COPY

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

VERIFIED PETITION OF DUKE ENERGY INDIANA, INC. REQUESTING THE INDIANA UTILITY REGULATORY COMMISSION TO APPROVE AN ALTERNATIVE REGULATORY PLAN PURSUANT TO IND. CODE § 8-1-2.5-1, ET SEQ., FOR THE OFFERING OF ENERGY EFFICIENCY CONSERVATION, DEMAND RESPONSE, AND DEMAND-SIDE MANAGEMENT PROGRAMS AND ASSOCIATED RATE TREATMENT INCLUDING INCENTIVES PURSUANT TO A REVISED STANDARD CONTRACT RIDER NO. 66 IN ACCORDANCE WITH IND. CODE §§ 8-1-2.5-1 ET SEQ. AND 8-1-2-42 (a); AUTHORITY TO DEFER PROGRAM COSTS ASSOCIATED WITH ITS ENERGY EFFICIENCY PORTFOLIO OF PROGRAMS; AUTHORITY TO IMPLEMENT NEW AND ENHANCED ENERGY EFFICIENCY PROGRAMS, INCLUDING THE POWERSHARE® PROGRAM IN ITS ENERGY EFFICIENCY PORTFOLIO OF PROGRAMS; AND APPROVAL OF A MODIFICATION OF THE FUEL ADJUSTMENT CLAUSE EARNINGS AND EXPENSE TESTS	)	CAUSE NO. 43374

FILED
OCT 27 2008
INDIANA UTILITY REGULATORY COMMISSION

SUPPLEMENTAL DIRECT TESTIMONY AND EXHIBITS OF J. RICHARD HORNBY

ON BEHALF OF

CITIZENS ACTION COALITION OF INDIANA. INC

OCTOBER 27, 2008

1 **I. INTRODUCTION AND SUMMARY**

2 **Q. PLEASE STATE YOUR NAME, EMPLOYER, AND PRESENT POSITION.**

3 A: My name is J. Richard Hornby. I am a Senior Consultant at Synapse Energy Economics,
4 Inc., 22 Pearl Street, Cambridge, MA 02139.

5 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS CASE?**

6 A: I am testifying on behalf of the Citizens Action Coalition of Indiana. Inc ("CAC").

7 **Q. ARE YOU THE SAME J. RICHARD HORNBY WHO SUBMITTED DIRECT**
8 **TESTIMONY IN THIS PROCEEDING**

9 A: Yes.

10 **Q. WHAT IS THE PURPOSE OF YOUR SUPPLEMENTAL DIRECT TESTIMONY?**

11 A: Duke Energy Indiana, Inc ("Duke Energy Indiana" or the "Company") and the Indiana
12 Office of Utility Consumer Counselor ("OUCC") have entered a Stipulation and
13 Agreement ("Agreement") on the issues in this proceeding. The agreement was filed
14 August 15, 2008 and has been submitted as Petitioner's Exhibit W-1. Several witnesses
15 from the Company and the OUCC have submitted testimony, dated September 5,
16 supporting the Agreement. The CAC retained Synapse to review various aspects of the
17 Agreement. The purpose of my testimony is to report on my review of the Settlement
18 and present my conclusions based upon that review.

19 **Q. ARE YOU PRESENTING ANY EXHIBITS TO SUPPORT YOUR**
20 **SUPPLEMENTAL DIRECT TESTIMONY?**

21 A: Yes. I have prepared one exhibit to support my supplemental direct testimony:

22 **Exhibit No. ___ (JRH-13)** **Shareholder Incentives – Duke Indiana**
23 **Agreement with OUCC versus several**
24 **existing**
25

