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PUBLIC UTILITIES COMMISSION

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

OPENING BRIEF

AND

CERTIFICATE OF SERVICE

RANDALL Y.K. YOUNG
Associate Counsel (Code 09C)
Naval Facilities Engineering Command, Pacific
258 Makalapa Drive, Suite 100
Pearl Harbor, HI 96860-3134
Telephone (808) 474-5514

ATTORNEY FOR
DEPARTMENT OF DEFENSE

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

Opening Brief of The Department of Defense

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

- The structure of cost recovery,
- Lost margins,
- Shareholder incentives,
- Program administration, and
- Decoupling.

DOD's witness for the various panels was Maurice Brubaker. Mr. Brubaker has testified in several hundred regulatory proceedings throughout the United States, including numerous dockets in Hawaii. As directed by the Commission, a copy of Mr. Brubaker's qualifications is attached to this brief.

RECOVERY OF PROGRAM COSTS

As Mr. Brubaker explained (Tr. Volume IV, p 14),* DOD favors including a reasonable estimate of program costs (including incentives paid to customers) in base rates. These costs are, in principle, no different than other costs incurred by the utility that are included in base rates, and remain at their included level until changed in a subsequent general rate case.

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*Although DOD timely ordered transcripts, it has to date only received an electronic version. If the page numbers in the official printed transcript differ from these, DOD will submit a revised version of this brief.

DOD does not see a reason to distinguish the DSM program costs from these other costs. For much the same reason that the level of fuel and purchased power cost experienced at the time of a rate proceeding goes into base rates, DSM costs also should go into base rates. Fuel and purchased power costs are subject to adjustment, up or down, from the amount included in base rates as these costs vary. It is generally appropriate to allow a utility to track increases or decreases in the cost of fuel and purchased power expense between rate proceedings because these costs are somewhat difficult to predict and are determined, at least in substantial part, by forces outside the control of the utility (Tr., Volume IV, pp. 14-15).

The same approach can be taken to DSM costs. In that regard, DOD supports a periodic adjustment to "true-up" actual program-related expenditures, above or below the amount included in base rates, subject to appropriate reasonableness reviews. True-ups should be limited to direct, identifiable, out-of-pocket expenses incurred by HECO. These types of expenses are more difficult to predict than the basic operational expenses for the program such as the level of employee costs, because they are, in part, a function of the success of the marketing effort (Tr., Volume IV, p 15). This would include incentives paid to customers and payments made to third parties.

It is appropriate to limit the true-ups in this regard because these items of costs are truly "out-of-pocket" expenditures to HECO that are paid to customers in order to facilitate participation in the DSM programs, or paid to third parties. Further, the amounts of payments to customers (and perhaps part or all of third-party payments) will be a function of the level of customer participation, which may be difficult to estimate. However, there should not be any true-ups for HECO internal costs such as payroll and general office expenses. Rate cases are the place where recovery of HECO's internal costs should be adjusted. There is no reason to elevate payroll and general expenses associated with DSM programs to a higher plane than other corporate expenses.

RECOVERY OF "LOST MARGINS"

HECO seeks to recover estimated "lost margins" from customers. This proposal is made despite the fact that HECO has foregone the right to do so by virtue of stipulations that it entered into with the Consumer Advocate (CA).[1] In these stipulations, HECO specifically agreed that it would not pursue the continuation of lost margins and shareholder incentives in the "next" rate case or thereafter.

Commission Ruling

At the outset of the panel hearings, the Commission entertained argument on HECO's motion for partial reconsideration of Interim Decision in Order No. 22420 concerning the recovery of lost margins and shareholder incentives. This Order required HECO to discontinue the recovery of lost margins and shareholder incentives within 30 days of the filing of the Interim Decision and Order No. 22420.

In Order No. 22921, issued October 4, 2006, the Commission upheld its initial decision, and required HECO to discontinue the collection of lost margins and shareholder incentives. In commenting on the stipulations and on its prior rulings, the Commission noted at page 15 of Order No. 22921:

> "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

[1]See letters dated October 5, 2001 in Docket No. 00-0169 and October 11, 2001 in Docket No. 00-0209 from HECO to the Commission, memorializing the stipulations entered into between HECO and the CA. These stipulations were approved by the Commission in Order Nos. 19019 and 19020, issued November 15, 2001.

would exhibit the same level of commitment to its DSM programs after determination of lost margins or shareholder incentives."

DOD reads this Order as effectively disposing of the question of lost margins and shareholder incentives associated with DSM programs that HECO has attempted to pursue in this docket. Accordingly, DOD believes that these issues need not be argued further. However, in the event that the Commission has a different view and wishes to continue to entertain these issues, DOD will also address them substantively.

Policy Issues

Lost margins are the revenues imagined to be forfeited because of the implementation of new DSM programs or the expansion of existing programs to add DSM measures on the premises of HECO's customers. Even without the preclusion that DOD believes results from the stipulations and Commission orders, DOD does not believe that allowing recovery of lost margins in isolation is appropriate for the following reasons.

