient.

While the Commission may have understandably been reluctant in the past to promote one energy source over another, with the passage of Act 129 and the adoption of

a TRC test to evaluate energy efficiency measures, the Commission now has the responsibility to ensure that energy efficiency expenditures, collected for consumers, are spent in a cost-effective manner and that all paths to energy efficiency are evaluated in a similar and fair manner.

OSBA

Some parties believe the conservation of electricity should be promoted through fuel-switching, *i.e.*, the substitution of natural gas for electricity, whenever such substitution would be cost-effective. This proceeding is not the proper venue for consideration of such a proposal.

The goal of Section 410(a) of the Recovery Act is to “sustain[s] or enhance[s] utility customers’ incentives to use energy more efficiently.” A reasonable inference is that Congress intended to encourage reduced consumption of *both* electricity and natural gas and not to reduce the consumption of one by increasing the consumption of the other.

Furthermore, the Commission has addressed this issue through the Fuel Switching Working Group at Docket No. M-00051865.

6. Elimination of Barriers to Use of On-site Generation for Customers to Decrease Reliance on Grid

Industrials

The Industrial Customer Groups support the Commission undertaking a full investigation into the impact of line extension, interconnection and back-up power rules on customer pursuit of on-site and distributed generation.

a. Electric backup service tariff rules

Commercial, industrial, and residential customers may undertake energy conservation efforts outside of a utility energy conservation program. A number of third-party vendors may offer these customers energy conservation programs. To facilitate these efforts, utilities must have reasonable electric backup service rules.

b. Interconnection rules

Commercial, industrial, and residential customers may undertake energy conservation efforts outside of a utility energy conservation program. A number of third-party vendors may offer these customers energy conservation programs. To facilitate these efforts, utilities must have reasonable interconnection rules for such equipment.

c. Natural gas line extension policies

Through the enactment of the Alternative Energy Portfolio Standards ("AEPS") Act, 73 P.S. §§ 1648.1 – 1648.8, and Commission policy regarding the Implementation of the AEPS

Act,⁹⁶ both the PUC and the Commonwealth have encouraged individuals and groups of individuals to have the ability to detach from or reduce reliance on supplies from the grid by considering self-generation options.

The inclusion of demand-side management through industrial by-product technologies using industrial process byproducts as well as distributed generation as Tier II alternative energy resources and activities such as the use of biomass energy as a Tier I alternative energy resource have incentivized customers to invest substantial time and money to have the ability to operate independently from the grid. In addition, the Commission has also recognized the value to the Commonwealth of alternative energy systems whose output is not used for producing electricity.⁹⁷ These views have had the result of diversifying the number of potential fuel sources and encouraged alternative types of generation. When providing these services, however, customers or groups of customers pursuing self-generation must still interconnect with utilities for distribution service and, potentially, for back-up service. In addition, when a gas-fired generator is installed, generators routinely must obtain line extensions in order to receive a sufficient amount of pressure for operation.

While the Commission has clarified its position to encourage alternative energy resources and reduce uncertainty about the jurisdictional status of certain viable alternative energy projects that may be developed in the Commonwealth,⁹⁸ other impediments regarding electric backup service tariff rules, interconnection rules and natural gas line extension policies remain.

7. Energy conservation projects outside of utility-operated programs

While Act 129 prescribes that utilities design programs to encourage energy efficiency and conservation and includes a cap and cost recovery for such efforts, Act 129 only credits efficiency as a result of an EDC-run program. As a result, customers that have implemented or will implement energy conservation projects outside of utility-operated programs do so at their own expense.

Industrials

The Industrial Customer Groups' Comments to Section V(3)(D) should be incorporated herein by reference.

⁹⁶ See *Implementation of the Alternative Energy Portfolio Standards Act of 2004*; Docket No. M-00051865, Final Policy Statement (Order entered December 5, 2006) ("The purpose of the proposed policy statement was to support and encourage the development of alternative energy resources and the use of alternative energy....").

⁹⁷ See *Implementation of the Alternative Energy Portfolio Standards Act of 2004*, Docket No. M-00051865, Proposed Policy Statement Order (Order entered November 16, 2005), pp. 3-4.

