STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF SOUTHERN INDIANA GAS AND ELECTRIC COMPANY D/B/A VECTREN ENERGY DELIVERY OF INDIANA, INC. ("PETITIONER") FOR APPROVAL OF AND AUTHORITY FOR (1) AN INCREASE IN ITS RATES AND CHARGES FOR ELECTRIC UTILITY SERVICE INCLUDING A SECOND STEP THAT WILL INCLUDE THE REVENUE REQUIREMENTS FOR ITS DENSE PACK PROJECTS; (2) NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO; (3) THE SHARING OF WHOLESALE POWER MARGINS BETWEEN PETITIONER AND ITS ELECTRIC CUSTOMERS; (4) A SALES RECONCILIATION ADJUSTMENT TO DECOUPLE FIXED COST RECOVERY FROM THE AMOUNT OF CUSTOMER USAGE FOR CERTAIN RATE CLASSES; (5) A DEMAND SIDE MANAGEMENT PROGRAM WHICH WILL INCLUDE A MECHANISM FOR THE TIMELY RECOVERY OF COSTS RELATING THERETO AND PERFORMANCE INCENTIVES BASED ON ACHIEVED SAVINGS; (6) AN ALTERNATIVE REGULATORY PLAN ALLOWING PETITIONER TO RETAIN ITS SHARE OF WHOLESALE POWER MARGINS AND DEMAND SIDE MANAGEMENT PERFORMANCE INCENTIVES; AND (7) APPROVAL OF VARIOUS CHANGES TO ITS TARIFF FOR ELECTRIC SERVICE INCLUDING NEW NET METERING, ALTERNATIVE FEED SERVICE, TEMPORARY SERVICE, AND STANDBY OR AUXILIARY SERVICE RIDERS, REVISIONS TO ITS EXISTING ECONOMIC DEVELOPMENT AND AREA DEVELOPMENT RIDERS, REVISIONS TO ITS EXISTING MISO COST AND REVENUE ADJUSTMENT AND RELIABILITY COST AND REVENUE ADJUSTMENT (INCLUDING THE ADDITION OF A COMPONENT TO TRACK VARIABLE PRODUCTION COSTS) AND REVISIONS TO ITS GENERAL TERMS AND CONDITIONS FOR SERVICE.	)	**CAUSE NO. 43839**

SUBMITTAL OF CORRECTIONS TO PREFILED TESTIMONY OF J. RICHARD HORNBY ON BEHALF OF CITIZENS ACTION COALITION OF INDIANA, INC.

The Citizens Action Coalition of Indiana, Inc. ("Coalition" or "CAC"), by counsel, hereby submits corrections to the prefiled testimony of J. Richard Hornby on behalf of the CAC. Attached herewith is a "clean" version of the corrected testimony as intended for introduction at the evidentiary hearing as well as a "redlined" copy showing changes in red with the deletions also in "strikethrough" and the insertions in bold. In addition, CAC hereby provides notice it does not intend to offer into evidence its previously prefiled Exhibit JRH-2.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing document was served by U.S. mail, first class postage paid, or by electronic mail transmission, upon the following on July 9, 2010:

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STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF SOUTHERN INDIANA GAS AND ELECTRIC COMPANY d/b/a VECTREN ENERGY DELIVERY OF INDIANA, INC. ("PETITIONER") FOR APPROVAL OF AND AUTHORITY FOR (1) AN INCREASE IN ITS RATES AND CHARGES FOR ELECTRIC UTILITY SERVICE INCLUDING A SECOND STEP THAT WILL INCLUDE THE REVENUE REQUIREMENT FOR ITS DENSE PACK PROJECTS; (2) NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO; (3) THE SHARING OF WHOLESALE POWER MARGINS BETWEEN PETITIONER AND ITS ELECTRIC CUSTOMERS; (4) A SALES RECONCILIATION ADJUSTMENT TO DECOUPLE FIXED COST RECOVERY FROM THE AMOUNT OF CUSTOMER USAGE FOR CERTAIN RATE CLASSES; (5) A DEMAND SIDE MANAGEMENT PROGRAM WHICH WILL INCLUDE A MECHANISM FOR THE TIMELY RECOVERY OF COSTS RELATING THERETO AND PERFORMANCE INCENTIVES BASED ON ACHIEVED SAVINGS; (6) AN ALTERNATIVE REGULATORY PLAN ALLOWING PETITIONER TO RETAIN ITS SHARE OF WHOLESALE POWER MARGINS AND DEMAND SIDE MANAGEMENT PERFORMANCE INCENTIVES; AND (7) APPROVAL OF VARIOUS CHANGES TO ITS TARIFF FOR ELECTRIC SERVICE INCLUDING NEW NET METERING, ALTERNATE FEED SERVICE, TEMPORARY SERVICE, AND STANDBY OR AUXILIARY SERVICE RIDERS, REVISIONS TO ITS EXISTING ECONOMIC DEVELOPMENT AND AREA DEVELOPMENT RIDERS, REVISIONS TO ITS EXISTING MISO COST AND REVENUE ADJUSTMENT AND RELIABILITY COST AND REVENUE ADJUSTMENT (INCLUDING THE ADDITION OF A COMPONENT TO TRACK VARIABLE PRODUCTION COSTS) AND REVISIONS TO ITS GENERAL TERMS AND CONDITIONS FOR SERVICE.	)	CAUSE NO. 43839

CORRECTED DIRECT TESTIMONY AND EXHIBITS OF J. RICHARD HORNBY

ON BEHALF OF CITIZENS ACTION COALITION OF INDIANA, INC.

I. INTRODUCTION

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

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

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

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

Q. PLEASE DESCRIBE SYNAPSE ENERGY ECONOMICS.

A. Synapse Energy Economics ("Synapse") is a research and consulting firm specializing in energy and environmental issues. Its primary focus is on electricity resource planning and regulation including computer modeling, service reliability, resource portfolios, financial and economic risks, transmission planning, renewable energy portfolio standards, energy efficiency, and ratemaking. Synapse works for a wide range of clients including attorneys general, offices of consumer advocates, public utility commissions, environmental groups, foundations, the U.S. Environmental Protection Agency, Department of Energy, Department of Justice, Federal Trade Commission and the National Association of Regulatory Utility Commissioners. Synapse has a professional staff of twenty-two with extensive experience in the electricity and natural gas industries.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I have a Bachelor of Industrial Engineering from the Technical University of Nova Scotia, now the School of Engineering at Dalhousie University and a Master of Science in Energy Technology and Policy from the Massachusetts Institute of Technology (MIT).

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

A. I have worked in the energy industry since 1976 as a project engineer, a senior civil servant and a regulatory consultant. As a project engineer I was responsible for identifying and pursuing opportunities to reduce energy use in a factory in Nova Scotia. Subsequently, after my graduate program at MIT, I spent several years as a senior civil servant with the government in Nova Scotia where I helped prepare the province's first comprehensive energy plan and served on a federal-provincial board responsible for regulating exploration and development of offshore oil and gas reserves. Since 1986, as a regulatory consultant I have reviewed numerous integrated resource plans in the gas and electric industries, testifying extensively regarding cost allocation and rate design. During the past several years I have managed various projects to estimate the avoided costs of electricity and natural gas, reviewed the economics of demand response and smart grid proposals and testified regarding the alignment of utility financial incentives and rates with the pursuit of energy efficiency. I have provided expert testimony and litigation support on these issues in over 100 proceedings on behalf of utility regulators, consumer advocates, environmental groups, energy marketers, gas producers, and utilities.

Q. HAVE YOU PREPARED AN EXHIBIT SUMMARIZING YOUR REGULATORY EXPERIENCE?

A. Yes. My regulatory experience is summarized in Exhibit JRH-1.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc. ("Petitioner", the “Company”, “Vectren” or “Vectren South – Electric”) is proposing numerous changes in its rates and tariffs. My testimony addresses its proposed Sales Reconciliation Adjustment ("SRA"). The fact that I do not address the Company's other proposed changes does not mean that I support them.

