

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION



VERIFIED PETITION OF SOUTHERN INDIANA GAS)
& ELECTRIC COMPANY D/B/A VECTREN ENERGY)
DELIVERY OF 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 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 PROGRAMS;)
AUTHORITY TO IMPLEMENT NEW AND)
ENHANCED ENERGY PROGRAMS AND APPROVAL)
OF MODIFICATION OF THE FUEL ADJUSTMENT)
CLAUSE EARNINGS AND EXPENSE TESTS.)

CAUSE NO. 43427

APPROVED: DEC 16 2009

BY THE COMMISSION:

David E. Ziegner, Commissioner
Loraine L. Seyfried, Administrative Law Judge

On January 22, 2008, Southern Indiana Gas & Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc. ("Petitioner," "Vectren," or "Company") filed its Verified Petition with the Indiana Utility Regulatory Commission ("IURC" or "Commission") for approval of an alternative regulatory plan ("ARP") for the offering of energy efficiency conservation, demand response and demand side management ("DSM") programs and associated rate treatment; authority to defer program costs associated with its energy efficiency portfolio programs; authority to implement new and enhanced energy programs; and approval of modification of its fuel adjustment clause ("FAC") earnings and expense tests. On February 6, 2008, Southern Indiana Gas & Electric Company Industrial Group ("Industrial Group") filed a Petition to Intervene, which was granted by Docket Entry dated February 18, 2008.

Petitioner filed its direct testimony and exhibits constituting its case-in-chief on September 29, 2008.¹ On January 8, 2009, Petitioner submitted the proofs of publication required under Ind. Code § 8-1-2.5-6(d). On January 9, 2009, Natural Resources Defense Council ("NRDC") filed a Petition to Intervene, which was granted by Docket Entry dated

¹ On October 1, 2008, Petitioner filed Pet.'s Ex. JLU-3, which was inadvertently omitted from its September 29, 2008 filing.

January 21, 2009. On January 14, 2009, the NRDC and the Indiana Office of Utility Consumer Counselor (“OUCC”) filed their respective direct testimony and exhibits. On February 4, 2009, the NRDC filed its cross-response testimony. On February 11, 2009, Petitioner filed its rebuttal testimony and exhibits. On February 20, 2009, Petitioner filed its responses to questions set forth in the Commission’s February 18, 2009 Docket Entry as well as corrections to its testimony and exhibits.

Pursuant to public notice duly given and published, proof of which was incorporated into the record by reference and placed in the Commission’s official file, a public hearing was held in this Cause on February 24, 2009 at 9:30 a.m. in Room 224 of the National City Center, 101 W. Washington Street, Indianapolis, Indiana. At the hearing Vectren, the OUCC, and NRDC appeared by counsel and offered their respective prefiled testimony and exhibits, which were admitted into evidence without objection. No other party or members of the general public appeared.

Based upon the applicable law and the evidence of record, the Commission now finds:

1. **Notice and Jurisdiction.** Proper notice of the hearing in this Cause was given as required by law. Vectren is a “public utility” within the meaning of Ind. Code § 8-1-2-1 of the Public Service Commission Act, as amended, and is subject to the jurisdiction of the Commission. As defined in Ind. Code § 8-1-2.5-2, Vectren is an Energy Utility and its electric service constitutes Retail Energy Service as defined in Ind. Code § 8-1-2.5-3. By its Verified Petition, Vectren elects to become subject to the provisions of Ind. Code §§ 8-1-2.5-5 and 8-1-2.5-6 for purposes of offering energy efficiency conservation, demand response and DSM programs. The Commission therefore has jurisdiction over Petitioner and the subject matter of this Cause in the manner and to the extent provided by the laws of the State of Indiana.

2. **Petitioner’s Characteristics.** Petitioner is an operating public utility, incorporated under the laws of the State of Indiana, with its principal office and place of business in the City of Evansville, Indiana. Petitioner provides electric utility service to approximately 140,000 customers in six (6) counties in southwestern Indiana. Petitioner renders such electric utility service by means of utility plant, property, equipment and related facilities owned, leased, operated, managed and controlled by it that are used and useful for the convenience of the public in the production, treatment, transmission, distribution and sale of electricity.

3. **Petitioner’s Request.** In this proceeding, Vectren requested approval of new, cost-effective, DSM programs (“DSM Program”), as well as recovery of the costs associated with such programs, including direct program costs, and administrative and evaluation costs via tracking and adjustment mechanisms to facilitate cost recovery. Vectren requested approval of a “decoupling” mechanism to address the inherent financial deterrent associated with reducing customer use as a result of volumetric rate design, and to more strongly align shareholder and customer interests in energy efficiency programs. Finally, Vectren requested approval of performance incentives designed to encourage the Company to meet or exceed target program participation and energy savings and goals. Vectren also proposed that such

incentives, if obtained, be excluded from the FAC earnings and expense tests to preserve the incentive opportunity.

4. **Petitioner's Proposed DSM Program.** Petitioner's proposed DSM Program consists of the following Residential and Commercial DSM programs:

Residential DSM Programs

Direct Load Control
On-site Residential Audits & Direct Install Kit
Energy Efficient Lighting
New Construction – Energy Star®
Low Income Weatherization and Non-Profit Weatherization
Second Refrigerator Pick-up and Recycle
Room Air Conditioning Recycling
Energy Efficient Pool Pump (Pilot)

Commercial DSM Programs

Direct Load Control
Audit and Customized Efficiency
Prescriptive Lighting
New Construction
Motors (Premium and Commutated)
Commissioning Pilot

5. **Petitioner's Direct Testimony.** L. Douglas Petitt, Vice President of Marketing and Conservation for Vectren, provided a summary of the Company's proposed DSM Program and cost recovery mechanism. He offered an explanation why use of a decoupled rate design supports the Company's efforts at an across-the-board (gas and electric) cultural change that makes energy efficiency a priority. He also explained why Vectren believes the proposed DSM Program is in the public interest and discussed the success Vectren has had with its conservation efforts on the gas side.

Mr. Petitt stated that Vectren is proposing a three year DSM Program with the goal of reducing residential and commercial customer energy usage by 61 million kWh after Year 3. This is approximately a 1% reduction in energy consumption from current usage levels. The DSM Program also has a goal to reduce summer peak demand by 15.56 MW after Year 3, which also represents a 1% reduction from current peak demand levels. To fund these programs, Vectren is proposing a budget starting at 1% of the rate case revenues authorized in Cause No. 43111, or about \$4.2 million. This number ramps up to \$7.9 million by Year 3 which is approximately 1.8% of the rate case revenues. Vectren proposed a cost recovery mechanism that includes periodic recovery of DSM Program costs, a new rate design that "decouples" electricity sales from fixed cost recovery, and a performance based incentive mechanism. The proposed incentive mechanism rewards performance in terms of actual achieved energy (kWh) and demand (kW) savings, which savings must be verified by an independent third party.

Mr. Petitt also summarized the basis for Vectren's requested rate design and incentive proposal. He testified that decoupling removes disincentives to the pursuit of energy efficiency and that a performance incentive gives the utility an opportunity to be rewarded for successful efforts to achieve energy efficiency. Together, he stated, the rate design/incentive proposal makes DSM a financially viable alternative to the traditional utility business model which allows utilities to earn a return on capital invested in generation, transmission and distribution facilities.

Mr. Petitt testified that Vectren's rate design proposal aligns the Company's interests with its customers' and eliminates the Company's need to increase sales in order to recoup fixed costs. He explained that alignment would allow Vectren to promote the most efficient use of energy and, in partnership with its customers, help to lower their bills. Vectren believes customer and Company interests must be aligned across both the gas and electric utilities to realize the full potential of conservation. In addition, he stated that decoupling the electric side of the business allows Vectren to be consistent in promoting its conservation message to its gas and electric customers. He asserted that the Commission has already found that decoupling provides necessary financial support for the implementation of comprehensive gas DSM. He explained that on the electric side, unlike gas, the Company also invests in the production of the energy provided to customers. Consequently, the Company believes that reduced consumption is an even greater issue to the electric utility because traditional regulation provides a return on supply-side resources in addition to distribution facilities.

Mr. Petitt testified that Vectren's DSM proposal is timely as a variety of stakeholders have identified the need to elevate DSM efforts, and support rate design/incentive proposals that will achieve the goal. He stated that with rising fuel, construction, and environmental compliance costs making supply-side options more costly, DSM has never been more economically attractive. Additionally, with the national concern regarding greenhouse gases, energy efficiency is being promoted as a key part of the initiative to decrease carbon emissions.

Mr. Petitt stated that by breaking the link between recovery of fixed costs and customer usage, Vectren will be positioned to take a more comprehensive approach to promoting the most efficient use of energy. He explained that Vectren wants to be able to encourage the direct use of natural gas, which reduces use of gas to generate electricity and thereby reduces carbon dioxide ("CO₂") emissions. He concluded that Vectren's decoupling proposal removes the financial need to sell electricity in order to recover costs and thus allows the Company to educate customers and promote the use of gas appliances that greatly improve the efficiency with which energy is consumed.

Mr. Petitt addressed the statutory requirements for approval of an ARP. As specified in Ind. Code § 8-1-2.5-6, the Commission may adopt alternative regulatory practices, procedures, and mechanisms, and establish rates and charges that are in the public interest and enhance or maintain the value of the energy utility's retail energy services or property; including practices, procedures, and mechanisms focusing on the price, quality, reliability, and efficiency of the service provided by the energy utility. Mr. Petitt testified that Vectren's

proposed DSM Program is in the public interest for the following reasons: it promotes the efficient use of energy by better aligning the Company's interests with those of its customers; it is responsive to technological and operating conditions faced by Vectren resulting from initiatives to decrease CO₂ emissions from generating units; it provides an alternative to supply-side resources at a time of rising construction and generating costs; it facilitates a more comprehensive approach to energy efficiency by encouraging a "source-to-site" analysis of different forms of energy and allows the Company to promote the direct use of natural gas as appropriate; it addresses the growing demand of customers who want to install alternative technologies like wind and solar systems and still receive electric service from Vectren for the demand their system cannot provide; and finally, it has the potential to decrease electric consumption by making the use of advanced metering infrastructure ("AMI") technology an energy efficiency strategy.

Mr. Petitt also stated that the Commission's DSM rules at 170 IAC 4-8-1 *et seq.* ("DSM Rules") provide support for Vectren's proposal. He noted that among other things, the DSM Rules provide for recovery of program costs, lost revenues, and shareholder incentives in an effort "to eliminate or offset regulatory or financial bias against DSM, or in favor of a supply-side resource, a utility might encounter in procuring least-cost resource."² Vectren's DSM proposal addresses the "regulatory bias" and allows the Company to commence the type of efficiency efforts that have been effective on Vectren's gas side. Mr. Petitt also opined that a combination of program cost recovery, decoupling and an incentive mechanism provides the right signal to management to wholeheartedly pursue energy efficiency.

Mr. Petitt testified that Vectren's regulatory proposal is founded upon long standing public policy. He stated that the proposed DSM Program is consistent with the State of Indiana's Strategic Energy Policy.³ He stated that the need for a new approach to move the needle on DSM was recognized in November of 2007 by the Environmental Protection Agency ("EPA") in a resource report supporting its National Action Plan for Energy Efficiency ("NAPEE"). He also noted that the National Energy Policy Act of 1992 urged state utility regulatory commissions to establish such regulation by stating that:

[t]he rates allowed to be charged by a State regulated electric utility shall be such that the utility's investment in and expenditures for energy conservation, energy efficiency resources, and other demand side management measures are at least as profitable, giving appropriate consideration to income lost from reduced sales due to investments in and expenditures for conservation and efficiency, as its investments in and expenditures for construction of new generation, transmission, and distribution equipment.⁴

Mr. Petitt further noted that Congress and the President recognized the importance of removing disincentives and motivating utilities to pursue energy efficiency through incentive mechanisms in the recently enacted Energy Independence and Security Act of 2007 ("EISA").

