

NEW YORK STATE  
PUBLIC SERVICE COMMISSION

At a session of the Public Service  
Commission held in the City of  
Albany on August 20, 2008

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman  
Patricia L. Acampora  
Maureen F. Harris  
Robert E. Curry, Jr.  
Cheryl A. Buley

CASE 07-M-0548 - Proceeding on Motion of the Commission  
Regarding an Energy Efficiency Portfolio  
Standard.

ORDER CONCERNING  
UTILITY FINANCIAL INCENTIVES

(Issued and Effective August 22, 2008)

BY THE COMMISSION:

INTRODUCTION

On June 23, 2008 the Commission issued an order establishing an Energy Efficiency Portfolio Standard (June 23 Order).<sup>1</sup> At that time we noted the potential value of promoting more effective efficiency programs by awarding financial incentives to utilities, but the issue was not ripe for decision. The June 23 Order announced our intention to issue guidance on incentives at least 30 days before certain utility efficiency program proposals would be due to be filed. This order provides that guidance and ensures that there will be no delay in the deadline for the utility proposals.

In this order, the Commission establishes a policy to govern the application of incentives in electric utility

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<sup>1</sup> Case 07-M-0548, Energy Efficiency Portfolio Standard, Order Establishing Energy Efficiency Portfolio Standard and Approving Programs (issued June 23, 2008). A full procedural history of the proceeding is included in the June 23 Order.

efficiency programs. The Commission adopts a model for incentives that (a) establishes potential statewide incentive levels relative to a pre-determined estimate of overall program costs; (b) applies symmetrical positive or negative monetary adjustments based on achieved megawatt-hour reductions; c) applies to all electric utility-administered efficiency programs, and (d) preserves some flexibility in application to ensure that all objectives of a portfolio of efficiency programs are achieved.

#### NOTICE OF PROPOSED RULEMAKING

A Notice of Proposed Rulemaking concerning utility incentives was published in the State Register on November 7, 2007. The minimum period for the receipt of public comments pursuant to the State Administrative Procedure Act (SAPA) regarding that notice expired on December 24, 2007.

#### NOTICE SOLICITING COMMENTS

On May 30, 2008, a Notice Soliciting Comments was issued by the Secretary that invited comment on a set of guidelines developed by the Department's Advisory Staff, an illustrative model to implement the guidelines, and on two other models, a Trial Staff proposal and the incentive mechanism adopted by the Public Utilities Commission of California.<sup>2</sup> Parties were encouraged to comment on: (1) whether incentives are necessary; (2) the reasonableness of the guidelines and any recommended modifications; (3) any other specific issues not encompassed within the guidelines; (4) the strengths and weaknesses of the three incentive models identified and any

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<sup>2</sup> Decision 07-09-043 (issued September 20, 2007). Rulemaking 06-04-010, Order Instituting Rulemaking to Examine the Commission's Post-2005 Energy Efficiency Policies, Programs, Evaluation, Measurement and Verification, and Related Issues.

recommended modifications; and (5) the range of incentive levels that will accomplish the objectives identified in the guidelines.

#### INCENTIVE MODELS

The Advisory Staff Model is based on an estimate of total statewide program costs required to reach the statewide jurisdictional megawatt-hour goal. The model establishes total statewide potential incentives as a percentage of estimated program costs, and expresses the percentage in terms of return on equity basis points. The maximum potential incentive level for all utilities would then be set in advance at that basis point level. For each utility, the maximum potential incentive level would be multiplied by the percentage of the service territory's megawatt-hour target allocated to the utility when its programs are approved; the product of that calculation would be the maximum potential incentive that could be earned by that utility. A utility achieving 75% to 90% of its proposed target would receive no incentive award. Performance below 75% of the target would yield negative revenue adjustments. There would be a linear relationship governing the negative revenue adjustments in the range between 60% and 75%, with the maximum negative adjustment occurring at 60% performance or lower. Performance above 90% of the target would yield positive incentive awards. The total amount of the maximum incentive would be spread over the 90% to 120% range. There would be a linear relationship governing the positive incentives in the range between 90% and 100% of the target, as well as a second, more gradual, linear relationship governing the range between 100% and 120% of the target. The maximum positive incentive would occur if 120% of the target were achieved.

Trial Staff's incentive model is based on the size of a utility's program budget. Up to 5% of program budget would be

available as a reward for achieving between 85% to 100% of the program megawatt-hour goal. Up to 9.5% of program budget would be available for program achievement between 101% to 111% of program goal, and up to 12% of program budget would be available for achievement between 112% to 122% of the program goal.

Achievement of less than 85% of the program goal, but more than 60%, would be ineligible for any incentive payment. Substandard performance, defined as achieving less than 60% of the program goal, would result in a negative revenue adjustment equal to 33% of the maximum incentive, while the remaining 66% of the maximum incentive amount would be assessed as a revenue adjustment for each unit of savings not achieved between 1% and 59% of the goal.

The California incentive plan is based on a sharing of net resource benefits between customers and utilities. If a utility meets 85% of its megawatt-hour savings target, it begins to earn 9% of the net benefits, measured in dollars, achieved by the program. If performance exceeds 100% of the goals, the earnings rate increases from 9% to 12%. If performance falls to 65% of the target or lower, the greater of two adjustments applies; a per-unit adjustment or a "cost effectiveness guarantee" which obligates shareholders to pay ratepayers the value of any negative net benefits. Total positive incentives are capped at \$450 million per year, which corresponds to \$3.9 billion in net benefits.

#### COMMENTS OF THE PARTIES

##### General Comments

Commenting parties can be classified into five groups: utilities; government entities; large customer advocates; not-

for-profit public advocates; and energy service providers. Initial comments were received from 21 parties.<sup>3</sup>

Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities (Con Edison/O&R) strongly support the use of financial incentives for utility-administered efficiency programs, and support using net resource benefits as the basis for calculating incentives. Con Edison/O&R caution that the Commission should refrain from adopting a uniform incentive mechanism directly applicable to each utility in advance of authorizing programs for each utility. They note that there are significant differences among utility service territories, especially between upstate and downstate regions. They urge that the Commission adopt principles only, and that those principles be tailored to the individual circumstances of each utility. They also suggest that, in order to avoid delay, deliberation on incentives can proceed in parallel with the authorization of programs.

Con Edison/O&R urge the Commission to adopt six principles, as follows: (1) financial incentives to utilities are essential to assure successful programs; (2) financial

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<sup>3</sup> New York State Consumer Protection Board; Multiple Intervenor; National Association of Energy Service Companies; New York Energy Consumers Council, Inc.; Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities; Natural Resources Defense Council; Pace Energy and Climate Center and the Association for Energy Affordability; Niagara Mohawk Power Corporation d/b/a National Grid; New York Independent System Operator; The City of New York; National Fuel Gas Distribution Corporation; Allied Converters, Inc.; The Alliance for Clean Energy New York; Dutchess County; The Independent Energy Efficiency Program; Central Hudson Gas & Electric Corporation; New York State Electric and Gas Corporation and Rochester Gas & Electric Corporation; EarthKind Energy; EnerNOC, Inc.; Community Environmental Center; and the New York State Department of Environmental Conservation.

penalties<sup>4</sup> may be appropriate, but need to be developed considering the uncertain nature of the targets and the lack of complete control utility management has over the results; (3) large scale energy efficiency programs may have negative financial implications for utility investors, in the absence of financial incentives; (4) incentives should be determined based on a sharing of net resource benefits; (5) any cap on incentives should be high enough to mitigate the negative financial impacts from large-scale energy efficiency programs and should not be based either directly or indirectly on program costs; and (6) the primary feature of an incentive program should be that a utility achieving a high percentage of its targets should be able to retain a non-trivial portion of the net resource benefits.

Central Hudson Gas & Electric Corporation argues that incentives are necessary because utilities are entitled to an opportunity to earn the level of profits that could be earned if the products and services were provided in a competitive marketplace. Central Hudson argues that performance incentives can only be evaluated properly in the context of the EEPS program implementation. It asserts that incentives must allow utilities to achieve the market penetrations and program innovations that will be necessary to persuade large numbers of customers to participate in energy efficiency measures. Central Hudson notes that the degree of difficulty for various types of efficiency programs will differ and that uniform incentive levels will necessarily be flawed in the absence of a demonstration to the contrary. Central Hudson argues that utility incentives should not be directly tied to a minimum

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<sup>4</sup> Several parties utilize the term "penalties" to denote negative revenue adjustments. Negative adjustments associated with incentive mechanisms should not be confused with penalties pursuant to Section 25 of the Public Service Law.

level of results, but rather that utilities are entitled to earn a profit from the first efforts they make and the first units of savings they produce. Central Hudson observes that utility incentives employed by the Commission in the 1980s, based on the value of net benefits, should not be rejected now when the Commission has recognized the increased value and necessity of energy efficiency as a critical element of State policy. Central Hudson argues that incentives should be applied to all savings produced and that incentive floors or deadbands are not appropriate.

