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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Joint Application of Questar Gas Company, the Division of Public Utilities, and Utah Clean Energy for the Approval of the Conservation Enabling Tariff Adjustment Option and Accounting Orders	Docket No. 05-057-T01

REBUTTAL TESTIMONY OF RALPH CAVANAGH

FOR QUESTAR GAS COMPANY

August 14, 2006

TABLE OF CONTENTS

I. BACKGROUND AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, ADDRESS, AND EMPLOYMENT.

A. My name is Ralph Cavanagh. I am the Energy Program Director for the Natural Resources Defense Council (NRDC), 111 Sutter Street, 20th Floor, San Francisco, CA 94104. NRDC is a nonprofit organization dedicated to environmental protection, with more than 3,730 members residing in Utah.

Q. PLEASE OUTLINE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I am a graduate of Yale College and Yale Law School, and I joined NRDC in 1979. I am a member of the faculty of the University of Idaho's Utility Executive Course, and I have been a Visiting Professor of Law at Stanford and UC Berkeley (Boalt Hall). From 1993-2003 I served as a member of the U.S. Secretary of Energy's Advisory Board. My current board memberships include the Bonneville Environmental Foundation, the Center for Energy Efficiency and Renewable Technologies, the California Clean Energy Fund, and the Northwest Energy Coalition. I have received the Heinz Award for Public Policy (1996) and the Bonneville Power Administration's Award for Exceptional Public Service (1986).

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying for Questar Gas Company.

Q. ARE YOU BEING COMPENSATED FOR THIS TESTIMONY?

A. No; NRDC does not accept compensation from utilities, to avoid any appearance of a conflict of interest in our advocacy, which frequently addresses issues of interest to the utility industry.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. My testimony rebuts challenges in this proceeding to the Company's proposal to institute modest annual rate true-ups, or "decoupling," in order to remove a strong disincentive to Company investments and advocacy in support of energy efficiency improvements,

Q. WHAT MATERIALS HAVE YOU REVIEWED IN PREPARATION FOR THIS TESTIMONY?

A. In addition to the Joint Application and Direct Testimony of Barrie L. McKay and Howard Geller, I have reviewed the Direct Testimony of witnesses David E. Dismukes, Elizabeth Wolf and Kevin C. Higgins, and the Supplemental Rebuttal of Mr. Dismukes which are cited below where relevant. I also was a participant in the Commission's June 7, 2006 Technical Conference on decoupling issues.

II. SUMMARY OF TESTIMONY

Q. SUMMARIZE YOUR TESTIMONY.

A. As Governor Huntsman recently emphasized in "unveil[ing] a comprehensive policy on energy efficiency for the State of Utah" on April 25, 2006, Utah urgently needs aggressive and sustained statewide efforts to improve the efficiency of natural gas use, in the face of unprecedented price increases and volatility.[1] My experience of almost thirty years has confirmed repeatedly that utilities are vital partners in such efforts. Yet the regulatory status quo unintentionally undercuts utility engagement, by penalizing their shareholders for any reductions in customers' natural gas use, regardless of the cost-effectiveness of any contributing energy-efficiency measures. From customers' perspectives, increases in throughput (above those contemplated when rates were established) result inappropriately in an uncompensated over-recovery of fixed costs by their utility. And a grave if unintended pathology of current ratemaking practice is the linkage of utilities' financial health to retail gas use. Increased retail gas sales produce higher fixed cost recovery, and reduced sales have the opposite effect. **I agree with witness McKay's calculation in his rebuttal testimony that a reasonably aggressive five-year energy efficiency investment program in its Utah service territory would**

[1]Governor Huntsman to Launch State Energy Policy, News Releases, State of Utah Governor Jon Huntsman, Jr. (April 25, 2006) (available at http://www. Utah.gov/governor/news/2006).

automatically inflict more than $23 million in losses on Questar's shareholders, regardless of the cost-effectiveness of the natural gas savings.[2] And as Ken Costello of NRRI points out in his recent Briefing Paper on Revenue Decoupling for Natural Gas Utilities, "[I]t would seem both unfair and counterproductive to order a utility to promote energy efficiency when detrimental to its shareholders."[3]

To address all these problems, I support the Company's request for a simple system of periodic true-ups in gas rates, designed to correct for disparities between the Company's actual fixed cost recoveries and the revenue requirement that this Commission has established. The true-ups would either restore to the Company or give back to customers the dollars that were under- or over-recovered as a result of fluctuations in retail natural gas sales. As I explain in detail below, four states have now approved decoupling mechanisms for some or all of their utilities (CA, MD, OR & NC), six others are actively considering it (ID, IN, OH, NJ, WA and WI), and one has deferred action (AZ); an additional Commission (CT) has indicated preference for an alternative solution to the energy-efficiency disincentives that decoupling seeks to remove. I agree with NRRI's Costello, however, that under the alternative favored by the Connecticut Commission, "an incentive problem arises where a utility would have an incentive to maximize measured or reported savings but to achieve minimal actual savings from energy efficiency initiatives."[4]

The three witnesses in opposition to the Company's proposal do not seriously contest the continuing availability of significant cost-effective conservation, Questar's ability to help tap it, nor the public interest in reducing system-wide gas use at a time of record commodity prices and volatility. At least two of the three opposition witnesses concede that decoupling could remove a material disincentive to Questar's participation in

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[2] Mr. McKay's calculation, presented in his rebuttal testimony, projects the cumulative five-year impact of annual savings equivalent to one percent of system-wide retail gas use. See QGC Exhibit SR 1.8.
[3] Ken Costello, Briefing Paper: Revenue Decoupling for Natural Gas Utilities, p. 7 (National Regulatory Research Institute, April 2006).
[4] Id. at p. 15.

urgently needed conservation efforts.[5] And Questar acknowledges both the need to pair this mechanism with expanded DSM programs and the importance of judging this pilot test in part on the basis of documented results from those efforts.

The opposition witnesses are concerned, primarily, with potential new costs allegedly associated with decoupling, its potential impact on allocation of risks between the Company and its customers, its impact on the Company's incentives to manage efficiency and promote economic growth, and its consistency with longstanding regulatory traditions. I demonstrate below that decoupling introduces no new costs, leaves efficiency and economic growth incentives unimpaired or strengthened, and is wholly consistent with traditional regulatory practice.