² 170 IAC 4-8-3(a).

³ Mr. Petitt cited to Indiana's Strategic Energy Plan, Indiana Office of Energy and Defense, 2006 at 10.

⁴ 16 U.S.C. § 2621(d).

The EISA encourages state regulators to integrate energy efficiency into electric and natural gas utility, State, and regional plans and adopting policies establishing cost-effective energy efficiency as a priority resource.⁵ He also noted that it requires States to consider as policy options: “removing the throughput incentive and other regulatory and management disincentives to energy efficiency; providing utility incentives for the successful management of energy efficiency programs; [and] allowing timely recovery of energy efficiency-related costs [. . .].”⁶

Mr. Petitt testified that Vectren’s proposal is supported by a 2004 National Association of Regulatory Commissioners (“NARUC”) Resolution which encourages state commissions to “address regulatory incentives to address inefficient use of gas and electricity” as well as an August 2, 2006 Resolution which supports the EPA’s NAPEE, including “[modifying] policies to align utility incentives with the delivery of cost-effective energy efficiency and modify ratemaking practices to promote energy efficiency investments.” Mr. Petitt also noted that Vectren considered rate mechanisms in other states where utilities have implemented DSM programs, including Massachusetts, Maryland, New York and Idaho.

Mr. Petitt stated that DSM programs can be an integral part of serving customers by avoiding construction of plant and associated operations & maintenance (“O&M”) and fuel costs. Mr. Petitt explained that a DSM performance incentive is not necessarily a “substitute” for a return on investment, however, it is an important tool in terms of providing some financial opportunity that encourages excellence in program implementation and the basis for the utility to achieve some revenue from activities that are a substitute for building plant to serve customers.

Mr. Petitt summarized Vectren’s gas conservation efforts and programs. He stated that the Company’s gas conservation efforts have been a model program with proven results, which could be applied as a model by Vectren’s electric business.

Robert C. Sears, Director of Conservation for Vectren, discussed the proposed DSM Program, as well as program funding, governance, administration, incentives and evaluation. Mr. Sears stated that Vectren has used DSM as a means of reducing customer load and providing reliable electric service. He noted that the DSM programs were included as part of Vectren’s Integrated Resource Plan (“IRP”) process and explained that the DSM programs provided for both peak demand and energy reductions.

Mr. Sears testified that Vectren’s past residential DSM programs have included direct load control using central air conditioning (“AC”), water heaters, pool pumps; high efficiency central AC and heat pump rebates; low income weatherization programs; whole house weatherization programs (non-low income); room AC rebates (limited); compact fluorescent rebates (limited); programmable thermostats; and new construction via prescriptive system rebates (typically heating, ventilation and air conditioning). He explained that Vectren has also operated past commercial DSM programs which included high efficiency lighting,

⁵ 16 U.S.C. § 2621(d); 15 USC § 3203.

⁶ *Id.*

industrial custom process efficiency rebates, central AC and heat pump rebates, and new construction design incentives.

Mr. Sears provided details regarding Vectren's ongoing Direct Load Control ("DLC") program, stating that it provides remote dispatch control for residential central cooling/heat pumps, electric water heating, and pool pumps through radio controlled load management receivers ("LMR"). He noted the DLC program was recently identified as part of Vectren's DSM Market Assessment study, as "of high quality and notable for its participation and program longevity." The Market Assessment study also recommended expansion of that program.

Mr. Sears provided an overview of how DSM relates to Vectren's IRP process. He testified that the IRP conducted in 2007 identified that in the 2008 - 2012 timeframe, Vectren will need additional generating resources totaling approximately 225 MW of nominal capacity. Mr. Sears stated that Vectren's proposed DSM Program is designed to help meet this future generation need by reducing demand by nearly 16 MW over three years. Mr. Sears explained that due to the escalating costs of adding additional capacity and escalating fuel and environmental costs, DSM provides a cost-effective alternative to supply-side resources and gives customers a better opportunity to become more energy efficient and thereby manage their energy bills. He also noted that energy efficiency is a key part of the nationwide effort to reduce greenhouse gases.

Mr. Sears provided details on the DSM collaborative ("Collaborative") established as a result of a Settlement with the OUCC and Citizens Action Coalition approved in Cause No. 42861. He stated that the Collaborative's objective was to select a consultant to perform a market assessment and recommend an action plan for effective electric DSM programs for the Vectren service territory, and then proceed if possible to reach agreement on new DSM programs. The Collaborative conducted a request for proposal process and selected H. Gil Peach and Forefront Economics, whose final report containing the market assessment and proposed DSM action plan was submitted to the Collaborative on April 24, 2007 ("DSM Action Plan").

The programs recommended in the DSM Action Plan were based on a review of programs that had been successfully implemented by utilities in other states. The program budget was based on broad assumptions regarding estimated participation levels. Mr. Sears pointed out that the DSM Action Plan identified all DSM programs that had technical potential but recommended implementation of only those programs that appeared to be cost-effective, primarily using the total resource cost ("TRC") test.

Mr. Sears stated that Vectren expanded upon the DSM Action Plan by performing its own research and design with the assistance of Vista Energy Group, Inc. ("Vista Energy"). The effort focused on leveraging Vectren's previous design and planning as well as consideration of successful efforts throughout the country, with the DSM Action Plan. Mr. Sears discussed the differences between the DSM Action Plan and the Vista Energy analysis.

Mr. Sears testified that the Collaborative provided input every step of the way in the planning of Vectren's proposed DSM Program including, selecting the consultant to conduct the Market Assessment study; reviewing the DSM Action Plan as well as Vectren's own research and the results of commercial customer surveys performed by Vectren; providing input on the work performed by Vista Energy, and reviewing the cost-effectiveness of energy efficiency and DSM programs, and its assumptions. In the end, the Collaborative assisted in structuring the design of the programs, setting funding levels, establishing program reporting, implementation, and administration and reviewing cost recovery issues.

Mr. Sears stated that the DSM Program will be offered to customers served under the Residential and General Service rate schedules. Mr. Sears explained that the large commercial and industrial rate tariffs do not have DSM programs designed to serve them due to their ability to conduct self-directed DSM efforts.

Mr. Sears stated that the DSM Program development process was consistent with the Commission's DSM Rules. He noted that the IRP guidelines outline many requirements for a utility to consider when analyzing future energy supply resources. Specifically, according to 170 IAC 4-7-6(a) and (b), an electric utility must consider demand side programs and demand side resources as sources of new supply. This includes innovative rate design and a comprehensive array of demand side measures that provide an opportunity for all ratepayers to participate in DSM. He also noted, as part of the selection of new supply sources like DSM, 170 IAC 4-7-7 requires the utility to conduct cost-benefit analyses utilizing several tests to make sure the proposed sources are cost-effective. Mr. Sears testified that all of the analyses contained in the DSM Action Plan, as well as the additional work by Vista Energy to develop Vectren's proposed DSM Program, were performed in the context of the DSM Rules.

Mr. Sears stated that the DSM Program has an initial term of three years with an annual funding amount, including evaluation costs, of \$4.27 million in Year 1, \$6.42 million in Year 2, and \$7.94 million in Year 3. The level of funding uses a starting point of 1% of revenue and grows to 1.8% of revenue by Year 3. The DSM Program establishes a goal of reducing residential and commercial customer usage by 61 million kWh of annual savings after Year 3, an approximate 1% reduction from current usage. The DSM Program also has a goal to reduce summer peak demand by 15.56 MW after Year 3, an approximate 1% reduction from current peak demand.

Mr. Sears stated that the level of DSM Program funding is consistent with the DSM Action Plan recommendation and the recommendations in Cause No. 42693 that one percent is a likely "floor" of needed funding. Mr. Sears also noted that the report commissioned in Cause No. 42693 indicated that the US average spent on conservation was 0.5%, but that in 2003, 13 states had DSM funding exceeding 1%. Based on this, he stated, Vectren believes the proposed funding level for its DSM Program supports aggressive pursuit of DSM and energy efficiency efforts.

Mr. Sears described the cost-effectiveness tests employed for its DSM Program planning and evaluation. He stated that Vectren worked with Vista Energy to model the cost-effectiveness of each component of its DSM Program. The modeling approach included

capturing the economics from various perspectives reflecting the California Standard Practice Methodology, including the Participant Test ("PT"), Utility Cost Test ("UCT"), Rate Impact Measure ("RIM") Test and the TRC Test. For this analysis, the results of all the tests were reviewed, with an emphasis on the TRC and UCT tests to gauge program cost-effectiveness.

Mr. Sears testified that the TRC test compares the total costs and benefits of a program, including costs and benefits to the utility and the participant with the avoided costs of energy supply. The programs that were found to be cost-effective from a TRC perspective were included in the DSM Program. Mr. Sears testified that including a program that passes the TRC test is consistent with 170 IAC 4-7-7(b), which requires that at least one of the tests listed above be used to evaluate the cost-effectiveness of a DSM program. He stated that the TRC test is commonly used to determine the cost-effectiveness of energy efficiency programs throughout many state jurisdictions.

Mr. Sears testified that the UCT was also considered as part of the planning process. He stated that the UCT assesses the benefits and costs from the utility's perspective by comparing utility benefits to utility costs. The UCT captures all the same costs and benefits as the TRC test while also including the utility program incentive as a program cost. Incentives are treated as a transfer of payments in the TRC test and not included in the stream of costs and benefits. Mr. Sears stated that the UCT test was used in conjunction with the TRC test in assessing whether the programs are cost-effective when considering Vectren's proposed performance incentive for successful management of the DSM Program.

Mr. Sears stated that avoided costs are utilized in the evaluation of cost-effectiveness through the use of projected avoided capacity costs as well as avoided energy costs, including the projected cost of environmental compliance. After discussions with the Collaborative, he stated that Vectren utilized a generic Simple Cycle Combustion Turbine ("CT") with an installation cost of \$755.00/kW based on a recent engineering study. Vectren's IRP also included assumptions of environmental cost compliance related to CO₂ regulation beginning in 2012 and escalating through the end of the planning period. He stated that because CO₂ costs were included in the IRP that compared the economics of supply and demand side alternatives, to be consistent, Vectren also used it as a component of the avoided energy cost calculation. All of the costs used in the avoided cost calculation were levelized over a 20 year planning horizon in order to determine the cost-effectiveness of the DSM programs.

Mr. Sears stated that the DSM Program will be governed by an Oversight Board, which will include membership similar to that of Vectren's Gas Oversight Board Collaborative and include a representative from Vectren, the IURC and the OUCC. Other potential members will be open to consideration. He also indicated that non-voting Board members may be added to provide additional advisory insights. By unanimous vote, the Oversight Board may add voting or advisory members. The Oversight Board will be responsible for monitoring the progress and effectiveness of the DSM Program, and for making key decisions with respect to the direction of the DSM Program and the use of DSM Program funding. The Oversight Board will agree upon evaluation methodology and will assess program evaluations. During the term of the DSM Program, the Oversight Board may

agree to modify program design and/or shift funds among programs to maximize benefits or propose new programs. Each Oversight Board member will have one vote.

Mr. Sears testified that Vectren envisions that the Oversight Board will make decisions using a consensus process similar to that used for the Vectren gas programs. Any individual member of the Oversight Board can raise issues and seek a majority decision. In the event the Oversight Board deadlocks on a voting issue, then the members of the Oversight Board could present their positions to the Commission for a decision.

He explained that the Oversight Board will receive data related to program cost and performance from Vectren and an independent third party evaluator, and will evaluate such data and provide annual reports to the Commission related to program results and pertinent metrics of the effectiveness of the programs. He stated that after reviewing each year's results, the Oversight Board may agree to make improvements to the evaluation process. Any such refinements would be based on a review of the data obtained and a discussion of what other information would be helpful, balanced with an assessment of the cost to change the evaluation process.