Q. ARE YOU PRESENTING ANY EXHIBITS TO SUPPORT YOUR TESTIMONY?

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

Exhibit JRH-3	Illustrative annual amounts recoverable from residential ratepayers in 2009 via a SRA and a LRAM

Q. WHAT DATA SOURCES DID YOU RELY UPON TO PREPARE YOUR TESTIMONY AND EXHIBITS?

A. I relied primarily on the Direct Testimony and exhibits of the Company witnesses as well as on Company responses to data requests. In addition I relied upon Commission Orders in several prior proceedings including Cause 42943 / 43046, Cause 42693 ("Phase II Order") and Cause 43427 ("Vectren DSM Order"). Finally, I relied upon surveys and tariffs documenting revenue adjustment mechanisms of utilities in other states.

II. CONCLUSIONS AND RECOMMENDATIONS

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS REGARDING THE COMPANY PROPOSAL TO IMPLEMENT DECOUPLING THROUGH A SRA.

A. The Phase II Order has established new explicit annual reductions in electricity sales for the Company and other jurisdictional electric utilities. It is appropriate to allow the Company to make a limited change in rate design to collect the revenues it would otherwise lose due to those new, future reductions in sales. The Company's proposed SRA would do much more than just collect the lost revenues resulting from reductions in future sales due to new DSM programs under the Phase II Order. It would eliminate the Company's existing revenue risk from all factors that affect its sales as well as eliminate its financial disincentive to promote sales of electricity to customers in those rate classes, often referred to as its throughput incentive. The proposed SRA is not the best approach to meeting the Commission's energy policy and ratemaking objectives because it does not represent a reasonable balancing of ratepayer and shareholder interests. Under its proposed approach the Company would shift all of its revenue risk to ratepayers without providing commensurate or offsetting benefits. In contrast, the Company's shareholders benefit by avoiding an increase in revenue risk from new DSM programs and from the elimination of existing revenue risk from all factors that affect its sales.

A Lost Revenue Adjustment Mechanism (LRAM) would achieve those energy policy and ratemaking objectives in a balanced manner. A LRAM would only adjust the Company's rates for the reduction in sales from the new DSM programs under the Phase II Order. The LRAM would benefit the Company by preventing an increase in revenue risk from the new DSM programs and would benefit ratepayers by limiting the amount of revenue risk shifted to them.

Based upon these conclusions I recommend that the Commission not approve the Company's proposed SRA. As an alternative, I recommend that the Commission allow the Company to implement a LRAM on a three year trial basis.

III. IMPLEMENTATION OF DECOUPLING VIA A SRA

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSAL TO IMPLEMENT DECOUPLING VIA A SRA.

A. The Company is proposing a SRA, a rate mechanism which would "decouple" the Company's recovery of the fixed cost component of its revenue requirements from the quantity of electricity that it sells. The Company is proposing the SRA for all rate classes except Large Power (LP), High Load Factor (HLF), Street Lighting (SL) and Outdoor Lighting (OL).

Q. HOW WOULD THE SRA BE CALCULATED?

A. The amount to be collected (refunded) via the SRA would be calculated monthly and the SRA would be re-set once a year to collect (refund) that amount. All of the calculations would be done by rate class. Company witness Ulrey describes the steps through which the proposed SRA would be set and applied on pages 24 through 27 of his testimony as well as in Exhibits JLU-6 through 8. Using his illustrative example in Exhibit JLU-6 as a point of reference, which is for residential customers in a year, the key steps in calculating the SRA are as follows:

- In this proceeding the Commission determines a fixed revenue requirement per customer for each rate class, which the Company refers to as the *Order Granted Fixed Cost Revenue/Customer*. This amount is $105.34 per residential customer in Exhibit JLU-6.

- In each rate effective period the Company would calculate an *Order Granted Fixed Cost Revenue*. This is the absolute amount of revenues the Company is entitled to collect in order to recover its fixed cost revenue requirement. This amount is equal to the number of customers it served in that period multiplied by the Order Granted Fixed Cost Revenue/Customer In Exhibit JLU-6 this amount is $154.66 million, which is $105.34 per residential customer times 1.468 million residential customers
- In each rate effective period the Company would then calculate a *SRA/Decoupling Amount.* This is the amount that the SRA would collect(refund). It is equal to the Order Granted Fixed Cost Revenue minus the *Actual Revenue less Adjustment and Variable*, i.e., the actual revenues the Company collected net of revenues for variable costs. In Exhibit JLU-6 this amount is $1.5 million, which is $154.66 million minus $153.15 million.

Q. WHAT IS THE COMPANY'S RATIONALE FOR IMPLEMENTING A SRA?

A. Company witnesses Chapman, Petit and Ulrey present several reasons to support the Company's request to implement a SRA. Their primary justification is that a SRA will enable the Company to recover the fixed cost portion of its revenue requirements it would otherwise lose due to new, future reductions in sales resulting from compliance with the Phase II Order. Their second justification is that a SRA will eliminate the Company's existing revenue risk due to existing factors that affect its sales and eliminate its financial incentive to promote sales of electricity to customers in the rate classes subject to the SRA, often referred to as its throughput incentive. They also note that their proposed SRA is similar to decoupling mechanisms that the IURC has approved for the Company's sister gas distribution companies and that regulators in other states have approved for electric utilities under their jurisdiction.

Q. DO YOU AGREE WITH THE COMPANY'S RATIONALE AND ITS PROPOSED SRA?

A. No. From an energy policy perspective I agree that it is appropriate to allow the Company to make a limited change in rate design to collect verified actual lost revenues from future reductions in sales resulting from compliance with the Phase II Order. However, the Company's proposed SRA would do much more than just collect those lost revenues, it would shift the Company's existing revenue risk from all factors that affect its sales to ratepayers without providing commensurate or offsetting benefits to ratepayers. As a result, the SRA is inconsistent with the ratemaking goal of setting rates that yield revenue requirements based upon the fair return standard. Thus the Company's proposal does not achieve these energy policy and ratemaking objectives in a manner that balances the interests of ratepayers and shareholders.

The balance of my testimony will explain why limiting the Company to an LRAM, at least for a initial period, would achieve these energy policy and ratemaking objectives in a balanced manner.

Q. WHAT IS THE COMPANY'S PRIMARY JUSTIFICATION FOR IMPLEMENTING A SRA?

A. The Company's primary justification for implementing a SRA is to enable it to recover the fixed cost portion of its revenue requirements it would otherwise lose due to new, future reductions in sales resulting from the new DSM programs that will be implemented under the Phase II Order.

Q. WOULD AN LRAM BE AS EFFECTIVE AS A SRA IN ENABLING THE COMPANY TO COLLECT LOST REVENUES FROM REDUCTIONS IN SALES RESULTING FROM THE PHASE II ORDER?

A. Yes. A LRAM would be just as effective as a SRA in enabling the Company to collect lost revenues due to reductions in sales resulting from new DSM programs. The LRAM could be designed to allow the Company to recover amounts equal to the documented reduction in kWh in each year multiplied by its fixed cost revenue requirement per customer. (The Company refers to this unit amount as the "Order Granted Fixed Cost Revenue/Customer"). The Phase II Order requires that these reductions be documented through evaluation, monitoring and verification (EM&V). This process eliminates the concern that establishing the quantity of reductions to use in a LRAM will be contentious.