On the issue of whether decoupling should result in a reduction in the Company's rate of return, it is important to recognize that the gas industry has only limited experience with this mechanism, and that it creates both upside and downside exposure for the Company's shareholders (they will no longer under-recover authorized fixed costs if sales drop below expectations, but they also will lose their longstanding opportunity for gains from sales increases). Whether the net result is a material change in the company's risk profile cannot be determined without company-specific experience and responses from the capital markets. This is particularly true for a mechanism, like this one, framed as a pilot program that does not in any way affect current allocation of weather-related risks. Finally, if the goal is to encourage the Company to devote more management resources and creativity to energy efficiency, the simultaneous imposition of a reduction in shareholder returns would be wholly counterproductive. I am aware of no state that currently has a decoupling mechanism that was linked to a reduction in an authorized rate of return. I know of only one Commission that has *ever* linked adoption of an electric or gas decoupling mechanism with a reduction in the authorized rate of return for the utility

[5] Witness Wolf states (p. 5) that "We do agree that this type of mechanism can serve to remove barriers to investing in DSM," and witness Higgins acknowledges (p. 11) that "QGC earns greater profits when customers buy more gas, *all other things being equal*. Conversely, when there is a decline in per-customer usage, *all other things being equal*, it impedes the Company's ability to reach its profit objectives." [Emphasis in original.]

involved, and that Commission (Maryland) subsequently reconsidered and eliminated the adjustment.

III. ELIMINATING FINANCIAL DISINCENTIVES FOR QUESTAR'S DEMAND-SIDE INVESTMENTS

a. The Nature of the Problem

Q. WHAT IS THE BASIS FOR YOUR CONCLUSION THAT QUESTAR'S FIXED COST RECOVERY IS STRONGLY TIED TO ITS RETAIL SALES VOLUMES?

A. Like most utilities, Questar recovers most of its fixed costs through the rates it charges per therm. In other words, a part of the cost of every decatherm represents the system's fixed charges for existing plant and equipment; the rest collects the cost of the gas commodity itself. After approving a fixed-cost revenue requirement, the Public Service Commission of Utah sets rates based on assumptions about annual retail sales. If sales lag below those assumptions, the Company will not recover its approved fixed-cost revenue requirement. By contrast, if the Company is successful in promoting consumption increases above regulators' expectations, its shareholders earn a windfall in the form of cost recovery that exceeded the approved revenue requirement.

Q. COULDN'T THIS PROBLEM BE SOLVED BY USING A FORWARD TEST YEAR AND INCORPORATING THE IMPACTS OF THE COMPANY'S ENERGY-EFFICIENCY PROGRAMS IN THE FORECAST OF SALES?

A. No. The utility's ongoing incentive to promote increased use and discourage efficiency is almost wholly unaffected by the test year and forecasting methodology chosen. Whether consumption ultimately ends up above or below whatever forecast is adopted, every reduction in sales from efficiency improvements yields a corresponding reduction in cost recovery, to the detriment of shareholders. The Company loses less in aggregate if the Commission adopts a low sales forecast rather than a high sales forecast, but the incentive at the margin is the same: reduced sales are always adverse to shareholders' financial interests if all that changes is the forecast used to set rates.

Q. WHY RECOVER FIXED COSTS IN VOLUMETRIC CHARGES AT ALL? WHY NOT SIMPLY MAKE THEM FIXED CHARGES?

A. Recovering all or most fixed costs as fixed charges would require radical changes in rate design, and would reduce customers' rewards for conserving at the very time when the public interest calls urgently for more efficient use of gas.

Q. BUT DOESN'T CONTINUING TO RECOVER FIXED COSTS AS PART OF VOLUMETRIC CHARGES MAKE ADDITIONAL CONSUMPTION LOOK MORE COSTLY THAN IT SHOULD?

A. That amounts to contending that the Commission is suppressing beneficial increases in natural gas use through its rate structure, and I strongly disagree. The rationale for more and better energy efficiency programs rests in part on the conclusion that even with today's relatively high retail rates, extensive market failures continue to block energy savings that are much cheaper than additional gas purchases. We would make a bad situation worse by reducing customers' rewards for conserving natural gas, which is precisely what would happen if the Company shifted costs from volumetric to fixed charges.

Q. DESCRIBE THE EVIDENCE THAT MARKET FAILURES CONTINUE TO BLOCK HIGHLY COST-EFFECTIVE ENERGY SAVINGS.

A. Overwhelming evidence has been marshaled in recent years by the National Research Council of the National Academy of Sciences, the U.S. Congress's Office of Technology Assessment, the National Association of Regulatory Utility Commissioners, and the national laboratories, among many others. Although "[t]he efficiency of practically every end use of energy can be improved relatively inexpensively,"[6] "customers are generally not motivated to undertake investments in end-use efficiency unless the payback time is very short, six months to three years . . . The phenomenon is not only independent of the customer sector, but also is found irrespective of the particular end uses and technologies

[6] U.S. National Academy of Sciences Committee on Science, Engineering and Public Policy, Policy Implications of Greenhouse Warming, p. 74 (1991). A more recent review of energy-efficiency opportunities and barriers appears in National Research Council, Energy Research at DOE: Was it Worth It? (September 2001).

involved."[7] Typically, customers are demanding rates of return of 40-100+%, and such expectations differ sharply from those of investors in utility assets. Utilities' returns on capital average 12% or less. The imbalance between the perspectives of consumers and utilities invite large, relatively low-return investments in natural gas supplies that could be displaced with more lucrative energy efficiency. These widely documented market failures generate "systematic underinvestment in energy efficiency," resulting in energy consumption at least 20-40% higher than cost-minimizing levels.[8]

There are many explanations for the almost universal reluctance to make long-term energy efficiency investments.[9] Decisions about efficiency levels often are made by people who will not be paying the utility bills, such as landlords or developers of commercial office space. Many buildings are occupied for their entire lives by very temporary owners or renters, each unwilling to make long-term improvements that would mostly reward subsequent users. And sometimes what looks like apathy about efficiency merely reflects inadequate information or time to evaluate it, as everyone knows who has rushed to replace a broken water heater or furnace.