Mr. Sears stated that while the initial term will be for three years, Vectren plans to continue DSM programs into the foreseeable future in order to maximize the potential of DSM efforts. The timing of this initial term will allow additional demand side alternatives to be analyzed in the IRP process and considered for inclusion as the Company plans for continuation of the DSM Program. Mr. Sears also testified that by having a three year term, direction received as a result of Phase II of the Commission's DSM investigation in Cause No. 42693 can be used to modify the DSM Program as necessary.

Mr. Sears stated that Vectren will act as the DSM Program administrator and will increase staffing as needed in the Conservation Connection Center to support handling customer calls related to energy efficiency, providing conservation education and advice as well as processing of rebates. He stated the Company will also select independent contractors when necessary to support the implementation and fulfillment of selected DSM programs. To facilitate review, Vectren agreed to provide quarterly reports to the Oversight Board on call volume, types of customers calling, rebates handled and program participation.

Mr. Sears stated that Vectren will have its Year 1 programs substantially implemented within 90 days from receipt of a Commission Order. He stated that Vectren will utilize the experience of implementation partners to design the most cost-effective programs to meet the program objectives. In doing so, Vectren believes actual results will not vary drastically from the estimates. However, during the course of Year 1, Vectren believes it may need the flexibility to alter the implementation of programs to make the overall DSM Program as successful as possible. Such flexibility would be exercised with approval of the Oversight Board. Specifically, Mr. Sears stated that Vectren should be allowed to shift costs within a program budget as needed and should be allowed to shift funds between programs.

Mr. Sears testified that the Oversight Board will also need flexibility to have the opportunity to review initial program results as reported by an independent third party

evaluator. Based on those results, the Oversight Board may consider appropriate modifications to the program portfolio on a prospective basis, including reallocation of funding between programs. Programs found no longer cost-effective would be modified to correct the deficiency or terminated by the Oversight Board. He suggested that the Oversight Board may also consider the design and implementation of new programs as long as they pass the TRC test and the overall DSM Program budget is not changed. Mr. Sears stated that an annual report will be prepared in cooperation with the independent third party evaluator summarizing the accomplishments of the past year, proposed changes in the DSM programs, and the rationale for the changes and revised program budgets and goals for the current year.

Mr. Sears stated that implementation of these DSM programs requires significant investment in internal and external resources. Detailed implementation planning will need to be completed as well as the selection of implementation partners. Mr. Sears stated that based upon the proposed DSM Program, the anticipated staffing includes seven (7) positions: a Manager of electric DSM with the required business and technical expertise to oversee the portfolio of programs, two (2) Program Coordinators to oversee the internal and external activities related to the programs in each sector, an Evaluation, Measurement and Verification ("EM&V") Coordinator to work with the selected independent third party evaluator and facilitate measurement and verification efforts, and up to three (3) Program Administrative and Conservation Connection resources to process customer rebate requests, track program results and assist customers with information on energy efficiency. Petitioner provided the budget provisions for these staffing requirements in the fixed cost budgets.

Mr. Sears stated that an outreach and education program is critical to raise awareness and drive customer participation to the DSM Program. The DSM Action Plan recommended spending \$406,000 annually during the program's five year term. Vectren proposes spending \$700,000 in Years 1 and 2 and \$500,000 in Year 3 of the DSM Program. He noted that while the proposed annual spend is higher than that recommended in the DSM Action Plan, on a program percentage basis, the actual spend is less. The original DSM Action Plan targeted \$2.03 million for outreach and education which equaled approximately 10.6% of the overall program budget. The proposed three (3) year funding level equals \$1.9 million, which is about 10.2% of the revised overall program budget.

Mr. Sears opined that in order to achieve a more aggressive implementation schedule it is necessary to provide an adequate amount of education and outreach funding so that the required level of customer awareness and interest in the programs is created. Mr. Sears asserted that without a significant public outreach campaign it would be difficult to achieve the levels of participation represented in the DSM Program as reasonable targets for the programs.

Mr. Sears described the outreach and education program and indicated that the messages will specifically focus on directing customers to available programs and resources. He stated the outreach program will include paid media, web based tools to analyze bills, and energy audit tools. Vectren plans to utilize outreach efforts similar to those used to promote gas efficiency including public forums, workshops, employee communications and

customer emails. Vectren also plans to utilize energy education and efficiency workshops for both residential and commercial customers.

Mr. Sears also provided details regarding the proposed performance incentive mechanism. He stated that absent an incentive mechanism to reward the utility for the successful implementation of aggressive DSM programs, the lost revenue stream from plant invested that would otherwise occur is not addressed. Consequently, as a component of its overall DSM Program, he stated that Vectren is proposing a performance based incentive mechanism that rewards actual energy efficiency savings achieved, measured, and verified by an independent third party. The proposed incentive mechanism is based on the performance of the programs measured in terms of their actual energy and demand savings compared to projected energy and demand savings. To earn an incentive, Vectren's programs must also pass the TRC and UCT cost-effectiveness tests. Separate target incentives are proposed for the Residential and Commercial sectors, which are set at 20% of the total program and evaluation budgets for each sector. Superior performance may be rewarded by up to 30% of the planned Residential and Commercial sector budgets.

Mr. Sears asserted that other utilities have been provided significant incentives for the successful implementation of DSM. He opined that the existence of a performance incentive has been shown to be very influential in impacting utility behavior and an important tool for regulators in setting policy and guiding utility behavior. He noted that while incentives take on different forms, a number of states provide utilities with incentives for the successful implementation of DSM programs.

Mr. Sears described the proposed performance incentive mechanism, which is calculated based on two components. The first measures the energy savings by comparing the projected kWh savings from installed measures (planned savings) and the actual kWh savings from installations (installed savings). The second measures the demand savings by comparing the projected kW savings from installed measures (planned savings) and the actual kW savings from installations (installed savings). Based on this, he stated there will be two separately calculated incentives: the Residential Sector Incentive and the Commercial Sector Incentive. The incentive amount for each of these sectors is dependent on the amount of combined savings from each of the sector's individual programs. Mr. Sears provided the proposed performance incentive calculation for each sector. Mr. Sears explained that Vectren will not earn a performance incentive unless the actual energy and demand savings percentage is greater than 60% of the planned energy and demand savings. He noted this threshold is applied separately to the Residential and Commercial sectors.

The "target" incentive for each sector is a before tax incentive equal to 20% of the planned energy efficiency program budget for that sector. In order to earn the "target" incentive, Vectren must achieve actual kW and kWh savings of 91% to 100% of the projected kW and kWh planned savings. He stated that while 20% is the target, the incentive mechanism is designed to provide Vectren an opportunity to earn a performance incentive for achievement around the target as well.

Mr. Sears stated that for purposes of calculating the performance incentive, the planned energy efficiency budget is defined as the actual program costs not to exceed the total program budget approved annually by the Oversight Board. The program costs will include outreach and education program costs allocated equally between the Residential and Commercial sectors minus performance incentives. The Residential Low Income Weatherization program will not be included in the Residential sector performance incentive.

Mr. Sears stated that the costs of the performance incentive will be included in the benefit/cost analysis. Vectren will not be eligible for an incentive unless both the UCT and TRC tests for the combined programs in each sector are greater than 1.0. Calculation of the tests will include the performance incentive amounts which, when included, cannot cause the test results to fall below 1.0. He explained that there will be a true-up process of the performance incentive based upon actual program results. He stated that the performance incentive will be calculated for each six (6) month period from the actual start of Vectren's DSM programs. The calculation will be based upon the results of the previous six (6) month period's actual savings versus target savings. The incentive will be trued up annually based upon evaluation, measurement, and validation results performed by an independent third party evaluator.

Mr. Sears stated that to ensure the performance incentives can be retained, Vectren proposes that its net operating income for purposes of the FAC earnings test be adjusted by the amount of the actual incentive earned. He stated that it is appropriate to provide a performance incentive if the DSM program exceeds 60% of goals. He opined that the role of incentives is critical in providing the correct opportunity for financial reward to the utility. He believes it is important to provide the utility the incentive to succeed to address the uncertainty and risks associated with introducing programs in a market where many of the DSM programs are either new or have been absent in the market for several years. The rationale for creating a bandwidth of program performance, he stated, recognizes the difficulties in correctly forecasting the streams of program costs and benefits, prior to program implementation. He testified that the role of creating a bandwidth has successfully worked in other state jurisdictions and incents the utility to be proactive in securing DSM impacts.

Mr. Sears stated that there are safeguards to assure incentives are only paid if savings are produced. He explained that the Oversight Board must be satisfied that the programs are achieving the desired savings results. In addition, the DSM program targets can be adjusted annually. He noted that Vectren is proposing a three year DSM program, and at the end of the term, there will be opportunities to modify the DSM Program moving forward.

Mr. Sears explained the EM&V process that is proposed for the DSM Program. He stated the evaluations will be primarily used to inform future decisions about cost-effectiveness and modifications necessary to enhance the success of the continuing programs. Vectren will also utilize the evaluation process to determine the demand and energy impacts, as well as actual program cost-effectiveness on a retrospective basis for the determination of performance incentives.

Mr. Sears explained that program quality control and verification will be conducted on an on-going basis. Surveys and interviews will be conducted to assess customer/market provider satisfaction as well as consumer satisfaction, and field verifications will be conducted on a sample of installations.

Mr. Sears testified that program evaluation will be conducted by an independent third party selected by the Oversight Board. A process evaluation will be performed to identify how well the programs are implemented. Impact evaluations will be used to examine the more technical effects of the programs, and the following aspects will be evaluated for each program: (1) demand (kW) and energy (kWh) reductions; (2) program participation compared to goals; (3) free-ridership levels; (4) persistence of savings over time; and (5) how programs could be improved to increase savings.

Mr. Sears testified that the estimated cost of EM&V for Vectren's DSM Program is 5.9% of the overall program budget, which falls well within the DSM Action Plan's conclusion that "[m]onitoring and evaluation expenses typically range from 5 to 10 percent of program cost." Mr. Sears testified that this level of evaluation spending is appropriate given the length of time since a robust DSM effort has been active in Vectren's service territory. Mr. Sears explained that as the programs mature, the cost of evaluation should decrease based on program experience, market acceptance and evaluation procedures which are understood by market participants. Mr. Sears also stated that the evaluation results are critical to crafting a sustainable and successful DSM program.

Matthew F. Rose, Principal of Vista Energy, explained the analysis used to determine program costs and benefits. He stated that Vectren's programs were developed through a sequential set of planning steps aimed at taking the most current industry and market information to screen and prioritize the relevant opportunities based on their costs and benefits.

Mr. Rose stated that a formal economic analysis of each candidate technology and program was conducted to determine cost-effectiveness. Mr. Rose testified that the analysis included all the relevant program costs including program administration, training, incentives and evaluation as well as estimated annual program participation. These costs were compared to electric avoided costs to provide a net present value impact of all costs and benefits. The result was a cost-benefit ratio and estimate of the economic value of the proposed DSM Program. Mr. Rose stated that by simulating the results of the DSM Program using a dedicated spreadsheet cost-effectiveness model, the full range of economic impacts were determined.

Mr. Rose explained that the economic analysis included a full range of market perspectives, including the PT, UCT, RIM Test and TRC Test. The results of each of the tests were conducted for each program. All the economic tests were based on the cost-effectiveness methodologies from the publication: *California Standard Practice Manual: Economic Analysis of Demand-Side Programs and Projects*, California Governor's Office of Planning and Research, 2002.