Q. PLEASE COMMENT ON THE IMPACT OF AN LRAM ON THE ESTABLISHMENT OF THE COMPANY'S ALLOWED RETURN ON EQUITY (ROE)?

A. While I am not testifying as a witness regarding ROE, it does not appear that implementation of an LRAM should have an impact on the establishment of the Company's ROE in this proceeding. As Mr. Chapman notes, in the absence of any change in its rate design, i.e., business as usual, the Company would experience an increase in its revenue risk due to its exposure to future reductions in sales from new DSM programs under the Phase II Order. Because this risk is new and prospective it has likely not been reflected in the Company's past or current ROE. Thus, if a LRAM is implemented to offset those anticipated lost revenues it will be preventing an increase in revenue risk, rather than reducing the Company's existing revenue risk from traditional factors such as weather, economic downturns, outages and bad debt.

Q. PLEASE COMMENT ON THE COMPANY'S POSITION THAT IT NEEDS A SRA IN ORDER TO ELIMINATE ITS THROUGHPUT INCENTIVE AS WELL AS ITS REVENUE RISK.

A. The Company's second justification for a SRA is that it will eliminate the Company's existing revenue risk due to existing factors that affect its sales as well as eliminate its financial incentive to promote sales of electricity to customers in the rate classes subject to the SRA, often referred to as its throughput incentive.

The Company's proposal does not represent a reasonable balancing of ratepayer and shareholder interests. Specifically, under its proposed approach the Company would shift all revenue risk from shareholders to ratepayers without providing ratepayers commensurate or offsetting benefits. In addition, the Company's proposed SRA has certain unintended adverse consequences in terms of environmental policy and ratemaking objectives.

Q. PLEASE BEGIN BY DESCRIBING THE THROUGHPUT INCENTIVE.

A. The Company's throughput incentive is its financial incentive to promote sales of electricity in order to maximize its revenues. The Company's revenue risk is the possibility that, in any give year, the amount of revenues it collects will be materially lower than its revenue requirements. Both are attributable to the mismatch between the fixed cost component of its revenue requirements and its collection of revenues. A significant portion of the Company's revenue requirement is fixed, at least in the short to medium term, according to Company estimates. In other words, that amount of annual costs does not vary with the annual quantity of electricity the Company sells. In contrast, under its current rate design the Company collects the majority of its annual revenues through volumetric rates expressed in cents per kWh. That amount of annual revenues does vary with the annual quantity of electricity it sells.

Q. HAS THE ELIMINATION OF THE THROUGHPUT INCENTIVE BEEN EXAMINED IN THE PAST?

A. Yes. The need to align utility financial incentives with support for improvements in efficiency, including the need to address the throughput incentive, has been the subject of debate for at least twenty years. The merits of alternative approaches to addressing the throughput incentive, in particular a LRAM versus a SRA approach, have been and continue to be hotly debated topics. In theory the primary rationale for implementing decoupling is that creates a more comprehensive incentive for the utility to support efficiency and that it reduces utility risk which would result in a lower ROE. In practice it is not clear that decoupling, as opposed to an LRAM, has a material greater impact on the incentive for vertically integrated electric utilities such as Vectren to pursue efficiency or to reduce their ROE[1].

(1) <u>Shifting of revenue risk to ratepayers under company proposal</u>

Q. DOES THE PROPOSED SRA ELIMINATE BOTH THE COMPANY'S THROUGHPUT INCENTIVE AND ITS EXISTING REVENUE RISK?

A. Yes. A SRA eliminates the Company's throughput incentive as well as its existing revenue risk. Company witness Chapman (p. 26 and 27) cites reduction in revenue risk due to factors other than reductions from DSM as his second justification for a SRA.

[1]Kihm, Steven. *When Revenue Decoupling Will Work…And When It Won't.* Electricity Journal. October 2009.

The SRA increases the certainty the Company will recover its fixed cost revenue requirements allocated to residential and commercial customers from those customers regardless of the reason for lower than expected actual revenues from those rate classes. The SRA eliminates this revenue risk by shifting it from shareholders to ratepayers.

Q. CAN YOU ILLUSTRATE THE RELATIVE AMOUNTS OF REVENUE RISK THAT A SRA AND A LRAM WOULD SHIFT TO RESIDENTIAL RATEPAYERS?

A. Yes. The Company has provided analyses that illustrate the relative amounts of revenue risk that a SRA and a LRAM would have each shifted to residential ratepayers had either mechanism been in effect in 2009. This illustration is presented in Exhibit JRH-3 and summarized below.

Had the proposed SRA been in effect in 2009 the Company would have filed to recover $6.9 million from residential ratepayers. That amount would have translated into an annual amount of approximately $74 for an average residential customer. Had the Company had an LRAM in effect in 2009 and experienced a 1.0% reduction in sales due to DSM programs, it would have filed to recover $1.0 million from residential ratepayers. That amount would have translated into an annual amount of approximately $11 for an average residential customer.

Q. IS THE COMPANY PROPOSING TO PROVIDE RATEPAYERS ANY OFFSETTING BENEFITS IN EXCHANGE FOR SHIFTING THIS REVENUE RISK FROM SHAREHOLDERS TO RATEPAYERS?

A. No.

Q. DID THE COMPANY QUANTIFY ANY BENEFIT TO SHAREHOLDERS FROM THE ELIMINATION OF THIS REVENUE RISK VIA THE SRA?

A. No. Not only did the Company not quantify any benefit to shareholders from the elimination of revenue risk via the SRA, the testimony of its witnesses is inconsistent as to the general magnitude of those benefits.

Mr. Chapman, p.24, maintains that the elimination of revenue risk is a benefit to the Company because the financial market evaluates companies based on risk and financial stability in addition to earnings growth. However, he does not quantify that benefit.

In contrast when Dr. Avera, the Company's ROE witness, discusses the potential implementation of a decoupling mechanism on the Company's ROE on page 55 of his testimony, he states "… there is certainly no evidence to suggest that implementation of the proposed tracker alone would alter its relative risk enough to warrant a change in its ROE." Dr. Avera does not quantify any benefit of the SRA.

Q. DO YOU AGREE THAT THE COMPANY WILL RECEIVE ZERO BENEFIT FROM ELIMINATING ITS EXISTING REVENUE RISK VIA THE SRA?

A. No. First, if the Company will receive no quantifiable benefit from eliminating its existing revenue risk I do not understand why it is requesting a SRA. That position implies that a LRAM provides just as much benefit to the Company as an SRA.

Second, a leading proponent of decoupling, the Regulatory Assistance Project, indicates that decoupling should result in a reduction in a utility's cost of capital, either through a reduction in the equity capitalization ratio or a reduction in the ROE.[2]

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[2] Shirley, Wayne et al. *Revenue Decoupling Standards and Criteria, A Report to the Minnesota Public Utilities Commission.* Regulatory Assistance Project. June 2008. pp. 13 -16.

Third, in addressing a request for decoupling by the Connecticut Natural Gas Corporation ("CNG"), the Connecticut Department of Public Utility Control ("DPUC") expressed the following position[3]:

> Full decoupling compensates the Company for any type of reduction in consumption, such as warmer weather, customer loss, a deteriorating economy as well as permanent and price induced conservation. Clearly, the very large potential risk of revenue instability is shifted from the Company to customers. If the Company were to purchase an insurance instrument to compensation and the Company would expect to make payment for the transfer of risk. The Company's decoupling proposal thrusts customers into the role of insurer without proffering compensation. By reviewing the level of compensation customers would require to breakeven under decoupling, the Department concluded that the requisite reduction in ROE needed as compensation would prove too draconian and actually impede the Company's ability to attract capital. The Company's own calculation shows that a 10% change in weather (HDDs) alone translates into a $4 million change in revenue.