Market failures like these mean that energy prices alone are a grossly insufficient incentive to exploit even the most inexpensive savings: NARUC analysts have determined, for example, that electricity customers who insist on two-year paybacks and see average rates of 7 cents/kWh "can be expected to forego demand-side measures with costs of conserved energy of more than 0.9 cents/kWh."[10] That is, energy prices would have to increase about eightfold to overcome the gap that typically emerges in practice between the perspectives of investors in energy efficiency and production, respectively.

Q. ARE YOU ADVOCATING PUNITIVELY HIGH NATURAL GAS RATES AS A SOLUTION TO THESE MARKET FAILURES?

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[7] National Association of Regulatory Utility Commissioners, Least Cost Utility Planning Handbook, Vol. II, p. II-9 (December 1988).
[8] See M. Levine, J. Koomey, J. McMahon, A. Sanstad & E. Hirst, Energy Efficiency Policy and Market Failures, 20 Annual Review of Energy and the Environment 535, 536 & 547 (1995).
[9] An extensive assessment appears in U.S. Congress, Office of Technology Assessment, Building Energy Efficiency, at pp. 73-85 (1992).
[10] National Association of Regulatory Utility Commissioners, note 7 above, p. II-10.

A. Certainly not, any more than I advocate changes in rate structure that would reduce rewards for saving natural gas. Instead, I urge increased reliance on the very solution that figures so strongly in Governor Huntsman's recent proposals: pursuit of cost-effective energy efficiency through utility investments rather than punitive prices.

b. The Potential Magnitude of the Problem

Q. HOW SUBSTANTIAL ARE POTENTIAL SHAREHOLDER LOSSES FROM REDUCED RETAIL SALES?

A. In his rebuttal testimony, witness Barrie McKay demonstrates that programs saving one percent of systemwide use would reduce the company's fixed-cost recovery by about $1.5 million in the first year. But the losses get even worse in the context of multi-year programs initiated under a long-term resource plan. Mr. McKay's testimony contemplates a five-year program that pursues annual savings equivalent to one percent of retail consumption in the initial year, with each year adding new savings equivalent to the savings achieved during the previous year, and all savings persisting for at least five years. The first year impact on fixed cost recovery is then about $1.5 million, followed by $3 million dollars in the second year (as an equal amount of savings is added), and so on: **the automatic five-year loss to shareholders from this steady-state utility investment program would exceed $23 million dollars**,[11] with shareholder losses continuing to escalate in succeeding years as initial energy savings persisted (with some gradual erosion) and more savings were added. Note that the shareholders would be absorbing these losses even as Utah gained from substituting less costly energy efficiency for more costly natural gas.

Q. WHAT MAKES YOU THINK UTILITIES CAN SUSTAIN COST-EFFECTIVE ENERGY EFFICIENCY PROGRAMS EQUIVALENT TO ABOUT ONE PERCENT OF SYSTEM CONSUMPTION?

A. This actually is somewhat less ambitious than the gas industry's proportionate share of the goal that Governor Huntsman has established for the state: "to increase the State's

[11] The cumulative loss estimate over five years is the sum of $1.5 million, $3.1 million, $4.6 million, $6.2 million and $7.8 million, as documented in Barrie McKay's Rebuttal Testimony.

overall energy efficiency by 20 percent by the year 2015."[12] The one percent annual goal also is the target that has been established for the Midwest Gas Initiative, which is "a cooperative effort by 8 Midwest states to develop a multi-state energy efficiency initiative to decrease natural gas consumption by 1% per year for five years."[13]

c. The Solution: Removing Disincentives with Rate True-Ups

Q. IF YOU OPPOSE HIGHER FIXED CHARGES, HOW WOULD YOU PROPOSE TO REMOVE THE FINANCIAL DISINCENTIVES DESCRIBED IN EARLIER SECTIONS OF YOUR TESTIMONY?

A. To eliminate a powerful disincentive for energy efficiency , I support Questar's proposal to use modest, regular true-ups in rates to ensure that its authorized fixed-cost recovery is not held hostage to sales volumes. This mechanism involves a simple comparison of actual sales to authorized fixed cost recovery during the period under review. The difference is then either refunded to customers or restored to the Company. Note that the true-up can go in either direction, depending on whether actual retail sales are above or below that allowed by the Commission.

IV. REVIEW OF DECOUPLING EXPERIENCE IN OTHER STATES

Q. IS THERE RELEVANT RECENT EXPERIENCE WITH COMPARABLE MECHANISMS IN OTHER STATES?

A. The most extensive recent activity with which I am familiar is in California, Oregon, Idaho, Maryland, North Carolina, Wisconsin and Washington. Four of those states have adopted gas decoupling mechanisms; in the other three, Commissions have indicated specific interest in acting and proceedings are underway or imminent. Ken Costello's

[12] See News Releases, State of Utah Governor Jon Huntsman, Jr., Governor Huntsman to Launch State Energy Efficiency Policy, June 25, 2006 (http://www.utah.gov/governor/news/2006).
[13] See www.mwnaturalgas.org/about. Supporters of the Initiative include Wisconsin Governor Jim Doyle, Iowa Governor Tom Vilsack, Commissioner Phyllis Reha of the Minnesotal PUC, and Ohio Consumer Counsel Janine Migden Ostrander.

recent Briefing Paper for NRRI lists four other states with pending decoupling filings (Indiana, New Jersey and Ohio, in addition to Utah).[14] More specifically:

California has embraced a true-up policy for all its investor-owned utilities, covering fixed costs of delivering both electricity and natural gas;[15] in California today, utilities' recovery of fixed costs is completely independent of retail sales. Not coincidentally, California utilities are conducting the nation's most aggressive energy efficiency programs (measured in savings as a percentage of retail electric and gas use).