Mr. Rose stated that the DSM planning effort leveraged the inputs and results of the DSM Action Plan. The Vista Energy analysis incorporated the technology, market and program data from the DSM Action Plan, wherever possible. He stated that Vista Energy also talked directly with the DSM Action Plan authors to better understand their methodology, inputs and results. He explained that in a few cases, DSM Action Plan data was not available, based on Vectren's decision to propose additional programs not included in the DSM Action Plan. These include: the Residential Audit and the Room Air Conditioner Recycling Programs. In the Commercial Sector, the DSM Action Plan analysis was used to provide detail in defining the Commercial Lighting, Audit and Efficiency Projects, Efficient Motors and Commissioning Programs. The DSM Action Plan included these programs as part of a larger comprehensive program with impacts based on melded incentives and savings. These programs were revised as stand-alone offerings to permit closer examination of cost-effectiveness results. In these cases, Mr. Rose stated, data was identified and applied from the DSM Action Plan in combination with other utility program offerings to facilitate the analysis efforts.

Mr. Rose explained that the other major difference in comparing the approach and results from the DSM Action Plan reflect changes in Vectren's system characteristics. He stated that the avoided cost estimates for Vista Energy's analysis were based on an updated set of costs associated with avoiding a CT, resulting in slightly higher capacity costs than the DSM Action Plan. He noted, however, the avoided energy costs did not appreciably change.

Mr. Rose stated that Vectren's avoided costs were developed by Vectren using its planning models, consistent with its IRP process. In Vista Energy's analysis, the electric avoided costs are used as a proxy for utility supply costs to assess the relative cost-effectiveness of the DSM programs. Mr. Rose testified that all the relevant economic analyses are based on modeling the net present value of costs and benefits to address the time value of money. The end result is a direct comparison of whether a candidate DSM program is more or less expensive than the supply alternative. Mr. Rose stated that programs with positive net present value results and a positive benefit-cost ratio indicate the DSM program is less expensive than the supply option.

Mr. Rose stated that each of Vectren's proposed programs was designed to incorporate delivery mechanisms which best allow the program to overcome market barriers and cost-effectively promote the relevant technologies in the marketplace. The mix of delivery mechanisms include education, leverage with trade allies/contractors, training, and incentives. Mr. Rose also stated that the program design includes costs reflecting market outreach activities, which were developed by Vectren and are included in the cost-effectiveness analysis.

Mr. Rose stated that the DSM programs are designed to attract more than 67,000 participants over the three year program implementation. As modeled, the programs are expected to save nearly 106,368 megawatt-hours and 15.5 megawatts of summer peak demand. The portfolio also includes nearly 59,000 therm savings resulting from the Residential Low Income Weatherization and the Residential On Site Audit and Direct Install Kit. The total budget for the entire portfolio is estimated at \$18.6 million.

Mr. Rose explained that each of the program designs includes a dedicated budget for program evaluation depending on the size and installation requirements of the program. He stated those programs needing careful follow-up and providing for customer installed measures require higher costs for evaluation due to the need to properly sample participants and obtain verification of proper installations. Overall, the evaluation costs for the proposed residential programs are estimated at 6.4%, and the commercial programs at 5.4%, of total program costs. Mr. Rose testified that the evaluation component of the programs is critical to determine proper load impacts and re-examine the programs as needed. He also explained that since the introduction of DSM in Vectren's service area is relatively new, there is a need to conduct process evaluations to properly determine how the programs are operating and the need for any changes.

Ronald G. Jochum, Vice President – Power Supply for Vectren, explained how DSM fits into Vectren's resource planning and how avoided costs were calculated. Mr. Jochum stated that Vectren's IRP model was updated to account for new capital cost information and was used in discussions with the Collaborative. He stated that Vectren did not consider any avoided transmission and distribution ("T&D") costs nor the potential reduction of greenhouse gases in its avoided cost calculation. He stated that the IRP base case had used an estimated CO₂ cost beginning in 2012 and escalated through the end of the planning period. In comparing DSM to supply-side resources, Vectren believes that carbon costs should be considered for both the IRP modeling and the avoided cost calculation in this proceeding.

Mr. Jochum stated that for purposes of calculating the avoided costs used in evaluating potential DSM programs, Vectren did not utilize the unit identified in its IRP. Like Mr. Sears, he noted that for purposes of this proceeding, after discussions with the Collaborative, Vectren decided to utilize the cost of a generic CT in its avoided cost calculation. Compared to the unit actually selected by the IRP model, avoided capacity costs were reduced by \$41.87/kW in 2010 and \$45.33/kW in 2014 for the DSM avoided costs calculation.

Mr. Jochum discussed the general benefits to Vectren's customers of implementing a DSM program. He stated that participants in the various programs would realize savings by reducing their consumption of energy, and paying less than they would have been charged based on the incremental cost of avoided capacity and energy. He also stated that all customers would realize savings, based upon avoided costs, including not only energy and capacity, but also required additional investment in T&D facilities and environmental compliance costs.

Mr. Jochum stated that generally speaking, the costs to Vectren and its customers include program implementation, administration, measurement and verification, marketing, and lost revenue/margin. Incentive costs would also be included if the programs are found to be successful in reducing demand and energy. He opined that these costs impose a barrier for regulated utilities to offer DSM programs if the utility is not allowed to timely recover these costs. Mr. Jochum also noted that the DSM Rules contain guidelines for cost recovery.

Mr. Jochum testified that the Commission has also addressed the concept of avoided cost in the Commission's IRP rules, which define "avoided cost" as "the amount of fuel, operation, maintenance, purchased power, labor, capital, taxes, and other cost not incurred by a utility if an alternative supply or demand side resource is included in the utility's integrated resource plan."⁷ He noted that the DSM Rules provide that "a shareholder incentive mechanism must reflect the value to the utility's customers of the supply-side resource cost avoided or deferred by the utility's DSM program minus incurred utility DSM program cost."⁸ Consequently, Mr. Jochum opined that the avoided cost calculation included in Vectren's IRP should be utilized to consider the effectiveness of the DSM programs as well as the performance incentive.

Mr. Jochum testified that the Strategist software tool for resource planning analysis was utilized in calculating Vectren's avoided cost. He stated that for purposes of this proceeding, the dataset from the November 2007 IRP was used, and the capital cost assumptions for gas fueled technology alternatives were updated. Avoided costs were assumed to have two components; a capacity charge and an energy charge.

Finally, Mr. Jochum stated that Vectren's avoided cost calculation includes a "market" component. He stated that the calculation of avoided cost for DSM modeling purposes is based upon the best Present Value Revenue Requirement in the IRP. He explained that this reflects cost increases to build new generation, which Vectren believes is "the market" since DSM helps to defer those options.

Jerome A. Benkert, Jr., Executive Vice President and Chief Financial Officer of Vectren, discussed how the Company's proposed performance incentive mechanism provides financial support that is important to competing for capital. He stated that as Vectren's CFO, he is responsible for the Company's ability to attract capital to invest in utility operations. This ability largely depends upon the Company's financial performance. Vectren's proposed DSM Program has been designed to aggressively reduce customer usage, thereby creating a number of benefits, including (1) deferring the need to build generating facilities, (2) reducing air emissions, (3) reducing fuel use and cost, and, (4) providing customers with enhanced ability to reduce their bills. He stated that the pursuit of these benefits means that due to the reduced consumption of electricity, the Company will have less revenue and will invest less capital in plant. Therefore, the Company will have less rate base growth as an earnings driver.

Mr. Benkert stated that in recognition of the inherent impact DSM has on the Company's financial performance, which could be viewed negatively by the financial community, the proposed DSM Program is accompanied by rate design and incentive proposals that provide financial support to Vectren's commitment to DSM in lieu of other supply alternatives. He asserted that the proposed "decoupled" rate design and performance incentive provide Vectren with information they can present to potential investors to show regulatory support, risk mitigation, and an opportunity for additional return that better positions Vectren to compete for capital. Mr. Benkert testified that to elevate and sustain

⁷ 170 IAC 4-7-1(b)

⁸ 170 IAC 4-8-7(f).

Vectren's promotion of DSM over time, the Company needs to have a positive message that clearly positions DSM as a good initiative for both customers and investors.

Mr. Benkert stated that he believes Vectren's financial results are under pressure for a number of reasons, including the fact that Vectren generally has a low growth territory and operating costs are rising dramatically. Mr. Benkert also noted recent events that threaten the overall stability of the U.S. financial system. Mr. Benkert indicated that Vectren believes its commitment to energy efficiency can impact its ability to access capital on reasonable terms.

Mr. Benkert compared the electric business to the gas business. He explained that unlike the gas distribution business where earnings are derived solely from delivery service, the generation of electricity has always been a primary driver of electric investment needs and earnings. He testified that approximately 60% of Vectren's electric rate base consists of generation related plant. Moreover, unlike gas which has witnessed a twenty (20) year decline in customer usage, generally electric usage has gradually risen over time, providing margin upside which can help to offset cost increases. He opined that as a result, absent some regulatory modifications, the threat to financial performance from electric DSM may be perceived much more negatively than gas efficiency programs.

Mr. Benkert stated that Vectren does not view the proposed incentives as a substitute for the foregone opportunity to earn a return on new generation assets. He noted that apart from some risk in the construction phase, once generation plant is in use, earnings are very predictable. He stated that while Vectren can forecast earnings on plant and rely on the resulting revenue stream for many years, its DSM performance incentive represents an unknown, at risk opportunity.

Mr. Benkert testified that he believes efficient energy use is a crucial part of monitoring the long term affordability and reliability of energy and that DSM needs to be a part of Vectren's service portfolio. He noted that the Commission's generic DSM investigation, Cause No. 42693, emphasized the need for Indiana utilities to step up and deliver programs based on best practices. He stated that DSM investment should be used to reduce load and benefit customers by reducing generation need; but opined that if revenue protection and incentives are not provided, Vectren will struggle in attempts to satisfy the financial community that the Company's future financial performance will not be impaired.

Angila M. Retherford, Director of Environmental Affairs and Senior Environmental Counsel for Vectren Corporation, explained the environmental benefits associated with DSM programs that reduce the need to generate electricity. Ms. Retherford provided an overview of federal and state carbon policy that has the potential to impact Vectren and its ratepayers. She stated that there are two primary regulatory scenarios that have been discussed in Congress: a carbon tax, and a carbon cap and trade program.

Ms. Retherford noted that while there are very significant political and regional differences with respect to form and stringency of carbon legislation, there is growing momentum in Congress to pass some form of carbon legislation. She further testified that the federal Energy Information Administration ("EIA") and others have modeled estimated cost

impacts of proposed carbon legislation. She indicated the range of estimated carbon allowance costs for the successful cost mitigation model scenario started at \$16.88/ton in 2012 rising to \$61/ton in 2030, while the limited alternative scenario with no international offsets model scenario started at \$50.62/ton in 2012 rising to \$156/ton in 2030. Ms. Retherford testified that Vectren did not model EIA's carbon compliance cost numbers in its cost benefit analysis. Instead, Vectren utilized the same carbon cost schedule used in its 2007 IRP, which ranged from \$4/ton starting in 2012 rising to \$15/ton in 2027.

Ms. Retherford concluded by opining that energy efficiency and DSM programs are cost-effective tools to reduce carbon emissions, to reduce the number of allowances that Vectren will have to purchase to comply with a mandatory reduction program, and to mitigate what could potentially be an equally significant rate increase to its customers.

Jerrold L. Ulrey, Vice President, Regulatory Affairs and Fuels for Vectren Utility Holdings, Inc., discussed the decoupling rate design proposal in detail. Mr. Ulrey described Vectren's proposal to (1) add an Energy Efficiency Funding Component ("EEFC") to its existing Demand Side Management Adjustment ("DSMA"), Sheet No. 66 of Vectren's Tariff for Electric Service, to recover from all customers the costs, including performance-based incentives, for the proposed DSM Program and (2) implement a decoupling mechanism, Sales Reconciliation Adjustment ("SRA"), proposed new Tariff Sheet No. 67, to pass back or recover from certain customer classes the difference between actual fixed cost recovery and the fixed costs authorized by the Commission for recovery from those customer classes in the Company's most recent general rate proceeding.