(2) <u>Potential unintended adverse consequences of decoupling</u>

Q. WHAT ARE THE POTENTIAL UNINTENDED ADVERSE ENVIRONMENTAL CONSEQUENCES OF THE COMPANY'S PROPOSAL?

A. As noted earlier, the SRA would eliminate the Company's risk of recovering the fixed cost portion of its revenue requirements. One component of that fixed cost portion would be the revenue requirements associated with any future investments that the Company makes to extend the life of its existing coal units. Thus, all things being equal, it is reasonable to assume that utility management would be more likely to make such investments if the Company had a SRA than if the Company had a LRAM. Thus,

[3] State of Connecticut, Department of Public Utility Control; Application of Connecticut Natural Gas Corporation for a Rate increase, Final Decision, June 30, 2009, pp. 76-77.

implementation of a SRA could have adverse unintended consequences relative to the environmental objective of reducing emissions of carbon dioxide.

Q. WHAT ARE THE POTENTIAL UNINTENDED ADVERSE RATEMAKING CONSEQUENCES OF THE COMPANY'S PROPOSAL?

A. As noted earlier, the SRA would collect the SRA/Decoupling Amount each year. That Amount is the difference between the Company's Order Granted Fixed Cost Revenue by rate class for its test year and the actual revenues it collected in a year. There are a number of factors that would cause actual revenues in a year to be different from the Order Granted Fixed Cost Revenue. Many of those factors are not within the control of Company management, such as weather, economic conditions and price elasticity. However, outages are a factor that affects sales and revenues for which the Company does have responsibility. In addition, bad debt is a factor that affects revenues and that is reflected in revenue requirements. Implementation of a SRA could have adverse unintended consequences relative to the ratemaking objectives of providing the Company a financial incentive to minimize outages and of preventing double-recovery of bad debt.

(3) <u>Implementation of SRA and LRAM mechanisms at other utilities</u>

Q. ARE THE SRA AND LRAM MECHANISMS IMPLEMENTED AT OTHER UTILITIES RELEVANT TO THE COMPANY'S PROPOSAL?

A. It is certainly worthwhile to review the experience of other utilities with SRA and LRAM mechanisms, but it is also very important to determine if the circumstances of those other utilities are comparable to the Company's circumstances.

The Company witnesses note that their proposed SRA is similar to decoupling mechanisms that the IURC has approved for the Company's sister gas distribution companies. The decoupling mechanisms at those gas utilities are of little relevance because of the major differences between the Company's circumstances and those of its sister gas utilities. First, the Company is a vertically integrated electric utility whose rate base includes investments in supply and transmission in addition to distribution. In contrast, its sister utilities are distribution only utilities. As a result, the magnitude of either a SRA or LRAM for the Company will be several times larger than a SRA or LRAM for its sister gas utilities. Second, the Company must achieve explicit reductions established in the Phase II Order, its sister gas utilities do not. Third, the Company has the opportunity to earn shareholder incentives from its DSM programs, its sister gas utilities do not. Fourth, the market for electricity is different from the market for natural gas.

The Company witnesses also note that their proposed SRA is similar to decoupling mechanisms that regulators in other states have approved for electric utilities in those jurisdictions. The electric utilities of most relevance to the Company are other vertically integrated electric utilities whose rate base includes investments in supply and transmission in addition to distribution. LRAMs are more common than SRA type mechanisms among vertically integrated electric utilities. As of January 2010, according to the Institute for Electric Efficiency,[4] four states – Idaho, Wisconsin, Vermont and Oregon - had approved decoupling for vertically integrated electric utilities. Six other states had approved LRAMs for their vertically integrated electric

[4] ____, *State Energy Efficiency Regulatory Frameworks*, Institute for Electric Efficiency, Edison Foundation, January 2010. www.edisonfoundation.net/IEE

utilities – Kentucky, North Carolina, South Carolina, Oklahoma, Colorado and Wyoming. At that time decisions were pending regarding fixed cost recovery mechanisms for vertically integrated electric utilities in Utah and Hawaii.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS REGARDING THE COMPANY PROPOSAL TO IMPLEMENT DECOUPLING THROUGH A SRA.

A. The Phase II Order has established new explicit annual reductions in electricity sales for the Company and other jurisdictional electric utilities. It is appropriate to allow the Company to make a limited change in rate design to collect the revenues it would otherwise lose due to those new, future reductions in sales. The Company's proposed SRA would do much more than just collect the lost revenues resulting from reductions in future sales due to new DSM programs under the Phase II Order. It would eliminate the Company's existing revenue risk from all factors that affect its sales as well as eliminate its financial disincentive to promote sales of electricity to customers in those rate classes, often referred to as its throughput incentive. The proposed SRA is not the best approach to meeting the Commission's energy policy and ratemaking objectives because it does not represent a reasonable balancing of ratepayer and shareholder interests. Under its proposed approach the Company would shift all of its revenue risk to ratepayers without providing commensurate or offsetting benefits. In contrast, the Company's shareholders benefit by avoiding an increase in revenue risk from new DSM programs and from the elimination of existing revenue risk from all factors that affect its sales.

A Lost Revenue Adjustment Mechanism (LRAM) would achieve those energy policy and ratemaking objectives in a balanced manner. A LRAM would only adjust the Company's rates for the reduction in sales from the new DSM programs under the Phase II Order. The LRAM would benefit the Company by preventing an increase in revenue risk from the new DSM programs and would benefit ratepayers by limiting the amount of revenue risk shifted to them.

Based upon these conclusions I recommend that the Commission not approve the Company's proposed SRA. As an alternative, I recommend that the Commission allow the Company to implement a LRAM on a three year trial basis.

Q. DOES THIS COMPLETE YOUR DIRECT TESTIMONY?

A. Yes.

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

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CORRECTED DIRECT TESTIMONY AND EXHIBITS OF J. RICHARD HORNBY

ON BEHALF OF CITIZENS ACTION COALITION OF INDIANA, INC. (REDLINED)

I. INTRODUCTION

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

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

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

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

Q. PLEASE DESCRIBE SYNAPSE ENERGY ECONOMICS.

A. Synapse Energy Economics ("Synapse") is a research and consulting firm specializing in energy and environmental issues. Its primary focus is on electricity resource planning and regulation including computer modeling, service reliability, resource portfolios, financial and economic risks, transmission planning, renewable energy portfolio standards, energy efficiency, and ratemaking. Synapse works for a wide range of clients including attorneys general, offices of consumer advocates, public utility commissions, environmental groups, foundations, the U.S. Environmental Protection Agency, Department of Energy, Department of Justice, Federal Trade Commission and the National Association of Regulatory Utility Commissioners. Synapse has a professional staff of twenty-two with extensive experience in the electricity and natural gas industries.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. I have a Bachelor of Industrial Engineering from the Technical University of Nova Scotia, now the School of Engineering at Dalhousie University and a Master of Science in Energy Technology and Policy from the Massachusetts Institute of Technology (MIT).

Q. PLEASE SUMMARIZE YOUR PROFESSIONAL EXPERIENCE.

A. I have worked in the energy industry since 1976 as a project engineer, a senior civil servant and a regulatory consultant. As a project engineer I was responsible for identifying and pursuing opportunities to reduce energy use in a factory in Nova Scotia. Subsequently, after my graduate program at MIT, I spent several years as a senior civil servant with the government in Nova Scotia where I helped prepare the province's first comprehensive energy plan and served on a federal-provincial board responsible for regulating exploration and development of offshore oil and gas reserves. Since 1986, as a regulatory consultant I have reviewed numerous integrated resource plans in the gas and electric industries, testifying extensively regarding cost allocation and rate design. During the past several years I have managed various projects to estimate the avoided costs of electricity and natural gas, reviewed the economics of demand response and smart grid proposals and testified regarding the alignment of utility financial incentives and rates with the pursuit of energy efficiency. I have provided expert testimony and litigation support on these issues in over 100 proceedings on behalf of utility regulators, consumer advocates, environmental groups, energy marketers, gas producers, and utilities.