1 Q. **WHAT DATA SOURCES DID YOU RELY UPON TO PREPARE YOUR**
2 **SUPPLEMENTAL DIRECT TESTIMONY AND EXHIBITS?**
3 A: I relied primarily on the Settlement Testimony of the Company and OUCC witnesses and
4 their responses to data requests on that testimony. I also reviewed materials regarding
5 performance incentives for utility efficiency programs in other states.
6 **Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AFTER REVIEWING THE**
7 **AGREEMENT.**
8 A.: My first conclusion is that the Company is proposing an unreasonably high management
9 incentive, also referred to as a performance target, for an unreasonably low level of
10 energy conservation. My second conclusion is that the value-of-service component of
11 the Agreement's compensation structure may limit the Company's ability to respond
12 easily to unexpected changes in market conditions.
13 **Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS REGARDING THE**
14 **AGREEMENT.**
15 A: My first recommendation is that the Commission not approve the management incentive
16 proposed under the Agreement. My second and third recommendations are the same as
17 those I made in my Direct Testimony, i.e.:
18 o the Commission should direct the Company to seek the input of stakeholders
19 regarding an expansion of the breadth of its energy conservation programs under
20 its existing ratemaking framework, and an increase in the aggregate budget for
21 those programs, and to then submit a filing requesting approval of those programs
22 and budgets. The goal is to have the Company increase its emphasis on energy
23 conservation in a timely manner at a total budget in the order of one percent of

1 retail revenues, which is consistent with the Commission's Phase I Order in Cause
2 No. 42693; and
3 o the Commission should require the Company to file a new application to develop,
4 implement and manage new energy efficiency programs under a ratemaking
5 framework that would, subject to Commission review, set revenue requirements
6 that would recover actual incurred costs, address verified revenue erosion or lost
7 revenues, and provide a shared saving incentive based on performance, i.e.
8 achievement of explicit reduction goals, and subject to a cap as well as to
9 penalties for poor performance.
10
11 **II. PERFORMANCE TARGETS AND COMPENSATION UNDER THE AGREEMENT**
12 **Q. DOES THE COMPANY PROPOSE TO INCREASE ITS EMPHASIS ON**
13 **ENERGY CONSERVATION UNDER THE AGREEMENT?**
14 A: No. The Company is proposing essentially the same portfolio of demand response and
15 energy conservation programs, and projected level of capacity and energy reductions
16 from those programs, under the Agreement as under the save-a-watt proposal as filed.
17 The one change is that the Advanced Power Manager program will be excluded from
18 compensation under the Agreement. (Schultz page 8, Data responses CAC 6.2.)
19 Thus, under the Agreement the Company would have a portfolio of programs that
20 is heavily weighted towards demand response rather than energy conservation. At a
21 100% level of achievement the Company's is continuing to project an incremental
22 reduction of only 0.27% of annual retail sales from energy conservation measures
23 implemented in the fourth year of its programs. (Schultz page 11 and Agreement, section

1 F.2). As noted in my Direct Testimony, and the Direct Testimony filed by Mr. Donald
2 Gilligan, this is a very low level of incremental reductions in energy (kWh) use relative to
3 the levels being achieved by the country's leading utilities.

4 **Q. HOW DOES THE COMPENSATION METHOD UNDER THE AGREEMENT**
5 **DIFFER FROM THE COMPENSATION FOR DEMAND RESPONSE AND**
6 **ENERGY CONSERVATION PROGRAMS UNDER THE SAVE-A-WATT**
7 **PROPOSAL AS FILED?**

8 A: Under the Agreement the Company would be compensated for demand response and
9 energy conservation programs based upon a mix of cost-of-service and value-of-service
10 ratemaking approaches, subject to a cap on earnings. In contrast, under the save-a-watt
11 as filed the Company would be compensated solely upon a value-of-service basis, with
12 no cap on earnings.

13 Under the Agreement the Company would receive two separate streams of
14 revenues, one to compensate it for "lost revenues" and one as compensation for program
15 costs and a management incentive. The compensation for "lost revenues" is a cost –of-
16 service approach, i.e., the Company would recover the lost revenues associated with
17 verified reductions in sales resulting from its programs for the first four years after a
18 measure was installed. The compensation for program costs and a management
19 incentive is a value-of-service approach with a cost-of-service type earnings cap. The
20 Company compensation for program costs and management incentive would be based on
21 a value of-service approach. That compensation would be 60% of avoided costs from
22 verified energy conservation measures plus 75% of avoided costs from verified demand
23 response measures. However, the level of management incentive within that

1 compensation amount would be subject to caps. Those caps vary according to the level
2 of avoided costs the Company actually achieves over the four-year term of the
3 Agreement as compared to an avoided cost target of $260 million. For example, if the
4 Company's actual avoided cost savings are equal to 100% of that target it has the
5 opportunity to earn a management incentive, after-tax, equal to 15% of its actual program
6 costs. (Schultz pages 10 and 11).