Mr. Ulrey testified that Vectren is proposing recovery of DSM Program costs, a performance incentive, and a decoupling mechanism in order to support aggressive DSM and other efforts by the Company to reduce its customers' consumption of electricity and peak demand. Mr. Ulrey stated that Vectren's proposed EEFC would recover the costs of the Company's proposed DSM Program and performance incentives. Under Vectren's proposal, the DSMA would be revised to reflect the addition of the EEFC.

Mr. Ulrey described how the EEFC recoverable DSM Program costs will be allocated to and recovered from customer classes. He explained that each of the individual programs included in the DSM Program will be examined at the start of each year to develop the proportions of the savings expected to result from reductions to kWh (energy) sales and/or kW (demand) sales. The budgeted costs of each program will then be apportioned to energy and demand based on those proportions. The demand-apportioned program costs for all of the individual DSM programs will be allocated to all customer classes based on the four (4) summer months' coincident peak class allocators reflected in the DSMA. The energy-apportioned program costs for all of the individual DSM programs will be allocated to the rate classes eligible for the DSM programs based on projected energy sales for the upcoming DSMA projection period. He stated that as for recovery of the allocated costs, the energy-allocated program costs will be recovered based on actual energy sales to the affected classes, while the demand-allocated program costs will be recovered from customers via the demand charges (for rate classes with demand charges) or based on actual energy sales (for rate classes that do not have demand charges).

Mr. Ulrey also described how the EEFC recoverable performance incentives will be allocated to and recovered from customer classes. He explained that the Company will calculate the incentive amount semi-annually after the DSM Program's performance for each six months has been determined. The performance incentive will be computed separately based on demand and energy results achieved. The separately determined demand and energy incentive amounts will be allocated to and recovered from rate classes in the same manner as described above for the DSM programs costs, in the next semi-annual DSMA filing. The incentive amount calculated by the Company each six months will be trued up annually based upon EM&V results performed by an independent third party evaluator. Any difference between the Company-calculated incentive amounts and the third party calculated incentive amounts will be reflected in a subsequent semi-annual DSMA filing. Mr. Ulrey stated that the DSMA amounts actually recovered from customers will be reconciled with DSMA amounts intended for recovery from customers for such period, with any variance being reflected in a subsequent semi-annual DSMA filing.

Mr. Ulrey stated that Vectren is proposing a decoupling mechanism to recover the difference between actual fixed cost recovery for certain rate classes and the fixed costs approved for recovery from those rate classes by the Commission in the Company's last general rate proceeding, Cause No. 43111. He stated that the fixed costs are those costs included in Vectren's approved revenue requirement that do not vary based on units sold to customers. Therefore, fixed costs that would be decoupled under the Company's proposal include the rate case levels of costs such as return, depreciation, labor, other O&M, and property and revenues taxes. Accordingly, variable costs, *i.e.*, those costs the Company incurs that do vary with actual sales units, are excluded from the revenues and base rate costs to be considered in the decoupling amount calculations.

Mr. Ulrey asserted that the decoupling mechanism eliminates or reduces the Company's disincentive to help its customers reduce their electric usage. He testified that based on current rate designs with demand and energy charges based on actual customer usages, the Company would forfeit fixed cost recovery as it helped its customers reduce their actual usage. This misalignment of Company and customer interests, he asserted, can be mitigated with the proposed decoupling mechanism.

Mr. Ulrey stated that Vectren is proposing a new Tariff Sheet applicable to certain rate classes to implement the SRA to decouple sales units from fixed cost recovery. He explained that each month, for the applicable rate classes, the Company would first calculate the actual fixed costs recovered that month. Then, the fixed costs recovered would be compared to the monthly portion of fixed costs approved for recovery in the most recent rate case, as adjusted for the actual number of customers. The differences between these calculated amounts would be the decoupling amount for that rate class for such month. The monthly decoupling amounts for all rate classes would be deferred for subsequent inclusion in an annual SRA filing, which would recover from or pass back to customers the accumulated deferred decoupling amounts. He stated that to determine actual fixed costs recovered each month, the Company would deduct from total costs recovered for each rate class the Adjustment revenues recovered and variable costs recovered. He stated the Adjustments are self-

reconciling, meaning they already are decoupled from actual sales units, so their recoveries may be removed from the decoupling calculation, even though some of them are recovering fixed costs. Variable costs are those costs that vary based on actual sales units; they are not fixed costs, so it is also appropriate to remove the recovery of these costs from the decoupling calculation.

The Adjustments revenues removed currently include the fuel costs (the base rate component and FAC, including variances), the MISO Cost and Revenue Adjustment ("MCRA"), the Reliability Cost and Revenue Adjustment ("RCRA"), the DSMA, and the Qualified Pollution Control Property – Operating Expense Adjustment ("QPCP-OE"). The variable cost recovery removed from the SRA calculation is comprised of a number of power production related expenses, including fuel handling costs, environmental chemicals expense, and ash disposal costs. To determine the monthly fixed costs approved for recovery, he stated that the Company will use a monthly split of fixed costs for each rate class to determine monthly fixed costs per customer. The monthly per customer amount will be multiplied by the number of actual customers in each rate class for that month to obtain the "order-granted" fixed costs. Finally, a prorated portion of the annual return amount reflected in the Qualified Pollution Control Property – Construction Cost Adjustment ("QPCP-CC"), which is fixed cost recovery approved by the Commission since the last rate case, will be added to the "order-granted" fixed costs to achieve the monthly fixed costs approved for recovery. The net result of the SRA is that over a year's time the Company would realize the fixed costs approved for recovery by the Commission - both in the most recent rate case and in subsequent QPCP-CC filings - as adjusted for actual number of customers.

Mr. Ulrey explained why the fixed costs to be recovered must be adjusted for the actual number of customers. He stated that the decoupling calculation effectively adds to or subtracts from the fixed costs to be recovered, the average fixed costs per customer from the last rate case for each customer added to or dropped from the electric system. To add new customers, the Company makes additional capital investment and incurs incremental O&M expense over time. The decoupling calculation allows the Company to retain the average fixed costs per customer for each new customer. He asserted that absent the ability to retain this average fixed cost amount, the Company will not recover its incremental fixed costs and will not be fully decoupled. In fact, he noted, given that some customers drop off the electric system each year, and the customer adjustment is based on net customer count changes (which subtracts dropped customers), even with decoupling there is a risk that the Company will not fully recover its incremental fixed costs. At the hearing, Mr. Ulrey further explained that if net customer counts decline, the revenues that Vectren can recover would be reduced. Tr. B-26. Mr. Ulrey also clarified that a customer is not longer considered a customer for purposes of the SRA upon disconnection. Tr. at B-22.

Mr. Ulrey stated that the SRA amounts actually recovered from customers will be reconciled with SRA amounts intended for recovery from customers for such period, with any variance being reflected in a subsequent annual SRA filing. He stated that this ensures a dollar-for-dollar recovery of the costs approved for recovery.

Mr. Ulrey explained that Vectren has previously implemented a decoupling mechanism for its gas utility. He testified that the major difference between the gas and electric mechanisms is the existence of significant non-fuel variable costs in the power production portion of the base rate revenue requirement for the electric utility, while the gas utility has virtually no non-fuel variable costs in its revenue requirement. He explained that this difference requires the treatment of variable costs as described above for the electric decoupling mechanism.

Mr. Ulrey also stated that the SRA acts as a weather-normalization adjustment by reversing the impact of non-normal weather on fixed cost recovery because each month the SRA compares actual fixed cost recovery, which includes any impacts of non-normal weather, to the order-granted fixed costs authorized for recovery, which was weather-normalized in the Cause No. 43111. He noted that this occurs for Vectren's gas utility rate via another mechanism, the Normal Temperature Adjustment. On the electric side, both decoupling and weather-normalization may be accomplished in the SRA.

6. **OUCC's Testimony.** April M. Paronish, Utility Analyst in the Resource Planning, Emerging Technologies and Telecommunications Divisions of the OUCC, chronicled the OUCC's involvement in the development of Vectren's proposed DSM Program and described the OUCC's support for the proposed programs with some modifications.

Ms. Paronish testified that all utilities' DSM portfolios should include the following set of core programs, together with related outreach and consumer education: (1) Lighting, (2) Audits, and (3) Low-Income Weatherization. While the Collaborative reached consensus on most program aspects, the OUCC identified the following as remaining issues and recommendations:

- The OUCC recommended that Vectren explain how it will differentiate participation in its existing DLC program from the new DLC program since the Commission did not authorize incentives for Vectren's existing program.
- Ms. Paronish suggested that the third party evaluator, which is selected by the Oversight Board, should determine and report appropriate net-to-gross ratio levels that include the net effects of free riders and free drivers for each program.
- Ms. Paronish noted that Vectren has increased the projected participation levels and associated budget for the Low Income Weatherization program from 1,851 homes recommended in the DSM Action Plan to 2,900 homes. She stated that this program is not eligible for incentives; and should the program under-perform, unspent funds allocated to the Low Income Weatherization program should not be eligible for reallocation to other programs.
- Ms. Paronish testified that Vectren's proposed addition of seven (7) employees is excessive in light of the fact that Vectren already employs customer service

DSM staff. Ms. Paronish recommended that the Oversight Board review the appropriate number of employees and associated compensation to accommodate the proposed programs. Ms. Paronish also recommended costs for these resources be a fixed dollar value that does not increase with salary (or other cost increases) in subsequent DSMA tracker proceedings.

- While the DSM Action Plan addressed only residential and small commercial customers with loads below 500 kW, Ms. Paronish opined that additional energy savings may be achieved if all customers are provided an opportunity to participate in DSM programs. Ms. Paronish recommended that Vectren research options for large commercial and small industrial customers to develop programs for those customer classes during the first year of the DSM Program.

Ms. Paronish testified that the evaluation approach discussed by Vectren is a good start to the development of an EM&V plan. However, she opined that the plan may evolve with input from the Oversight Board. Ms. Paronish noted that Vectren indicated it would follow the International Performance Measurement Verification Protocol (“IPMVP”) standards for only 6 out of 15 of its proposed DSM programs and opined that the Collaborative should explore the possibility of utilizing IPMVP standards for all programs.

Ms. Paronish also recommended that Vectren report actual energy efficiency participation to the Oversight Board for review of quarterly and annual information related to estimated rate impact, actual net-to gross ratio experiences and EM&V results. She testified that Vectren’s proposed EM&V budgets of 5.9% of average DSM program costs for residential and commercial customers is reasonable. She noted that this percentage also aligns with the NAPEE recommendation of 3% to 6% of program costs.

Greg A. Foster, a Utility Analyst in the Electric Division of the OUCC, testified against Vectren’s decoupling proposal. He stated that decoupling is a generic term for a rate adjustment mechanism that separates (*i.e.*, decouples) a utility’s fixed cost recovery from the amount of electricity or gas it sells. He asserted that decoupling ensures that the utility will recover its Fixed Cost Revenue Requirement (“FCRR”) as determined in the utility’s last base rate case. Under decoupling, if declines in Average Use Per Customer (“AUPC”) cause the utility to recover less than its FCRR, then an upward adjustment to per kWh rates is made to “true up” rates and ensure recovery of the FCRR. Mr. Foster testified that decoupling is symmetrical. Consequently, if increases in AUPC cause the utility to recover more than its FCRR, then a downward adjustment to per kWh rates is made to “true up” rates and ensure recovery of the FCRR.

