BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Duke	**)**	
Energy Ohio, Inc. for an Energy Efficiency	**)**	
Cost Recovery Mechanism and for	**)**	**Case No. 11-4393-EL-RDR**
Approval of Additional Programs for	**)**	
Inclusion in its Existing Portfolio	**)**	

DIRECT TESTIMONY OF

DYLAN SULLIVAN

ON BEHALF OF THE

NATURAL RESOURCES DEFENSE COUNCIL

MAY 30, 2012

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Part 1: Introduction and Qualifications

Q: What is your name, address, and position?

A: My name is Dylan Sullivan. My business address is 2 North Riverside Plaza, Suite 2250, Chicago, Illinois 60606. I am employed by the Natural Resources Defense Council ("NRDC") as a Staff Scientist.

Q: Describe your educational background and professional experience.

A: I earned a Bachelor of Arts degree, magna cum laude, in Environmental Geology from the University of Missouri-Columbia in 2004. I was awarded a Master of Science in Civil and Environmental Engineering from Stanford University in June 2008. My Masters degree was energy focused: I graduated from the Civil and Environmental Engineering Department's Atmosphere/Energy program and took classes on economic analysis of natural resources and climate policy, air quality analysis, and energy efficiency and renewable energy technologies and practices. I joined NRDC in June 2008, where I monitor the performance of Midwestern utilities' energy efficiency portfolios, recommend new programs or modifications to existing programs to capture cost-effective energy efficiency, and conduct research and advocacy on changes to the utility business model that ensure utilities and customers can benefit from energy efficiency. At NRDC, I have worked on many matters related to this docket, including:

- Preparing testimony responding to electric utility energy efficiency programs and portfolios of programs, electric utility resource plans, and electric utility proposals for energy efficiency cost recovery mechanisms, including lost revenue adjustment mechanisms, performance incentives, and program cost recovery;
- Participating in groups advising Commonwealth Edison, Ameren Illinois Utilities, American Electric Power-Ohio ("the Companies" or "AEP-Ohio"), Duke Energy-Ohio, and FirstEnergy's Ohio operating companies on implementing energy efficiency programs;

- Researching and writing about utility regulations related to energy efficiency, particularly decoupling, a policy that removes a utility's disincentive to help improve the efficiency with which customers in its service territory use energy.

In October 2011, I co-wrote an article about decoupling that was published in the *Electricity Journal*. I also co-wrote NRDC's recent decoupling fact sheet.[1]

Q: Have you previously testified before state regulatory commissions?

A: Yes. I most recently testified before the Commonwealth of Kentucky Public Service Commission in Case No. 2011-00375, and I've testified before the Public Utilities Commission of Ohio ("PUCO" or "Commission") several times.[2]

Q: What is the purpose of your testimony?

A: The purpose of my testimony is to answer some of the questions asked by the Commission in Finding 9 of the May 9th Order in the instant case. Specifically, I'll address whether Duke Energy-Ohio's ("Duke" or "Company") incentive should be limited to performance that exceeds statutory benchmarks, if an incentive should be equal or greater to the return on investment that could earn by investing the same sums in utility infrastructure, and how the Commission should consider the revenue from performance incentives as it applies the Significantly Excessive Earnings Test ("SEET").

Part II: Performance Incentives

Q: Describe the public policy rationale for performance incentives?

A: Investor-owned utilities ("IOUs") have a fiduciary responsibility to their shareholders, and the financial incentives created by regulations guide their decision-making and investments. All regulation creates financial incentives for IOUs, so the question for regulators is not *whether* to

[1] http://www.nrdc.org/energy/decoupling/

[2] Case No. 11-351-EL-AIR, et al., Case No. 08-935-EL-SSO, et al., Case No. 09-1947-EL-EEC, et al., and Case No. 10-388-EL-SSO, et al.

adopt incentives but how to *align* them with the public interest. Regulators should make investing in the lowest cost, least risky, and cleanest resources (i.e., energy efficiency) the most profitable option for utilities. The National Association of Regulatory Utility Commissioners' recommendation to its members more than two decades ago to "ensure that the successful implementation of a utility's least-cost plan is its most profitable course of action"[3] remains an urgent priority today.