7 **Q. DID ANY OF THE COMPANY WITNESSES PRESENT EVIDENCE IN THEIR**
8 **SETTLEMENT TESTIMONY SUPPORTING THE LEVEL OF MANAGEMENT**
9 **INCENTIVE PROPOSED IN THE AGREEMENT?**

10 A: No.

11 **Q. DO THE MATERIALS THE COMPANY PROVIDED IN RESPONSE TO CAC**
12 **DATA REQUESTS PROVIDE EXPLICIT SUPPORT FOR THE MANAGEMENT**
13 **INCENTIVE PROPOSED IN THE AGREEMENT?**

14 A: No. The CAC submitted two data requests for all analyses and/or regulatory decisions on
15 performance incentives that the Company witnesses had prepared and/or reviewed to
16 determine if the incentives at various levels of performance were reasonable.

17 In response to data request CAC 6.6, Mr. Stanley stated that he reviewed all
18 Commission Orders addressing the Company's energy efficiency initiatives since 1991
19 and the Commission Order in the DSM generic investigation. The response does not
20 provide citations to sections of any those Commission Orders to support the various
21 levels of performance incentives that the Company is proposing, nor does it provide any
22 supporting analyses.

1 In response to data request CAC 6.8, Mr. Schultz provided a 2006 survey of
2 decoupling and performance incentives published by the American Council for an
3 Energy-Efficient Economy (ACEEE)[1]. Mr. Schultz did not provide citations to specific
4 sections of that survey to support the various levels of performance incentives that the
5 Company is proposing, nor did he provide any supporting analyses.

6 **Q. DID THE OUCC WITNESSES PRESENT EVIDENCE SUPPORTING THE**
7 **LEVEL OF MANAGEMENT INCENTIVE PROPOSED IN THE AGREEMENT**
8 **IN THEIR SETTLEMENT TESTIMONY?**

9 A: No.

10 **Q. DO THE MATERIALS THE OUCC PROVIDED IN RESPONSE TO CAC DATA**
11 **REQUESTS SUPPORT OF THE MANAGEMENT INCENTIVE PROPOSED IN**
12 **THE AGREEMENT?**

13 A: No. The CAC requested (CAC 1.4) all analyses and/or regulatory decisions on
14 performance incentives that Dr. Polito had prepared and/or reviewed to determine if the
15 incentives at various levels of performance were reasonable. In response the OUCC
16 provided three documents. The first is the proposed decision of the California Public
17 Utilities Commission dated August 9, 2007 regarding performance incentives in
18 Rulemaking Docket 06-04-010. The second is section 6.2 on utility incentives for
19 demand-side resources from a 2006 report published by the EPA[2]. The third document is
20 a March 2007 report on policies that promote utility energy efficiency programs prepared

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[1] Kushler, Martin et al. *Aligning Utility Interests with Energy Efficient Objectives: A Review of Recent Efforts at Decoupling and Performance Incentives*, ACEEE, Washington, D.C. October 2006.

[2] *Clean Energy-Environment Guide to Action Policies, Best Practices and Action Steps for States*, United States Environmental Protection Agency, Washington, D.C. April 2006.

1 by the U.S. Department of Energy[3]. The response did not provide citations to specific
2 sections in any of the three documents that support the level of performance incentives
3 under the Agreement.