⁹⁸ See *Implementation of the Alternative Energy Portfolio Standards Act of 2004*; Docket No. M-00051865, Final Policy Statement (Order entered December 5, 2006).

VII. 1307 Adjustment Proceedings

This Working Group has focused on identifying changes to Commission policies and programs that can be implemented under existing State law and that will align utility financial incentives with helping customers use energy more efficiently.

A statutory provision that may serve as the vehicle for implementing policies and programs consistent with ARRA is 66 Pa CSA § 1307, which sets forth the rules for establishing a sliding scale of rates or adjustments to rates. Specifically, we focus on Section 1307(a), which provides in pertinent part that public utilities:

“ . . . may establish a sliding scale of rates or such other method for the automatic adjustment of the rates of the public utility as shall provide a just and reasonable return on the base rate of such public utility, to be determined upon such equitable or reasonable basis as shall provide such fair return. A tariff showing the scale of rates under such arrangement shall first be filed with the commission, and such tariff, and each rate set out therein, approved by it. The commission may revoke its approval at any time and fix other rates for any such public utility if, after notice and hearing, the commission finds the existing rates unjust or unreasonable.”

66 Pa. CSA § 1307(a).

Based on the plain language of Section 1307(a), the Commission has the power and authority to approve, outside of a base rate proceeding, rate designs that adjust automatically similar to some of those discussed in Section V.B. of this report. Furthermore, the Pennsylvania Commonwealth Court has clarified that, “the purpose of this section [Section 1307(a)] was to permit reflection in customer charges of changes in one component of a utility’s cost of providing public service without the necessity of the broad, costly and time-consuming inquiry required in general rate cases and the automatic provision does not eliminate the requirement for approval of revisions in the charges by the PUC.” *Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission*, 653 A.2d 1336, 1348 (Pa.Cmwlth. 1995) (“*PIEC*”). The Court further explained that the automatic adjustment clause permitted by Section 1307(a) allows for rapid recovery of specific identifiable expenses, with more comprehensive analysis upon reconciliation of actual costs with previously projected costs to establish the effective rate. *Id.* at 1349. The Court went on to note, however, that Section 1307 “should have limited application and the PUC should not use it to disassemble the traditional rate-making process.” *Id.* at 1349. In *PIEC*, the Court upheld the use of a Section 1307 adjustment clause to allow automatic recovery of conservation and load management expenses because, it found, such recovery was authorized by Section 1319 of the Public Utility Code. (Note that Section 1319 applies to natural gas utilities as well.)

Although rate adjustments submitted pursuant to Section 1307(a) are limited in scope and are not to be employed as a universally available alternative to a base rate case, the Court in PIEC has approved the recovery of expenses related to the implementation of demand-side

management programs by electric utilities through Section 1307(a). *Id.* at 1353. As with the demand-side management initiatives of electric utilities, which sought to decrease customer demand for energy and promote conservation (similar to the objectives of ARRA), Section 1307(a) is available as a possible procedural tool for public utilities and the Commission to expedite adoption of new conservation programs and cost recovery mechanisms that, if appropriately structured, can be used to align utility financial incentives with helping customers conserve energy and that provide timely cost recovery and a timely earnings opportunity for utilities as provided under ARRA. In addition, as noted above, Act 129 of 2008 permits automatic adjustment recovery for electric utility costs (excluding lost revenues) incurred under the energy conservation and smart meter provisions of that Act. Thus, to the extent the General Assembly has authorized automatic adjustment recovery of conservation costs, 66 Pa CSA §1307, 1319, and Act 129 of 2008 provide the Commission the authority to review and approve utilities' energy conservation programs and methods of cost recovery.

Columbia Gas

Columbia agrees with the conclusion that a §1307 adjustment factor mechanism could be a procedural tool for utilities and the Commission to accomplish recovery of costs associated with conservation programs. However, as discussed in our comments on Section IV. Present Policies or Laws that Address Policy Goals Outlined in ARRA 410(a), there is no certainty associated with the recovery of lost revenues through a §1307 adjustment factor mechanism. Until such recovery is approved, it is Columbia's position that the use of a §1307 adjustment factor mechanism will not satisfy the Section 410(a) directive to implement "a general policy that ensures that utility financial incentives are aligned with helping their customers to use energy more efficiently...."