National Grid also supports incentives and cites its experience implementing energy efficiency programs in other jurisdictions. National Grid states that in other jurisdictions, when the Company's interests are fairly aligned with energy efficiency and environmental objectives, both customers and the public realize substantial benefits.

National Fuel Gas Distribution Corporation (NFG) takes the position that a revenue decoupling mechanism provides the most effective mechanism for the removal of disincentives and that there is no need for additional financial incentives. NFG cautions that financial incentives can in fact be counterproductive.<sup>5</sup> NFG observes that the size of proposed incentives, relative to overall revenues, are not of sufficient materiality to capture management's attention beyond the level that currently obtains. NFG further expresses the concern that incentive mechanisms can evolve over time into mechanisms with only negative adjustments. Finally, NFG argues that the additional administrative, legal, and measurement and

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<sup>5</sup> NFG notes that its comments are limited to incentives for gas distribution utilities and are not intended to apply to electric utilities.

verification overhead costs incurred in order to implement incentives will increase costs for all parties involved.

New York State Electric and Gas Corporation and Rochester Gas and Electric Corporation (NYSEG/RG&E) caution that incentive and disincentive mechanisms are most appropriate where the companies have control over the success of their efforts. NYSEG/RG&E express concern that an incentive structure related to energy efficiency may be inappropriate in the near term because utilities generally have not focused on energy efficiency management, and the ultimate decision to participate in the program resides with customers. NYSEG/RG&E state that incentive mechanisms based on verified results might be appropriate for longer-term energy efficiency programs once more experience has been gained, but that it is premature to adopt such a system for the fast track programs. As an alternative, NYSEG/RG&E suggest that a near-term incentive mechanism could be designed based on milestones within the companies' control, including various implementation, outreach and education, and customer awareness measures.

The Independent Energy Efficiency Program (IEEP), the energy efficiency arm of 24 municipal utility systems, argues that incentives are unnecessary and inappropriate. IEEP states that energy efficiency services are a core mission of its member systems and that providing energy efficiency is an obligation.

The New York Independent System Operator (NYISO) generally endorses the use of both positive and negative performance-based incentives. The NYISO emphasizes the need for clear and consistent measurement and verification of results, so that its electric system planning working group has a firm basis on which to decide how to include efficiency plans in its reliability planning efforts.



The City of New York agrees with those utilities that argue that net resource benefits should be the principal basis for awarding utility performance incentives. The City argues that it would be a form of false economy to deny utility incentives in order to reduce overall expenditures, if such a course also sharply reduced the likelihood of success. The City strongly cautions against the use of highly complicated or finely calibrated incentive and disincentive structures. The City argues that incentives are far more likely to gain the commitment of utility management if they are simple, readily understood, and not subject to gaming.

The Consumer Protection Board (CPB) argues that energy efficiency can be ordered by the PSC as a least-cost means of ensuring just and reasonable rates, and, therefore financial incentives are not strictly required. CPB also disagrees that utilities should earn a return on efficiency spending that is comparable to supply-side investments, because funding for efficiency programs will be recovered as incurred.

Notwithstanding this analysis, the CPB recommends that utilities be provided reasonable financial incentives, to ensure their long-term commitment to the objective of this proceeding. CPB argues that specific utility incentives should be calibrated to the degree of difficulty of the programs, taking into account the aggressiveness of the targets, whether the proposals are innovative, and the extent to which they produce permanent rather than temporary energy efficiency savings. CPB also proposes that incentives should take into account whether the efficiency projects demonstrably obviate the need for ratepayer-funded utility investment in supply-side infrastructure.

Dutchess County states that utility incentives may be appropriate, but that a single rigid policy should not be applied and incentives should be considered in individual rate

case proceedings. The County cautions that providing incentives at levels above existing rates of return may be insensitive to the concerns of ratepayers.

Multiple Intervenors (MI) opposes the provision of financial incentives to utilities. MI states that incentives are not necessary, would further increase the already substantial cost of the EEPS, and are highly susceptible to gaming. The Commission, MI argues, can simply direct the State's utilities to administer efficiency programs. MI states that the Commission routinely establishes new requirements for utilities, for example, stray voltage testing and flex-rate contracts, without finding it necessary to offer financial rewards for utility compliance. MI states that incentives will induce gaming because incentives linked to costs will induce utilities to spend as much money as possible on programs, while incentives linked to performance cause utilities to overstate reductions achieved or understate projected reductions. MI argues that not only the program administrators, but also the Commission itself, will be highly motivated to cast program results in a favorable light, and that financial incentives for utilities would exacerbate this tendency. In the event the Commission does adopt utility financial incentives, MI argues that they should be very limited in magnitude.

The New York Energy Consumers Council (NYECC) states that incentives are not necessary. They may be appropriate where utilities achieve superior results, NYECC asserts, if those superior results can be measured with confidence and if the original targets are not artificially low.

Alliance for Clean Energy New York (ACE NY) supports the use of incentives and disincentives for utilities, with the caveats that adequate measurement and verification will be

essential and that the majority of cost savings should remain with consumers.

Natural Resources Defense Council, Pace Energy and Climate Center, and the Association for Energy Affordability (NRDC/Pace/AEA) argue that incentives are important to ensure that the utilities assign the requisite corporate management attention and programmatic and fiscal resources to efficiency programs. They observe that revenue decoupling mechanisms only remove a disincentive and do not provide an affirmative incentive. NRDC/Pace/AEA argue that incentives should be based on actual verified performance, but that additional metrics tied to other criteria, such as low-income participation, should also be used to avoid an exclusive focus on savings to the potential detriment of considerations such as equity and comprehensiveness.

EnerNOC generally supports the proposals to provide incentives, with the condition that incentives should also be applied to demand response programs.

The National Association of Energy Service Companies (NAESCO) supports utility incentives calculated as a percentage of net benefits.

Earth Kind Energy also supports incentives, but adds that incentives should reflect the varying lifespans of efficiency measures, so that measures with a longer than average lifespan are properly encouraged.

Allied Converters Inc. states that utility incentives are needed to induce utilities to implement efficiency measures. Allied Converters argues that there are many efficiency improvements that utilities could have enacted prior to this time, except that regulatory structures made it more profitable for the utilities to ignore the efficiency improvements.

Community Environmental Center supports utility incentives but urges that utilities' customer-enrollment processes need to be examined, and that climate change mitigation should be among the factors in measuring the effectiveness of utility programs.

Specific Comments on Advisory Staff Guidelines<sup>6</sup>

1. The overall objectives of performance incentives in the context of energy efficiency are to:  
(1) encourage superior performance and deter weak performance; and (2) align utilities' financial interests with energy efficiency as a resource option.

Con Edison/O&R support this principle except to the extent that it would be used to deter weak performance. They argue that the Commission should not penalize utilities if they have prudently incurred expenses and that an alternative remedy is simply to reduce the utility's role, or put it out of the energy efficiency business. Con Edison/O&R further argue that promotion of energy efficiency is not one of the Company's statutory responsibilities, which makes it more appropriate for incentives to be used.

Central Hudson states generally that the Advisory Staff Guidelines are not specific enough to support detailed comments. Central Hudson states that neither of the Staff positions would align utilities' financial interests with energy efficiency because they are based on program targets and would reward safe programs, not innovation.

National Grid agrees with Guideline #1, particularly given the urgency for achieving significant results, and supports inclusion of financial disincentives, so long as they are not punitive and do not deter innovation.

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<sup>6</sup> The guidelines are enumerated here as proposed by Advisory Staff in the Notice Soliciting Comments.

National Fuel does not agree that incentives are required for the purposes described in the guideline and cautions that incentives might shift management's focus to achieving incentive targets without regard to the ultimate objective.

NYSEG/RG&E do not agree that utilities should be at risk for failure to meet targets that depend ultimately on customer acceptability and action. NYSEG/RG&E state that failure to meet objective milestones within the company's control could reasonably put utilities at risk for disincentives.

