

# CHANGING THE RULES AFTER THE SEVENTH INNING STRETCH

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## BACKGROUND

Energy efficiency programs have been offered by utilities to their customers for many years. Their origins can be traced back to the establishment of the Department of Energy in October 1977 and a need for a national plan to control consumption in an effort to reduce dependency on foreign fuel. Since the early 1980's various programs have been developed, introduced, launched and run with the goal of managing energy-related resources, and ultimately reducing consumption at the consumer level.

The first programs in the 1980's were given names such as Conservation and Load Management or Demand Side Management Programs. The idea was to (a) reduce the pace of system expansion requirements due to ever-growing demand on both the electrical generation and gas pipeline systems and (b) do so by controlling/reducing the demand at the point of use. Ultimately, the programs were designed to let consumers do more with less. Since that time and over the following twenty years, the programs would evolve, be branded and often used as marketing tools while keeping the focus of reducing consumption.

Many of these types of programs exist today, in many different jurisdictions and states using a variety of funding mechanisms and support structures. The reality is that energy consumption has and still is a national priority and will remain so for the foreseeable future. The energy efficiency programs help reduce the nation's dependency on foreign fuel, allow end-users to be more energy efficient, and could have positive impacts on the environment.

The programs also reduce revenues for the utilities that offer them.

There is no other industry or business where, for over twenty years, it has been required to actively encourage its customers to use less of the product it is trying to sell and/or deliver. Following the directives and mandates of public utility commissions and legislation, by offering and promoting the energy efficiency programs, the utility is actively engaged in promoting a reduction in revenues to its shareholders.

## THE INCENTIVE MECHANISM

To offset the idiosyncrasy of self-promoting a reduction in sales, or said another way, offset the financial disincentive of delivering such programs, utilities have been allowed, and at times encouraged to earn financial incentives. These incentives are often based upon the performance of their energy efficiency programs. The idea behind incentives is an attempt to make the utility financially "whole" in spite of the loss of, or reduction in, its base revenues as a result of the energy conservation programs. Incentives are a reasonable solution, since utility rates are structured based on a projected sales forecast. In between rate cases, if that sales forecast is substantially reduced by successful energy efficiency program delivery, incentives provide a balancing solution.

Financial incentives have taken on many different and interesting forms with varying degrees of success. Early on, there were financial incentives based upon a percentage of the budget allocated or spent in a program. For example, if a company spent \$1M in energy efficiency programs, with an incentive of 5%, the utility would earn \$50,000 at the end of the program year. Whether this incentive matched the amount of lost revenues as a result of reduction in sales was not always entirely clear and more often than not, did not correlate with the reduction of revenues. In order to induce the companies to excel at energy efficiency program delivery, additional incentives were often available if the utility exceeded its forecasted energy savings. Like many other industries where goals are the measure of success, energy efficiency programs established threshold, target and maximum performance levels. Financial incentives were earned based upon performance, often without direct correlation to the amount of revenues lost as a result of the program activity.

In the mid 1990's some states in the northeast adopted a Lost Base Revenue ("LBR") mechanism. Though not directly an incentive, LBR is an attempt to quantify the energy savings (i.e. reduction in consumption) of a particular energy efficiency program, and translate that reduction into lost revenues (dollars). Some in the industry believe the LBR mechanism is a more accurate way to reflect the reduction in revenues to the utility because it records individual energy efficiency measures and overall program performance, while taking into account actual weather, customer class rates and life of the measure. And, unlike other incentive mechanisms that are only earned for the current program year, the LBR mechanism accounts for the loss in revenues as long as the energy efficiency measure is installed or until the utility establishes new base rates.<sup>A</sup>

More recently, as energy efficiency programs evolve, so have the financial incentive mechanisms. In the northeast, the most popular incentives are now called Metrics. Metrics are a series of benchmarks used for measuring the performance and success of a particular energy efficiency program. They no longer relate solely to reduction in sales but rather focus on a wide variety of measurements. In addition to energy savings and reduction of throughput, some metrics measure tangentially related performance<sup>B</sup>.

## **STOP! LET'S CHANGE THE RULES**

In the early to mid-1990's most Massachusetts gas utilities launched energy efficiency programs and incorporated recovery of LBR. A large amount of effort, resources (both internal and external) and money were expended by the companies to determine and establish the appropriate parameters, methods and guidelines for calculating LBR. The Massachusetts Department of Telecommunications and Energy<sup>C</sup> granted approval for each of the companies to collect LBR based upon the performance and results of their individual programs. The intent was to allow the companies to record, accumulate and collect LBR on an annual basis for a period equal to the expected life of the installed energy efficiency measures, or until a rate case was filed to establish new billing determinants including the impact of the energy efficiency programs, whichever occurred first.

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<sup>A</sup> When filing for a base rate case, the test year billing determinants take into account current sales volumes, the impact of energy efficiency programs and the resulting impact on revenues. Thus, the need to track past LBR is negated and at the time that the new rates go into effect the utility is experiencing zero LBR.