Oregon's PUC adopted a true-up mechanism for PacifiCorp in 1998, covering fixed costs of electricity distribution.[16] Initial rate impacts of the Oregon "Alternative Form of Regulation" were extremely modest for all classes, and (as predicted) adjustments went in both directions; the largest annual rate increase for any class was 1.9%, the largest annual rate reduction was 0.83%, and out of a total of fifteen true-ups from 1999 – 2001, seven resulted in rate reductions and eight resulted in rate increases. More recently (in 2002), the Oregon PUC also adopted a modified true-up mechanism for Northwest Natural Gas; an independent evaluation concluded in March 2005 that the mechanism was "effective in altering Northwest Natural's incentives to promote energy efficiency" and should be retained, although the authors recommended removing some rather complex features that were not relevant to the mechanism's primary purpose.[17] The Commission adopted an order in August 2005 adopting a stipulation that simplified the mechanism and extended it for another four years.[18] The State's other major gas distributor, Cascade Natural Gas, secured its own decoupling mechanism recently when the Oregon Commission approved its May 18, 2006 tariff filing.[19]

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[14] Ken Costello, Briefing Paper: Revenue Decoupling for Natural Gas Utilities, p. 4 (National Regulatory Research Institute, April 2006).

[15] In 2001, the legislature enacted Public Utilities Code section 739.10, directing the PUC to "ensure that errors in estimates of demand elasticity or sales do not result in material over- or under-collections." The PUC has responded by reestablishing true-up mechanisms covering retail sales of both electricity and natural gas.

[16] Oregon PUC, Order No. 98-191 (May 5, 1998) (covering 1998 – 2001). Rate impact data were supplied to me by PacifiCorp's Paul Wrigley.

[17] D. Hansen & S. Braithwait, A Review of Distribution Margin Normalization as Approved by the Oregon Public Utilities Commission for Northwest Natural (March 2005), pp. 67-68.

[18] Oregon PUC, Order No. 05-934 (UG 163, August 25, 2005).

[19] The filing, numbered CNG/O05-10-01, was approved by the Commission on May 23, 2006

The **Wisconsin** Public Service Commission determined in July 2005 that utilities' financial disincentives were inappropriately constraining statewide energy efficiency development, and that "the time is right to fully explore true-up mechanisms and performance-based incentives."[20] Those efforts are now underway as Alliant, one of the state's principal utilities, convenes multi-party workshops to seek consensus on proposals to present to the Commission.

In May 2004, the **Idaho** Public Utilities Commission opened a proceeding to address financial disincentives for Idaho Power's energy efficiency investments and performance-based incentives tied to the utility's success in delivering cost-effective savings.[21] Subsequent workshops yielded a report to the Commission, embraced by all participants, which included the conclusions that "the workshop participants agreed that material financial disincentives to the implementation of DSM programs do exist," and called for detailed retrospective and prospective financial analyses "to evaluate incorporation of a true-up mechanism into the [Company's next] rate filing," along with pilot testing of a performance-based DSM incentive.[22] That process is now complete, and the Company's decoupling application is now pending at the Commission.

In November 2005, the **North Carolina** Utilities Commission approved a three-year test of a decoupling mechanism for residential and commercial customers, citing the joint statement of NRDC and AGA and the need to eliminate "an inherent conflict between the interests of the Company and its customers with respect to conservation."[23] The Commission conditioned its approval on "a substantial and effective initiative by the Company to assist its residential and commercial customers with conservation."[24]

Ken Costello's recent NRRI Briefing Paper lists **Maryland** among the states that have embraced gas decoupling, and cites evidence that the mechanism has operated effectively

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[20] Public Service Commission of Wisconsin, Order No. 6680-UR-114, p. 55 (July 2005).
[21] Case No. IPC-E-03-13, Order No. 29505 (May 25, 2004), pp. 68-69.
[22] Final Report on Workshop Proceedings, Case No. IPC-E-04-15 (Feb. 14, 2005), pp. 6 & 10-11.
[23] North Carolina Utilities Commission, Order Approving Partial Rate Increase and Requiring Conservation Initiative, Docket No. G-9, SUB 499, pp. 20 & 22 (November 2005).
[24] Id. at p. 23.

and met expectations there.[25] Costello also notes that in one case (involving the Baltimore Gas and Electric Company), the Maryland Commission included in its decoupling order a 50 basis point reduction in the company's authorized return on equity "to reflect reduced revenue risk for the utility."[26] However, in a more recent (December 2005) BG&E rate case order, the Commission decided that rate of return adjustments based on that same decoupling mechanism were not appropriate.[27]

Washington's Utilities and Transportation Commission approved a revenue cap mechanism for Puget Power in 1991. As the Commission determined at that time:

[T]he revenue per customer mechanism does not insulate the company from fluctuations in economic conditions, because a robust economy would create additional customers and hence, additional revenue. Furthermore, the Commission believes that a mechanism that attempts to identify and correct only for sales reductions associated with company-sponsored conservation programs may be unduly difficult to implement and monitor. The company would have an incentive to artificially inflate estimates of sales reductions while actually achieving little conservation.[28]

The Commission implemented Puget's revenue-per-customer cap by "set[ting] up a deferred account allowing a reconciliation of revenue and expenses that would be subject to hearing and review."[29] In its initial review of the mechanism that it had adopted two years earlier, the Commission in 1993 "accept[ed] the parties representations" that the revenue-per-customer cap had "achieved its primary goal – the removal of disincentives to conservation investment," and concluded that "Puget has developed a distinguished reputation because of its conservation programs and is now considered a national leader in this area."[30] Based on these findings, the Commission granted a three-year extension

[25] Costello, note 4 above, at pp. 4 & 18-19
[26] Id. at pp. 11-12.
[27] See Public Service Commission of Maryland, Order No. 80460, Case No. 9036, pp. 67-68 (December 2005) (addressing the same "Rider 8" discussed in Ken Costello, note 4 above, at pp. 11-12.
[28] Docket No. UE-901183-T, Third Supplemental Order (April 10, 1991), p. 10. The Commission also determined that the mechanism did not constitute retroactive ratemaking, and that it was "fair, just and reasonable" even though it did not perfectly match costs and rates: "even under the current system of ratemaking, costs and rates will diverge immediately following implementation of a rate change." Id. at p. 10.
[29] Id., at p. 10.
[30] See Washington UTC, Eleventh Supplemental Order, Docket No. UE-920433, p. 10 (September 21, 1993).

