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BEFORE THE

PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

In the Matter of the Application of HAWAIIAN ELECTRIC COMPANY, INC. For Approval and/or Modification of Demand-Side and Load Management Programs and Recovery of Program Costs and DSM Utility Incentives.	)	DOCKET NO. 05-0069

STATEWIDE ENERGY EFFICIENCY DOCKET

DEPARTMENT OF DEFENSE'S

REPLY BRIEF

AND

CERTIFICATE OF SERVICE

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HAWAIIAN ELECTRIC COMPANY, INC.
Docket No. 05-0069

Reply Brief of The Department of Defense

Pursuant to the direction of the Commission, the Department of Defense (DOD) hereby submits its reply brief on the proposals which Hawaiian Electric Company, Inc. (HECO) has made in this proceeding. DOD's reply brief addresses the following issues:

- Shareholder incentives, and
- Lost margins.

DOD is not offering further comments with respect to the other issues that it addressed in its opening brief, namely the structure of cost recovery, program administration and decoupling. DOD's position with respect to these issues was fully set forth in its opening brief, and none of the commentary of the other parties in their opening briefs requires further response.

SHAREHOLDER INCENTIVES

In it opening brief (OB), HECO spends a considerable number of pages discussing various incentive mechanisms. It discusses mechanisms that it initially proposed in this docket, and then abandoned; and it discusses incentive mechanisms that it claims have been allowed in other jurisdictions for other utilities at other times. HECO modified its proposal in its final statement of position (FSOP) and at the hearings seemingly narrowed its request. However, it is not clear what purpose is served by the extensive recitation of other methodologies that are not even being proposed. DOD will not address the abandoned proposals.

HECO Has Agreed Not To Request Incentives

At the policy level, HECO continues to argue for shareholder incentives. It claims that it had not previously abandoned its right to seek shareholder incentives as a consequence of stipulations entered into with the CA and approved by the Commission. This is particularly puzzling in light of the Order of the Commission (Order No. 22921) issued October 4, 2006 in which the Commission clearly stated that its expectation from the stipulations was that HECO had receded from and would not now be seeking shareholder incentives or lost margins. At page 15, the Commission specifically said:

> "Clearly, the commission understood that (1) HECO would not be seeking lost margins or shareholder incentives in its next rate case or thereafter, and (2) HECO would exhibit the same level of commitment to its DSM programs after the termination of lost margins or shareholder incentives."

This should end the argument. But, in case the concept is further entertained, we also respond substantively to HECO's arguments.

HECO Has Not Established A Need For Incentives

At pages 181-182 of its OB, HECO argues that incentive approaches have been more successful than the structured approaches, which are characterized by HECO as "command and control." In particular, HECO makes the following statement:

> "The "command and control" approach, by itself, has proven to be less effective than an incentive approach."

HECO offers absolutely no proof of this proposition. Rather, it cites to opinions expressed in orders by other commissions when establishing such mechanisms. All of these statements are pure conjecture, and HECO has offered absolutely no proof of its claim that DSM has been more effectively implemented by using incentive mechanisms.

It is also notable that the decisions of other state commissions that HECO cites beginning at page 182 of its OB are ten or more years old. They are all from the early 1990s, which was the time that DSM programs and cost recovery mechanisms were first being established. HECO did not cite any recent Commission decisions that would suggest a belief that shareholder incentives are required. As noted by the CA in its OB (CA OB, page 39), shareholder incentives may have been an appropriate part of DSM programs 10 to 15 years ago when the programs being established were novel, there was little experience with them and utilities were understandably reluctant to undertake these new approaches to planning and fulfilling their public service obligations.

Since then, substantial experience has been gained in the planning and implementation of DSM programs. HECO has a large staff that is experienced in DSM and claims to have been very successful in implementing DSM programs and producing demand and energy savings.

It is also notable that the Hawaii DSM framework to which HECO repeatedly refers makes it clear that incentives are not required, but are optional on the part of the Commission. Thus, the question becomes: Are they necessary? This would require a conclusion that HECO would not do a credible and professional job of implementing DSM in the absence of these incentives. But, the record clearly dispels this notion. Under cross-examination as to how it would behave in the absence of incentives, the HECO witness testified as follows:

> "MODERATOR HEMPLING: Hold on, Mr. Waller. If there were no DSM incentive program and if there were no lost revenues recovery mechanism and you were faced with two choices, one is to conduct a DSM program which would reduce sales and the other is not to engage in the DSM programs and thereby not reduce sales and if it was not debatable that the DSM approach would lower ratepayer cost, do you understand your utility obligation to be to choose the DSM alternative?
>
> MR. WALLER: Given those circumstances, we would professionally pursue the demand-side management option and pursue fulfilling the obligation to provide electricity at the minimum cost.