4 **Q. PLEASE COMMENT ON THE ANALYSES THE OUCC PROVIDED IN**
5 **RESPONSE TO CAC DATA REQUESTS REGARDING THE RATIONALE FOR**
6 **DR. POLITO'S SUPPORT OF THE MANAGEMENT INCENTIVE PROPOSED**
7 **IN THE AGREEMENT?**

8 A: The CAC requested (CAC 1.3) all analyses upon which Dr. Polito based his assertion that
9 the return under the Agreement would be consistent with a return under a competitive
10 market.

11 Response CAC 1.3 refers to the three possible "comparison standards" that Dr.
12 Polito presented in his Direct Testimony. These are third-party administrative costs,
13 ranging from 7.5% to 10.5%, the Company's most recently authorized after-tax weighted
14 average cost of capital (6.97%) and the Company's most recently authorized after-tax
15 return on common equity (10.5%). None of those standards support the Agreement's
16 performance incentive of an after-tax return equal to 15% of program costs.

17 First that performance incentive substantially exceeds all three potential
18 comparison standards that Dr. Polito has cited. Second, neither Dr. Polito nor the
19 Company provided any evidence to support the use of the highest of the three possible
20 standards, an incentive equal to the Company's after-tax return on common equity. This
21 level of incentive implies that the Company is capitalizing its program costs and

[3] *State And Regional Policies That Promote Utility Energy Efficiency Programs Carried Out By Electric And Gas Utilities* U.S. Department of Energy. Washington, D.C. March 2007.

1 financing them with shareholder equity. In contrast the Company is expensing its
2 program costs and financing them primarily with revenues from Rider EE.
3 Response CAC 1.3 also states that Dr. Polito believes the Company's actual level
4 of performance will be well below the target, and therefore will produce returns ranging
5 from 12 percent to minus two percent. His expectation that it is very unlikely that the
6 Company will achieve even 90% of its target, and will more likely operate at much lower
7 levels of performance, is apparently based upon his experience with the OUCC over 12
8 years ago, i.e., June 1993 to December 1996, and more recently, since June 2007. Dr.
9 Polito has not provided any evidence on the record in this Docket to support his low
10 expectations regarding the Company's anticipated performance.
11 Q. **HAVE THERE BEEN RECENT MAJOR GENERIC PROCEEDINGS**
12 **REGARDING THE DESIGN OF SHAREHOLDER INCENTIVES FOR UTILITY**
13 **ENERGY EFFICIENCY PROGRAMS IN OTHER STATES?**
14 A: Yes. Both California[4] and New York[5] have completed major generic proceedings on
15 shareholder incentives in the past two years. Each of these proceedings considered the
16 history of shareholder incentives as well as the range of approaches to designing them.
17 The California Public Utilities Commission (CPUC) placed considerable
18 emphasis on estimating the level of shareholder incentive that would produce earnings
19 from conservation equivalent to earnings from supply. They did this by estimating the
20 earnings their utilities would have received from meeting a given quantity of customer
21 annual energy requirements from supply instead of from conservation. The CPUC

[4] Public Utilities Commission of the State of California, "Interim Opinion on Phase 1 Issues: Shareholder Risk/Reward Incentive Mechanism for Energy Efficiency Programs," Rulemaking 06-04-010, Decision 07-09-043, September 20, 2007.
[5] New York Public Service Commission, Case 07-M-0548, order issued August 22, 2008, p.45

1 ultimately approved a performance-based shareholder incentive expressed as a pre-tax
2 amount equivalent to a percentage of net savings. The performance target equates to
3 incremental reductions greater than 1% of annual retail sales. If a California utility's
4 actual performance is equal to 100% of the performance target it will earn an incentive,
5 pre-tax, equal to 12% of net savings, i.e. avoided costs minus program costs. (This
6 equates to an after-tax amount equal to 7.2% of net savings). The structure includes
7 penalties for failure to meet specified minimum levels of performance. Demand response
8 conducted by California utilities is not included in this program.