of the revenue-per-customer cap.[31] In 1995, as part of a litigation settlement proposal intended to create no precedent, Puget and several other parties filed a request with the Commission to terminate a complex system of rate adjustment mechanisms that included the revenue-per-customer cap (along with, e.g., a controversial approach to allocating risks of hydropower fluctuations). The Commission approved that request, but the proposal itself expressly reserved the right of all parties to bring forward in the future "other rate adjustment mechanisms, including decoupling mechanisms, lost revenue calculations, [and] similar methods for removing or reducing utility disincentives to acquire conservation resources."[32] In 2004, the Commission invited PacifiCorp and other stakeholders to begin discussions regarding the design of such a mechanism, in its order approving a settlement proposal by NRDC, the Commission staff, and PacifiCorp.[33]

Q. BUT WITNESS DISMUKES SAYS THAT THE WASHINGTON COMMISSION REJECTED DECOUPLING IN 2006; WHAT'S YOUR RESPONSE?

A. As a witness in that case, I can attest that the Commission emphatically did not "reject decoupling." It rejected a specific proposal by the Company and NRDC, principally because (as indicated in the passage quoted by Mr. Dismukes, p. 29) continuing disputes over multi-state allocation of the company's fixed-cost revenue requirement made it impossible to calculate Washington's share of that revenue requirement, a prerequisite for any decoupling mechanism. In addition, unlike the Company in this proceeding, PacifiCorp had not made a public commitment to expand its conservation efforts. I expect soon, on behalf of NRDC, to file a new joint decoupling proposal with PacifiCorp in Washington, and I am confident that the Commission will approve it. I note also that both Puget Energy Services and Avista have natural gas decoupling proposals pending at the Washington Commission.

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[31] See id. , p. 10 (concluding that "the PRAM/decoupling experiment should continue for at least another three-year cycle").

[32] Docket No. UE-921262, Joint Report and Proposal Regarding Termination of the Periodic Rate Adjustment Mechanism (April 20, 1995).

[33] See Washington UTC v. PacifiCorp, Docket No. UE-032065, Order No. 06, pp. 29-30 (October 2004) (inviting PacifiCorp, following discussion with other parties, to "propose a true-up mechanism, or some other approach to reducing or eliminating any financial disincentives to DSM investment").

Q. WITNESS DISMUKES ALSO SAYS THAT CONNECTICUT'S REGULATORS "RECENTLY RULED AGAINST REVENUE DECOUPLING FOR ITS ELECTRIC AND GAS UTILITIES" (p. 27); IS THAT YOUR UNDERSTANDING?

A. Not exactly. The Commission didn't "rule" on a utility application for a decoupling mechanism (Connecticut's gas utilities are only minimally involved in conservation efforts and are on record in opposition to decoupling). Mr. Dismukes is referring to a report that the Commission filed recently with the state legislature, in which the Commission acknowledged the need to remove financial disincentives for utility support of DSM but expressed a preference for calculating and restoring lost revenues associated with specific gas utility programs. It is worth noting also that the Connecticut Commission's concerns about shifting weather risks as part of decoupling proposals (cited in Mr. Dismukes's testimony at p. 28) are irrelevant to this proceeding, and that the Commission acknowledged specifically that decoupling "removes a disincentive for [utility] companies to promote conservation" (see passage quoted from Commission report at id.). The Connecticut Commission and its natural gas utilities prefer to address this problem by calculating and restoring to utilities lost revenues associated with their (very modest) conservation programs; as indicated earlier, I agree strongly with NRRI's Ken Costello that under this approach "an incentive problem arises where a utility would have an incentive to maximize measured or reported savings but to achieve minimal actual savings from energy efficiency initiatives."[34] I note further that this approach sharply raises the cost to customers of conservation programs, by adding adjudicated lost revenues to the costs of the programs themselves, and that over time these costs escalate sharply as lost revenues from long-lived savings continue to pile up, year after year.

Q. WHAT ABOUT THE ARIZONA COMMISSION'S RESERVATIONS ABOUT DECOUPLING (Dismukes, pp. 28-29)?

A. Unlike Questar in Utah, which already has participated in extensive informal discussions and workshops on decoupling (most recently on June 7), Southwest Gas's proposal in Arizona included little prior involvement and no support from other parties. The Arizona

[34] Costello, note 4 above, at p. 15.

Commission adopted a proposal by my organization (NRDC) and others to defer action on the company's proposal pending workshops and discussions among interested parties and further review of contentious issues such as "who bears the risk of weather variations;" rather than rejecting decoupling, the Commission directed Southwest gas to "coordinate its efforts to pursue implementation of a decoupling mechanism through discussions with Staff, RUCO, SWEEP/NRDC, and any other interested parties."[35] In this case, of course, Questar has already done precisely what Southwest Gas had neglected to do by way of productive advance consultations among all parties -- as demonstrated in part by my and others' strong support for its proposal.

Q. ARE DECOUPLING MECHANISMS ALWAYS ADDRESSED AS PART OF GENERAL RATE CASES?

A. No; for example, the Cascade Natural Gas mechanism in Oregon was adopted through Commission approval of a tariff filing by the utility; the scope of that filing was limited to the proposed creation of a four-year decoupling mechanism and an expanded investment by the company in energy-efficiency programs.

Q. WHY DON'T MORE STATES HAVE TRUE-UP MECHANISMS IN PLACE TO ELIMINATE DISINCENTIVES FOR UTILITY INVESTMENT IN DEMAND-SIDE RESOURCES?

A. A strong trend in that direction was interrupted in the mid-1990s by a stampede toward an industry restructuring model (pioneered in California) that denied utilities any substantial role in resource planning or investment. On that theory, there was no reason to worry about utilities' energy efficiency incentives, because utilities would be transferring their resource management responsibilities to unregulated participants in wholesale and retail electricity markets. The Western electricity and natural gas crisis of 2000-2001 has discredited that model, which in any case never took hold in Utah. Most states are now restoring full or at least significant utility responsibility for resource portfolio management, and I can attest from frequent appearances at regulatory and utility forums that interest in true-up mechanisms is reviving. But natural gas decoupling has

[35] Arizona Corporation Commission, Decision No. 68487, pp. 31-34 (Feb. 23, 2006).

only attracted broad industry interest and support in the last two years; for example, NRDC and the American Gas Association issued their widely cited joint statement in support of decoupling at NARUC's summer 2004 meeting,[36] and it was just last November that NARUC passed a resolution encouraging all state commissions to "review the rate designs they have previously approved to determine whether they should be reconsidered in order to implement innovative rate designs that will encourage energy conservation and energy efficiency that will assist in moderating natural gas demand and reducing upward pressure on natural gas prices."[37]

V. REBUTTAL TO ADDITIONAL CONTENTIONS OF WITNESS DISMUKES

Q. DOES THIS PROPOSAL REPRESENT A SIGNIFICANT DEPARTURE FROM THE WAY THAT TRADITIONAL UTILITY REGULATION HANDLES DISTRIBUTION NON-GAS REVENUES?