First, an increase in DSM programs does not necessarily result in a reduction in HECO's total sales. Despite the fact that HECO has had in place DSM programs for over ten years, its total system sales and generation requirements have continued to grow. There is nothing which would suggest that this circumstance will change. Indeed, HECO has identified a need to add generation capacity to serve its growing load, even though it expects demand reductions from DSM to grow (Tr., Volume IV, p. 67). DOD might be more sympathetic to HECO if the end result of its programs were actually net reductions in sales volumes, but that does not appear to be the case.

Second, ratemaking is dynamic. Once rates are established in a rate case on the basis of the test year, and go into effect, many things, which affect the revenue requirement will change.

Examples are improved work practices and advancements in information technology that reduce the cost of providing utility services, refinancing of higher cost debt, the availability of more rapid tax depreciation for capital additions, the declining rate base that results from the accrual of depreciation from the time that rates are set, and doubtless many other factors. It is the combined effect of changes in all factors that determines when a utility needs more money because its return has dropped to an unacceptably low point (Tr., Volume IV, p. 24). Singling out one item, such as calculated "lost margins" without considering the changes in other factors that influence the revenue requirement is the kind of single-issue ratemaking that should be avoided.

Lost Margin Recovery is Not Required

At the panel hearings, HECO confirmed that it did not require lost margin recovery in order for it to act professionally and pursue the appropriate combination of DSM and supply side resources (Tr., Volume IV, pp. 70-71). Thus, the Commission should not be concerned that the absence of a rider or other special mechanism for recovery of "lost margins" will result in the consumers being short changed. HECO has confirmed that it will pursue the appropriate course of action regardless of the presence or absence of a separate mechanism for recovery of lost margins.

SHAREHOLDER INCENTIVES

In the stipulations and orders referenced above, HECO made the same pledges with respect to not pursuing recovery of shareholder incentives, and the Commission has made the same rulings. Therefore, DOD believes that the issue of shareholder incentives also has been laid to rest. However, in the event that the Commission should desire to further entertain these concepts, DOD addresses the substance below.

Policy Issue

Putting aside the question of whether HECO may even make such a request, DOD is opposed to the request for several reasons.

First, DOD does not believe that shareholders need to receive rewards for doing what HECO is supposed to do. Regulated electric utilities have an obligation to provide safe, reliable and adequate service at the lowest reasonable overall cost. To the extent that there is a role for energy efficiency programs, demand response programs and other demand-side alternatives, then these resources should be pursued. The pursuit should be consistent with the results of Integrated Resource Planning (IRP) in which both supply-side and demand-side resources are considered and the appropriate combination is selected. DOD does not believe shareholders should be rewarded with special compensation either for doing a good job with DSM or for doing a good job with supply-side resources.

DOD believes that the overall quality and performance of management should be taken into account when operations are reviewed during general rate cases. The Commission may take into account an exemplary performance in deciding the range of a reasonable rate of return to establish the return on equity. This allows for a full consideration of all relevant factors, rather than an isolated view of one particular factor without considering performance in other areas.

To the extent any incentive is found appropriate, it should be based on a careful evaluation of program performance. HECO should not be rewarded just for implementing programs and spending ratepayer's money, but should be rewarded if it implements programs in such a way that the performance of the programs exceed reasonable expectations. In other words, a realistic expectation of the amount of savings should be established. Actual performance should be compared to expected performance to determine whether HECO achieved, surpassed, or fell short of expectations (Tr., Volume IV, pp. 108-109).

To the extent shareholders have the possibility of being rewarded for HECO performance that exceeds the expected level, they should similarly be subject to some reduction in compensation, i.e., a penalty, if the performance is below expectations. It is only fair and reasonable for any such incentive mechanism to operate on a symmetrical basis. In operation, this mechanism will not result in an over-recovery or under-recovery of costs, but will enhance or reduce the utility's return on equity (Tr., Volume IV, p. 100).

Shareholder Incentives are Not Required

Similar to the statement it made with respect to the lost margin issue, HECO confirmed that it does not require shareholder incentives in order to act professionally and pursue the appropriate combination of DSM and supply-side resources (Tr., Volume IV, pp. 70-71). Thus, the Commission should not be concerned that the absence of special shareholder incentives will result in the consumers being short changed. HECO has confirmed that it will pursue the appropriate course of action regardless of the presence or absence of shareholder incentives.

ADMINISTRATION OF PROGRAMS

There was extensive discussion concerning whether an independent third party should administer some or all of the DSM programs. DOD has not made a specific recommendation in this regard, but rather has noted some important issues that must be addressed if administration by a third party is considered.

If this approach is taken, the first step would be to define the structure of the entity that would be administering these programs, determine whether it is to be a for profit or a non profit entity, and establish the basis for its compensation. The relationship between this entity and HECO, as well as the degree of regulation by the Commission, would also have to be established.