9 New York allows retail competition and thus its shareholder incentives apply to
10 distribution utilities. However, the levels of incentive approved in that proceeding are
11 based upon a review of incentives in other jurisdictions, including the California
12 incentive structure. The New York Commission also approved a performance based
13 incentive. The performance target equates to incremental reductions of approximately
14 0.7% of annual retail sales. If a New York utility's actual performance is equal to 100%
15 of the performance target it will earn an incentive, pre-tax, equal to 12% of program
16 costs. (This equates to an after-tax amount equal to 7.2% of net savings). The incentive
17 structure also includes penalties for failure to meet specified minimum levels of
18 performance and does not apply to demand responses.

19 **Q. CAN THE MANAGEMENT INCENTIVE UNDER THE AGREEMENT BE**
20 **COMPARED DIRECTLY TO THE TYPES OF SHAREHOLDER INCENTIVES**
21 **FOR UTILITY ENERGY EFFICIENCY PROGRAMS APPROVED IN OTHER**
22 **JURISDICTIONS?**

1 A: No. Under the agreement the Company is proposing to recover program costs in the year
2 incurred, i.e. to treat program costs as an expense, and to collect a management incentive
3 expressed as an after-tax amount. In contrast, shareholder incentives in other
4 jurisdictions where program costs are recovered as expenses are expressed as pre-tax
5 amounts, either a percentage of actual program costs received pre-tax or a percentage of
6 net savings, i.e. avoided costs minus program costs, received pre-tax. Thus, one cannot
7 compare the levels of management incentives under the Agreement directly to the levels
8 of shareholder incentives approved in other states. (In order to make direct comparisons
9 in this testimony, I have multiplied pre-tax incentive amounts by 60% in order to convert
10 them to post-tax incentive amounts. The 60% reflects an assumed aggregate average tax
11 rate of 40%).

12 Q. **HAVE YOU COMPARED THE LEVEL OF MANAGEMENT INCENTIVE**
13 **PROPOSED UNDER THE AGREEMENT TO SHAREHOLDER INCENTIVES**
14 **FOR UTILITY ENERGY EFFICIENCY PROGRAMS APPROVED IN OTHER**
15 **JURISDICTIONS?**

16 A: Yes. One of the steps I took in order to assess the reasonableness of the level of
17 management incentive proposed under the Agreement was to compare it to existing
18 shareholder incentives for utility energy efficiency programs in other jurisdictions. The
19 results of that comparison, presented later in my testimony, are meant to help inform the
20 Commission's decision making on this issue. However, those results are subject to two
21 important caveats.

22 • First, a shareholder or management incentives is only one component of the
23 regulatory framework within which a utility is delivering energy efficiency