MODERATOR HEMPLING: You're aware of no executive level pressure in your company to do anything other than what you just said, Mr. Waller, right?

MR. WALLER: That is our position." (Tr., Volume IV, pp. 885-886)

Obviously, HECO intends to pursue the appropriate courses of action regardless of whether the shareholders are receiving incentives. This is as it should be. Utility management should act responsibly and implement those programs which are in the overall best interest of its ratepayers. HECO has said that it would do this, and the Commission should take HECO at its word. Accordingly, shareholder incentives are not necessary and should not be approved.

If Incentives Are Allowed – There Should Be Symmetry

Beginning at page 222 of its OB, HECO argues that if it is rewarded for achieving certain DSM objectives, it should not similarly face a penalty or negative incentive for failing to achieve a reasonable level of performance. HECO wants a one-way incentive, and does not want to tie the incentive to achieving expected performance levels. In essence, it wants always to win or tie, but never lose. This is highly asymmetrical, and not in the best interest of customers.

HECO goes on to argue at page 223 that any penalty that is incorporated should be triggered only if "...the utility fails to achieve a minimum acceptable level of demand or energy savings." DOD believes that if a penalty is triggered at a "minimum" acceptable level of performance, then any reward should be applicable only if the utility achieves a clearly "superior" level of performance. In between, at the expected level, and around that level with some bandwidth, HECO should not be entitled to any incentive. To do otherwise would reward mediocre performance and disregard inferior performance. Notably, the moderator (Mr. Hempling) clearly stated his belief that incentives should be symmetrical (Tr., Volume IV, p. 854).

<u>Demand Side Management Is Less Risky Than Supply-side Management</u>

DOD also endorses the comments of the CA at pages 40-41 of its OB wherein CA succinctly lays out the difference in risk between supply-side and demand-side options. As noted by CA, DSM programs pose less risk to the utility than do traditional supply-side resources. With DSM programs, the utility recovers its investment in a much shorter period of time compared to supply-side resources that are depreciated over 30-40 years. Also, the risks associated with potential disallowances of costs are smaller, and, because the investments are in smaller increments, there is less financial pressure on the utility because it does not have to finance in such large increments.

<u>LOST MARGINS</u>

At page 199 of its OB, HECO argues that the "single-issue ratemaking" objection is not applicable to lost margins. HECO's reasoning is that lost margins will <u>always</u> have a negative impact on the utility. This misses the point. The single issue objection is applicable whether the item in question is always negative, always positive or sometimes negative and sometimes positive. Taking HECO's point that lost margins will always have a negative impact does not mean that other changes in the utility's operations will not <u>offset</u> the negative impact of lost margins. As discussed at the panel hearings (Tr. Volume IV, pp. 804-807) and in DOD's FSOP, once rates are established in a rate case, many elements of the revenue requirement will change. Assets depreciate and unless capital additions overwhelm the increase in deprecation, the utility's net rate base will decrease, reducing its revenue requirement. Utilities also routinely implement improved technology and work practices and drive down costs by doing so. Numerous other examples could be recited, but the fact that lost margins act in only one direction does not at all negate the single issue ratemaking objection to the collection of lost margins.

CONCLUSION

DOD's recommendations to the Commission remain the same as in its opening brief, namely:

1. Include in base rates predictable program costs, leaving only items such as customer incentives and program costs that vary directly with participation to be trued-up through a rider mechanism.

2. Reject HECO's proposal for separate treatment or special recovery of lost margins or shareholder incentives, in any form.

3. In order to ensure that there are no unintended consequences, require a comprehensive analysis and the inclusion of appropriate safeguards if third-party administration of some or all DSM programs is deemed appropriate.

4. Reject proposals to decouple revenues and earnings from sales volumes. The track record for these programs has been just short of disastrous, and nothing offered in this proceeding indicates that there would be more good than harm from a decoupling approach.

Submitted on this 15th day of November 2006.

Respectfully submitted,

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I hereby certify that I have this date served one copy of the foregoing DEPARTMENT OF DEFENSE'S FINAL STATEMENT OF POSITION, STATEWIDE ENERGY EFFICIENCY DOCKET in Docket No. 05-0069 upon the following parties by causing copies hereof to be mailed, postage prepaid, and properly addressed to each such party, as noted below:

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