Q. HAVE YOU PREPARED AN EXHIBIT SUMMARIZING YOUR REGULATORY EXPERIENCE?

A. Yes. My regulatory experience is summarized in Exhibit JRH-1.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc. ("Petitioner", the "Company", "Vectren" or "Vectren South – Electric") is proposing numerous changes in its rates and tariffs. My testimony addresses ~~two of those proposed changes, the proposed allocation of production demand revenue requirements in its cost of service study (COSS) and~~ its proposed Sales Reconciliation Adjustment ("SRA"). The fact that I do not address the Company's other proposed changes does not mean that I support them.

Q. ARE YOU PRESENTING ANY EXHIBITS TO SUPPORT YOUR TESTIMONY?

A. Yes. I have prepared ~~two~~ one exhibit~~s~~ to support my testimony:

~~Exhibit JRH-2~~	~~Normalized Cost of Service at Proposed Rates with Classification of Production Demand Revenue Requirements per the Equivalent Peaker Method~~
Exhibit JRH-3	Illustrative annual amounts recoverable from residential ratepayers in 2009 via a SRA and a LRAM

Q. WHAT DATA SOURCES DID YOU RELY UPON TO PREPARE YOUR TESTIMONY AND EXHIBITS?

A. I relied primarily on the Direct Testimony and exhibits of the Company witnesses as well as on Company responses to data requests. In addition I relied upon Commission Orders in several prior proceedings including Cause 42943 / 43046, Cause 42693 ("Phase II Order") and Cause 43427 ("Vectren DSM Order"). Finally, I relied upon surveys and tariffs documenting revenue adjustment mechanisms of utilities in other states ~~and on public estimates of the capital and operating costs of various types of generating capacity~~.

II. CONCLUSIONS AND RECOMMENDATIONS

~~**Q. PLEASE SUMMARIZE YOUR CONCLUSION AND RECOMMENDATION REGARDING THE COMPANY'S PROPOSED ALLOCATION OF PRODUCTION DEMAND REVENUE REQUIREMENTS AMONG RATE CLASSES.**~~

~~A. The Company's proposed allocation of production demand revenue requirements among rate classes is not consistent with the principle of allocating costs to reflect cost causation. That allocation implies that the Company made one-hundred percent of its investments in generating units solely to meet the demand of its customers. That cost causation assumption is not consistent with electric utility resource planning principles, under which utilities invest in combustion turbine generating units solely as a source of capacity to meet the demand of their customers but invest in coal-fired steam units and other types of units as a source of both capacity and energy, i.e., to meet both the demand and annual energy requirements of their customers.~~

~~Based upon that conclusion I recommend that the Commission not approve the allocation of revenue requirements among rate classes from the Company's COSS. Instead, I recommend that the Commission require the Company to allocate revenue requirements based upon a classification of production demand revenue requirements as 28 percent demand-related and 72 percent energy-related.~~

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS REGARDING THE COMPANY PROPOSAL TO IMPLEMENT DECOUPLING THROUGH A SRA.

A. The Phase II Order has established new explicit annual reductions in electricity sales for the Company and other jurisdictional electric utilities. It is appropriate to allow the Company to make a limited change in rate design to collect the revenues it would otherwise lose due to those new, future reductions in sales. The Company's proposed SRA would do much more than just collect the lost revenues resulting from reductions in future sales due to new DSM programs under the Phase II Order. It would eliminate the Company's existing revenue risk from all factors that affect its sales as well as eliminate its financial disincentive to promote sales of electricity to customers in those rate classes, often referred to as its throughput incentive. The proposed SRA is not the best approach to meeting the Commission's energy policy and ratemaking objectives because it does not represent a reasonable balancing of ratepayer and shareholder interests. Under its proposed approach the Company would shift all of its revenue risk to ratepayers without providing commensurate or offsetting benefits. In contrast, the Company's shareholders benefit by avoiding an increase in revenue risk from new DSM programs and from the elimination of existing revenue risk from all factors that affect its sales.

A Lost Revenue Adjustment Mechanism (LRAM) would achieve those energy policy and ratemaking objectives in a balanced manner. A LRAM would only adjust the Company's rates for the reduction in sales from the new DSM programs under the Phase II Order. The LRAM would benefit the Company by preventing an increase in revenue risk from the new DSM programs and would benefit ratepayers by limiting the amount of revenue risk shifted to them.

Based upon these conclusions I recommend that the Commission not approve the Company's proposed SRA. As an alternative, I recommend that the Commission allow the Company to implement a LRAM on a three year trial basis.

~~III. ALLOCATION OF PRODUCTION DEMAND REVENUE REQUIREMENTS~~

~~Q. PLEASE DESCRIBE THE COMPANY'S INVESTMENT IN GENERATION CAPACITY AND THE PRODUCTION DEMAND REVENUE REQUIREMENTS ASSOCIATED WITH THAT INVESTMENT.~~

~~A. The Company's investment in generation capacity consists of 12 units with an aggregate installed capacity of 1,448 MW. This investment consists of five coal-fired steam units with an aggregate installed capacity of 1,110 MW, one 3 MW landfill gas unit and six gas-fired combustion turbines with an aggregate installed capacity of 338 MW. This data is drawn from the Company's 2009 FERC Form 1 and is presented on Schedule 1 of Exhibit JRH-2.~~

~~The Company's production demand revenue requirements consist of its return on this investment in generating units as well its return of that investment. The return on investment is a portion of its net operating income and its return of those investments is a portion of its depreciation and amortization expense. (My testimony is limited to the allocation of production demand revenue requirements, it does not address the reasonableness of the Company's proposed revenue requirements or the allocation of other components of those revenue requirements).~~

~~**Q. HOW DOES THE COMPANY ALLOCATE THESE PRODUCTION DEMAND REVENUE REQUIREMENTS IN ITS COSS?**~~

~~A. The COSS presented in Exhibit KAH-S2 allocates one-hundred percent of production demand revenue requirements among rate classes using the 4 CP Allocator, which is a demand allocation factor. The 4 CP demand allocation factor reflects the relative contribution of each rate class to peak demand in four summer months. The alternative COSS using the 12 CP Allocator. Methodology, presented in Exhibit KAH-S6, allocates one-hundred percent of these production demand revenue requirements using the 12 CP Allocator. That demand allocation factor reflects the relative contribution of each rate class to peak demand in each calendar month.~~

~~**Q. WHAT DO THOSE ALLOCATIONS IMPLY REGARDING THE CAUSE OF THE COMPANY'S INVESTMENTS IN ITS GENERATING UNITS?**~~

~~A. Those allocations imply that the Company made one-hundred percent of its investments in generating units solely to meet the demand of its customers. The allocations flow from the "classification" step in each COSS. In that step the Company's COSS witness, Mr. Heid, has made an assumption regarding the factor, or combination of factors, that cause the Company to incur each category of costs composing its revenue requirements. He has classified one-hundred percent of the Company's production demand revenue requirements as demand-related. That classification of production demand revenue requirements implies that the Company made one-hundred percent of its investments in generating capacity solely to meet the demand of its customers.~~

~~Q. IS IT REASONABLE TO CLASSIFY ONE HUNDRED PER CENT OF THE COMPANY'S PRODUCTION DEMAND REVENUE REQUIREMENTS AS DEMAND-RELATED?~~

~~A. No. Classifying one-hundred percent of the Company's production demand revenue requirements as demand-related is not consistent with utility resource planning principles. According to those principles, discussed further below, the amount the Company invested in combustion turbine generating units was driven or "caused" solely by the peak demand of its customers. However, the amount it invested in coal-fired steam units was caused by both the demand and the energy requirements of its customers. Based upon those principles it is reasonable to classify all of the Company's investments in its combustion turbines as demand-related but only a portion of its investments in coal-fired steam plants.~~