Mr. Foster explained that decoupling does not guarantee that a utility will earn its authorized return, but decoupling does ensure recovery of FCRR, as determined in the last base rate case, including the cost of capital. The utility must still manage its costs to earn a reasonable return. Mr. Foster stated that he has investigated decoupling proposals in other states and provided a summary of the results of his research. Mr. Foster stated that currently,

three gas utilities have approved decoupling mechanisms in Indiana. At this time, no Indiana electric utilities have a decoupled rate design.

Mr. Foster stated that proponents of decoupling believe that it promotes utility DSM efforts by breaking the "throughput incentive" and ensuring fixed cost recovery, regardless of volumetric sales. Under traditional rate design, fixed cost recovery is dependent on volumetric sales. Thus, he stated, there is a disincentive for a utility to engage in DSM programs, as the promotion of conservation ultimately leads to decreased sales revenue. Decoupling makes the utility indifferent to the volume of sales. If the utility sells fewer units due to effective DSM programs, then the utility will not suffer financially. Utilities would thus have an incentive to encourage its customers to reduce usage.

Mr. Foster stated that critics, however, believe that decoupling shifts a great deal of risk to ratepayers. Mr. Foster, citing to a recent National Regulatory Research Institute study on gas rate decoupling, agreed that decoupling reduces risk for the utility.

Mr. Foster indicated his understanding that Vectren was proposing full decoupling for certain residential and commercial rate classes. He compared Vectren's proposed electric decoupling program with its gas decoupling program. He stated that the scale and scope of electric decoupling are significantly greater than gas decoupling. Gas utilities are normally distribution companies. However, he noted that on the electric side, Vectren is a vertically integrated utility with distribution, generation, and transmission assets with directly related fixed costs. He testified that on the electric side, fixed costs are much larger in dollar terms and as a percentage of total customer bills. For example, the fixed cost portion of a residential customer bill for Vectren Gas is approximately 25%, compared to approximately 76% for Vectren Electric.

Mr. Foster disagreed that Vectren's decoupling proposal ensures that the Company will recover the amount of fixed cost approved by the Commission in its most recent rate case. He testified that Vectren's authorized return on equity ("ROE") was last determined and set at a level that does not reflect these assurances. He stated that although Vectren's proposal will reduce the Company's risk, Vectren has not proposed any reduction in its authorized ROE. He further testified that decoupling protects Vectren from sales declines caused by all factors, including recessions, the weather, and purely customer-initiated conservation efforts. Consequently, he testified, if Vectren is to be insulated from such risks, then its authorized ROE should be reduced.

Mr. Foster stated that the OUC does not support Vectren's electric rate decoupling proposal. He stated that decoupling is a major change in rate design and ratemaking practices. He opined that decoupling, on the scale and scope proposed by Vectren, would be best accomplished in the context of a base rate proceeding where all issues, including risk and rate of return, are open to evaluation. He opined that Vectren's proposal to fundamentally change electric ratemaking through an alternative regulatory plan between rate cases is inappropriate.

Mr. Foster testified that it is possible for Vectren to profitably move forward with electric DSM programs without decoupling. He stated the OUC proposed the following: (1)

full and timely recovery of reasonable costs of implementing Vectren's DSM Program; (2) recovery of "lost revenue" consistent with the DSM Rules and based on measured and verified impacts of Vectren's DSM Program; and (3) reasonable shareholder incentives for the DSM Program. He opined that these alternatives would permit Vectren to profitably move forward with enhanced DSM programs now and leave Vectren free to propose decoupling in its next base rate case where it can be considered within the context of a comprehensive review of its risk, revenue requirements and rate design.

Mr. Foster stated that if the Commission decides to implement some form of decoupling, the OUCC recommends that decoupling be limited to the distribution cost segment of Vectren's electric service (as opposed to generation and transmission cost segments) on a pilot basis. Mr. Foster opined that by guaranteeing recovery of Vectren's distribution fixed costs, partial electric decoupling would provide assurances for shareholders, while limiting the exposure to ratepayers. Partial decoupling would stabilize earnings in the distribution segment of Vectren's business and would mirror the essence of gas decoupling since gas utilities are normally distribution only. Furthermore, he stated, it would afford the Commission and OUCC staff the opportunity to evaluate electric utility decoupling on a limited basis prior to Vectren's next rate case.

Jenny A. Sumner, a Utility Analyst in the Electric Division of the OUCC, explained the OUCC's recommendation to modify Vectren's proposed performance incentive. Ms. Sumner stated that she investigated electric utility performance incentives approved in other states and provided a summary of her research. She stated that performance incentives have been approved based on a percentage of program costs, a percentage of net benefits (benefits minus costs) generated, or an increased return on investment for energy efficiency.

She noted that Vectren proposed a performance incentive based on tiered percentages of program costs. Vectren proposed a threshold of 60% and a cap of 30% of program costs when 111% of the savings goal is achieved. While the proposal for an incentive based on tiered percentages of program costs is consistent with incentives in other states, she asserted that Vectren's proposal had one of the lowest threshold values surveyed accompanied by one of the highest caps. A threshold value represents the minimum achievement needed in order to receive an incentive. Ms. Sumner recommended that the Commission modify Vectren's proposed performance incentive to cap the incentive percentage at a lower level, establish a higher threshold target, and be symmetrical, *i.e.*, provide a disincentive for under-performance in addition to an incentive for excellent performance.

7. **NRDC's Testimony.** Rebecca Stanfield, Senior Energy Advocate for the Midwest office of the NRDC, described the NRDC's general support for Vectren's DSM Proposal. Ms. Stanfield supported Vectren's proposal for revenue decoupling and agreed with Vectren's witnesses that decoupling the Company's recovery of fixed costs from sales volume is the appropriate way to align the utility's interests with the interests of its customers. Ms. Stanfield pointed out that the DSM Rules clearly support the notion that utilities are more than just providers of a commodity, but rather are stewards of their customers' energy investment dollars. She stated the Commission's rules vest the state's utilities with the obligation for resource planning, and require each utility to demonstrate that their plans

maximize economical load management, conservation, nonconventional technology relying on renewable resources, cogeneration and energy efficiency improvements as sources of new supply. Ms. Stanfield opined that so long as Vectren's ability to recover its Commission approved fixed costs depends upon maintaining the anticipated volume of sales over the recovery period, it will face a serious conflict between its obligation to maximize energy savings potential to lower overall system costs, and its obligation to shareholders to maintain and increase revenues.

Ms. Stanfield disagreed with the OUCC that decoupling shifts the risk of fluctuating sales to ratepayers. She stated that decoupling reduces risk for both the utility and customers. While she indicated that risk mitigation through measures like decoupling could lead to an impact on the utility's cost of capital, she opined that it is efficient to approve decoupling now and address the cost of capital impacts in Vectren's next rate case. Finally, she expressed disagreement with the OUCC's recommendation that Vectren be allowed to recover lost revenues instead of decoupling because she believes this would raise the risk of fixed cost over-recovery for Vectren's customers. She stated that a lost revenue recovery mechanism does not calculate or net out the extent to which other factors may have increased sales, nor does it eliminate the utility's incentive to increase sales.

8. Petitioner's Rebuttal Testimony. Mr. Petitt disagreed with the OUCC's recommendation that consideration of a "decoupled" rate design should wait until a final order is issued in Vectren's next base rate case. He reiterated that to date, gas decoupling has removed obstacles to the pursuit of efficiency and thus delivered great benefits. He asserted that a decoupled electric utility can move forward with a number of effective demand/use reduction initiatives well beyond DSM programs. Mr. Petitt opined that a change to a decoupled rate design does not have a downside for customers because it creates a more stable recovery of fixed costs for Vectren, which supports its credit ratings and therefore, its ability to attract capital.

He testified that the primary reason the OUCC does not support moving to decoupling now is their contention that decoupling shifts the risk of fluctuating sales to the ratepayers. Mr. Petitt opined that this opposition is based on a failure to fully appreciate how the current volumetric rate design affects Vectren's customers. He stated that because sales under volumetrically designed rates fluctuate with weather conditions and with changes in customer usage, both the utility and its customers are at risk for fixed cost recovery variations from rate case projected sales levels. He stated that the shift to decoupled rates eliminates the risk to customers that they will "overpay" for service due to increased usage.

Mr. Petitt stated that the OUCC's proposal to decouple just the distribution segment of Vectren's electric service does not accomplish the "alignment" of customer and Company interests. He stated this alignment is important because it allows the Company to promote the most efficient use of energy and, in partnership with its customers, help lower monthly bills. Further, he stated, because Vectren's gas utilities are already decoupled, full decoupling on the electric side also aligns Vectren's interests with its customers by allowing both utilities to promote a consistent conservation message.

Mr. Petitt stated that the level of fixed costs is not the only difference between gas and electric utilities in terms of customer usage and fixed cost recovery. He testified that when Vectren's gas utility instituted decoupled rates, the change to a decoupled rate design came after a long term decline in customer usage. In contrast, he noted, average electric use has risen over time. Mr. Petitt asserted that the historic increase in electric AUPC provides a counter argument to the OUCC's contention that a dramatic shift in risk will occur if decoupling is adopted. He asserted that because decoupling is symmetrical in nature, Vectren is agreeing to give up the effects of hot summers and the potential impact of increased computer usage, plasma TVs, and other appliances by customers.

Mr. Petitt opined that the OUCC's concerns regarding the higher level of electric fixed costs when compared to gas fixed costs does not provide a valid reason to reject the policy of alignment of short and long term efficiency efforts. He stated that if AUPC declines over the next three years of the DSM Program, decoupling will add minimal amounts to customer bills. As AUPC drops, the benefits of reduced fuel cost, reduced air emissions, and deferral of future generation provide substantial reasons to pursue enhanced efficiency gains to the maximum extent.

Mr. Sears responded to each of the recommendations made by the OUCC regarding the design and implementation of Vectren's DSM Program, including the performance incentive mechanism. Mr. Sears agreed with Ms. Paronish's recommendation to differentiate new DLC program participation from old DLC program participation when calculating program costs and incentives. He stated that Vectren will identify all new DLC participants in the customer information and billing system with a unique rate code so that the incentives earned are limited to the new DLC participants. Further, the costs for the replacement and maintenance of the existing DLC equipment versus the cost for new DLC customer installations will be separately tracked and recorded. An existing customer will be defined as any customer currently on the DLC program at the time of approval of the proposed DSM Program. Vectren also proposed that any premise that is removed from the program and remains inactive for one year would be considered a new customer on the program if a new DLC switch is thereafter installed.

Mr. Sears also stated that Vectren agrees with the OUCC's proposal to limit the approval for DLC Inspection and Maintenance Program ("DLC I&M Program") cost recovery to one year. Mr. Sears also agreed to communicate the results of that program in a future DSMA filing and reserved the right to request continuation of the program and associated cost recovery at that time.

Mr. Sears stated that Vectren agrees with the OUCC's recommendation that the third party evaluator, selected by the Oversight Board, should determine and report appropriate net-to-gross ratio levels for each program. He stated that program evaluation will be conducted by an independent third party selected by the Oversight Board. Mr. Sears agreed that part of the responsibility of the selected third party evaluator would be to determine not only the free-ridership, but also the overall net-to-gross ratio level which includes the net effect of both free riders and free drivers. The determined net-to-gross ratios would then be used to determine

the actual net energy and demand impacts, and the resulting incentive performance compared to the planned net energy and demand savings.

Mr. Sears stated that Vectren proposed an aggressive low-income weatherization program and, after consideration of recent events, agrees with the OUCC's recommendation that the participation numbers and associated budget need to be revised. Mr. Sears stated that the participation and associated budget should be reduced to 1,000 participants in order to reflect current market delivery conditions.