CPB argues that utilities do not require a return on energy efficiency that is equivalent to the return they earn on other resource options, because funding for energy efficiency programs will be provided entirely from ratepayers on an as-needed basis. CPB recommends that a third overall objective be included: to assure the long-term sustainability of the Commission's ratepayer-funded energy efficiency program. According to CPB, excessive incentives will jeopardize the long-term sustainability of the overall effort.

Dutchess County comments in general that a number of the incentive guidelines rely on measurement and verification that will be very difficult to achieve.

MI observes that financial incentives should not be necessary to encourage compliance.

NYECC generally agrees with Advisory Staff's Guidelines, subject to the overriding condition that only superior results should be rewarded.

NRDC/Pace/AEA state that the Advisory Staff Guidelines generally represent a balanced workable approach. With respect to Guideline #1, they emphasize that the incentives must be to promote performance, not excessive program cost levels.

2. The maximum amount of money available to utility stockholders from an energy efficiency incentive should account for the size of the utility program portfolio target relative to the jurisdictional goal for the utility's service territory, and should encourage improved utility performance without placing an excessive burden on ratepayers.

National Grid disagrees with this Guideline to the extent that it contemplates a top-down allocation of efficiency targets to each utility, rather than developing targets through studies undertaken by individual utilities.

Con Edison/O&R generally agree with this concept, but emphasize that basing an incentive on net resource benefits will not place an excessive burden on ratepayers. They also stress that a cap will not be effective because it will encourage utilities to seek efficiency only up to the cap and no further.

NYSEG/RG&E argue that the maximum incentive should be based on achievable net benefits.

The City of New York acknowledges the inherent tension between generous incentives and the burden placed on ratepayers, but cautions that consideration of this topic should not be too short term in nature, and that the short-term burden placed on ratepayers by incentives should be considered in the context of the long-term benefits of efficiency programs.

CPB does not dispute this Guideline, but would not consider it a complete list of factors. In particular, CPB would also account for the degree of difficulty of achieving energy efficiency targets and the extent to which permanent rather than temporary energy savings are obtained.

MI does not disagree with the Guideline as an abstract principle, but expresses skepticism that any incentive program can be accomplished without placing an excessive burden on ratepayers.

ACE NY disagrees with the implication of the phrase "without placing an excessive burden on ratepayers," because it implies that consumers will not see corresponding economic benefits from efficiency programs.

NRDC/Pace/AEA agree with Guideline #2 in principle, and, like other parties, argue that incentives based on total net benefits will not place an excessive burden on ratepayers.

3. The formula by which a maximum monetary incentive and intermediate monetary incentives and disincentives are calculated should not induce utilities to increase program costs artificially or to manipulate the program design and implementation inappropriately.

Con Edison/O&R and National Grid interpret this principle as meaning that incentives should not be based on a percentage of program costs, with which they agree.

NYSEG/RG&E caution that this principle should not be used to artificially discourage expansion of a successful program.

The City of New York cautions that elaborate incentive schemes will permit parties to manipulate numbers or program expenditures. The City observes that mature efficiency programs with known or predictable results should not be treated identically to efforts that are untested, and that concerns about manipulation of program design should not prevent implementation of new and innovative programs. According to the City, this emphasizes the need for direct Staff oversight.

CPB supports this principle and emphasizes the need for thorough review and analysis of proposed programs.

MI agrees with the goal of this Guideline, but again expresses skepticism that any incentive mechanism could avoid creating inappropriate inducements. If incentives are linked to program costs, an inducement is created to spend as much as

possible, and if incentives are linked to benefits achieved, inducements are created to overstate reductions and understate projections.

NRDC/Pace/AEA agree with this Guideline and, like the City and CPB, note that it highlights the importance of the Commission and Staff exercising oversight over program design and approval.

4. The incentive formula should provide for both positive and negative revenue adjustments.

Con Edison/O&R disagree that negative adjustments are appropriate where the utility has acted prudently.

National Grid agrees in principle that both incentives and disincentives may be reasonable, but only where targets are developed through a utility-specific process. Incentives indexed to targets that are based on statewide allocations may present unreasonable risks because the targets may be set too high or too low.

NYSEG/RG&E oppose disincentives for programs that ultimately depend on customer acceptance and which utilities do not have recent experience in implementing.

The City agrees that both positive and negative revenue adjustments are needed, but cautions that if the formula is too finely drawn, it will create protracted debate and potential litigation.

MI also agrees, noting that the maximum amount of potential negative adjustments should at least equal the maximum amount of positive adjustments.

CPB and NRDC/Pace/AEA agree that any incentive formula should provide for both positive and negative revenue adjustments.



5. The effectiveness of a utility's energy efficiency program portfolio, based on measurement and verification results, should be the basis for determining revenue adjustments.

Con Edison/O&R agree with this principle while reiterating that measurement and verification protocols should be the same for all program administrators including public authorities and private sector administrators.

National Grid agrees that M&V should be the basis for assessing incentives, but suggest that the best estimate of savings from program efforts available at the end of each program year should be the basis for determining performance.

NYSEG/RG&E reiterate that these mechanisms, applied to fast-track programs, would be too detailed and would risk penalizing utilities for the failure of customers to participate.

CPB states that it is of paramount importance that actual, verified energy efficiency results, as opposed to projections, be used to determine financial incentives.

MI agrees with the guideline in principle, but observes that there are a wide variety of ways in which the evaluation of program performance can be gained.

NRDC/Pace/AEA argue that this guideline is critical and should be strengthened. They state that not only should measurement and verification be the basis for measuring performance, but also that it must be independent.

6. The utility must achieve a high percentage of its target before realizing a positive revenue adjustment tied to performance.

National Grid does not oppose a threshold level for earning incentives, but cautions that if the threshold is set too high it would discourage sustained program efforts if it

appears to the utility that actual performance will fall short of the threshold.

Con Edison/O&R disagree with Guideline #6 and argue that it has no basis in economics. They argue that because every megawatt-hour achieved by a utility will produce net resource benefits, a utility should be able to earn an incentive for each megawatt-hour achieved. Moreover, because the utilities are just beginning to ramp up their efficiency program efforts, any thresholds set should be set at a relatively low level.

NYSEG/RG&E agree that a relatively high percentage of the target should be achieved before a positive revenue adjustment is awarded.

The City of New York would modify this guideline to take into account the achievable potential, the relative amount of responsibility placed on the utility, and the overall maturity of the utility program. The City argues that a new and untried program should be given greater latitude in the City of threshold levels. The City suggests that a number at or near 80% would be a reasonable target achievement level, while achievements greater than 120% should be rewarded with a supra normal revenue adjustment.

CPB agrees that 80% would be a reasonable level for achievement of a positive incentive.

MI states that, if incentives are adopted over its objections, this guideline is essential, and the threshold level should be set at or near 100% of the targets.

NRDC/Pace/AEA agree that a high percentage of the target should be realized; they propose that this threshold be set at 85%.

7. The primary gauge for determining the effectiveness of a utility's energy efficiency program portfolio should focus on verified megawatt-hour savings. For programs that are approved with a specific peak reduction target, the primary gauge should be MW savings.

Con Edison/O&R agree with this principle, with the clarification that peak demand should not necessarily mean summer daytime coincident bulk-power peak, but can also mean the relevant network peak.

National Grid would seek to clarify this guideline with the suggestion that the primary measure should be the creation of net benefits quantified using the preliminary year-end estimate of savings compared to the expected net benefits in the pre-approved energy efficiency plan.

The City also suggests that net benefits be the primary gauge, with megawatt or megawatt-hour savings included as a secondary consideration. The City adds that additional criteria will need to be incorporated for programs such as low-income efforts.

CPB cautions that the megawatt-hour savings used as a gauge for incentives must explicitly exclude free ridership.

MI objects to the use of megawatt-hour savings as a sole determinant of effectiveness and argues that program costs must be considered as well. MI notes that the megawatt-hour goal established for this proceeding should have been compared to all possible alternative goals.

NRDC/Pace/AEA argue that energy savings should not be the only criterion established, but that other performance criteria based on comprehensiveness and equity should be adopted as well. NRDC/Pace/AEA observe that the guidelines are silent as to what timeframe should apply to the revenue adjustments, and recommend that a three-year timeframe be adopted. They

argue that annual metrics may tend to focus utilities on short-term resource acquisition.