~~Electric utilities invest in a variety of types of generating units in order to meet the demand and annual energy requirements of their customers in a reliable manner at reasonable cost. Some types of generating units, such as coal-fired steam units, have relatively high capital costs and relatively low operating costs. Other types of generating units, such as gas-fired combustion turbines, have relatively low capital costs and high operating costs. Utilities determine the quantity of each type of capacity to acquire by analyzing the quantity of electricity customers will require in each hour of the year, referred to as the load shape or load duration curve. They divide that hourly load into three basic segments, according to the nature of the load and the characteristics of the generating capacity that would serve it most economically. These~~

~~segments and the corresponding types of capacity are baseload, load-following or intermediate and peak. Their key characteristics are as follows.~~

- ~~**Baseload**. This is the level of load that occurs in at least 70% of the hours of the year. This segment would generally be served by units such as coal-fired steam units with relatively high fixed costs and relatively low variable costs, operated at a relatively steady level and high capacity factor[1].~~
- ~~**Load-following or intermediate**. This segment of load varies substantially from hour to hour during most hours of the year. The capacity used to serve this segment must have the flexibility to operate at a wide range of output levels and to vary its level of operation quickly. This segment would generally be served by coal-fired steam units with the ability to vary their output quickly or by gas-fired combined cycle plants.~~
- ~~**Peak load**. This segment of load consists of the extreme hourly peaks that occur in a very few hours of the year. The capacity used to serve this segment must have the flexibility to operate at very high output levels with short notice for short periods. This segment would ideally be served by gas-fired combustion turbines, which have low fixed costs and high variable costs.~~

~~**Q. PLEASE DESCRIBE YOUR PROPOSAL FOR CLASSIFYING THE COMPANY'S PRODUCTION DEMAND REVENUE REQUIREMENTS**~~

~~A. I propose classifying the Company's production demand revenue requirements partially as demand-related and partially energy-related using the "equivalent peaker"~~

~~[1] Capacity factor is the ratio of annual generation from a unit divided by the maximum annual generation that unit could generate. Thus, it is a useful indicator of a unit's annual average utilization. The higher a unit's capacity factor, the more electricity it generates and the lower its unit fixed cost of production, since its absolute fixed cost is being spread over more generation.~~

~~method. Under this approach, as described in the 1992 NARUC Electric Utility Cost Allocation Manual, the analyst classifies the investment in peaking units as demand-related but classifies the investment in other types of generation, such as coal-fired steam units, partially as demand-related and partially as energy-related. This approach is consistent with the resource planning principle that utilities acquire peaking capacity solely to meet demand but acquire other types of generating capacity to meet both energy and demand.~~

~~Under the equivalent peaker method the portion of the cost of other types of capacity that is demand-related is equivalent to the corresponding cost of a peaking unit. For example, if the unit cost of coal-fired capacity is $1,000 per kw and the unit cost of peaking capacity is $300 per kw, then 30 per cent of the coal-fired capacity is considered to be demand-related and the remaining 70 per cent is considered to be energy-related. Applying this method to Company data from its most recent FERC Form 1 filing indicates that 28 per cent of its production demand revenue requirements are demand-related and 72 per cent are energy-related. The development of that split is presented on Schedule 1of Exhibit JRH-2.~~

~~Q. HAVE YOU PREPARED AN ALTERNATIVE ALLOCATION OF REVENUE REQUIREMENTS BY ALLOCATING PRODUCTION DEMAND REVENUE REQUIREMENTS ACCORDING TO THE EQUIVALENT PEAKER METHOD.~~

~~A. Yes. I have developed an alternative allocation of revenue requirements by re-running the Company's COSS model based on the peaker method. The results of that alternative allocation by rate class are presented on Schedule 2 of Exhibit JRH-2. The~~

~~allocation to residential customers is $213.8 million as compared to the allocation of $218.5 million under the Company's COSS. That reduces the Company's proposed increase to residential customers by $4.7 million, from $23.0 million (11.8%) to $18.4 million (9.4%)~~

~~Q. PLEASE SUMMARIZE YOUR CONCLUSION AND RECOMMENDATION REGARDING THE COMPANY'S PROPOSED ALLOCATION OF PRODUCTION DEMAND REVENUE REQUIREMENTS AMONG RATE CLASSES.~~

~~A. The Company's proposed allocation of production demand revenue requirements among rate classes is not consistent with the principle of allocating costs to reflect cost causation. That allocation implies that the Company made one-hundred percent of its investments in generating units solely to meet the demand of its customers. That cost causation assumption is not consistent with electric utility resource planning principles, under which utilities invest in combustion turbine generating units solely as a source of capacity to meet the demand of their customers but invest in coal-fired steam units and other types of units as a source of both capacity and energy, i.e., to meet both the demand and annual energy requirements of their customers.~~

~~Based upon that conclusion I recommend that the Commission not approve the allocation of revenue requirements among rate classes from the Company's COSS. Instead, I recommend that the Commission require the Company to allocate revenue requirements based upon a classification of production demand revenue requirements as 28 percent demand- related and 72 percent energy-related.~~

~~IV.~~III. IMPLEMENTATION OF DECOUPLING VIA A SRA

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSAL TO IMPLEMENT DECOUPLING VIA A SRA.

A. The Company is proposing a SRA, a rate mechanism which would "decouple" the Company's recovery of the fixed cost component of its revenue requirements from the quantity of electricity that it sells. The Company is proposing the SRA for all rate classes except Large Power (LP), High Load Factor (HLF), Street Lighting (SL) and Outdoor Lighting (OL).

Q. HOW WOULD THE SRA BE CALCULATED?

A. The amount to be collected (refunded) via the SRA would be calculated monthly and the SRA would be re-set once a year to collect (refund) that amount. All of the calculations would be done by rate class. Company witness Ulrey describes the steps through which the proposed SRA would be set and applied on pages 24 through 27 of his testimony as well as in Exhibits JLU-6 through 8. Using his illustrative example in Exhibit JLU-6 as a point of reference, which is for residential customers in a year, the key steps in calculating the SRA are as follows:

- In this proceeding the Commission determines a fixed revenue requirement per customer for each rate class, which the Company refers to as the *Order Granted Fixed Cost Revenue/Customer*. This amount is $105.34 per residential customer in Exhibit JLU-6.
- In each rate effective period the Company would calculate an *Order Granted Fixed Cost Revenue*. This is the absolute amount of revenues the Company is entitled to collect in order to recover its fixed cost revenue requirement. This

amount is equal to the number of customers it served in that period multiplied by the Order Granted Fixed Cost Revenue/Customer In Exhibit JLU-6 this amount is $154.66 million, which is $105.34 per residential customer times 1.468 million residential customers

- In each rate effective period the Company would then calculate a *SRA/Decoupling Amount.* This is the amount that the SRA would collect(refund). It is equal to the Order Granted Fixed Cost Revenue minus the *Actual Revenue less Adjustment and Variable*, i.e., the actual revenues the Company collected net of revenues for variable costs. In Exhibit JLU-6 this amount is $1.5 million, which is $154.66 million minus $153.15 million.

Q. WHAT IS THE COMPANY'S RATIONALE FOR IMPLEMENTING A SRA?

A. Company witnesses Chapman, Petit and Ulrey present several reasons to support the Company's request to implement a SRA. Their primary justification is that a SRA will enable the Company to recover the fixed cost portion of its revenue requirements it would otherwise lose due to new, future reductions in sales resulting from compliance with the Phase II Order. Their second justification is that a SRA will eliminate the Company's existing revenue risk due to existing factors that affect its sales and eliminate its financial incentive to promote sales of electricity to customers in the rate classes subject to the SRA, often referred to as its throughput incentive. They also note that their proposed SRA is similar to decoupling mechanisms that the IURC has approved for the Company's sister gas distribution companies and that regulators in other states have approved for electric utilities under their jurisdiction.