<sup>B</sup> For example, training a certain number of individuals about energy efficient technologies or practices in a given year is now a popular metric among both utilities and public utility commissions. Other metrics include customer satisfaction levels, Program dollars spent vs. energy saved or number of participants. These metrics are much more about the ability of the energy efficiency program to bring about change in the market place, also known as Market Transformation.

<sup>C</sup> Known as the Department of Public Utilities at that time.

And then the rules changed.

After years of promoting and implementing energy efficiency programs and adversely impacting future revenues as a result of the programs, in late 1999, the Massachusetts Department of Telecommunications and Energy modified the methodology by which gas companies could calculate and recover LBR<sup>D</sup>. The change may be summarized as follows: Instead of accumulating the impact of all energy efficiency measures through their useful life (or until establishing new base rates), utility companies were ordered to essentially “fix” the life of all measures to a period equal to the average time between the last four rate cases. This became known as the Rolling Period Method (“RPM”). For most of the gas companies this change meant that measures older than three to five years could no longer be included in the LBR calculation. Instead these measures must be excluded from the amount of revenues recovered using LBR. The change meant that millions of dollars of lost revenues were now unrecoverable. The change in policy to RPM forced at least one gas company in the state to file a rate case, and two others to petition the Department to allow recovery by other means. In the end, both the energy efficiency programs and the regulatory constraints that changed after programs were filed and implemented adversely impacted the companies’ revenues.

Similar events [almost] occurred in New Hampshire during early 2003.

In the late-1990’s, over twenty stakeholders in energy efficiency programs formed the New Hampshire Energy Efficiency Working Group (“EEWG”). Together the group committed, among other things, to take “a fresh look at utility sponsored programs and other energy efficiency programs and services in New Hampshire including the funding, design and implementation of such programs and services.”<sup>E</sup> Among the many issues addressed in the final report, were financial incentives to the utility companies. The group determined and agreed that it was appropriate for both gas and electric companies to earn incentives for the successful delivery of energy efficiency programs. The group developed and recommended a methodology to calculate those incentives with a target incentive of 8% percent of the annual budget and a cap of 12%. Following the EEWG final report, during 2001 and 2002, the electric and gas utilities developed and launched their respective energy efficiency programs with the understanding that that they would have the ability to earn a shareholder incentive equal to 8% of their program budgets. However, in early 2003, just days after the New Hampshire Public Utility Commission (“NHPUC”) approved the gas energy efficiency programs, NHPUC staff opened a docket<sup>F</sup> seeking to review shareholder incentive levels.

Over a period of several months, energy efficiency stakeholders spent a fair amount of effort, resources (both internal and external) and money discussing the merits of the incentive levels currently in effect. The NHPUC staff advocated to significantly lower incentive levels while most advocated to continue with the recommendations the EEWG spent over a year developing. In the end, the NHPUC concurred with the other energy efficiency stakeholders and allowed the incentive levels to remain at 8% of the budget for the time being and that any future changes would be on a prospective basis<sup>G</sup>. In its analysis, the NHPUC stated that evaluation mechanisms associated with energy efficiency programs “provides a partial compensation to the utility for the fact that the more successful the energy efficiency program, the lower the utility’s net income.”<sup>H</sup> The analysis expands on this by citing and quoting the 1999

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<sup>D</sup> Colonial Gas Company, D.T.E. 97-112 (1999)

<sup>E</sup> Report to the New Hampshire Public Utilities Commission On Ratepayer-Funded Energy Efficiency Issues in New Hampshire, Docket No. DR 96-150, From the New Hampshire Energy Efficiency Working Group, July 6, 1999.

<sup>F</sup> DM 03-006, Performance Incentives for Energy Efficiency Programs for Gas and Electric Utilities

<sup>G</sup> New Hampshire Public Utility Commission Order No. 24,203, September 5, 2003

<sup>H</sup> NHPUC Order No. 24,203 at Page 13

EEWG report, which states “the purpose of the incentive is to motivate the utilities to aggressively pursue achievement of the performance goals of their energy efficiency programs.”<sup>1</sup>

### **LOOKING TOWARDS THE FUTURE**

There is no doubt that energy efficiency is and will remain a national priority. It is equally important at the state and local level. There is also no doubt that energy efficiency programs adversely impact a utility’s ability to earn revenues by reducing the demand for the very product it is in business to sell and/or deliver. It is important for all stakeholders to understand that while reduction in fuel consumption is a valid goal, so is the financial stability of the utilities and their shareholders.

Alliances must be formed between all energy efficiency stakeholders, including the state commissions, to work toward a common goal of guiding and assisting consumers to reduce energy consumption without having an adverse financial impact on the utility. Financial incentives are just one mechanism to achieve this goal. If offered, incentives must reflect and offset the true negative financial impact on the utility and must be in place for the period equal to the impact of the energy efficiency measures. Furthermore, an attempt to adjust and/or reduce negotiated financial incentives for existing programs (or measures) already in place will only serve to erode any good faith that exists between the stakeholders and potentially undermine the success of future energy efficiency initiatives.

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<sup>1</sup> 1999 EEWG Report at Page 20