Mr. Sears also indicated that based on discussions with program providers, Vectren had identified other program modifications that are advisable. With respect to the Residential Second Refrigerator Pick-up, he stated that the benefit cost modeling for this program erroneously included the cost of recycling the second refrigerator as a customer cost instead of a utility program cost. In addition, the life of the measure savings at 5 years was also determined to be too low compared with other values used in other market assessment studies. With respect to the Residential Window AC Pick-up, Mr. Sears indicated that the participation for this program was determined to be extremely aggressive and the proposed delivery method and budget needed to be modified in order to be cost-effective. Mr. Sears stated that during the Collaborative process these program changes were proposed and that he believes the OUCC is supportive of them.

Mr. Sears stated that Vectren does not agree with the OUCC's recommendation to reduce the staffing level proposed for the DSM Program. Mr. Sears noted that the OUCC argues this number is excessive because Vectren already employs customer service DSM staff; however, such staff is employed for Vectren's gas conservation efforts. He also indicated that the three Program Administrator and Conservation Connection positions already reflect consideration of the support that will be provided by existing employees. Mr. Sears testified that in developing the DSM Program and determining the necessary staffing level, Vectren considered four key factors, including maturity of the market and technology; implementation and delivery strategy; experience in delivering DSM; and the scope and type of program. Mr. Sears explained why he believed, based on these factors, the proposed staffing levels are reasonable.

Mr. Sears stated that Vectren agreed with the OUCC's suggestion that in addition to the DSM Program, Vectren should conduct research regarding DSM options for large commercial and industrial customers. He stated that while the DSM Action Plan identified the market potential for customers under 500 kW, Vectren has proposed the Commercial Programs of its DSM Program be available to customers on tariff rates SGS, DGS and OSS. He asserted that the proposed program designs will provide significant opportunity for participation and energy savings by all customers on these rate tariffs.

Mr. Sears noted that the large commercial and industrial rate tariffs, LP and HLF, do not have DSM programs designed to serve them due to their ability to conduct self-directed DSM efforts. However, Mr. Sears stated that Vectren realizes these customers can provide significant energy savings and is agreeable to investigating voluntary offerings to these customers that could produce benefits to all of Vectren's customers. He stated that Vectren

would bring any proposals to the Oversight Board for review, with incremental funding to be approved by the Commission.

Mr. Sears stated Vectren generally agrees with the OUCC's recommendation that the Collaborative explore the possibility of utilizing IPMVP standards for all programs. He stated that he would not classify the IPMVP as "standards" for evaluation based upon his understanding of their purpose. Instead, he would consider IPMVP as "methods" which can be employed to determine the energy impacts of a DSM program. He explained that the IPMVP is not a standard, but instead is intended to be used by professionals as a basis for preparing savings reports. Each user must establish its own specific EM&V plan that addresses the unique characteristics of the project.

Mr. Sears testified that the IPMVP are one set of protocols the independent third party evaluator should utilize as part of its evaluation efforts, however, the Oversight Board should allow for deviations from these standards if justified by the independent third party evaluator. Further, Vectren believes the Oversight Board should also encourage the independent third party evaluator to employ evaluation efforts, studies, and activities that are consistent with other nationally recognized evaluation standards like those used in the California Evaluation Protocols.

Mr. Sears testified that Ms. Sumner's comparison of Vectren's proposal to existing incentive proposals in other states has significant limitations. First, states have individual energy consumption characteristics that may need to be considered in such an analysis. Another factor that makes a comparison like the OUCC's difficult is that utilities with incentive mechanisms operate in the different state regulatory structures.

Mr. Sears stated that it is important to note that many of the proposed DSM programs are first time programs in Vectren's service territory. He noted that Ms. Sumner believes Vectren will likely be able to achieve success easier with the new DSM Program than more established programs because Petitioner's consumers have not yet had the opportunity to take advantage of the proposed programs. However, Mr. Sears asserted that there is actually more risk in achieving the goals in any new program because of the uncertainties regarding market conditions. He noted that other factors, like free ridership, the effect of other efficiency programs (e.g., future changes in standards), program costs and participation rates also create uncertainty for new program implementation.

Mr. Sears asserted that a review of other states' incentive mechanisms does not support inclusion of a disincentive. He noted only one of the 13 states listed by the OUCC with DSM incentives also include a penalty for performance below a threshold. Mr. Sears stated that the failure to earn an incentive on DSM expenditures is in itself a penalty given that by engaging in DSM the utility has already foregone the upside of a return opportunity on supply-side alternatives.

However, Mr. Sears stated that Vectren is amenable to some modifications of its incentive proposal. Recognizing the OUCC's concerns about the level of threshold target to receive a performance incentive, Mr. Sears proposed a more simplified incentive structure

that provides a 15% target incentive (on a pre-tax basis) based upon a bandwidth of performance that recognizes the uncertainties of achieving DSM goals in the early years of program deployment. The incentive is also structured to provide for a larger incremental decrease if performance falls below 80%. He proposed the following modified incentives:

<u>Performance Level</u>	<u>Incentive Level</u>
0% - 64%	0.0%
65% - 70%	2.5%
71% - 80%	5.0%
81% - 90%	10.0%
91% - 110%	15.0%
111% or above	20.0%

While the top tier is reduced under this modified proposal, Mr. Sears stated Vectren continues to believe that achieving savings in excess of 110% of target deserves recognition. He also stated that because the programs pass the TRC test, the additional savings more than pay for any incremental incentive.

Mr. Sears concluded by stating that Vectren's modified cap at 20% of program costs is well within the range of caps in other states. In addition, the 15% of program costs incentive level for achieving target savings compares favorably to the states that authorize an incentive of 12% of net benefits. He indicated this is true because the net benefit approach can provide a greater opportunity than obtaining a percentage of program costs. Mr. Sears further testified that the modified proposal still meets the policy objective to support more aggressive DSM efforts.

Ms. Retherford responded to the NRDC's assertion that Vectren's assumptions regarding CO₂ emissions costs are low. She explained that recent attention given to the carbon issue by the new Presidential administration coupled with the stated intent expressed by both houses of Congress to move carbon legislation this year make the need for an effective DSM program even more pressing. In the absence of commercially demonstrated carbon reduction technology, she stated Vectren will have to rely on the purchase of carbon allowances for compliance with a carbon cap and trade program. An effective DSM program will help reduce carbon emissions and the number of allowances that Vectren will need to acquire for compliance, thus reducing the financial impact to customers from the purchase of those allowances.

9. Commission Discussion and Findings.

A. Legal Consideration of DSM Proposals. The Commission has developed a regulatory framework that allows a utility to meet long term resource needs with both supply-side and demand side resource options in a least-cost manner. As part of its IRP, an electric utility must consider alternative methods of meeting future demand for electric service, including a comprehensive array of demand side measures that provide an opportunity for all ratepayers to participate in DSM, including low-income residential ratepayers.⁹

⁹ 170 IAC 4-7-6(b).

In 1995, the Commission adopted the DSM Rules providing guidelines for DSM cost recovery. The DSM Rules were specifically designed to assist the Commission in its administration of the Utility Powerplant Construction Act, Ind. Code § 8-1-8.5 *et seq.*, and to facilitate increased use of DSM as part of the utility resource mix. As further set forth in 170 IAC 4-8-3(a), the purpose of the DSM Rules was to:

(a) ...[provide] a regulatory framework that allows a utility an incentive to meet long term resource needs with both supply-side and demand-side resource options in a least-cost manner and ensures that the financial incentive offered to a DSM program participant is fair and economically justified. The regulatory framework attempts to eliminate or offset regulatory or financial bias against DSM, or in favor of a supply-side resource, a utility might encounter in procuring least-cost resources. The commission, where appropriate, will review and evaluate the existence and extent of regulatory or financial bias....

(c) To ensure a utility's proposal is consistent with acquiring the least-cost mix of demand-side and supply-side resources to reliably meet the long term electric service requirements of the utility's customers, the commission, where appropriate, will review and evaluate, as a package, the proposed DSM programs, DSM cost recovery, lost revenue, and shareholder DSM incentive mechanisms.

This regulatory framework acknowledges the possibility of financial bias against DSM, recognizes the need to evaluate the extent of any bias, and provides ways for the Commission to eliminate any bias through adoption of a package of cost recovery and incentive mechanisms designed to facilitate the use of DSM to meet the long-term resource needs of customers.

B. Commission Order in Phase II of the DSM Investigation. On December 9, 2009, the Commission issued its Phase II Order in Cause No. 42693, *In the Matter of the Commission's Investigation into the Effectiveness of Demand Side Management Programs* ("Phase II Order"). In this Order, the Commission found that jurisdictional electric utilities, of which Vectren is one, are required to offer certain Core DSM programs ("Core Programs") to all customer classes and market segments. The Core Programs are to include the following: (1) Home energy audit program, (2) Low income weatherization program, (3) Residential lighting program, (4) Energy efficient schools program, and (5) Commercial and Industrial program. To implement these programs, electric utilities are required to pursue coordinated marketing, outreach and consumer education strategies on a statewide basis.

The Commission also determined that an Independent Third Party Administrator should be utilized by the electric utilities to oversee the administration and implementation of the Core Programs. In addition, a DSM Coordination Committee is to be formed to address DSM program oversight generally within the State of Indiana. The Commission also found that a single statewide evaluation protocol was necessary in order to track achievement with

DSM goals. Consequently, jurisdictional electric utilities are required to contract with an independent entity to conduct the EM&V with respect to the Core Programs.

Finally, the Commission found that the associated ratemaking and cost recovery issues associated with an electric utility's DSM programs should be addressed on a case by case basis in individual utility proceedings.

C. Vectren's Proposed DSM Program. Based on the evidence presented, it appears that Vectren's proposed 3 year DSM Program contains many of the programs determined by the Commission in its Phase II Order to be Core Programs. As we have already found that these Core DSM programs are required offerings for jurisdictional electric utilities, the Commission approves Vectren's offering of DSM programs that are considered and determined to be Core Programs in accordance with the requirements of the Phase II Order.

Although the specifics of the Core Programs have yet to be determined, it is clear that Vectren's proposed DSM Program also includes programs that exceed or go beyond the type of programs contemplated to be Core Programs. In addition, when the specifics of the Core Programs are determined in accordance with the procedure set forth in the Phase II Order, it is possible that additional aspects of Vectren's proposed DSM programs may exceed what is determined to be part of a Core Program. The Commission considers these DSM programs, or portions of DSM programs, that exceed the Core Programs to be "Core Plus Programs" and hereby approves Vectren's offering of these programs consistent with the findings set forth below.

D. DSM Program Cost Recovery. The DSM Rules provide that the Commission will determine the cost recovery mechanism for a DSM program when the DSM program is submitted for Commission approval. This is also consistent with the Commission's findings in the Phase II Order.

In this proceeding, Vectren proposes to recover DSM program costs and related incentives by revising Tariff Sheet No. 66 to reflect the addition of these costs and incentives. Pursuant to the settlement approved in Cause No. 43111, the DSMA was created to specifically recover all of Vectren's DSM costs. No party opposed this proposal, and based upon the evidence presented, the Commission finds that Vectren should be authorized to include both the Core and Core Plus Program costs and related incentives in its existing DSMA.

Vectren also proposes to allocate the demand-apportioned program costs for all of the individual DSM programs to all customer classes based on the 4CP (*i.e.*, 4 summer months' coincident peak) class allocators reflected in the DSMA as approved in Vectren's last rate case. The energy-apportioned program costs for all of the individual DSM programs are proposed to be allocated to the rate classes eligible for the DSM programs based on projected energy sales for the upcoming DSMA projection period. The energy-allocated program costs are proposed to be recovered based on actual energy sales to the affected classes, while the demand-allocated program costs are proposed to be recovered from customers via the demand

charges (for rate classes with demand charges) or based on actual energy sales (for rate classes that do not have demand charges). No party opposed this proposal, and based upon the evidence presented, the Commission finds that Vectren's proposed method to allocate costs should be approved for both the Core and Core Plus Programs.