8. Incentives should be calculated over aggregated portfolio performance rather than by specific programs; however, a mechanism must be in place to assure that individual program targets are not sacrificed to maximize incentives.

Con Edison/O&R agree that incentives should be based on performance of an entire portfolio, but they disagree with this guideline to the extent it would prevent reallocation of money between and among programs. Con Edison/O&R maintain that an inability to reallocate money among programs would inhibit utilities from pursuing innovative programs. They argue that innovation should be encouraged, but that the utility must have the ability to reallocate the funds away from a program that is not performing in a cost-effective manner. Con Edison/O&R acknowledge that the ability to reallocate funds should be restricted with respect to certain programs that have other important public policy goals, e.g. aid to low-income customers.

National Grid also agrees that incentives should be calculated over a portfolio, but has concerns regarding the flexibility of shifting funds among programs. National Grid suggests that any budget-control mechanisms should focus on customer classes rather than specific program budgets, to ensure that all customer classes receive the appropriate level of focus. NYSEG/RG&E share the concerns of Con Edison/O&R.

The City of New York and CPB agree with this guideline. NRDC/Pace/AEA also agree that incentives should be calculated over aggregated portfolio performance, while stating that the best mechanism to ensure that individual program targets are not sacrificed is vigilant regulatory oversight.

MI disagrees with this guideline. It states that superior performance on one program should not relieve the

utility of the negative consequences associated with poor performance on another program. Moreover, because positive adjustments from some programs would be offset by negative adjustments from other programs, applying incentives on an individual program basis might be the equivalent to a portfolio approach, without the additional complication of devising a mechanism to ensure that certain programs are not sacrificed. MI also argues that applying financial incentives on an individual program basis would provide greater transparency regarding a utility's performance.

9. Incentives would not be available for programs in which a utility transfers funds from ratepayers to NYSERDA. (This principle would not preclude a utility from obtaining incentives for a program that it undertakes that was previously conducted by NYSERDA with ratepayer funds transferred by the utility).

Con Edison/O&R agree that a utility would be entitled to a lesser incentive if it is not actually administering a program, but they argue that incentives should be available when utilities support NYSERDA by providing outreach and marketing support. Con Edison/O&R note that Con Edison was entitled to an incentive of \$22,500 for each megawatt enrolled in a NYSERDA program pursuant to its three-year rate plan adopted in Case 04-E-0572.<sup>7</sup>

National Grid states that the proposed guideline should apply only where the utility's activities are limited to providing funding and not substantive assistance.

The City of New York and CPB agree with the utilities that incentives should be available where utilities provide marketing assistance to NYSERDA.

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<sup>7</sup> Case 04-E-0572, Consolidated Edison Company of New York, Inc. - Electric Rates, Order Adopting Three-Year Rate Plan (issued March 24, 2005), Joint Proposal, Appendix A, at 71-72.

Multiple Intervenors and NYSEG/RG&E agree with the guideline.

NRDC/Pace/AEA also agree with the guideline, and add that there must be clarity regarding how savings and spending are allocated between a utility and NYSERDA, to avoid double counting.

CPB suggests that the guideline be treated as a rebuttable presumption.

10. Consistent statewide incentive principles based upon overall program performance are necessary for ease of administration and to prevent confusion among potential market participants.

Con Edison/O&R agree that statewide principles are appropriate, but caution that the application of principles must take place on a utility-specific basis. They further suggest that the reference to "confusion among potential market participants" is unclear and should be eliminated.

National Grid supports a consistent application of incentive principles statewide. NYSEG/RG&E also agree with this guideline.

CPB agrees with Con Edison/O&R that differences among utilities and regions may warrant differences in the structure and size of incentives.

NRDC/Pace/AEA agree with the guideline. MI also agrees with this guideline, noting that absent statewide principles, adoption of utility-specific incentive proposals would be contentious, possibly leading to litigation.

11. Incentives (assuming performance at 100% of the utilities proposed program target) must be included in the cost estimates of program proposals.

Con Edison/O&R argue that incentives have traditionally not been part of the total resource cost test,

which has included only direct program costs. If utility incentives are included in the cost calculation, Con Edison/O&R argue that the Commission should ensure that all the costs of NYSERDA programs also be included when making comparisons. These costs would include administrative fees, the time value of funds, and all costs associated with utility outreach and marketing for NYSERDA programs. In addition, Con Edison/O&R argue that fair consideration of NYSERDA program costs in the Con Edison and O&R territories should take into account the total funds provided by those utilities compared to the likely amount of benefits to be obtained in those territories from the NYSERDA programs.

National Grid agrees that shareholder incentives should be included as a cost when assessing program cost-effectiveness, provided that in an incentive mechanism that uses net benefits as an index, the cost of incentives should be excluded from the calculation of net benefits.

NYSEG/RG&E, CPB, NRDC/Pace/AEA, NYECC and Multiple Intervenor agree with this guideline.

#### The Advisory Staff Illustrative Model

National Grid is concerned that the model is based on estimates of statewide program costs, rather than being informed by utility-specific assessments based on unique service territory and customer attributes. National Grid also objects to basing the equity returns on program costs rather than on expected net benefits. With respect to the neutral band, National Grid suggests that it should be set at a lower percentage level, considering the aggressive energy savings targets of the overall program. Although National Grid supports the inclusion of a negative revenue adjustment, it cautions that setting the performance level too high will discourage new and innovative programs. National Grid recommends that a target

incentive rate be applicable to results greater than 75% up to 100%, with a higher incentive rate for results from 100% to 125%.

NYSEG/RG&E state that the Advisory Staff model lacks the detail necessary for a complete evaluation and is not clear on whether it would apply to the utility expedited programs, or only the longer-term programs.

The NYISO states that the illustrative model is unnecessarily convoluted and contains too many inflection points, which may be costly to administer. The NYISO believes that it would be better to use a simple linear ramp between the highest and lowest incentive levels.

The City of New York takes exception to the model's reliance on a percentage of program costs. According to the City, the model would fail to take into account the variability between modest and incremental programs, and more aggressive or far-reaching ones. The City also opposes the use of sharply graduated thresholds, noting that moving from a 59.99% to 60% achievement would eliminate a significant adjustment, while moving from 79.99% to 80% would result in a significant incentive. According to the City, such a model would give rise to a false aura of precision that cannot be realized in practice. The City recommends that the mechanism would be much simpler and less contentious if the incentive levels rose smoothly.

NRDC/Pace/AEA are concerned that an incentive mechanism that works through rates of return on rate base may create a perverse incentive for utilities to expand their rate base by increasing capital investments, which is counter to the objectives of the proceeding.

MI supports many aspects of Advisory Staff's model, assuming that any incentive model will be adopted, but expresses



concern that no relationship between return on equity basis points and efficiency programs has been identified. MI is also concerned that the structure of the model would induce utilities to administer only programs for which financial rewards appear easy to attain. MI is also concerned about the use of the utilities' proposed target as a performance threshold, given the difficulty in determining whether a proposed target is reasonable. Finally, MI argues that no incentives should be awarded for performance lower than 100% of a target.

#### The Trial Staff Model

National Grid objects to the use of program costs, rather than net benefits, as a basis for awarding incentives and also suggests that the percentage of target that must be achieved before a utility may earn an incentive should reflect the challenges involved in meeting the program targets. National Grid advocates that a negative adjustment should only be applied when less than 50% of a goal is achieved. National Grid supports the ability in the Trial Staff model to consider incentives for utilities working with NYSERDA to implement programs.

NYSEG/RG&E object to the Trial Staff model insofar as it would award incentives based on individual program targets rather than a portfolio, which might constrain utilities from directing program resources to the most effective energy efficiency programs. NYSEG/RG&E also recommend that incentives should be based on net benefits rather than program costs.

CPB opposes the use of 12% of program budget as a maximum incentive, arguing that such an incentive level is excessive.

NRDC/Pace/AEA argue that the Trial Staff method of allocating a percentage of program costs would not meet the objective of causing utility managers to view energy efficiency

as a core part of the utility's operations. NRDC/Pace/AEA also oppose limiting incentives to efficiency savings that are within 122% of program targets.

NAESCO argues that the methodology used by Staff to develop incentives based on program costs is not as transparent as awarding a simple percentage of net benefits.

