

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF
COLORADO**

DOCKET NO. 08I-113EG

IN THE MATTER OF THE INVESTIGATION OF REGULATORY AND RATE
INCENTIVES FOR GAS AND ELECTRIC UTILITIES.

**RESPONSE OF THE GOVERNOR'S ENERGY OFFICE TO
COMMISSION DECISION NO. C08-0448 REQUESTING
COMMENTS**

Introduction

The Governor's Energy Office (GEO) is pleased to provide comments on this investigatory docket. This docket is important because the incentives inherent in the economic regulations governing Colorado utilities have a critical influence on three areas that are of paramount importance to GEO: (1) the outcome and ultimate success of the Colorado Climate Action Plan (CAP)¹ (2) GEO's efforts to keep energy bills affordable for Coloradans at a time when worldwide energy prices are at record high levels, and (3) increasing reliance on Colorado's domestic, clean, renewable energy resources (see "Connecting Colorado's Renewable Resources to the Market").²

As the Commission has requested, GEO's comments focus on the scope of the investigation and the questions and issues posed in the Order. Each of the questions that the Commission has laid out in its Order is important, and is appropriate to be addressed in this investigatory docket.

Comments of the Governor's Energy Office

Can you offer general comments on the incentives inherent in the current regulatory structure?

Colorado's regulatory structure parallels that of most other states and has been based on the principle that regulated utilities should be given a fair return on their prudently incurred investments in power and gas infrastructure necessary to generate and deliver energy to customers in the state. Also similar to other state regulatory practices, the utility passes its fuel costs, generation, transmission, and distribution costs, and costs of purchased power agreements through to customers. This structure has many consequences that affect regulated utilities' behavior, including, but not limited to the following:

¹ http://www.colorado.gov/energy/in/uploaded_pdf/ColoradoClimateActionPlan_001.pdf

² http://www.colorado.gov/energy/in/uploaded_pdf/ConnectingColoradoResources.pdf

Hesitation that results from concerns over cost recovery: The utility needs clear signals from the Commission that it will be able to recover its prudently-incurred expenses for energy efficiency. Uncertainty about cost recovery for such investments, especially in light of their growing importance in the Company's Electric Resource Plan (ERP), will naturally cause the Company to be hesitant to make such investments.

Incentive to hold assets in ratebase: A rate of return structure rewards utilities for the assets that they own and keep in their rate base. This structure has proven valuable in the sense that it rewards the utility for making prudent investments that keep the energy system operating reliably. The utility's financial incentive that results from this structure is to build and maintain assets to ensure reliable service to its customers. Nonetheless, under conventional regulatory structure, Commissions rewards utilities for building new capacity rather than for reducing demand through efficiency programs that obviate or delay the need to build such capacity. In addition, although federal and state laws require this, the current structure does not provide direct financial rewards to utilities for securing generation supplies from the competitive market. While the utility can expense its power purchase costs it does not earn a return on these expenses; its primary incentive is to build and rate base its own generating assets.

Throughput incentive inherent in current structure: Between rate cases, the only way for a utility to increase earnings is to sell more energy; rates remain stable apart from fuel or other automatic adjustment clauses. As a result, absent economic growth or weather events that increase energy usage, a utility will not earn increased revenues until a new rate case may allow it to raise rates. Although this structure may not in and of itself prompt a utility to aggressively pursue measures that increase energy usage, the current structure does not provide direct incentives to reduce sales through energy efficiency. Indeed, efficiency measures decrease revenues, so this structure is a disincentive to pursue efficiency.

Fixed cost recovery risk resulting from energy efficiency: A portion of every kWh that electric utilities sell goes to pay down the costs of their capital investments and to give them a profit margin. This compensation structure could represent a penalty for gas and electric utilities that elect to make investments in energy efficiency. Utilities earn their profit margins and recover their investments in capital investments like power plants or power lines based on load forecasts that predict how much energy they will sell. To overcome this incentive to sell, mechanisms to address lost margins can help utilities to keep their revenues stable and remove the disadvantages of reducing sales. However, this may pose other issues that should be carefully anticipated.

Fuel adjustment clauses and electric cost adjustments. These clauses represent a streamlined way to compensate utilities for changes in fuel input or other cost that are beyond their control. The adjustments reduce the frequency, cost and administrative burden of rate cases. To this extent, they are valuable because utilities do not have control over fuel input or certain other costs beyond the use of fuel price hedging strategies, which by themselves, do not guarantee the intended outcome. The clauses nonetheless shift all fuel price risk to customers who have no control over the utility's fuel purchasing strategies. As a result, the clauses remove any additional incentive that a

utility might have to pursue energy efficiency investments as part of a hedging strategy to protect itself from the effect of higher fuel prices.

Can you offer some general perspectives on some alternatives to the Rate Base-Rate of Return model?