NFG

Some parties to this proceeding argue that the Court's decision in *PIEC* precludes the use of § 1307(a) to establish a surcharge mechanism to recover the costs of energy efficiency and conservation plans, including lost revenues. Although the Court pursuant to § 523 precluded recovery of financial incentives via a surcharge mechanism, the Court did not enter a ruling as to recovery of lost revenue. As to the recovery of lost revenue the Court stated:

While we do not address whether recovery of lost revenue is authorized as DSM costs "associated with the development, management, financing and operation of the program" under Section 1319 because it was not an issue raised by the Industrial Coalition, we agree with the PUC that whether the manner of recovery violates the Code is not yet ripe for determination. The Industrial Coalition asserts that no calculation of lost revenues could accurately determine what revenues were lost due solely to a DSM program. While we agree, as did the PUC, that lost revenues are difficult to measure, there is the possibility that a sufficiently reliable calculation could be developed. Until the PUC develops a calculation for the award of lost revenues, whether a non-

speculative calculation can be developed is too speculative to consider and the matter is not yet ripe for review.
PIEC, 653 A. 2d at 1352.

Because the Court in *PIEC* did not issue a ruling as to recovery of lost revenue under sections 1319 and 1307(a), utilities and the Commission are free to consider implementation of a reconcilable revenue decoupling mechanism under § 1307(a). Although Act 129 would preclude such a mechanism for electric companies, that statutory exclusion does not apply to gas utilities. Hence, at present the Commission may modify its ratemaking policies and approve a revenue decoupling mechanism as to gas utilities. Some parties to this proceeding will argue that the ban on revenue decoupling mechanisms for electric utilities shows that the Pennsylvania legislature is opposed to allowing a gas RDM. Such arguments lack merit as they are nothing more than an attempt to bootstrap the specific statutory exclusion applicable to electric utilities onto all other utilities. Because no statutory exclusion for RDM exists as to gas utilities, the Commission is free to review and adopt an RDM as to gas utilities.

Section 1307(a) is an established procedural tool that the Commission can immediately utilize as a vehicle to modify its ratemaking structures and policies and allow gas utilities to request and implement ratemaking mechanisms, like an RDM, that would ensure that the financial incentives of gas utilities are aligned with customer conservation consistent with the requirements of the ARRA.

OCA

The OCA agrees with the description of this issue set forth in the Draft Report. That is, Section 1307 provides an appropriate framework for recovery of natural gas utility conservation costs as long as those costs meet the requirements of Section 1319 of the Public Utility Code and the rate recovery standards set forth in the Commonwealth Court's decision in Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission, 653 A.2d 1336, 1348 (Pa.Cmwlt. 1995) ("PIEC"). As set forth above, with respect to electric utilities, Act 129 provides a separate, detailed automatic adjustment type recovery for electric conservation costs.

Industrials

The Industrial Customer Groups agree with and adopt herein the September 30, 2010 Comments of the OCA on this topic.

VIII. Does Pennsylvania Already Fully Comply with Policy Goals of 410(a)?

There is a great deal of debate amongst the Working Group members with regard to this question.

Allegheny Power

Allegheny Power's position is that legislative changes would be needed should the PUC desire to offer utilities a full spectrum of options to address the financial disincentive from implementing energy conservation programs. Specifically, the

prohibition on reconcilable automatic adjustment clauses, such as revenue decoupling mechanisms, instituted by Act 129 would need to be repealed.

Columbia Gas

No. Columbia applauds the Commission for its support and encouragement of conservation programs, particularly for low-income customers, with recovery of certain costs associated with those programs, such as program implementation costs and program management costs. However, Columbia submits that Pennsylvania does not comply with the policy goals outlined in Section 410(a). Columbia maintains that so long as rate designs are in effect where increases or decreases in energy consumption produce corresponding increases or decreases in utility revenue and earnings, utility disincentives to promote conservation will continue to exist. Columbia supports the SFV rate design for a utility's distribution service which more appropriately permits recovery of the utility's fixed costs without regard to consumption levels. Columbia continues to support using a volumetric rate structure for the recovery of commodity costs as those costs are variable in nature. Moving toward a SFV rate design, which provides the utility with fixed recovery of distribution service costs, but continues with a volumetric rate design for commodity costs is the next logical step in the evolution of the utility industry and it will begin to provide utilities with the necessary incentives to encourage energy conservation and usage reduction without the concern of reducing revenues and earnings.