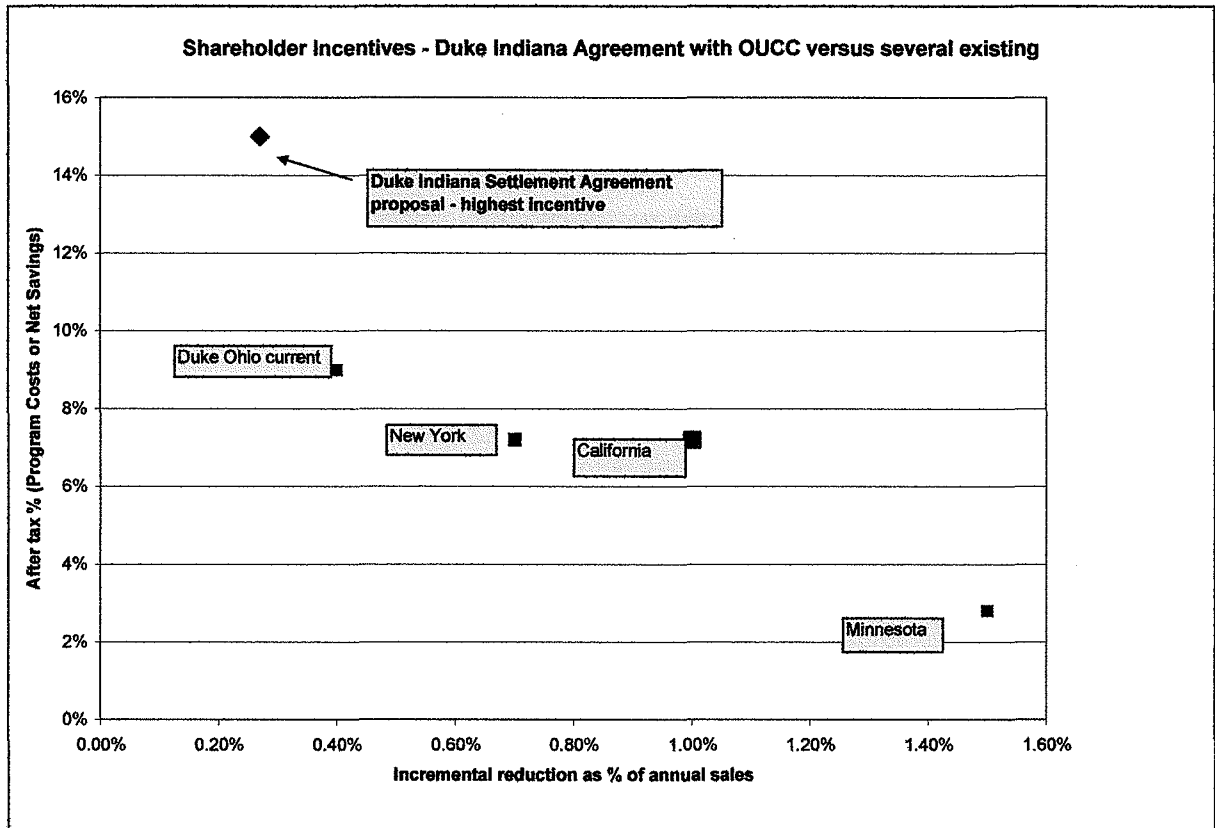
1 programs. Other relevant components may include statutory requirements,
2 explicit performance targets, the method of program cost recovery, the method of
3 lost margin recovery, rate design, and rate levels. It is very difficult to either
4 "normalize for" or capture all of these factors in any comparison of shareholder
5 incentives. For example, both Ohio and California have regulatory frameworks
6 that allow for recovery of program costs, an incentive and lost margins.
7 However, California has an explicit penalty for utilities that do not achieve a
8 threshold level of reductions. Minnesota allows recovery of program costs and a
9 shareholder incentive but does not allow utility compensation for one of the three
10 categories of costs, i.e., lost revenues.

11 • Second, the shareholder incentives in other jurisdictions are primarily for energy
12 conservation programs. In contrast, Duke Energy Indiana is proposing a
13 management incentive for savings from both energy conservation and demand
14 response programs.

15 Q. **HOW DOES THE LEVEL OF MANAGEMENT INCENTIVE PROPOSED**
16 **UNDER THE AGREEMENT COMPARE TO SHAREHOLDER INCENTIVES**
17 **FOR UTILITY ENERGY EFFICIENCY PROGRAMS APPROVED IN OTHER**
18 **JURISDICTIONS?**

19 A: The level of management incentive proposed under the Agreement appears to be higher
20 than most, if not all, existing shareholder incentives for utility energy efficiency programs
21 in other jurisdictions. This fact is illustrated graphically in Exhibit____(JRH-13) and
22 summarized below.

23



The chart presents the levels of shareholder incentive versus the corresponding level of target performance under the Agreement and under the incentive structures in several other states. The horizontal or "x" axis presents the performance target under each shareholder incentive. For comparison purposes these targets are expressed in terms of incremental reductions as a percentage of annual retail sales. The vertical or "y" axis plots the level of incentive a utility receives if its actual reductions are equal to its performance target. Again, for comparison purposes, these incentives are expressed as after-tax amounts, either percentages of program costs or percentages of net savings.