In order to allow energy efficiency to compete with other investments for utilities' time, capital, and ingenuity, regulators must allow utilities to benefit when they perform well in helping customers save energy. NRDC supports incentives that:

- are based on verified *performance* in delivering energy efficiency, not investments,
- create a *win-win* opportunity for customers and shareholders, and
- provide a balance of potential *risks* and *rewards*.

Well-designed shared savings mechanisms have these features.

Q: Describe shared savings mechanisms.

A: Shared savings mechanisms are intended to provide investor-owned utilities an earnings opportunity by offering shareholders a portion of the net benefits customers receive (that is, the benefits from avoiding costlier energy sources less the cost of the efficiency programs) as a reward for excellent performance at saving energy and lowering customer bills, provided minimum performance thresholds are met.

Q: Describe Duke's shared savings mechanism.

A: The shared savings mechanism that parties (including NRDC) stipulated to in this case would provide Duke an increasing portion of the net benefits customers receive from its energy efficiency programs when the Company exceeds its annual energy savings requirements under

[3] National Association of Regulatory Utility Commissioners (NARUC), *Resolution in Support of Incentives for Electric Utility Least-Cost Planning*, adopted July 27, 1989. The resolution framed the term "least-cost" over an extended time horizon. Congress endorsed NARUC's objective in the National Energy Policy Act of 1992, although the final decision remains with state regulators. (16 USC Section 2621 (d)(8))

Ohio Revised Code Section 4928.66. The portion of the net benefits Duke receives at each "tier" of performance is shown in the table below.

Energy Savings (% of annual target)	**Percent of net benefits Duke receives (after-tax)**
≤ 100	0%
> 100-105	5.0%
≥ 105-110	7.5%
≥ 110-115	10%
≥ 115	13%

Energy savings (and net benefits) from projects that mercantile customers conduct themselves and then submit to the Commission will not be included in this calculation. For the purposes of the shared savings mechanism only, the load of mercantile customers that participate in the self-direct program will not be included when calculating the "annual target" that Duke's performance is measured against, and self-direct customer savings will not be included in the energy savings that is compared to the annual target. NRDC supports this provision because the purpose of the mechanism is to create incentives for Duke's *own performance*: the Company shouldn't get rewarded in the shared savings mechanism for projects that its programs did not catalyze. Under the stipulation, transmission and distribution projects that reduce line losses are excluded from the annual energy savings that is compared to the annual target. Again, we are trying to create incentives for Duke to perform well in delivering energy efficiency *in concert with its customers*. Projects that reduce line losses occur without customer involvement, and the Company already receives a rate-of-return for these projects. The mechanism will expire at the end of 2015, after it is reviewed by interested parties in 2014.

Q: Why does NRDC support the shared savings mechanism?

A: In addition to the provisions discussed above that focus the mechanism on the Company's own performance in helping its customers save energy, NRDC supports the mechanism because it:

- Aligns Duke's incentives with that of its customers: when its programs cost effectively save energy for customers, the Company benefits;

- Is based on performance, not investment: we shouldn't be rewarding Duke simply for spending money (as percentage-of-program-cost incentives can do);
- Balances the *risks* already included in Ohio law (the non-compliance penalty in Revised Code Section 4928.66 (C)) with a *reward* based on performance;
- Includes a review by interested parties and an expiration date, so that we can evaluate its performance.

Part III: Commission Questions

Q: Should Duke's incentives be limited to performance that exceeds statutory benchmarks?

A: Yes and no. One of the key decisions parties make when designing shared savings mechanisms is the level of performance at which the utility should begin to "share" the net benefits its energy efficiency programs create for customers. In this case, parties set that threshold at the point where Duke begins over-complying with the energy savings requirements in Ohio Revised Code Section 4928.66 when the impacts of transmission and distribution projects and mercantile self-direct projects are excluded. That choice was made because the law requires energy savings that meet the law's requirements. So it is reasonable to set the mechanism's "trigger" as the point at which the Company exceeds minimal requirements, although it's important to realize that customers would still save money (just not as much) if the Company did not quite meet the law's requirements. For that reason, some shared savings mechanisms (like California's[4]) are triggered when a utility meets a high percentage of the target, such as 80%. However, in this case, I think the appropriate trigger was chosen.