Columbia has successfully promoted programs that encourage customers to invest in energy efficiency efforts that effectively reduce customer consumption. For over two decades, Columbia's Low Income Usage Reduction Program ("LIURP") has provided participating low-income customers with average annual consumption savings of 25%. In contrast, "organic" energy efficiency gains driven by price signals during the same time period have resulted in annual energy savings for Columbia residential customers of between only 1 and 2%. Columbia's LIURP obtained superior results because long-standing Commission policy consistently embraces energy efficiency by encouraging Columbia to provide the LIURP through assurances that Columbia would recover the costs of the program. As noted by the OCA, "the Commission is obligated to balance the interests of the utility shareholders and consumers and to approve only those programs that the Commission determines best serve the overall public interest." Columbia submits that a volumetric rate design that provides the customer with greater incentive to conserve through false price signals but concurrently allows the customer to pay less than the utility's cost to provide his service represents a failure to fulfill the obligation of balance between the shareholder and the consumers. Columbia submits that proper regulatory policy which incorporates the utility into the energy efficiency equation by removing the link between revenues and sales will both fulfill the obligation of balance between the shareholder and consumers and result in substantial and sustainable energy efficiency improvements that will bring Pennsylvania in compliance with the requirements of the ARRA.

NFG

A number of parties recommend that the status quo, whereby a utility files a base rate case to recover lost revenues, is sufficient to meet the ARRA requirement that utility

financial incentives be aligned with customer conservation initiatives.⁹⁹ If the status quo were acceptable there would have been no reason for the Congress to enact the ARRA and request alignment of utility financial incentives with customer conservation efforts because the base rate case option was available to utilities before the ARRA was signed into law. While a base rate case can offset declining revenues, it does not change the fact that current *rate structures and policies*, where a utility's profit is derived largely from volumetric concerns, create a disincentive for the utility to promote conservation. Hence the base rate case option stands as a direct obstacle to satisfying the directive of the ARRA to align utility financial incentives with customer conservation measures. Furthermore, if it were obvious that the status quo was sufficient to meet the requirements of the ARRA, the Commission would not have needed to institute this proceeding and the Chairman could simply have advised the Governor that he need not worry about the alignment of utility financial incentives because utilities can file expensive and time consuming base rate cases year after year. What is clear from this proceeding and the volumes of pages included in this report, is that the status quo does not meet the requirements of the ARRA.

Utilities are not alone in recognizing the need for changes to current regulatory policies. In a similar proceeding investigating utility incentives to promote energy efficiency in New York¹⁰⁰, the Natural Resources Defense Council submitted a statement (“NRDC Statement of Agreement”) supported by 89 signatories stating:

Current regulatory policy distorts distribution utility decision-making by linking their financial health to the amount of natural gas and electricity distributed over the pipes and wires. This results in revenues and profits being reduced when customers or distribution utilities invest in energy efficiency or clean on-site generation. Under the current regulatory system, there is little incentive for distribution utilities to encourage energy efficiency as a method of minimizing long-term cost of providing reliable distribution service.

The right regulator response to this challenge should include two key elements. First, in order to eliminate financial disincentive[s] utilities have towards distributed resources (such as energy efficiency policies and programs, combined heat and power, micro-turbines, fuel cells, photovoltaics, wind, anaerobic digesters, and thermal storage fuel switching to steam or natural gas chillers),

⁹⁹ Comments of the Industrial Customer Groups, p. 5; OSBA, p. 7; and OCA, p. 12.