MI states that Trial Staff's incentive structure is relatively straightforward and seeks to limit customer exposure to incentive costs while balancing customer and utility interest. MI has four objections to Trial Staff's proposals. First, MI argues that the structure would create a strong inducement for utilities to spend as much money as possible in order to maximize potential incentives. Second, MI states that under this model, utilities would have an inducement either to overstate reductions achieved or to understate projected reductions. Third, MI argues that a utility achieving only 61% of its performance should not be held harmless for a mediocre performance. Finally, MI argues that 100% of the targeted performance should be the minimum threshold for receiving an incentive.

#### The California PUC Model

National Fuel notes that the California model is based on the premise that there is an inherent utility bias toward supply-side procurement. National Fuel states that, while this may be true for certain electric utilities that may own and operate electric generation facilities, it is not true for New York's natural gas LDCs.

National Grid supports the California Model insofar as it is based on a sharing of net benefits, but does not support the inclusion of separate metrics uniquely focused on megawatt, megawatt-hour and savings targets. National Grid also suggests that incentive calculations should be closed out on an annual

basis rather than requiring the utilities to wait for 18-month and 36-month evaluations. National Grid also objects to the requirement of the California model that, whenever portfolio costs exceed verified savings, shareholders must pay ratepayers back on a dollar for dollar basis; the company argues that this will discourage innovation.

Con Edison/O&R generally favor the California model because it bases returns on net benefits and seeks equivalency with supply-side returns. Con Edison/O&R claim that New York's efficiency goal is more aggressive than California's, as a percentage of incremental electricity needs, which makes it all the more important for incentives to be used to motivate utility managers to view energy efficiency as a core business activity.

NYSEG/RG&E note that California's incentive mechanism was the result of a lengthy and extensive process including evidentiary hearings and workshops. NYSEG/RG&E caution against adopting incentives without a comparable level of scrutiny. NYSEG/RG&E also observe that the California Commission has restored utilities to their traditional energy procurement responsibilities, in contrast to New York, and that this responsibility clearly influenced the incentive mechanism adopted in California. NYSEG/RG&E support the California model's utilization of general targets which allow utilities flexibility in allocating resources across specific programs.

CPB opposes the California model, arguing that California's regulatory structure is not comparable to New York's, and that incentives awarded in California would be excessive for New York. CPB argues that because California's utilities have more supply-side responsibilities, the rationale of making efficiency programs comparable to supply-side investments is more applicable in California than in New York.

The City of New York agrees that the California model

is too rich in incentives to serve as a model for New York. The City also argues that the California model is too complex and is based on an unrealistic level of precision in measuring results.

The New York State Department of Environmental Conservation notes that California's incentive system provides separate treatment for low-income programs so that they are not disadvantaged.

NRDC/Pace/AEA endorse the California model, arguing that while the model may provide a larger financial benefit to a utility that performs well, the large majority of the benefits of better performance will remain with customers. In addition, they argue that tying incentives to net benefits, rather than program budgets, ensures that utilities implement cost-effective programs at least cost.

NAESCO endorses the fundamental principles of the California model, but does not support the complexity of its mechanism.

MI argues that the California model is too complex and would be subject to manipulation and gaming. MI also objects that incentives should not be awarded for achieving only 85% of targeted performance or that negative adjustments should begin only at the level of 65%. MI argues that any proceeding that seeks to determine the value of resource benefits would be extremely contentious, and that the net result of the California model applied in New York would increase the burden on customers already imposed by the EEPs program.

#### Range of Incentive Levels

National Fuel suggests that as an alternative to the incentive mechanisms proposed in the Notice, the Commission could entertain proposals from utilities to allow them to earn returns on their investments on energy efficiency programs, including a greater rate of return for efficiency investments

than would otherwise be achieved for typical utility plant investments.

Con Edison/O&R state that a reasonable percentage level would be 10% of net customer benefits.

National Grid would recommend 10% of net benefits for performance between 75% and 100% of a target, and an enhanced reward of 15% for achieving over 100%.

NYSEG/RG&E observe that there are precedents for a wide range of incentive levels and that the relative importance that the Commission attaches to energy efficiency goals should inform its ultimate decision on incentive levels.

CPB recommends that incentives for achieving 100% of efficiency targets be in the range of 5% to 6% of program costs. CPB cites neighboring states, such as Massachusetts and Connecticut, which provide incentives based on 5% of program costs. CPB also cites an American Council for an Energy Efficient Economy (ACEEE) report which shows that of 16 states that have energy efficiency programs administered by utilities, six have no incentives at all.

The City of New York recommends 5% of net benefits for performance between 80% and 100% of a target, 10% of benefits between 80% and 110%, and 15% of benefits for performance above 110% of targets. The City states that under its proposal, incremental savings would result from incremental benefits without any abrupt graduations.

Dutchess County suggests that incentives should not exceed existing rates of return. Allied Converters Inc. suggests that incentives should approximate a reasonable return but should not provide a windfall.

NRDC/Pace/AEA recommend the incentive levels adopted by the California PUC.

NYECC suggests that 10% of program budget is a reasonable incentive level, but only for superior performance and only when accompanied by the possibility of negative adjustments.

REPLY COMMENTS

Multiple Intervenors notes that several utilities are viewing energy efficiency as a profit center, while others are prepared to forsake financial incentives. MI argues that the overall rate impacts of the EEPs program are too high and should not be exacerbated further with utility incentives.

MI challenges the assertion of Central Hudson, that a utility is entitled to earn a profit on the first unit of electricity saved through an efficiency program. MI argues that a utility is not entitled to a private-sector profit, because the utility bears little risk when implementing a ratepayer-funded program. MI further argues that a utility is not entitled to a profit where it might have done a poor job in implementing a program.

MI states that utilities should not be able to demand incentives as the price for complying with Commission policy, so long as utilities are kept whole for their expenditures. MI challenges National Grid's assertion that improperly structured incentives might cause utilities to "give up" on certain programs.

MI argues that incentives, if they are to be approved, should be postponed until a later phase of the proceeding when all cost allocation issues have been resolved.

National Grid argues that incentives serve the practical purpose of focusing a utility's management attention. National Grid agrees that the vast majority of benefits should be retained by customers, but that a benefit-based incentive

program will encourage resourcefulness and innovation in the design and implementation of programs.

With regard to incentives for assisting NYSERDA programs, National Grid states that it may be appropriate to consider the level of involvement rather than customer savings as a metric for calculating incentives.

National Grid disputes CPB's characterization of the Massachusetts incentive program. National Grid states that Massachusetts' incentive design is not directly comparable because Massachusetts has a relatively modest efficiency program, and that the pretax incentive rate in Massachusetts is approximately 8.2%. National Grid also observes that none of the New England programs include negative adjustment risks for utilities.

NFG emphasizes that utilities must be willing partners in the State's effort to achieve efficiency goals, and that a disproportionate level of risk will frustrate that objective. NFG argues that the proposal of CPB would place tight limits on utility gains while leaving open the possibility of very large negative adjustments. NFG states that this is particularly problematic for efficiency programs where success is dependent on customer participation and Commission approval of programs. NFG also replies to parties concerned about the impact of incentives on the overall cost of the EEPs program by stating that other issues are likely to have a much greater impact on overall costs.

Con Edison/O&R dispute the argument that revenue decoupling eliminates all disincentives for utilities to pursue energy efficiency. Con Edison states that efficiency costs a utility the earnings it would otherwise receive on increased investment to meet load growth; efficiency also reduces a utility's long-term revenue stream and the size of the company.

Con Edison/O&R argue that other required programs, such as stray voltage testing, pertain to a utility's public safety obligation, and Con Edison/O&R state that energy efficiency is not one of the utilities' statutory responsibilities. Con Edison/O&R state that if energy efficiency is an obligation, then a utility is entitled to earn a return equivalent to a supply-side return. Con Edison/O&R also challenge the argument that incentives be authorized only for superior performance, because all achieved energy efficiency provides benefits and because superior performance is not well-defined.

Con Edison/O&R dispute the claim that California's incentive program is inapplicable in New York. Con Edison/O&R argue that the ambitious nature of New York's efficiency goal is more significant than whether energy markets are restructured.

Con Edison/O&R do not agree that the ACEEE study cited by CPB is relevant, noting that the California PUC had given the study little weight in light of the time span that it covered. Con Edison/O&R also argue that there is no support for CPB's assertion that New York's efficiency programs from the early 1990s were cancelled because of excessive incentives.

Con Edison/O&R take issue with CPB's argument that utilities are not entitled to a return on efficiency investments that is comparable to supply-side investments because efficiency spending will be recovered as incurred and will not be placed into rate base. Con Edison/O&R agree that efficiency expenditures should be recovered as incurred, but they argue that the supply-side equivalent return they seek would also be awarded as incurred, rather than on an ongoing basis.