Since Vectren's proposed DSM Program is not being approved as proposed, but is instead being separated into Core and Core Plus Programs, the EEFC proposed by Vectren is likely to change. For example, Vectren proposed to hire seven (7) full time equivalent staff members to assist in the implementation and evaluation of its DSM Program. However, because the Phase II Order provides for implementation and evaluation of the Core Programs by a third party, Vectren may no longer require seven (7) full time employees. Therefore, the Commission finds that Vectren shall provide an updated EEFC as part of the Compliance filing required in Finding Paragraph 9.G. below.

E. Elimination of the Throughput Incentive. Vectren is proposing a rate mechanism, the SRA, to "decouple" its fixed cost recovery from actual customer usage for certain rate classes to incent its offering of DSM programs. More particularly, the Company would compare revenues collected to the revenue requirement set in its last rate case for the customer classes covered by Vectren's DSM proposal. It would then true-up the difference between the actual and the approved revenue requirement so that customers pay the full fixed cost related revenue requirement authorized in Vectren's last rate case regardless of actual sales. Fixed costs are those costs included in Vectren's approved revenue requirement that do not vary based on the number of units sold. Fixed costs that would be decoupled under the Company's proposal include the rate case levels of costs such as, but not limited to, return, depreciation, labor, some O&M expenses, and property and revenues taxes.

Although no party opposed the concept of decoupling an electric utility's rates under any and all circumstances, the OUCC urged the Commission to delay consideration of decoupling until Vectren files its next base rate case. The OUCC does not believe it appropriate for Vectren to move forward with major rate decoupling absent further rate adjustments being made at the same time, such as during a base rate case where a reduction in the ROE to reflect the company's reduced business risk can also be made.

Consistent with our previous findings, we agree with the OUCC's assessment with respect to timing. As noted by the parties, the Commission has previously approved settlements concerning energy efficiency programs for natural gas utilities that have included a decoupling mechanism.¹⁰ The Commission recently recognized in its October 21, 2009 Order in Cause No. 43180, *In re Commission's Investigation into Rate Design Alternatives and Energy Efficiency Measures for Natural Gas Utilities*, that addressing rate design is most reasonable in a base rate case. (p.10.) "In the context of a rate case, parties, and ultimately this Commission, can address and thoroughly review issues regarding revenues, expenses, and cost of service. Further, we agree with the OUCC's comments that decoupling mechanisms

¹⁰ See, *In Re Verified Petition of Vectren North and Vectren South*, Consolidated Cause Nos. 42943 and 43046 (IURC, 12/1/2006); *In Re Petition of Citizens Gas & Coke Co.*, Cause No. 42767, Order on reh'g (IURC, 8/29/2007).

clearly shift risk from the utility to ratepayers, and that reduction of risk should be considered in determining the appropriate return on equity....” *Id.*

Furthermore, Vectren’s decoupling proposal is the first such proposal from an Indiana electric investor-owned utility. Electric utility operations in fully integrated states, such as Indiana, include a production component that does not exist in the gas industry. This production component carries significant long-term fixed cost, variable cost, and short-term fixed cost. In addition, the line between fixed and variable cost is also less clear for electric utilities than for gas utilities.

As it has been more than two years since Vectren’s last rate case, which did not contemplate a decoupled rate design, the Commission declines to approve Vectren’s decoupling proposal at this time. However, the Commission would consider an alternative proposal to recover lost revenues based on the measured and verified results of both its Core and Core Plus Programs consistent with the Commission’s DSM rules in a subdocket to this proceeding should Vectren make such a request within sixty (60) days of the date of this Order.

F. Performance Incentives. Vectren has also proposed a performance incentive mechanism to reward the Company for actual energy efficiency savings achieved. The proposed incentive mechanism is based on the performance of the programs measured in terms of their actual energy (kWh) and demand (kW) savings compared to projected energy and demand savings. To earn an incentive, the savings must be measured and verified by an independent third party. The Company also cannot earn an incentive unless the programs, with the incentive payout, pass the TRC and UCT cost-effectiveness tests.

We note that incentives are authorized pursuant to the Commission’s DSM Rules at 170 IAC 4-8-7(a), which states: “[w]hen appropriate, the commission may provide the utility with a shareholder incentive to encourage participation in and promotion of a demand side management program.” We are also aware that NARUC has issued Joint Resolutions which support the notion of modifying and using regulatory ratemaking practices to align utility incentives to promote cost-effective energy efficiency opportunities, including the use of performance incentive mechanisms to encourage utilities to aggressively pursue DSM.¹¹ The NARUC Resolutions on energy efficiency recognize that current ratemaking structures may act as a disincentive to promoting energy efficiency, and that removing disincentives may not be enough to sustain a meaningful commitment to the promotion of DSM. The NAPEE has also recognized the possible need for adoption of performance incentives to promote aggressive and sustained investments in energy efficiency.¹² Similarly, Congress in the EISA required state regulatory bodies to consider whether to provide utility incentives for the “successful management of energy efficiency programs.”¹³

¹¹ See NARUC’s July 14, 2004 Resolution on Gas and Electric Energy Efficiency and NARUC’s August 2, 2006 Resolution Supporting the National Action Plan on Energy Efficiency.

¹² See, November 2007 NAPEE Report, *Aligning Utility Incentives with Investment in Energy Efficiency*.

¹³ 16 U.S.C. § 2621(d)(17).

With respect to the Core Programs, the Commission found in its Phase II Order that jurisdictional electric utilities should have a standard group of core DSM programs as part of its basic utility service offering. As the Core Programs are required offerings, we find the structure of the regulatory compact in Indiana provides the necessary incentive to encourage the implementation and administration of such programs.

However, with respect to the Core Plus Programs, the Commission finds that a performance incentive mechanism for Vectren is appropriate in light of the Commission's DSM Rules; the strengthening national trend toward promoting energy efficiency; the aggressive savings goals contained in the Phase II Order; and, the evidence of record in this proceeding. The reasonableness of any incentive opportunity hinges on the robustness of the back end evaluation of program results. Here, the evidence indicates that the OUCC and Vectren have jointly agreed to an EM&V process that will use a third party evaluator, and will have an Oversight Board that will review the results of this process and prospectively modify energy savings targets as appropriate.¹⁴ These factors provide reasonable safeguards to having an incentive and are critical to our review of the proposed performance incentive.

In addition, the Commission notes that the Phase II Order (at p. 46) requires jurisdictional utilities to seek "proposals from independent entities to conduct EM&V with respect to the Core Programs and additional DSM Programs undertaken by the parties to ensure that the overall savings objectives identified in [the] Order are being met in a timely and cost effective manner." Consequently, we encourage Vectren to consider utilizing the same third party evaluator selected in accordance with the Phase II Order for its Core Plus Programs.

While the Commission finds the concept of incentives to be appropriate in this instance, and the referenced safeguards have been put in place, we still must determine the appropriate performance threshold at which the Company can begin receiving an incentive, the maximum cap on the incentive, and whether there should be a penalty for achieving 50% or less of the targeted energy savings, as proposed by the OUCC. The following chart compares the OUCC's proposal for performance incentives (Table 1) to that proposed by Vectren (as modified in its rebuttal testimony) (Table 2):

Table 1		Table 2	
OUCC's Proposed Performance Incentive		Vectren's Proposed Performance Incentive	
0%-49%	-4%	0%-64%	0.0%
50%-64%	0	65%-70%	2.5%
65%-74%	2%	71%-80%	5.0%
75%-89%	4%	81%-90%	10.0%
90%-99%	8%	91%-110%	15.0%
100%-120%	12%	111% or above	20.0%

¹⁴ The Commission encourages Vectren to consider utilizing the DSM Coordination Committee established as part of the Phase II Order to also oversee its Core Plus Programs in lieu of its proposed Oversight Board.

After reviewing the evidence, we find that the OUCC has proposed the more balanced and reasonable approach. Vectren, the OUCC, and other interested parties will be responsible for setting the performance targets at reasonable levels for the Core Plus Programs. These parties will continue to collaborate and any target level will come as a result of this collaboration.¹⁵ The collaborative will likely spend considerable time in defining these performance targets and choose levels that can be reasonably achieved. Failure to achieve a minimum performance level should result in a penalty. Likewise, exceptional performance should be rewarded, although not as highly as Vectren has proposed. Therefore, the Commission finds that the OUCC's performance incentive proposal shown in Table 1 above is reasonable and should be approved.

Vectren also proposes that its net operating income ("NOI") for purposes of the FAC earnings test be adjusted by the amount of the actual incentive earned. Vectren proposes that, to the extent necessary, the Commission approve this adjustment pursuant to an alternative regulatory plan as permitted by Ind. Code § 8-1-2.5-6. In each FAC proceeding, the Company's actual NOI is compared to its authorized NOI and if the actual exceeds the authorized, any excess is returned to customers.¹⁶ Vectren believes that including any incentives earned by the Company in performing DSM could increase NOI and put the Company at risk of not retaining the earned incentives. Whereas, excluding earned incentives from NOI for purposes of the FAC earnings test ensures the Company retains any incentives it has earned.

The authorized NOI approved by the Commission is generally determined in the context of a base rate case and based upon an allowed rate of return for a given investment amount in full consideration of the risks confronting the utility's investors. The inclusion of any DSM incentive as a component of a utility's NOI for purposes of the FAC earnings test prevents the utility from earning more than the allowed rate of return embodied in the utility's authorized NOI. The proposed exclusion of such incentive revenue from the NOI evaluation overrides this prevention. This exceptional treatment goes beyond overcoming the general financial bias that the Commission's DSM regulatory framework is designed to accomplish. Accordingly, we deny Vectren's proposal to adjust the FAC earnings test by the amount of actual incentive earned.

G. Compliance Filing. In order to implement the Commission's findings contained herein, Vectren shall make a Compliance Filing in this Cause of its revised Tariff Sheet No. 66 and all supporting documents incorporating the findings herein. Given the significant alterations made in this Order to Vectren's proposed DSM Program, the Commission finds that upon Vectren's filing of its revised Tariff Sheet No. 66 and supporting documentation, the parties to this proceeding shall have ten (10) days to review the filing and notify the Commission of any objections to the filing. If the parties do not raise any objections and the Commission does not otherwise notify Vectren within ten (10) days of its

¹⁵ We note that any performance target established by the Oversight Board will necessarily be considered in Vectren's DSMA filings.

¹⁶ Any return to customers is, of course, subject to the earnings bank calculation provided for in Ind. Code 8-1-2-42.3.

Compliance Filing, the revised Tariff Sheet No. 66 will be approved and become effective upon the date of approval.

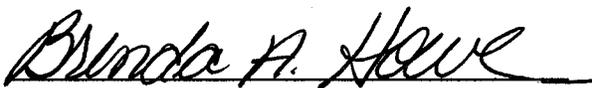
IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. Vectren's proposed DSM Program is approved as modified in Finding Paragraph 9 above.
2. Vectren's proposed Sales Reconciliation Adjustment is hereby denied. If Vectren determines to seek Commission approval of an alternative proposal to recover lost revenues, Vectren shall file such a request in accordance with Finding Paragraph 9.E. above.
3. Vectren shall file with the Electricity Division of the Commission, prior to placing into effect, the revised Tariff Sheet No. 66 for Electric Service and supporting documents in accordance with Finding Paragraph 9.G. above.
4. Vectren's proposed performance incentive for the Core Plus Programs is approved as set forth in Finding Paragraph 9.F.
5. This Order shall be effective on and after the date of its approval.

HARDY, ATTERHOLT, GOLC, LANDIS, AND ZIEGNER CONCUR:

APPROVED: DEC 16 2009

I hereby certify that the above is a true and correct copy of the Order as approved.


Brenda A. Howe,
Secretary to the Commission