Incentives in Ohio, New York, California and Minnesota are plotted as squares. The management incentive under the Agreement, i.e., 15% of program costs after-tax at an incremental reduction equal to 0.27% of annual sales, is plotted as a diamond. As

1 indicated by its location in the uppermost left-hand section of the chart, the Agreement
2 contemplates the highest management incentive for the lowest performance target.
3

4 **II. LIMITS ON FLEXIBILITY**

5 **Q. PLEASE IDENTIFY THE VALUE-OF-SERVICE COMPONENT OF THE**
6 **AGREEMENT'S COMPENSATION STRUCTURE**

7 A. As noted earlier, under the Agreement the Company's compensation for program costs
8 and a management incentive is based upon a value-of-service approach. That
9 compensation is equal to 60% of avoided costs from verified energy conservation
10 measures plus 75% of avoided costs from verified demand response measures.

11 **Q. PLEASE EXPLAIN HOW THAT VALUE-OF-SERVICE COMPONENT MAY**
12 **CONSTRAIN THE COMPANY'S ABILITY TO RESPOND TO CHANGES IN**
13 **MARKET CONDITIONS.**

14 A: The compensation levels of 60% of avoided costs from energy conservation measures
15 and 75% of avoided costs from demand response measures under the Agreement simply
16 reflect current expectations regarding avoided costs and program costs. It is certainly
17 possible that, over the next two or three years, market conditions, avoided costs and/or
18 program costs may change dramatically. There is no guarantee that those compensation
19 levels, which are based upon current expectations of value-of-service, will continue to
20 ensure that the Company pursues all cost-effective conservation if market conditions
21 change dramatically. If the compensation under the Agreement is not adequate under
22 dramatically different market conditions, the entire Agreement will have to be

1 renegotiated. In contrast, a compensation structure based upon cost-of-service principles
2 would not be affected by changes in market conditions.

3

4 **II. CONCLUSIONS AND RECOMMENDATIONS**

5 **Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AFTER REVIEWING THE**
6 **AGREEMENT.**

7 A.: My first conclusion is that the Company is proposing an unreasonably high management
8 incentive, also referred to as a performance target, for an unreasonably low level of
9 energy conservation. My second conclusion is that the value-of-service component of
10 the Agreement's compensation structure may limit the Company's ability to respond
11 easily to unexpected changes in market conditions.

12 **Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS REGARDING THE**
13 **AGREEMENT.**

14 A: My first recommendation is that the Commission not approve the management incentive
15 proposed under the Agreement. My second and third recommendations are the same as
16 those I made in my Direct Testimony, i.e.