[4] National Action Plan for Energy Efficiency, *Aligning Utility Incentives with Investment in Energy Efficiency*, U.S. Environmental Protection Agency, November 2007, Page 6-9.

I said "yes and no" because the Commission should not limit the pool of net benefits from which the Company takes a share to only those net benefits in excess of the law's requirements. For example, if Duke exceeds the law's targets by 108% when taking out the impact of mercantile self-direct programs and transmission and distribution projects, the Commission should allow the Company to receive as an incentive a portion of the net benefits of all the programs that allowed the Company to exceed the benchmark, rather than only allowing the Company to get a portion of the net benefits of "last 8%" of performance. To only allow the Company to get a share of the "last 8%" of performance would not create enough of an earnings opportunity to change Company behavior, in my opinion. It would also put energy efficiency as a disadvantage compared to other opportunities for Company investment and ingenuity. After all, the Company doesn't just get a rate or return on the marginal distribution investments that allow it to meet minimum requirements; Duke receives a rate of return on the entire rate base. Shared savings mechanisms operate in Texas, Oklahoma, Michigan, Minnesota, Ohio, Georgia, Arizona, Hawaii, and New Hampshire. No mechanism I'm familiar with only allows sharing on the "last 8%" of net benefits.

Q: Should an incentive be equal or greater to the return on investment that Duke could earn by investing the same sums in utility infrastructure?

A: The goal of an incentive is to equalize investment opportunities between energy efficiency and competing sources of utility time and capital. So, in general, the answer is yes. But because energy efficiency is just different than other utility investments, there are complications. For one, Duke does not face the same regulatory lag for energy efficiency investments that it does for distribution investments included in rate base: it expenses the costs of energy efficiency programs so costs are collected roughly concurrently with spending. Also, energy efficiency investments may be less risky for the utility than other investments, again because they are expensed and the utility is not responsible for their performance once they are installed on customer premises. So our goal should be to get energy efficiency incentives in the same "ballpark" as other incentives the Company enjoys, rather than to get them precisely equal. The level of sharing proposed in this case is within the range of what other states have found reasonable. American Electric Power's shared savings mechanism in Oklahoma, for example, allows it get 25% of the net benefits from measurable energy efficiency programs.[5] California's energy efficiency performance incentive allowed utilities to get 9% of net benefits when it reached 85% to 100% of its energy efficiency goals.[6]

The key benefit of the shared saving mechanism in this case is that it encourages the Company to seek more energy savings, and more cost effective energy savings.

Q: How should the Commission view Duke's proposed incentive mechanism in light of Duke's significantly excessive earnings threshold?

A: The Commission should exclude revenue from the shared savings mechanism from Duke's total revenues that are compared to the earnings threshold. The Company should not have to give back revenue rewarded to it for exemplary performance in delivering energy efficiency programs because other factors (outside of energy efficiency) led to significantly excessive earnings. Requiring Duke to give back revenue from the shared savings mechanism would *re-misalign* incentives between the Company and its customers when Duke does a good job of running energy efficiency programs, and would be directly counter to the long-ago NARUC resolution – discussed earlier in testimony – that urged regulators to make utility pursuit of least cost resources the most profitable course of action for utilities.

Q: Does this conclude your testimony?

A: Yes.

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[5] Report and Recommendation of the Administrative Law Judge, Oklahoma Corporation Commission Cause No. 200700449, April 8, 2008, available at: http://imaging.occeweb.com/AP/CaseFiles/OCC3710105.PDF. See Page 8 for ALJ recommendation that the Corporation Commission approve the stipulation, and the stipulation on Page 9. The Oklahoma Corporation Commission approved the ALJ's recommendation on June 13, 2008 in Order No. 555302, available here: http://imaging.occeweb.com/AP/Orders/00393217.pdf.

[6] Id.

CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the foregoing *Direct Testimony of Dylan Sullivan on Behalf of the Natural Resources Defense Council* has been filed with the Public Utilities Commission of Ohio and has been served upon the following parties via electronic mail, on May 30, 2012.

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