Several alternatives to a rate base/rate of return model exist and are worthy of consideration. GEO looks forward to informative discussions on these models. GEO will consider these models in light of a number of factors: (1) their impact on a utility's investment decisions, especially investment decisions related to energy efficiency; (2) the resulting impact on carbon emissions; (3) the new incentives that alternative ratemaking policies will engender including reallocation of risk between utilities and customers; (4) the effect of such models on lower income customers, in light of the fact that the GEO operates the state's weatherization programs for low income Coloradoans; and (5) the extent to which these alternative models may hasten or slow the need to expand transmission to tap into Colorado's vast renewable resource generation development areas..

GEO feels it is important that the Commission facilitate a discussion with stakeholders on a variety of models, including the following:

- Performance-based models that reward a utility for successful investments in energy efficiency.
- Models, including those based on decoupling, that reduce or eliminate the financial disincentives to investing in energy efficiency that are inherent in the current rate of return model.
- Competitive models for resource procurement.

Would you please offer GEO's view on how the Commission should address decoupling?

GEO looks forward to the discussion of several regulatory models, including decoupling. Although decoupling has received a considerable amount of attention in Colorado a decade ago, and elsewhere in the country, it is not a uniform regulatory structure and is being pursued in different ways in different jurisdictions. (See Appendix A: Survey of State Approaches to Regulatory Structures for Energy Efficiency). GEO encourages the Commission to examine a variety of decoupling mechanisms, and to consider alternatives to decoupling that may have similar effects. Performance based models that reward utilities for successful energy efficiency programs for example, may have an equivalent effect on the utility incentive structure because they encourage energy efficiency through other means.

GEO currently takes no position on how appropriate these models are to Colorado at this point, but feels that it is important that they be fully explored in an open discussion.

Would you please offer perspective on the considerations that the Commission should take into account when investigating the impact of regulatory structures on the build-or-buy decision?

GEO notes that the current regulatory structure provides little direct financial incentive for the utility to buy power from competitive power providers, and indeed it has been argued that rating agencies may penalize a utility for exposure to power purchase agreements by treating that exposure as equivalent to debt on the utility's balance sheet and in its bond ratings. Others will vigorously debate whether this influence is overstated. From the utility's perspective, the "buy" decision presents a challenge that would naturally lead them away from competitive bidding practices. From a utility's financial perspective, the "buy" decision not only sacrifices the return that it might otherwise earn if it were to build and put the asset in ratebase, but it may be penalized by paying a higher cost of capital stemming from a rating agency that imputes its "buy" decision as debt.

It is unclear to GEO at this point what impact these factors have in actual fact on Colorado utilities. We are, of course, aware that this topic is at issue in the Electric Resource Plan. GEO may offer input on this issue at a later date.

Would you please offer a summary of activity taking place at the commission or legislative level across the country?

The past one to three years have brought on what might be considered the second generation of regulations that promote energy efficiency. The first generation ended in 1993-1994 when many states began to engage in serious discussions about restructuring their electricity markets. By that time 25 states had adopted policies to provide for cost recovery for energy efficiency investments (mostly by capitalizing energy efficiency investments). Five had adopted decoupling mechanisms and 26 had adopted performance rewards for energy efficiency investments.³

In today's second generation of regulatory mechanisms, interest has focused much more heavily on decoupling, on expensing of efficiency investments and on performance rewards that provide financial incentives for energy savings. The following table shows the status of these state efforts as of early 2008. The table demonstrates a great deal of activity at regulatory commissions, but very little current experience with decoupling mechanisms. Given the high level of interest in the issue, it appears that there will soon be much more experience with these new policies.⁴

Do you have any concluding statement?

GEO applauds the Commission's investigation into this topical area and looks forward to engaging in any subsequent processes in this docket.

³ "Aligning Utility Incentives with Investment in Energy Efficiency" a product of the National Action Plan for Energy Efficiency, 2007, Val Jensen, p. 11.

⁴ "Designing the Utility Regulatory Structure for Energy Efficiency," DRAFT, Prepared for The Alliance to Save Energy by Matthew H. Brown, InterEnergy Solutions. 2008.