Q. DO YOU AGREE WITH THE COMPANY'S RATIONALE AND ITS PROPOSED SRA?

A. No. From an energy policy perspective I agree that it is appropriate to allow the Company to make a limited change in rate design to collect verified actual lost revenues from future reductions in sales resulting from compliance with the Phase II Order. However, the Company's proposed SRA would do much more than just collect those lost revenues, it would shift the Company's existing revenue risk from all factors that affect its sales to ratepayers without providing commensurate or offsetting benefits to ratepayers. As a result, the SRA is inconsistent with the ratemaking goal of setting rates that yield revenue requirements based upon the fair return standard. Thus the Company's proposal does not achieve these energy policy and ratemaking objectives in a manner that balances the interests of ratepayers and shareholders.

The balance of my testimony will explain why limiting the Company to an LRAM, at least for a initial period, would achieve these energy policy and ratemaking objectives in a balanced manner.

Q. WHAT IS THE COMPANY'S PRIMARY JUSTIFICATION FOR IMPLEMENTING A SRA?

A. The Company's primary justification for implementing a SRA is to enable it to recover the fixed cost portion of its revenue requirements it would otherwise lose due to new, future reductions in sales resulting from the new DSM programs that will be implemented under the Phase II Order.

Q. WOULD AN LRAM BE AS EFFECTIVE AS A SRA IN ENABLING THE COMPANY TO COLLECT LOST REVENUES FROM REDUCTIONS IN SALES RESULTING FROM THE PHASE II ORDER?

A. Yes. A LRAM would be just as effective as a SRA in enabling the Company to collect lost revenues due to reductions in sales resulting from new DSM programs. The

LRAM could be designed to allow the Company to recover amounts equal to the documented reduction in kWh in each year multiplied by its fixed cost revenue requirement per customer. (The Company refers to this unit amount as the "Order Granted Fixed Cost Revenue/Customer"). The Phase II Order requires that these reductions be documented through evaluation, monitoring and verification (EM&V). This process eliminates the concern that establishing the quantity of reductions to use in a LRAM will be contentious.

Q. PLEASE COMMENT ON THE IMPACT OF AN LRAM ON THE ESTABLISHMENT OF THE COMPANY'S ALLOWED RETURN ON EQUITY (ROE)?

A. While I am not testifying as a witness regarding ROE, it does not appear that implementation of an LRAM should have an impact on the establishment of the Company's ROE in this proceeding. As Mr. Chapman notes, in the absence of any change in its rate design, i.e., business as usual, the Company would experience an increase in its revenue risk due to its exposure to future reductions in sales from new DSM programs under the Phase II Order. Because this risk is new and prospective it has likely not been reflected in the Company's past or current ROE. Thus, if a LRAM is implemented to offset those anticipated lost revenues it will be preventing an increase in revenue risk, rather than reducing the Company's existing revenue risk from traditional factors such as weather, economic downturns, outages and bad debt.

Q. PLEASE COMMENT ON THE COMPANY'S POSITION THAT IT NEEDS A SRA IN ORDER TO ELIMINATE ITS THROUGHPUT INCENTIVE AS WELL AS ITS REVENUE RISK.

A. The Company's second justification for a SRA is that it will eliminate the Company's existing revenue risk due to existing factors that affect its sales as well as eliminate its financial incentive to promote sales of electricity to customers in the rate classes subject to the SRA, often referred to as its throughput incentive.

The Company's proposal does not represent a reasonable balancing of ratepayer and shareholder interests. Specifically, under its proposed approach the Company would shift all revenue risk from shareholders to ratepayers without providing ratepayers commensurate or offsetting benefits. In addition, the Company's proposed SRA has certain unintended adverse consequences in terms of environmental policy and ratemaking objectives.

Q. PLEASE BEGIN BY DESCRIBING THE THROUGHPUT INCENTIVE.

A. The Company's throughput incentive is its financial incentive to promote sales of electricity in order to maximize its revenues. The Company's revenue risk is the possibility that, in any give year, the amount of revenues it collects will be materially lower than its revenue requirements. Both are attributable to the mismatch between the fixed cost component of its revenue requirements and its collection of revenues. A significant portion of the Company's revenue requirement is fixed, at least in the short to medium term, according to Company estimates. In other words, that amount of annual costs does not vary with the annual quantity of electricity the Company sells. In contrast, under its current rate design the Company collects the majority of its annual revenues through volumetric rates expressed in cents per kWh. That amount of annual revenues does vary with the annual quantity of electricity it sells.

Q. HAS THE ELIMINATION OF THE THROUGHPUT INCENTIVE BEEN EXAMINED IN THE PAST?

A. Yes. The need to align utility financial incentives with support for improvements in efficiency, including the need to address the throughput incentive, has been the subject of debate for at least twenty years. The merits of alternative approaches to addressing the throughput incentive, in particular a LRAM versus a SRA approach, have been and continue to be hotly debated topics. In theory the primary rationale for implementing decoupling is that creates a more comprehensive incentive for the utility to support efficiency and that it reduces utility risk which would result in a lower ROE. In practice it is not clear that decoupling, as opposed to an LRAM, has a material greater impact on the incentive for vertically integrated electric utilities such as Vectren to pursue efficiency or to reduce their ROE[2].

(1) <u>Shifting of revenue risk to ratepayers under company proposal</u>

Q. DOES THE PROPOSED SRA ELIMINATE BOTH THE COMPANY'S THROUGHPUT INCENTIVE AND ITS EXISTING REVENUE RISK?

A. Yes. A SRA eliminates the Company's throughput incentive as well as its existing revenue risk. Company witness Chapman (p. 26 and 27) cites reduction in revenue risk due to factors other than reductions from DSM as his second justification for a SRA. The SRA increases the certainty the Company will recover its fixed cost revenue requirements allocated to residential and commercial customers from those customers regardless of the reason for lower than expected actual revenues from those rate classes. The SRA eliminates this revenue risk by shifting it from shareholders to ratepayers.

[2] [1]Kihm, Steven. *When Revenue Decoupling Will Work…And When It Won't.* Electricity Journal. October 2009.

Q. CAN YOU ILLUSTRATE THE RELATIVE AMOUNTS OF REVENUE RISK THAT A SRA AND A LRAM WOULD SHIFT TO RESIDENTIAL RATEPAYERS?

A. Yes. The Company has provided analyses that illustrate the relative amounts of revenue risk that a SRA and a LRAM would have each shifted to residential ratepayers had either mechanism been in effect in 2009. This illustration is presented in Exhibit JRH-3 and summarized below.

Had the proposed SRA been in effect in 2009 the Company would have filed to recover $6.9 million from residential ratepayers. That amount would have translated into an annual amount of approximately $74 for an average residential customer. Had the Company had an LRAM in effect in 2009 and experienced a 1.0% reduction in sales due to DSM programs, it would have filed to recover $1.0 million from residential ratepayers. That amount would have translated into an annual amount of approximately $11 for an average residential customer.

Q. IS THE COMPANY PROPOSING TO PROVIDE RATEPAYERS ANY OFFSETTING BENEFITS IN EXCHANGE FOR SHIFTING THIS REVENUE RISK FROM SHAREHOLDERS TO RATEPAYERS?

A. No.

Q. DID THE COMPANY QUANTIFY ANY BENEFIT TO SHAREHOLDERS FROM THE ELIMINATION OF THIS REVENUE RISK VIA THE SRA?

A. No. Not only did the Company not quantify any benefit to shareholders from the elimination of revenue risk via the SRA, the testimony of its witnesses is inconsistent as to the general magnitude of those benefits.

Mr. Chapman, p.24, maintains that the elimination of revenue risk is a benefit to the Company because the financial market evaluates companies based on risk and financial stability in addition to earnings growth. However, he does not quantify that benefit.