¹⁰⁰ State of New York Public Service Commission; Case 03-E-0640, Proceeding on the Motion of the Commission to Investigate Potential Electric Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies, and Distributed Generation; 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.

regulators should ensure that distribution utilities' cost recovery is independent of total electricity or natural gas delivered and accomplished through modest, regular adjustments in rates (kWh rates for electricity). Second, distribution companies should be financially rewarded for lowering their long-term costs through an incentive mechanism that equitably shares gains with shareholders.¹⁰¹

Initiatives such as those conducted in New York were at the forefront of addressing the removal of financial disincentives to utility promotion of customer conservation. The language of the ARRA is directed at addressing and resolving the concerns regarding energy efficiency incentives expressed by numerous parties in New York. As articulated in the NRDC Statement of Agreement, in the "current regulatory system", which includes the ability to file for base rate cases, "there is little incentive for distribution utilities to encourage energy efficiency."

Base rate case filings in Pennsylvania are insufficient in eliminating a utility's financial disincentive to promote customer conservation. One need only look at the future test year requirements in establishing rates to recognize that the ratemaking process (particularly for natural gas utilities in saturated markets) in Pennsylvania is deficient in eliminating any financial disincentive to promote conservation. Pennsylvania base rate making does not employ a fully forecasted rate year. That is, Pennsylvania base rate making utilizes costs and revenues for a "future" test period that measures costs and revenues for a time period *before* new rates go into effect. The example below will illustrate this.

Assume that a utility files a base rate case to recover lost revenues associated with conservation efforts. As required by Pennsylvania rate regulation, a utility must provide a historical rate year ("HTY") that has 12 months of known information. It takes a utility approximately 3-4 months to assemble this historical information (regulations allow for the filing of a base rate case up to four months after the HTY). Utilities are allowed to project costs during the future rate year ("FTY") defined as twelve months after the HTY. A base rate case that runs the full suspension period will not have new rates into effect until nine months after the filing. This results in new rates not going into effect until the end of the FTY. Hence, all volume reductions associated with utility conservation promotion efforts after the FTY would *not* be included in rates, nor could they ever be included under current base ratemaking policy as utilities are precluded from filing a base rate case as long as a rate case is currently pending (this is commonly referred to as rate case anti-pancaking rule).

This regulatory lag may also preclude timely recovery of conservation costs incurred by utilities. Since Pennsylvania might preclude the recovery of costs beyond the FTY in

¹⁰¹ Statement of Agreement, NYPSC Case 03-E-0640 and Case 06-G-0746, Electric and Natural Gas Distribution Cost Recovery – Aligning Interests of Shareholder and Customers, September 8, 2006. A copy of which is included as Attachment 3 to these reply comments.

a base rate case, any costs of providing conservation services above those established in the FTY would not be recovered. A utility faced with this circumstance would have a strong incentive to manage its conservation program to meet FTY costs instead of managing its conservation program to maximize energy savings on the part of its customers. The reality of Pennsylvania's current policies is that the base ratemaking design precludes timely cost recovery as required by ARRA and also, contrary to the objectives of the ARRA, perpetuates financial disincentives for utilities to promote customer conservation.

Finally, penalty mechanisms (such as those set forth in Act 129 for electric utilities) are not the incentives intended by the ARRA, and therefore are not a means to align a utility's financial interests with customer conservation. Penalty mechanisms represent a "big stick approach" to regulation that would *force* utilities to promote conservation, which is vastly different from the ARRA "collaborative approach" to regulation that requires States to *align* utility financial incentives with customer conservation. Using penalties as the primary means to force utilities onto the conservation bandwagon is not only contrary to the ARRA, but opens the door to protracted litigation to determine appropriate conservation goals and penalties, followed by further litigation as to whether or not a utility has met the goals and whether any penalty imposed is just and reasonable. Regardless, the utility is placed in a "lose-lose" situation because it is either financially disadvantaged due to the impact of conservation efforts on revenues, or it is subjected to fines/penalties for missing goals, or the utility experiences both.

To conclude, the ARRA requires Pennsylvania to do more than the status quo. The ARRA requires Pennsylvania to adopt new and creative ratemaking structures and policies, such as a revenue decoupling mechanism, which will create appropriate financial incentives for utilities to aggressively promote customer conservation.

PECO

PECO believes that changes to existing practice, such as the addition of positive incentives for exemplary energy efficiency performance and the removal of disincentives by an annual interim rate adjustment, formula rate or other appropriate mechanism, are needed to allow Pennsylvania to comply fully with ARRA 410(a). However, PECO believes that the Commission already has authority under existing law to make many helpful changes toward the alignment of utility and customer incentives with energy efficiency and conservation goals.