A. Decoupling has a 25-year history and is entirely consistent with traditional regulation. It uses the Commission's adjudicated fixed cost revenue requirement, employs the same regular true-ups that have been adopted for a host of other purposes, and (as Mr. Dismukes himself acknowledges) performs basically the same function as a very traditional fixed charge, without in the process requiring a change in existing rate structures.

Q. DO YOU AGREE THAT THE COMPANY HAS MADE NO WELL-DEFINED COMMITMENT TO PURSUE DSM SAVINGS?

A. No. I agree with Howard Geller that the Company is proposing the right way forward on DSM, based on a collaborative process with all parties. I am satisfied with the sincerity of the company's commitment, based on extensive interaction with both its management

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[36] Joint Statement of the American Gas Association and the Natural Resources Defense Council (Submitted to NARUC in July 2004) (including, p.2: "NRDC and AGA join in supporting mechanisms that use modest automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail sales").

[37] National Association of Regulatory Utility Commissioners, Resolution on Energy Efficiency and Innovative Rate Design (Sponsored by the Committee on Gas, Adopted by the NARUC November 16, 2005).

and Mr. Geller. And of course this is a pilot program, and if the Company fails to deliver on DSM the Commission can and should draw the appropriate conclusions and end the experiment.

Q. WHY SHOULDN'T THE COMMISSION WAIT TO RESOLVE THE DECOUPLING ISSUE UNTIL AFTER DSM PROGRAMS ARE IN PLACE, WITH CLEAR REPORTING AND EVALUATION METRICS?

A. It seems to me far more logical to get the utility's interests aligned with those of its customers right up front; that should get us better programs and better results. As NRRI's Ken Costello notes in his Briefing Paper on decoupling, "it would seem both unfair and counterproductive to order a utility to promote energy efficiency when detrimental to its shareholders."[38]

Q. SHOULD APPROVAL OF THE COMPANY'S PROPOSAL BE CONDITIONED ON A COST OF CAPITAL ADJUSTMENT TO REFLECT REDUCED FINANCIAL RISKS TO SHAREHOLDERS?

A. I disagree with both the conclusion and the premise on which it rests. It is important to recognize (as Mr. Dismukes himself clearly does) that the gas industry has only limited experience with this mechanism, and that it creates both upside and downside exposure for company shareholders (they will no longer under-recover authorized fixed costs if sales drop below expectations, but they also will lose their longstanding opportunity for gains from sales increases). Whether the net result is a material change in the company's risk profile cannot be determined without company-specific and capital market experience. This is particularly true for a mechanism, like this one, which is framed as a pilot program that does not in any way affect current allocation of weather-related risks. Finally, if the goal is to encourage the company to devote more management resources and creativity to energy efficiency, the simultaneous imposition of a reduction in shareholder returns would be wholly counterproductive.

[38] Costello, note 4 above, at p. 7.

Q. HOW DO YOU RESPOND TO THE CONTENTION THAT THE DECOUPLING PROPOSAL "MAKES THE COMPANY WHOLE FOR REVENUE LOSSES THAT GO BEYOND ANY REVENUE LOSSES CAUSED BY ENERGY EFFICIENCY PER SE . . . [IT] IS LIKE USING A STEAM ROLLER TO CRACK A PEANUT" (Dismukes, p. 8)?

A. Potential revenue losses from a robust conservation program are clearly material, as I showed earlier in describing the calculation of potential $23 million in automatic shareholder losses to Questar from a five-year systemwide conservation initiative. Peanut-sized conservation initiatives are what we will continue to get if Mr. Dismukes's advice is accepted. Also, note that mechanisms focused solely on conservation-driven revenue losses guarantee both regular rate increases and costly adjudication; by contrast, the company's proposal envisions adjustments that could go either up or down following a simple calculation based on easily ascertainable empirical data (customer count, actual non-gas revenues and authorized revenue per customer).

Q. DO YOU AGREE WITH MR. DISMUKES THAT THE COMPANY COULD AVOID ANY PROSPECT OF REVENUE LOSSES BY SHIFTING RATHER THAN REDUCING GAS USE AND IMPOSING A "RIM TEST" TO ENSURE THAT ONLY PROGRAMS RESULTING IN LOWER GAS RATES ARE ADOPTED (Dismukes, pp. 11 & 13)?

A. That particular cure is even worse than the disease, because the result would be a suite of programs that saved no natural gas whatsoever. The point is not to move gas consumption around but to reduce it. And as to the "RIM" test, it is failed automatically by any measure or program that reduces gas use, as long as retail gas rates are higher than the cost of additional gas procurement. Programs that save natural gas *at no cost to the utility or its customers* will generally fail the "RIM" test.[39]

[39] This is because the "RIM" test fails any measure that raises rates to other customers, however minutely, and even no-cost conservation has that effect if it reduces the company's retail revenues more than it reduces company costs (which happens whenever retail rates exceed gas commodity costs to the company).

Q. ISN'T THE COMPANY REQUIRED BY LAW TO PURSUE ALL COST-EFFECTIVE DSM, REGARDLESS OF ANY INCENTIVES OR DISINCENTIVES (Dismukes, p. 14)?

A. Assuming for the sake of argument that Utah law so provides, which I cheerfully will, the state could still expect better results if it aligned utilities' financial incentives with their legal mandates.

Q. HOW DO YOU RESPOND TO THE CONTENTION THAT THE COMPANY CANNOT PROVE THAT GAS CONSUMPTION PER CUSTOMER IS DECLINING, AND THAT IN ANY CASE ITS AVERAGE REVENUES PER CUSTOMER AND RETURN ON EQUITY ARE RELATIVELY STABLE, SO THAT THE COMPANY HAS "AN OPPORTUNITY TO MAINTAIN PROFITABILITY DESPITE DECREASES IN AVERAGE USE" (Dismukes, pp. 20-22)?