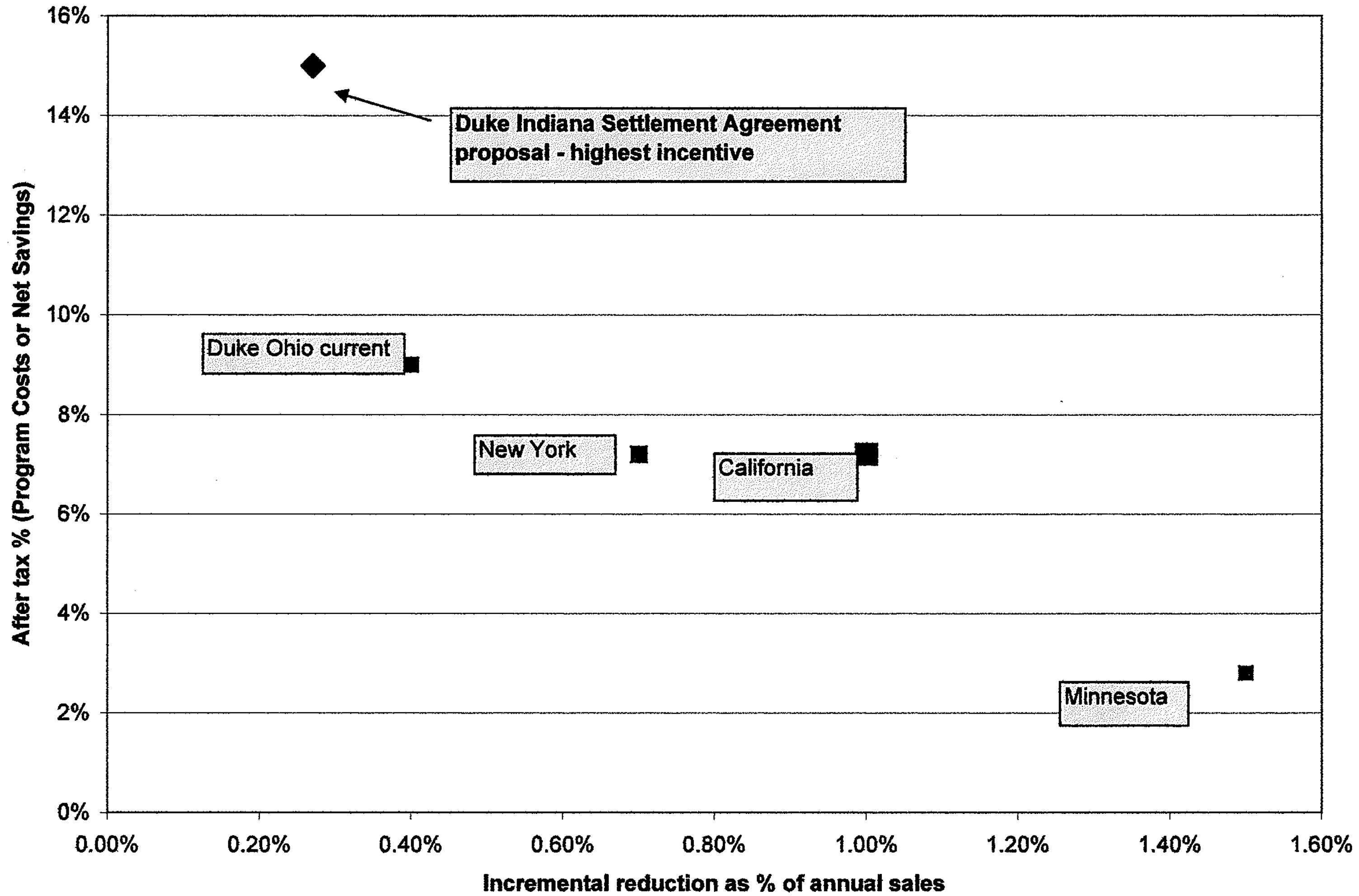
17 - the Commission should direct the Company to seek the input of stakeholders
18 regarding an expansion of the breadth of its energy conservation programs under
19 its existing ratemaking framework, and an increase in the aggregate budget for
20 those programs, and to then submit a filing requesting approval of those programs
21 and budgets. The goal is to have the Company increase its emphasis on energy
22 conservation in a timely manner at a total budget in the order of one percent of

1 retail revenues, which is consistent with the Commission's Phase I Order in Cause
2 No. 42693; and
3 o the Commission should require the Company to file a new application to develop,
4 implement and manage new energy efficiency programs under a ratemaking
5 framework that would, subject to Commission review, set revenue requirements
6 that would recover actual incurred costs, address verified revenue erosion or lost
7 revenues, and provide a shared saving incentive based on performance, i.e.
8 achievement of explicit reduction goals, and subject to a cap as well as to
9 penalties for poor performance.

10 **Q. DOES THIS COMPLETE YOUR SUPPLEMENTAL DIRECT TESTIMONY?**

11 A: Yes.

Exhibit___(JRH-13)



Exhibit___(JRH-13)

Jurisdictional Revenue Requirement Associated with Duke Energy Indiana Energy Efficiency Plan - Settlement Agreement with Office of Utility Consumer Counselor versus Rebuttal Filing

(Dollars in Millions)

Line	Source	Time Period	Rebuttal Filing		Settlement Agreement		Differences	
			Level of achievement (%)	Total ($)	Level of achievement (%)	Total ($)	Amount	Percent
	A		B	C	D	E	F = E - C	G = F/C
1	Petitioner's Exhibit Y-1	Years 1 to 4	100%	162.90	85%	137.2	-25.70	-15.8%
2	Petitioner's Exhibit Y-1 + Settlement Agreement	Years 1 to 6	100%	162.90	85%	151.10	-11.80	-7.2%
3	Synapse calculation	Years 1 to 6	100%	162.90	100%	177.77	14.87	9.1%