OCA

As noted above, it is the position of the OCA that through prior enactments of the General Assembly and Commission policies, the Commonwealth meets the policy goals of ARRA Section 410(a).

Both the Commission and the General Assembly have long recognized the importance of energy conservation and energy efficiency measures to Pennsylvania's future. Dating back to 1986, the General Assembly has included several provisions in the Pennsylvania Public Utility Code to address the implementation of energy

conservation measures, to provide for timely cost recovery of any implemented measures, and to provide for performance factor considerations related to actions (or failure to act) to encourage the development of conservation and load management measures. Specifically, through Act 114 of 1986, the following sections were included in the Public Utility Code:

Section 1505(b)—Authority to order conservation and load management: This section provides that the Commission may order the utility to establish a conservation and load management program as part of determining or prescribing safe, adequate and sufficient service.

Section 1319—Financing of energy supply alternatives (specifically conservation and load management programs): This section provides for the recovery of all prudent and reasonable costs of conservation and load management programs.

Section 523(b)(4)—Performance factor considerations related to conservation and load management: This section provides for consideration for actions or failure to act to encourage the development of cost effective conservation and load management programs when determining just and reasonable rates.

66 Pa. C.S. §§523(b)(4), 1319, 1505(b).

More recently, with respect to electric utilities, the General Assembly has of course passed comprehensive energy efficiency and demand response legislation – Act 129 of 2008 -- that addresses many of the issues raised in Section 410(a). Act 129 requires each major electric distribution company (EDC) in Pennsylvania to reduce energy consumption by a minimum of 1% by May 31, 2011 and by a minimum of 3% by May 31, 2013. 66 Pa.C.S. §2806.1(c). The failure of an EDC to achieve the specified reduction targets results in a financial penalty of not less than \$1,000,000 and not more than \$20,000,000. 66 Pa.C.S. §2806.1(f)(2). Act 129 explicitly permits utilities to recover the costs of conservation programs in a timely manner through an automatic adjustment clause. While Act 129 prohibits the recovery of decreased revenues due to conservation measures through an automatic adjustment clause between base rate cases, the Act permits the utilities to reflect reduced revenues prospectively through pro forma energy sales and revenue calculations in a base rate case.

While Act 129 applies only to electric companies, the Commission is authorized through various sections of the Public Utility Code to approve energy efficiency programs for natural gas companies and to provide timely cost recovery and earnings opportunity associated with such programs. As noted above, through Section 1505(b), the Commission is authorized to order a utility to establish conservation and load management programs. Section 1319 provides that the Commission shall allow the recovery of conservation or load management programs implemented by a natural gas or

electric utility that are found to be prudent and cost effective. Expenses incurred pursuant to Section 1319 may be recovered either through base rates or through an automatic adjustment clause under Section 1307 to the extent they meet the standards set forth by the Commonwealth Court in the PIEC case, which is discussed above. The Commission is also required to consider a natural gas utility's efforts in pursuing cost-effective conservation and load management opportunities when determining just and reasonable rates. 66 Pa.C.S. §523; 52 Pa. Code §69.35. With these provisions of the Public Utility Code, and the additional guidance provided to the Commission in Act 129, the Commission has full ratemaking authority to align the interests of natural gas utilities and customers as it concerns using energy more efficiently.

While the statutes ensure proper authority to the Commission to meet the requirements set forth in Section 410(a) of ARRA, the Commission has also promulgated regulations, issued Policy Statements and issued Orders to sustain or enhance the incentives of customers and utilities to use energy more efficiently, to provide timely cost recovery and an opportunity for a utility to earn a fair rate of return.

For example, through Chapter 58 of the Commission regulations addressing the Low Income Usage Reduction Programs (LIURP), Pennsylvania electric and natural gas companies have implemented some of the best programs in the Nation for delivering weatherization, efficiency and conservation measures to low income customers. 52 Pa. Code Chapter 58. A recent study of Pennsylvania's LIURP programs found that since 1988, over \$330 million has been spent on weatherization treatments for more than 292,071 households. Long Term Study of Pennsylvania's Low Income Usage Reduction Program, John Shingler, Consumer Services Information Project, Penn State University (January 2009). Currently, residential ratepayers are supporting these programs mostly through dollar-for-dollar current cost recovery mechanisms.