A. From a public interest perspective, the case for decoupling is of course even stronger if customers' use of natural gas is stable or increasing; the system's need for and opportunities to secure savings will be correspondingly greater at a time of rising consumption, soaring costs and price volatility. Note also the inconsistency between Mr. Dismukes's claim that decoupling yields large shareholder benefits and his argument that we don't really know whether use per customer is declining. If use per customer is likely to be stable or rising over time, the Company would gain little or no financial benefit if it secured decoupling, since its shareholders would do as well or better by cashing in on a growing state's retail sales increases without decoupling.

Q. DOES DECOUPLING REDUCE A UTILITY'S INCENTIVE TO PURSUE COST EFFICIENCIES, BY ASSURING FIXED REVENUES PER CUSTOMER FOR A UTILITY WITH A GROWING CUSTOMER BASE (Dismukes, p. 25)?

A. No. Under both the status quo and decoupling, cost efficiencies between rate cases yield identical bottom line benefits, and cost inefficiencies come out of shareholders' pockets.

Q. DO YOU AGREE THAT QUESTAR'S DECOUPLING PROPOSAL WILL ELIMINATE ITS INCENTIVE TO PROMOTE ECONOMIC DEVELOPMENT IN UTAH (Dismukes, p. 36)?

A. No. Mr. Dismukes is effectively equating economic development with increased fuel use; that kind of thinking undercuts energy efficiency progress and efforts to reduce Utahns' exposure to fossil fuel price risks. The right kind of economic development incentive links utilities' fixed cost recovery to growth in the customer base, rather than the use of natural gas, and that is precisely what the company is proposing.

Q. DOES DECOUPLING INTRODUCE EQUITY CONCERNS BY PENALIZING CUSTOMERS WHO HAVE MADE THEIR OWN ENERGY EFFICIENCY INVESTMENTS AND CANNOT TAKE ADVANTAGE OF THE COMPANY'S PROGRAMS (Dismukes, pp. 39-40)?

A. As documented earlier in this testimony, formidable barriers to energy efficiency ensure that few if any customers already will have taken full advantage of cost-effective opportunities to save natural gas. Also, and at least equally important, this objection overlooks the benefits that all customers will receive if sustained reductions in gas use push wholesale prices down, as indicated in the ACEEE studies cited in Mr. Geller's rebuttal testimony. Finally, I note that Ken Costello addresses the issue of customer-initiated efficiency extensively in his NRRI Briefing Paper, and concludes that decoupling "would probably have little effect on customer-initiative energy efficiency."[40]

Q. IS DECOUPLING REALLY A HIGHER FIXED CHARGE IN DISGUISE, AS MR. DISMUKES CONTENDS (pp. 40-41)?

A. On the contrary, as Mr. Dismukes appears to recognize, the great strength of decoupling is that it yields the benefits to utilities of fixed charges without reducing customers' rewards for saving natural gas; Mr. Dismukes inexplicably says that "the fact that these charges are applied volumetrically is a difference without a distinction," when in fact this difference is at the heart of the distinction between decoupling and fixed-charge increases.

[40] Costello, note 4 above, at pp. 12-13.

VI. REBUTTAL TO CONTENTIONS OF WITNESS WOLF

Q. RESPOND TO WITNESS WOLF'S STRONG SUPPORT FOR UTILITY INVESTMENT IN ALL COST-EFFECTIVE DEMAND-SIDE MANAGEMENT (DSM) OPPORTUNITIES.

A. I agree with her, and indeed that objective has been the primary focus of my 27 years of advocacy in the utility sector.

Q. WITNESS WOLF CONTENDS THAT THE COMPANY'S PROPOSAL PUTS THE CART BEFORE THE HORSE, AND THAT THE COMMISSION SHOULD FIRST ENSURE THAT COST-EFFECTIVE DSM PROGRAMS HAVE BEEN APPROVED; OTHERWISE SHE SAYS THAT CUSTOMERS MAY GET NO BENEFITS WHILE PAYING ADDITIONAL COSTS. DO YOU AGREE?

A. No. Customers are much likelier to get benefits if the Company is not penalized for delivering them. It also bears emphasis that decoupling imposes no new or additional costs on customers; it simply ensures that recovery of fixed costs already approved by the Commission is not affected by changes in gas use.

Q. RESPOND TO WITNESS WOLF'S CONTENTION THAT THE COMPANY'S PROPOSAL WOULD "VIRTUALLY ASSURE ITS PROFITABILITY" AND ELIMINATE ANY NEED FOR IT TO FILE RATE CASES.

A. The Company's proposal does not guarantee, "virtually" or otherwise, any level of profitability; it simply prevents fluctuations in gas use from affecting the Company's ability to recover previously approved revenue requirements unrelated to gas use. This reform should not affect the frequency of rate cases (which will be driven, as always, primarily by changes in the company's costs of operations); what will change is the company's incentives to promote reductions in systemwide gas needs between rate cases.

Q. DO YOU AGREE WITH WITNESS WOLF THAT THE COMPANY'S PROPOSAL UNFAIRLY SHIFTS COSTS AND BURDENS TO RATEPAYERS?

A. No, because the proposed mechanism adds no new costs or burdens, and rates could go either up or down (very modestly) as a result of its regular true-ups. On the other hand, without these true-ups and the associated changes in the Company's incentives, ratepayers are unlikely to see the substantial benefits associated with creative large-scale energy efficiency programs.

Q. DO YOU CONTEST WITNESS WOLF'S OBSERVATION THAT REMOVING DISINCENTIVES IS DIFFERENT FROM PROVIDING INCENTIVES, AND THAT UTAH ALSO NEEDS INCENTIVES AND PROGRAMS SUPPORTING EFFICIENCY IMPROVEMENTS?

A. I agree with her on this point, but of course that's not a reason to delay further in removing a large disincentive. The Company's proposal is an important first step toward goals that witness Wolf and I both support.