In contrast when Dr. Avera, the Company's ROE witness, discusses the potential implementation of a decoupling mechanism on the Company's ROE on page 55 of his testimony, he states "… there is certainly no evidence to suggest that implementation of the proposed tracker alone would alter its relative risk enough to warrant a change in its ROE." Dr. Avera does not quantify any benefit of the SRA.

Q. DO YOU AGREE THAT THE COMPANY WILL RECEIVE ZERO BENEFIT FROM ELIMINATING ITS EXISTING REVENUE RISK VIA THE SRA?

A. No. First, if the Company will receive no quantifiable benefit from eliminating its existing revenue risk I do not understand why it is requesting a SRA. That position implies that a LRAM provides just as much benefit to the Company as an SRA.

Second, a leading proponent of decoupling, the Regulatory Assistance Project, indicates that decoupling should result in a reduction in a utility's cost of capital, either through a reduction in the equity capitalization ratio or a reduction in the ROE.[~~3~~2]

Third, in addressing a request for decoupling by the Connecticut Natural Gas Corporation ("CNG"), the Connecticut Department of Public Utility Control ("DPUC") expressed the following position[~~4~~3]:

[~~3~~ 2] Shirley, Wayne et al. *Revenue Decoupling Standards and Criteria*, *A Report to the Minnesota Public Utilities Commission.* Regulatory Assistance Project. June 2008. pp. 13 -16.

[~~4~~ 3] State of Connecticut, Department of Public Utility Control; Application of Connecticut Natural Gas Corporation for a Rate increase, Final Decision, June 30, 2009, pp. 76-77.

> Full decoupling compensates the Company for any type of reduction in consumption, such as warmer weather, customer loss, a deteriorating economy as well as permanent and price induced conservation. Clearly, the very large potential risk of revenue instability is shifted from the Company to customers. If the Company were to purchase an insurance instrument to compensation and the Company would expect to make payment for the transfer of risk. The Company's decoupling proposal thrusts customers into the role of insurer without proffering compensation. By reviewing the level of compensation customers would require to breakeven under decoupling, the Department concluded that the requisite reduction in ROE needed as compensation would prove too draconian and actually impede the Company's ability to attract capital. The Company's own calculation shows that a 10% change in weather (HDDs) alone translates into a $4 million change in revenue.

(2) <u>Potential unintended adverse consequences of decoupling</u>

Q. WHAT ARE THE POTENTIAL UNINTENDED ADVERSE ENVIRONMENTAL CONSEQUENCES OF THE COMPANY'S PROPOSAL?

A. As noted earlier, the SRA would eliminate the Company's risk of recovering the fixed cost portion of its revenue requirements. One component of that fixed cost portion would be the revenue requirements associated with any future investments that the Company makes to extend the life of its existing coal units. Thus, all things being equal, it is reasonable to assume that utility management would be more likely to make such investments if the Company had a SRA than if the Company had a LRAM. Thus, implementation of a SRA could have adverse unintended consequences relative to the environmental objective of reducing emissions of carbon dioxide.

Q. WHAT ARE THE POTENTIAL UNINTENDED ADVERSE RATEMAKING CONSEQUENCES OF THE COMPANY'S PROPOSAL?

A. As noted earlier, the SRA would collect the SRA/Decoupling Amount each year. That Amount is the difference between the Company's Order Granted Fixed Cost Revenue by rate class for its test year and the actual revenues it collected in a year. There are a number of factors that would cause actual revenues in a year to be different from the Order Granted Fixed Cost Revenue. Many of those factors are not within the control of Company management, such as weather, economic conditions and price elasticity. However, outages are a factor that affects sales and revenues for which the Company does have responsibility. In addition, bad debt is a factor that affects revenues and that is reflected in revenue requirements. Implementation of a SRA could have adverse unintended consequences relative to the ratemaking objectives of providing the Company a financial incentive to minimize outages and of preventing double-recovery of bad debt.

(3) <u>Implementation of SRA and LRAM mechanisms at other utilities</u>

Q. ARE THE SRA AND LRAM MECHANISMS IMPLEMENTED AT OTHER UTILITIES RELEVANT TO THE COMPANY'S PROPOSAL?

A. It is certainly worthwhile to review the experience of other utilities with SRA and LRAM mechanisms, but it is also very important to determine if the circumstances of those other utilities are comparable to the Company's circumstances.

The Company witnesses note that their proposed SRA is similar to decoupling mechanisms that the IURC has approved for the Company's sister gas distribution companies. The decoupling mechanisms at those gas utilities are of little relevance because of the major differences between the Company's circumstances and those of its sister gas utilities. First, the Company is a vertically integrated electric utility whose rate base includes investments in supply and transmission in addition to distribution. In contrast, its sister utilities are distribution only utilities. As a result, the magnitude of either a SRA or LRAM for the Company will be several times larger than a SRA or LRAM for its sister gas utilities. Second, the Company must achieve explicit reductions established in the Phase II Order, its sister gas utilities do not. Third, the Company has the opportunity to earn shareholder incentives from its DSM programs, its sister gas utilities do not. Fourth, the market for electricity is different from the market for natural gas.

The Company witnesses also note that their proposed SRA is similar to decoupling mechanisms that regulators in other states have approved for electric utilities in those jurisdictions. The electric utilities of most relevance to the Company are other vertically integrated electric utilities whose rate base includes investments in supply and transmission in addition to distribution. LRAMs are more common than SRA type mechanisms among vertically integrated electric utilities. As of January 2010, according to the Institute for Electric Efficiency[~~5~~4], four states – Idaho, Wisconsin,~~only two states –~~ Vermont and Oregon - -had approved decoupling for vertically integrated electric utilities. Six other states had approved LRAMs for their vertically integrated electric utilities – Kentucky, North Carolina, South Carolina, Oklahoma, Colorado and Wyoming. At that time decisions were pending regarding fixed cost recovery mechanisms for vertically integrated electric utilities in Utah and Hawaii.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AND RECOMMENDATIONS REGARDING THE COMPANY PROPOSAL TO IMPLEMENT DECOUPLING THROUGH A SRA.

[~~5~~4] ____, *State Energy Efficiency Regulatory Frameworks*, Institute for Electric Efficiency, Edison Foundation, January 2010. www.edisonfoundation.net/IEE

A. The Phase II Order has established new explicit annual reductions in electricity sales for the Company and other jurisdictional electric utilities. It is appropriate to allow the Company to make a limited change in rate design to collect the revenues it would otherwise lose due to those new, future reductions in sales. The Company's proposed SRA would do much more than just collect the lost revenues resulting from reductions in future sales due to new DSM programs under the Phase II Order. It would eliminate the Company's existing revenue risk from all factors that affect its sales as well as eliminate its financial disincentive to promote sales of electricity to customers in those rate classes, often referred to as its throughput incentive. The proposed SRA is not the best approach to meeting the Commission's energy policy and ratemaking objectives because it does not represent a reasonable balancing of ratepayer and shareholder interests. Under its proposed approach the Company would shift all of its revenue risk to ratepayers without providing commensurate or offsetting benefits. In contrast, the Company's shareholders benefit by avoiding an increase in revenue risk from new DSM programs and from the elimination of existing revenue risk from all factors that affect its sales.

A Lost Revenue Adjustment Mechanism (LRAM) would achieve those energy policy and ratemaking objectives in a balanced manner. A LRAM would only adjust the Company's rates for the reduction in sales from the new DSM programs under the Phase II Order. The LRAM would benefit the Company by preventing an increase in revenue risk from the new DSM programs and would benefit ratepayers by limiting the amount of revenue risk shifted to them.

Based upon these conclusions I recommend that the Commission not approve the Company's proposed SRA. As an alternative, I recommend that the Commission allow the Company to implement a LRAM on a three year trial basis.

Q. DOES THIS COMPLETE YOUR DIRECT TESTIMONY?

A. Yes.