Con Edison/O&R state that negative adjustments are generally unwarranted, but they agree with National Grid that negative adjustments may be appropriate where utilities are



allowed to set their own targets based on their own projections of market potential in their territories. Because the targets established by the Commission are based on estimates and are levelized, Con Edison/O&R argue that they might not be realistic and it would be unfair to impose negative adjustments. At a minimum, Con Edison/O&R argue that negative adjustments should be based on three-year goals and not annual targets.

In response to CPB's claim that free ridership must be accounted for in evaluating savings, Con Edison/O&R respond that spillover effects should also be counted.

#### DISCUSSION

##### The Need for Incentives in the Context of this Proceeding

Con Edison/O&R are incorrect when they state that efficiency services are not part of their statutory obligation. The Legislature has given the Commission an explicit mandate to promote energy conservation by utilities in the performance of their public service responsibilities<sup>8</sup> and has given the PSC "broad discretion to choose the means of achieving the legislative objective."<sup>9</sup>

The Commission's authority to order utilities to implement efficiency programs does not, however, preclude the awarding of incentives. The Commission's authority to award incentives for efficiency measures, as an exercise of our discretion in choosing the means of achieving the policy objective, has been recognized and explicitly upheld.<sup>10</sup>

We agree with CPB that, although utilities can be ordered to implement efficiency programs, incentives are

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<sup>8</sup> PSL § 5(2).

<sup>9</sup> Multiple Intervenors v. Public Service Commission, 166 A.D.2d 140, 144 (3d 1991).

<sup>10</sup> Id., at 143-144.

valuable in securing a long-term commitment by utilities to achieving efficiency goals. We have established energy efficiency as a high priority, due to the benefits that it provides related to customer bills, system reliability, environmental impacts, energy security, and economic development.<sup>11</sup> For that reason, incentives will be warranted if they increase the likelihood of achieving our efficiency goals in a cost-effective manner.<sup>12</sup>

Incentives for utility-administered efficiency programs will fulfill a number of purposes that are important to the success of this proceeding. They will promote better program performance. They will motivate utilities to pursue efficiency programs as a resource option. They will enable us to hold utilities accountable for meeting targets.

Properly designed incentives can reduce overall program costs rather than add to them. If incentives are included as a cost in the analysis used to choose between competing programs, utilities will need to keep other program costs low in order to present programs with competitive benefit/cost ratios. Utilities will have a motivation to propose programs at the lowest cost possible, to increase the likelihood of their proposals being approved.

We do not, however, dismiss the comments of many parties, including some utilities, arguing for a cautious approach to incentives. The utilities lack a large amount of recent experience with efficiency programs. It is difficult at

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<sup>11</sup> June 23 Order, at 2.

<sup>12</sup> We have previously stated that positive incentives, in addition to revenue decoupling mechanisms, may be desirable to increase utilities' promotion of efficiency, where the utilities are directly engaged in program administration. See, e.g., Case 06-G-1332, Consolidated Edison Company of New York, Inc. - Gas Rates, Order Adopting in Part the Terms of the Parties' Joint Proposal (September 25, 2007), at 32.

this early stage to predict with precision the ability to meet the ambitious program targets established in this proceeding. The greater the rewards and risks of an incentive mechanism, the more the lack of experience has the potential to undermine the effectiveness of the incentives.

For that reason, our incentive policy will begin at modest levels. As utilities gain experience in program planning and implementation, other approaches to incentives could be considered.

#### Proposed Incentive Models

In establishing a model for efficiency program incentives, a number of factors must be considered. These include the likely impact of the selected model on ratepayers; the extent to which the incentives will encourage innovation; the impact of the incentives on portfolio balance, including measures serving low-income customers and other valuable measures that have relatively low benefit/cost ratios; the administrative complexity of the model; the extent to which it relies on precise measurement and verification; and its vulnerability to gaming.

Although there are numerous issues that must be determined for any incentive system, we have identified three principal components that determine our selection of an incentive model. These are: the basis on which the maximum potential incentives will be established for each electric utility; the metric or yardstick by which utility performance will be measured; and the balance of risk and opportunity.

##### 1. Basis for Establishing Maximum Potential Incentives

Three alternative bases for establishing maximum potential incentives have been proposed. The first is a sharing of the net resource benefits achieved by the efficiency measure.

This option is attractive in theory, but presents several obstacles in practice. As several parties have observed, it relies strongly on a precise evaluation process. It also relies on precision in estimating avoided costs of electricity. Although these factors must be considered in the approval and evaluation of efficiency programs, the greater the amount of ratepayer money at risk due to incentives, the smaller our tolerance for uncertainty in evaluation results and avoided cost estimates. The higher degree of complexity of a net resource benefits approach would significantly increase gaming opportunities as well as the administrative burden of overseeing the program.

Given the volatility of commodity prices, net resource benefits from efficiency programs may be more affected by swings in fuel prices than they are by the performance of program administrators. Although this could be addressed by adjusting for these variations, that would add another level of administrative complexity.

Another disadvantage to the use of a net resource benefits approach is the encouragement it would give utilities to concentrate their efforts only on the measures with the highest returns, at the possible expense of a balanced portfolio. Generally, concentration on measures with higher savings is to be preferred; however, as identified in the Selection Criteria adopted in the June 23 Order, there are numerous values served by efficiency programs other than net resource benefits. Measures selected for a variety of reasons (e.g., benefits to underserved customer classes, or achievement of deep savings) will be fundamental to achievement of the 15 x 15 goal. The California PUC partially addresses this issue by separating low-income measures from the calculation of incentives. There are likely to be, however, numerous measures

other than low-income measures that will have relatively lower benefit-cost ratios but will be selected in order to maintain a balanced portfolio.

We conclude that the net resource benefits approach is potentially very efficient at motivating utilities to emphasize high value megawatt-hours in their proposed programs, but it is not the optimal method for calculating incentives at this stage of this proceeding.

Another proposal is to establish the maximum potential incentive for each utility based on a percentage of that utility's program costs. This method does not rely on an estimate of avoided costs, and it would provide no incentive to pursue an unbalanced portfolio. It suffers, however, from a different infirmity, which is that it would encourage the artificial inflation of program costs.

The third method, as detailed in the Advisory Staff proposal, would establish the maximum potential incentive from a percentage of a pre-determined estimate of overall statewide program costs. The estimate of overall statewide program costs is independent of the individual program cost estimates that will be submitted by utilities. This method would not encourage utilities to artificially inflate their program costs in their filings or to propose unbalanced portfolios, nor would it rely on controversial and highly variable estimates of avoided costs.

Several parties raised concerns about this method. Parties argued that because it is based on an estimate of overall costs, rather than on specifically approved program costs, it will be less accurate than a cost-based method. In our view, however, it is more important that the incentive mechanism not tend to artificially inflate program costs. The maximum potential incentive amount to be set relies primarily on our judgment as to a reasonable level and is not by its nature

mathematically precise. Basing the maximum potential incentive levels on an estimate of statewide program costs supports the underlying purpose of the incentives while minimizing unintended consequences and administrative burdens.

Another criticism is that the Advisory Staff proposal would lack the flexibility needed to reflect the varying degrees of innovation, difficulty, and risk of non-achievement that will exist within a balanced portfolio of efficiency measures. This criticism, however, does not relate to setting the overall incentive amount. Several utilities have argued that they should be allowed to shift funds among programs to maximize overall effectiveness. We have repeatedly stressed the importance of a balanced portfolio. If we find it appropriate when considering how to apply the overall incentive amount to a particular utility portfolio of programs, we may apply administratively practical formulas to ensure that both overall portfolio and individual program objectives are met in awarding incentives. We have broad experience in applying such administratively practical formulas to incentives in the customer service and service reliability incentive programs of most utilities. For example, instead of simply counting achieved megawatt-hour reductions, the potential incentive dollars could be apportioned among programs so that the portion of potential incentive related to low-income programs in the portfolio could not be earned except by conducting low-income programs. Alternatively, the apportionment could be adjusted to give greater weight to low-income programs so as to ensure those programs are treated by the utilities as high priorities. We are persuaded that retaining the flexibility to adapt the incentive formulas to specific portfolios is desirable, so long as the uniformity we seek in establishing the overall incentive amount is maintained. This uniformity in overall amount limits

the administrative burden of creating incentives and provides the utilities, as they prepare their proposed portfolios, with a clear expectation as to the level of incentive rewards and risks.