Q. WITNESS WOLF SAYS THAT SOME LOW INCOME ADVOCATES HAVE "SEEN INSTANCES IN WHICH DECOUPLING MECHANISMS HAVE BEEN IMPLEMENTED IN ORDER TO ENCOURAGE UTILITY INVESTMENT IN ENERGY EFFICIENCY WITH THE RESULT OF HIGHER COSTS FOR CUSTOMERS WITH LITTLE OR NO ACTUAL INVESTMENT" (p. 7); HOW DO YOU RESPOND?

A. As a long-time advocate of low-income efficiency programs, I have to say that I have never seen that. It is no coincidence that the Western states with the most extensive decoupling experience, California and Oregon, also have the strongest traditions of supporting targeted energy efficiency programs for low-income households. And again: decoupling doesn't add any new costs to customers, and in my experience it is a necessary condition to sustained progress in energy efficiency. It is certainly possible to get spurts of utility activity through Commission mandates, but my experience is that the activity dies off if regulators do not address the mismatch between customer and shareholder interests.

Q. WITNESS WOLF OBSERVES THAT "THIS TYPE OF MECHANISM PASSES ON COSTS TO LOW INCOME HOUSEHOLDS WITHOUT THE ABILITY OF THOSE HOUSEHOLDS TO PARTICIPATE IN THE PROGRAMS UNLESS THERE ARE SPECIFIC PROGRAMS DESIGNED FOR LOW-INCOME CUSTOMERS;" WHAT IS YOUR VIEW ON THIS?

A. I certainly agree regarding the need for and value of targeted low-income programs, and I'm confident that Questar will find ways to support them cost-effectively in Utah, but the likelihood of success is much greater if the Commission acts first to remove significant financial disincentives to such support. I reemphasize that this mechanism does not create or pass on any new costs, to low-income customers or anyone else.

Q. DO YOU AGREE WITH WITNESS WOLF THAT USE OF A FORECASTED TEST YEAR COULD LESSEN THE FINANCIAL IMPACT OF REDUCTIONS IN CUSTOMERS' NATURAL GAS USE ON THE COMPANY?

A. The use of a forecasted test year doesn't materially affect the financial disincentives associated with energy efficiency improvements, from utilities' perspectives, but it does introduce a costly new source of contention in rate cases. Without decoupling, regardless of the forecast used in setting rates, utilities automatically lose on every reduction in sales and gain on every increase in sales. Obviously in such circumstances lower forecasts are better for utilities in general, because they get to keep any gains from sales in excess of the forecast; this is the reason why sales forecasts are typically hotly contested in states that use future test years. By contrast, under decoupling, forecasting errors have no financial consequences for the company or its customers, since regular rate true-ups correct automatically for any disparities between actual and predicted consumption.

VII. REBUTTAL TO CONTENTIONS OF WITNESS HIGGINS

Q. WITNESS HIGGINS ARGUES THAT THE PROPOSAL TRANSFERS RISK TO CUSTOMERS AND SHOULD NOT BE ADOPTED WITHOUT REDUCING THE COMPANY'S ALLOWED RETURN.

A. I strongly disagree, for the reasons already addressed in the summary of my testimony and my earlier response to the same argument by Mr. Dismukes.

Q. DO YOU AGREE WITH WITNESS HIGGINS THAT DECOUPLING REPRESENTS "A FUNDAMENTAL AND UNWARRANTED CHANGE IN RATEMAKING PHILOSOPHY, BECAUSE IT MAKES THE NON-FUEL PORTION OF BASE RATES VARIABLE (p. 6)?

A. I think he's got it backwards here. The non-fuel portion of base rates is effectively variable without decoupling, because actual recovery goes up and down in lockstep with gas sales; assuming this should be avoided (as I do), decoupling is crucial to the solution, not a contributor to the problem.

Q. ADDRESS WITNESS HIGGINS'S CONCERN THAT DECOUPLING IS "A HAZARDOUS UNDERTAKING THAT IS AKIN TO SINGLE-ISSUE RATEMAKING," IN THAT IT COULD CREATE RATE INCREASES AT TIMES WHEN RATES MIGHT ACTUALLY DESERVE TO BE REDUCED IF ALL RELEVANT VARIABLES WERE CONSIDERED (p. 12).

A. Traditional ratemaking makes ample provision for "trackers" and/or true-ups associated with, e.g., weather and fuel costs; the Company's proposal is no different in its "single issue" implications, and the public interest justification is at least as compelling. Ken Costello of the National Regulatory Research Institute has investigated whether decoupling mechanisms meet the traditional tests justifying state utility regulators' use of "tracking mechanisms that adjust rates and revenues whenever sales deviate from their targeted level," and has concluded that "[u]nless a state commission faces legal restrictions in implementing a 'sales tracker' or has a built-in policy of limiting trackers in general, [revenue decoupling] would seem to meet the regulatory threshold for a tracker."[41] I agree.

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[41] Id. at p. 9.

Q. RESPOND TO WITNESS HIGGINS'S CONTENTION THAT DECOUPLING ISN'T NEEDED, BECAUSE CUSTOMERS ARE REDUCING THEIR NATURAL GAS USE WITHOUT IT (p. 12).

A. But Mr. Higgins does not suggest that we are tapping anything close to all cost-effective conservation, and if the State of Utah and the Commission want the utility to serve as an effective partner in getting more, we need decoupling, for all the reasons explored in this testimony.

Q. DO YOU AGREE WITH WITNESS HIGGINS THAT IF CONSERVATION IS IN THE PUBLIC INTEREST, THE COMMISSION SHOULD SIMPLY ORDER THE COMPANY TO SUPPORT IT, RECOGNIZING THAT "WITH THE PRIVILEGE OF A MONOPOLY COMES THE OBLIGATION TO COMPLY WITH COMMISSION DETERMINATIONS OF THE PUBLIC INTEREST" (pp. 13-14)?

A. Without in any way contesting Mr. Higgins's characterization of the Commission's authority, I believe that the public interest clearly would be served better if Commission policy and utility incentives were aligned, rather than at cross purposes. Regulated companies are not and should not be indifferent to financial incentives, and regulators should act to correct significant misalignments between customer and shareholder interests.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

Dated this 16th day of June, 2006

Ralph Cavanagh

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Ralph Cavanagh