The Commission also has regulations and policy statements in place that allow the Commission to monitor energy conservation efforts, ensure that certain conservation standards are met, and provide for the timely recovery of cost-effective energy conservation programs. For example, the Commission's regulations call for reporting on energy conservation initiatives through its universal service and energy conservation reporting requirements for both electric and natural gas companies. 52 Pa. Code §54.71-78 (electric) and §62.5 (natural gas). Through these reports, the Commission can assess the on-going efforts of the companies in energy efficiency programs. As early as 1983, the Commission adopted a Policy Statement on the financing of energy supply alternatives. 52 Pa. Code §§69.31 to 69.36. Among the energy supply alternatives included in the policy statement were conservation and load management initiatives. 52 Pa. Code §69.31 and §69.34. The policy statement provides for the rate treatment of the reasonable and prudent costs incurred for cost-effective conservation and load management to be at least on par with any supply option. 52 Pa. Code §69.35. Additionally, the policy statement allows the Commission to consider the utilities' efforts when the Commission establishes just and reasonable rates. 52 Pa. Code §69.35. Finally, the policy statement requires the utilities to annually provide customers with

information on specific means to efficiently utilize energy services. 52 Pa. Code §69.35(1).

Finally, in base rate proceedings, the Commission must determine the appropriate rate design for each class. In particular, the design of the usage charges for both distribution rates and supply rates can have a significant impact on the conservation incentive provided to the customer. Historically, some Pennsylvania natural gas companies and Pennsylvania electric companies used a declining block rate structure. This form of rate structure, however, may no longer be consistent with current energy pricing and the Commission's energy conservation goals. Through the base rate process, the Commission has recognized this point and exercised its authority to approve rate designs that are more aligned with customer conservation initiatives.¹⁰² As set forth above, the PUC has supported the gradual elimination of declining block rates and has rejected proposals by utilities to implement high fixed customer charges. Both of these rate design policies are consistent with this Commission's pro-conservation policies and are particularly relevant to the provision of ARRA Section 410(a) that requires policies that sustain or enhance "consumers' incentives to use energy more efficiently."

As can be seen, the Commission has ratemaking authority to address issues related to energy efficiency through the ratemaking process, and has taken care to specifically consider these issues. This authority allows the Commission to meet the requirements of ARRA Section 410(a) and the Commission has exercised its authority in a way that is consistent with the goals of that federal law.

OSBA

Nothing in Section 410(a) explicitly requires the Commonwealth to implement electric conservation programs beyond those which will be implemented under Sections 2806.1 and 2807(f). To interpret Section 410(a) otherwise would penalize the Commonwealth for taking the initiative to achieve energy conservation. In contrast, Section 410(a) can be construed as requiring Pennsylvania to become more aggressive regarding gas conservation in order to qualify for federal funding.

Industrials

As previously indicated above, the Industrial Customer Groups unequivocally state that upon consideration of current Pennsylvania law and policy in combination with cost-based pricing and rate design, Pennsylvania already meets the policy goals of Section 410(a) of the ARRA. In addition to having a general ratemaking policy in support of cost-based rate allocation and design, Pennsylvania has at least three provisions in the Public Utility Code that contemplate and address the implementation of energy conservation measures, provide for timely cost recovery for implemented measures and provide for performance factor considerations to encourage the use of conservation and

¹⁰² For electric utilities serving as provider of last resort, the Commission has also issued a policy statement encouraging each EDC to implement rate designs that do not incorporate declining blocks, demand charges or similar elements. The Commission regulation states that POLR rate designs should encourage conservation. 52 Pa. Code §69.1810.

load management measures. Moreover, the recent enactment of Act 129 promotes quantifiable energy efficiency savings for Electric Distribution Companies ("EDCs") through mandatory programs, financial incentives, and the use of new technology. As a result, the Commission should be confident that with the continued implementation of cost of service principles for rate design, and the enactment of legislation such as Act 129, Pennsylvania has already taken aggressive action to promote conservation by utilities and consumers, in compliance with Section 410(a). As a result, no further action by the Commission is necessary at this time.