We conclude that the percentage of estimated overall program costs basis for establishing the maximum potential incentives will best promote the objectives of this proceeding, but that retaining flexibility to adapt the incentive formulas to specific portfolios is desirable, so long as the uniformity we seek in establishing the overall incentive amount is maintained.

## 2. Metric for Measurement of Utility Performance

The second principal factor in selecting an incentive model is the metric by which utility performance will be measured. Under the "net benefits" model, incentives would be a function of both achieved megawatt-hour reductions and avoided electricity costs. For the reasons described above, we do not favor this approach at this time.

We conclude instead that the incentive model will rely on megawatt-hour reductions. It is not cost-effective or likely even possible to segregate and measure in real time every reduction in electricity usage made possible by energy efficiency programs. Instead, the evaluation of energy efficiency programs relies on measurement and verification activities that include estimates and sampling over time to ensure a chosen degree of statistical precision in the estimates. In the June 23 Order, we increased funding to enhance evaluation to achieve a higher degree of statistical precision than we have accepted in the past. The new evaluation requirements will provide us better assurance that ratepayers will be obtaining the best value for energy efficiency expenditures on their behalf. Each efficiency program should

include a high-quality forward-looking estimate for each specific program measure of the expected megawatt-hour efficiency achievement of installing or performing the measure.<sup>13</sup> Such forward-looking estimates should be based on the best actual measurement and verification data available from any jurisdiction. Each efficiency program should also include a verifiable and auditable method of counting how many efficiency measures were installed or performed with sufficient checks to ensure veracity and accuracy. On a year-to-year basis, the achievements-per-measure forward-looking estimates will be applied to the verifiable number of measures installed or performed to determine the megawatt-hours saved for the purposes of calculating incentive awards. Similarly, every year the achievements-per-measure forward-looking estimates will be revised to incorporate the latest actual measurement and verification results to use going forward.

We note that there is an ongoing working group in this proceeding attempting to formulate recommendations regarding efficiency programs that would primarily target megawatt reductions instead of megawatt-hour reductions. Until some further action is taken, as a necessary exception to the policy stated above, we shall allow for an added incentive to be applied to electric utility energy efficiency programs to be undertaken in New York City to encourage peak megawatt reductions for that capacity-restricted area of the State. The metric for measuring utility performance for such added incentive shall be achieved peak-hour megawatt reductions, defined as the savings of four times or more megawatt-hours during the hour of system peak than savings during an average hour of the year for the program (i.e., the peak coincidence

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<sup>13</sup> Megawatt efficiencies should also be estimated, tracked and verified as appropriate to achieve the megawatt objectives of the portfolio of programs.



factor must be 0.25 or less). The programs that will be eligible for this added incentive must be efficiency programs by nature; pure load-shifting and programs that substitute generation sources will not be eligible. The percentage of the megawatt-based incentive earned must be capped by the level of achievement in the megawatt-hour incentive, to ensure that the megawatt objectives are met in a manner that does not operate to the detriment of the megawatt-hour objectives.

3. Balance of Utility Risk and Opportunity

It is axiomatic that utility regulation should achieve a reasonable balance of risk and opportunity for the utility. This does not mean that each discrete item in a utility's rate plan must reflect a balance, but only that the utility's rate plan taken as a whole reflects a balance. If efficiency incentives were negotiated on a case-by-case basis for each utility, they would likely be affected by risks and opportunities presented by other elements of each utility's rate plan. Under those circumstances, it might be preferable for a utility-specific incentive system to contain positive adjustments only, or negative adjustments only.

Because we are establishing a model for efficiency incentives that will apply without reference to other elements of a utility's rate plan, it is more important for the opportunity for positive earnings be offset by a corresponding risk of negative adjustments. In light of the great advantages to customers that are offered by energy efficiency and the relative lack of utility experience in administering programs, we find it reasonable at this time to restrict negative incentives to cases of obviously poor performance, while making

modest positive incentives available for reasonable levels of achievement.<sup>14</sup>

We do not agree with the argument that positive incentives should be established only for exceptional performance levels. The many benefits of energy efficiency warrant incentives for achievements that are reasonably related to program targets. Moreover, we find that a moderated approach to incentive levels, covering a relatively wide range of results, is more likely to have the intended effect on utility behavior than an abrupt threshold. Allowing a utility to earn an incentive only if performance exceeds a high level (e.g., performance exceeding an approved target) decreases the relevance of the incentive to utility behavior.<sup>15</sup> Several parties have observed that gradual changes in incentive levels are more effective than abrupt thresholds that place a large amount of money at stake over a very small difference in achievement. We agree. Abrupt thresholds have the potential to encourage inefficient behavior, and also assume a precision of evaluation that is not realistic. For that reason we establish

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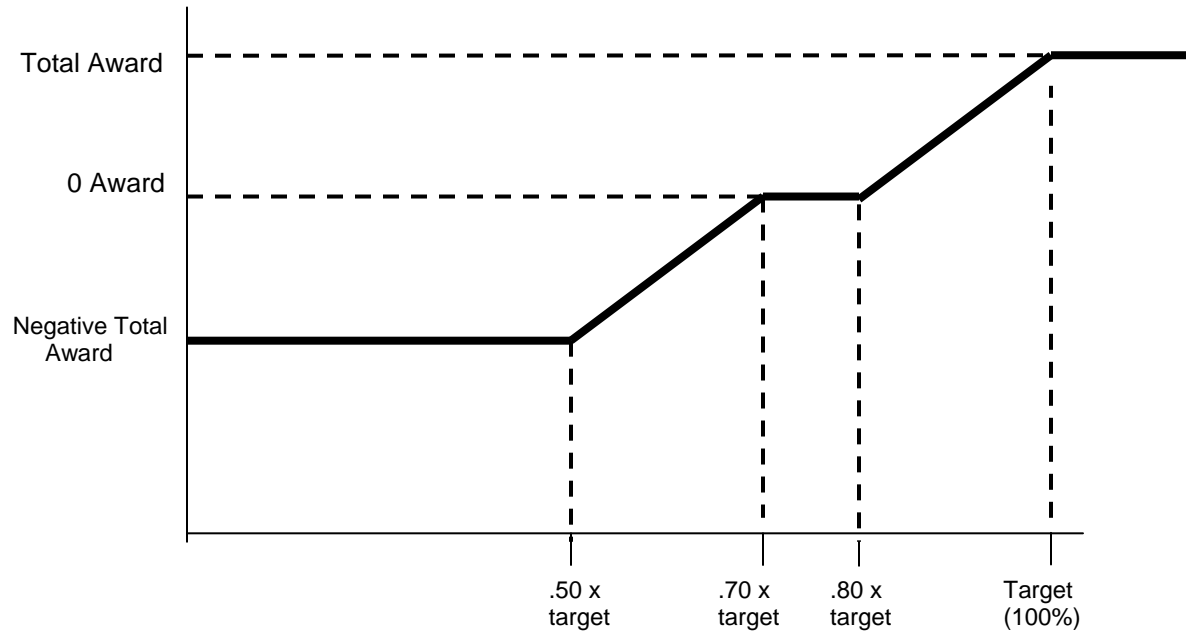
<sup>14</sup> Utilities have also argued that they should not suffer negative adjustments where the ultimate success of the measure relies on customer participation. In keeping with our general approach to incentives in this order, we are establishing negative adjustments at levels that reflect obvious poor performance on the part of program administrators. For the longer term, however, we will not give great weight to the argument that efficiency programs are uniquely dependent on customer behavior. Energy efficiency programs have been implemented in varying forms for decades, and customer response rates can be predicted. Utility performance of traditional supply-side functions also relies on statistical estimates of customer behavior.

<sup>15</sup> If a utility determines, at some point in the implementation of a measure, that it is not likely to exceed the target threshold, then the utility (from the standpoint of incentives) becomes indifferent to whether it achieves 80% or 100%, and the incentive has ceased to influence its behavior.

incentive levels that change in a graduated manner rather than adopting an "all-or-nothing" approach.