Appendix A: Review of State Activity

<i>State</i>	<i>Cost Recovery Addressed?</i>	<i>Status (Gas)</i>	<i>Status (Electric)</i>
Arizona	Addressed through individual rate cases.		
California	Funding provided through public benefits charges and rates.	All 4 major gas IOUs	All three electric investor owned utilities operate under regulations allowing for cost recovery for energy efficiency, decoupling and performance incentives.
Colorado	Addressed through individual rate cases.	<i>Limited decoupling mechanism in the last PSCo rate case</i>	<i>Incentive level is being discussed in the context of the current DSM and ERP dockets.</i>
Connecticut	Funding provided through public benefits charges.	The CT 2007 Energy Act requires the Department of Public Utility Control (DPUC) to decouple distribution revenue recovery from sales for each electric and gas company in their next rate proceeding.	The CT 2007 Energy Act requires the Department of Public Utility Control (DPUC) to decouple distribution revenue recovery from sales for each electric and gas company in their next rate proceeding.
Delaware		Commission Order 7153 opened Docket 59 to consider Delmarva's (PEPCO's) proposal for both electric and gas decoupling.	Commission Order 7153 opened Docket 59 to consider Delmarva's proposal for both electric and gas decoupling.
District of Columbia			PEPCO (filed in Case 1053)
Florida	Provided through rate recovery or a tariff rider/surcharge		
Idaho	Provided through rate recovery or a tariff rider/surcharge		Idaho Power (approved)
Illinois	Addressed through individual rate cases.		
Indiana		Vectren (approved)	
Iowa	Cost recovery policies in place.	In the 12/18/06 Order in Docket NOI-06-1 the Board stated that individual natural gas utilities may propose decoupling or other mechanisms as	

		necessary.	
Kansas		November 2007, Commission opened an investigation into cost-recovery, incentives and decoupling: Docket No.08-GIMX-441-GIV	November 2007, Commission opened an investigation into cost-recovery, incentives and decoupling: Docket No.08-GIMV-441-GIV
Maine	Funding provided through public benefits charges.		1987 Statute grants the Commission the authority to use mechanism such as decoupling and incentives to promote energy conservation. PUC will report back to the legislature during January 2008 on this topic.
Maryland		BG&E, Washington Gas (approved)	PEPCO (Docket 9092) and Delmarva (Docket 9093) (filed), BGE (Supplement 392 to P.S.C. Md. E-6) (may have been approved)
Massachusetts	Funding for electric efficiency programs provided through public benefits charges.	DTE has opened an investigation (DTE 07-50) into electric and natural gas utility rate structures that will promote efficient deployment of demand resources and remove disincentives. A straw proposal decoupling mechanism is included in the Order opening the investigation.	DTE has opened an investigation (DTE 07-50) into electric and natural gas utility rate structures that will promote efficient deployment of demand resources and remove disincentives. A straw proposal decoupling mechanism is included in the Order opening the investigation.
Minnesota	Cost recovery policies in place.	2007 statute requires the PUC to develop criteria and standards for decoupling, and to authorize pilot decoupling programs that meet these criteria.	2007 statute requires the PUC to develop criteria and standards for decoupling, and to authorize pilot decoupling programs that meet these criteria.
Missouri		Atmos is decoupled and has an EE spending requirement. Decoupling and increased conservation were considered in cases GR 2007-0208 and 2006-0422.	

Montana	Cost recovery policies in place.		
Nevada	Electric cost recovery policies in place; addressed through rate cases		
New Hampshire	Funding provided through public benefits charges.		Commission has opened an investigation, DE 07-064
New Jersey	Funding for electric efficiency programs provided through public benefits charge.	New Jersey Natural Gas and South Jersey Gas (approved)	
New Mexico	Addressed through individual rate cases.		PNM filing on hold due to natural gas Order
New York	Funding for electric efficiency programs provided through public benefits charges.	All gas utilities must file revenue decoupling proposals in rate cases	all electric utilities must file revenue decoupling proposals in rate cases
North Carolina		All 3 natural gas utilities approved	
North Dakota		In Docket 2004 PU04-578, Northern States Power was granted a decoupling mechanism.	
Oregon	Electric and gas funding provided through public benefits charge.	NW Natural Gas, Cascade Natural Gas (approved)	
Ohio	Addressed through individual rate cases and a tariff rider.	Vectren (approved)	
Rhode Island	Funding for electric efficiency programs provided through public benefits charge.		
South Dakota			Otter Tail's EE filing in Docket EL07-011 suggests that the Commission investigate various options to eliminate disincentives, including decoupling.
Texas	Cost recovery policies in place.		
Utah	Addressed through individual rate cases and a tariff rider.	Questar (approved)	
Vermont	Funding for electric efficiency programs provided through		Green Mountain Power (approved) Central Vermont Public Service

	public benefits charge.		Company (filed)
Virginia			The 2007 re-regulation statute allows the Commission to approve a wide variety of performance-based regulation mechanisms, provided they meet certain statutory obligations. Utilities can choose to apply for a form of performance-based regulation.
Washington	Addressed through individual rate cases and a tariff rider.	Avista, Cascade (approved)	
Wisconsin	Electric efficiency programs funded through public benefits charge; additional funding through rates possible subject to PSC approval.		

Sources for Table: “Aligning Utility Interests with Energy Efficiency Objectives: A Review of Recent Efforts at Decoupling and Performance Incentives, Martin Kushler, Dan York and Patti Witte, American Council for an Energy Efficient Economy, Report NumberU061, October 2006; and Regulatory Assistance Project, February, 2008.