We conclude that opportunities to earn awards will be accompanied by risks of negative adjustments; the adjustment levels will be graduated and will avoid abrupt thresholds. In order to carry out such principles, overall incentives for each utility portfolio will be applied in the symmetrical manner illustrated in the following chart:

**Relationship Between Performance and Incentive Award**



Incentive awards will be calculated over aggregated portfolio performance, provided that the contribution of any particular program toward the overall calculation may be capped or weighted, in order to prevent undue emphasis being placed on one or more programs at the expense of a balanced portfolio. We will leave it to our individual determinations on a utility case-by-case basis when considering the actual portfolio of programs approved to determine any weighting of programs or other administratively practical formulas to calculate the

percent of the incentive earned to be applied to the chart illustrated above. Consistent with the general approach reflected in this Order, in a future phase of this proceeding we may reconsider the thresholds for positive and negative adjustments.

#### Other Provisions

##### 1. Specific Incentive Levels

Parties proposed a varied range of percentage levels for both positive and negative adjustments. Complicating the analysis of party comments is the fact that some parties proposed percentages of program costs while others proposed percentages of net benefits.

In establishing incentives, we are very mindful of potential opportunities for gaming. In particular, we are concerned that a utility may be encouraged to understate the potential efficiency savings in a proposed program to increase its chances of meeting or exceeding program targets. Considering proposals on a competitive basis, as established in our June 23 Order, will mitigate this concern. Further experience with the process of selecting programs must be gained before the full extent of the gaming concern can be evaluated. Until that time, we will adopt a cautious approach to incentive levels.

We conclude that the total maximum amount of electric incentives should be set using a reference figure of \$40 million annually statewide in relation to estimated total annual program

costs of approximately \$325 million<sup>16</sup> and levelized total annual incremental reduction targets of 1,029,521 megawatt-hours.<sup>17</sup> Forty million dollars equates to roughly 20 basis points on the return on equity of New York's major electric utilities and approximately 12% of estimated program costs. The maximum incentive amount will be applied to utility portfolios at the rate of \$38.85/incremental megawatt-hour<sup>18</sup> targeted in the utility portfolio. The following table shows the application of the maximum incentive amount to the levelized targets by service territory:

<b><u>Service Territory</u></b>	<b><u>Potential MWhs</u></b>	<b><u>Maximum Potential Incentive</u></b>
Central Hudson	40,478	\$1,572,693
Con Edison	255,316	\$9,919,798
NYSEG	97,769	\$3,798,621
Niagara Mohawk	223,270	\$8,674,714
O&R	29,939	\$1,163,221
RG&E	47,179	\$1,833,047
UTILITY TOTALS	693,951	\$26,962,092
NYSERDA Fast Track	335,570	\$13,037,908 <sup>19</sup>
Grand Total	1,029,521	\$40,000,000

<sup>16</sup> June 23 Order, Table 15, Grand Total of \$329,832,455, less \$5,250,000 for enhanced M&V for the SBC III program, equals \$324,582,455.

<sup>17</sup> June 23 Order, Table 6 annual figure of 1,098,156 megawatt-hours, less Table 7 annual figure of 68,635 for Conservation TIP program [not included in cost estimate], equals 1,029,521 megawatt-hours.

<sup>18</sup>  $\$40,000,000 \div 1,029,521 \text{ megawatt hours} = \$38.85/\text{megawatt-hour}.$

<sup>19</sup> This number is included for illustrative purposes only; NYSERDA is not eligible to earn incentives.

For the megawatt incentive to be applied only in New York City, we will apply a rate of \$100,000 per megawatt up to a maximum of \$5 million (maximum 50 megawatts). The megawatt-based incentive will be capped by the level of achievement in the megawatt-hour incentive. For example, if only 90% of the megawatt-hour incentive is earned, only a maximum of 90% of the megawatt incentive may be awarded. This cap will ensure that the megawatt objectives are met in a manner that does not operate to the detriment of the megawatt-hour objectives.

## 2. Applicability

Incentives can be established through a generally applicable policy, or on a utility-by-utility basis. The chief argument for establishing incentives on a utility-specific basis is that the motivation of utilities to earn incentives and their tolerance for associated risk will vary. A generic policy runs the risk of awarding incentives to utilities that might have exerted equivalent efforts at lower incentive levels. This risk must be weighed against the difficulty of establishing and administering a varied range of incentive measures in a number of individual proceedings that would take place over a period of several years. On balance, we find that a generally applicable incentive system is preferable where, as here, all utilities will share in the statewide effort to achieve our efficiency goal and where efficiency programs will be approved outside the context of individual rate cases.

We conclude that the incentive regime will be applied to all electric utilities. The concerns expressed by NYSEG/RG&E are mitigated by the fact that the amount of incentives is moderate and any negative adjustments are graduated and only apply at levels of very poor performance.

3. Interval for Incentive Calculation and Recovery

The target megawatt-hours for each year will be set when utility efficiency programs are approved. The June 23 Order allows utility proposals to reflect a reasonable ramp-up period so long as the pace of annual savings is sufficient to achieve the cumulative savings targeted for 2011. The maximum incentive level of \$38.85/megawatt-hour will be applied to the approved target for each year. The greater the annual target, the greater the amount of potential incentives.

Each year, the actual number of efficiency measures installed or performed will be tallied, and those numbers will be applied to the respective savings estimate for the measures to determine the achieved megawatt-hour reductions. This annual calculation will keep utilities accountable every year and will not diminish the effect of the incentives due to an unnecessary time lag between performance and reward. No "borrowing" or "banking" will be allowed between years because such practice would tend to facilitate gaming and laggardness. Annual adjustments in the forward-looking savings estimates will keep the achievement levels as accurate as possible.

4. Inclusion of Costs of Incentives in the Total Resource Cost Test

Because incentives will be recovered from ratepayers, the estimated ratepayer cost of incentives, at a 100% achievement level, should be included within the estimate of individual utility efficiency program costs to be prepared for the purpose of our selecting from among competing programs.<sup>20</sup>

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<sup>20</sup> Similarly, if there is a potential that a New York State Cost Recovery Fee will be imposed on NYSEDA applicable to incremental efficiency programs it may administer, such costs should be included within the estimate of individual NYSEDA efficiency program costs to be prepared for the purpose of our selecting from among competing programs.

5. Cooperation with NYSERDA and Independent  
Program Administrators

Cooperation among program administrators, where it will contribute to more effective distribution of efficiency services, is necessary. In particular, the customer access enjoyed by utilities makes them well-suited to assist with intake services for programs administered by NYSERDA or independent administrators. Utilities should not need the encouragement of incentives to enter into such arrangements. Our Order regarding Revenue Decoupling Mechanisms<sup>21</sup> was designed to remove impediments to this type of utility activity. As the selection criteria adopted in the June 23 Order make clear, we will take into account, in selecting program administrators, the extent to which complementary resources of program administrators are utilized in a cooperative fashion. We note, also, that if utilities refuse to actively provide such cooperation, we will consider removing the ability of utilities to earn positive incentive awards with respect to their own programs.

In order to encourage additional cooperative efforts by utilities, we will consider on a case-by-case basis proposals for utility incentives where utilities will provide assistance beyond simple customer referrals. Such a proposal must clearly identify the measures to be taken by the utility to promote or otherwise assist in program administration, and must distinguish between those efforts and the basic customer referrals that we expect will be provided on a routine basis.

6. Applicability to Gas Efficiency Programs

While many of the principles we are applying here to electric utility energy efficiency incentives may be applicable

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<sup>21</sup> Cases 03-E-0640 and 06-G-0746, Order Requiring Proposals for Revenue Decoupling Mechanisms(issued April 20, 2007).



to gas utilities, we are not today establishing a uniform level of incentives for gas programs. Incentives for gas utility programs, if any, will continue to be set on a case-by-case basis for the near future.

SEQRA FINDINGS

Pursuant to our responsibilities under the State Environmental Quality Review Act (SEQRA), in conjunction with this order we find that the incentive policies adopted here are within the overall action previously examined by us and will not result in any different environmental impact than that previously examined. In addition, the SEQRA findings of the June 23 Order are incorporated herein by reference and we certify that: (1) the requirements of SEQRA, as implemented by 6 NYCRR Part 617, have been met; and (2) consistent with social, economic, and other essential considerations, from among the reasonable alternatives available, the action being undertaken is one that avoids or minimizes adverse environmental impacts to the maximum extent practicable.

The Commission orders:

1. Incentives for electric utility energy efficiency programs resulting from the Energy Efficiency Portfolio Standard shall be applied in the manner described in the body of this order. The affected electric utilities shall take cognizance of this requirement and prepare their program portfolio filings in a manner that reflects this order.

2. This proceeding is continued.

By the Commission

(SIGNED)

JACLYN A. BRILLING  
Secretary