DOD is not opposed to a third party administering DSM programs, provided the appropriate safeguards are in place. The safeguards would include Commission determination of the programs to be offered and their funding levels, reporting requirements, approval of the compensation provided to the third party, approval of changes in programs, approval of changes in the level of funding of programs, and all similar matters that are now the subject of Commission regulation when HECO administers the DSM programs. These key Commission oversights are appropriate regardless of whether HECO or an independent third party administers the programs. Customers need to be assured that the amounts spent on DSM programs are appropriate and the programs selected are reasonably capable of delivering the estimated demand and energy reduction benefits. Only if the Commission retains its decision-making authority with respect to each of these issues, customers would have appropriate assurances.

It is critical that in regulating the third party the same rules and practices which apply to regulation of HECO are used. In this way, customers and all other relevant interested parties would have the right of intervention and all of the other rights accorded to them in a general rate proceeding for HECO or any other regulated utility.

DOD would note that one major potential advantage of having a third-party administer these programs is the removal of any concerns that HECO might not be doing as good a job as it could because of concerns over lost revenue. If the third party is independent of HECO and has a profit motive to excel in the delivery of DSM, then there is no issue with respect to HECO's behavior, as it is not making the critical decisions. Rather, HECO is given an added incentive to manage its business and deliver supply-side electricity at the most reasonable cost possible. The third-party administration of the DSM programs in effect creates competition between HECO supplying electricity efficiently, and the third party delivering DSM programs efficiently.

DECOUPLING

The basic idea behind decoupling is to separate a utility's revenues from its sales volumes. DOD is opposed to decoupling for a number of reasons. First, disassociating revenues from sales volumes effectively shifts the risk of changes in economic conditions, variations in weather patterns, and all other factors that affect sales away from the electric utility to the customer. With these risks being borne by the customer, the motivation for the utility to accommodate the needs of the customer is diminished because reduced sales would not impact the utility's bottom line.

If the objective of decoupling (as some would suggest) is to give the utility additional motivation to pursue DSM, DOD would suggest that the preferable alternative of utilizing a third party to administer and implement the DSM measures, thereby creating direct competition between energy efficiency programs delivered through the third party and the efficient production and delivery of electricity on the part of the utility. As noted above, creating the direct competition between: (1) the provision of energy efficiency programs and devices by a third party; and (2) the provision of supply-side electricity by the utility, incents each party to do the best job it can in order to provide the best possible service and to maximize its income, subject to Commission regulation. Thus, a third-party approach helps accomplish this goal while avoiding all the complications and problems associated with a decoupling approach.

Decoupling experience in the past has been limited and unfavorable. In 1991, the state of Maine adopted a decoupling mechanism which focused on "revenue per customer." Shortly after implementation of the mechanism, there was an economic downturn which caused significant reductions in sales, significant deferrals of costs and brought about higher rates. This program was cancelled after only two years. In October of 1991, The Washington Utilities and Transportation Commission adopted a mechanism for Puget Power called PRAM, which consisted of a combination of decoupling and a cost adjustment mechanism. This mechanism was cancelled in 1995 because it resulted in significant deferrals and rate increases for customers. The reason the Commission terminated this mechanism was because it did not provide clear incentives for the utility to manage power costs or to acquire conservation and other resources at the lowest possible cost. [2]

DOD points out that no party proposes to subject Schedule P customers to decoupling. As noted at the panel hearings, RMI acknowledges that there is a wide range of customer characteristics within Schedule P, which would make any kind of decoupling program based on per customer usage difficult. Also, the rate structure of the Schedule P tariffs essentially provides for a certain amount of decoupling, already (Tr., Volume IV, p. 76).

[2]Docket Nos. UE-950618, Third Supplemental Order Approving Stipulations; Rejecting Tariff Filing; Authorizing Refiling, April 20, 1995, page 6.

CONCLUSION

DOD urges the Commission to:

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 _25_ day of October 2006.

Respectfully submitted,

RANDALL Y.K. YOUNG
Associate Counsel (Code 09C)
Naval Facilities Engineering Command, Pacific
258 Makalapa Drive, Suite 100
Pearl Harbor, HI 96860-3134

ATTORNEY FOR THE
DEPARTMENT OF DEFENSE

CERTIFICATE OF SERVICE

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:

Catherine P. Awakuni, Executive Director — 6 Copies
Division of Consumer Advocacy
Department of Commerce and Consumer Affairs
P.O. Box 541
Honolulu, HI 96809

William A. Bonnet
Vice President, Government and Community Affairs
Hawaiian Electric Company, Inc.
P.O. Box 2750
Honolulu, Hawaii 96840-0001

Edward Reinhardt, President
Maui Electric Company, Ltd.
P.O. Box 398
Kahului, HI 96733-6898

Warren Lee, President
Hawaii Electric Light Company, Inc.
P. O. Box 1027
Hilo, HI 96721-1027

Dean K. Matsuura
Director, Regulatory Affairs
Hawaiian Electric Company, Inc.
P.O. Box 2750
Honolulu, Hawaii 96840-0001

Thomas W. Williams, Jr., Esq.
Peter Y. Kikuta, Esq.
Goodsill Anderson Quinn & Stifel
Alii Place, Suite 1800
1099 Alakea Street
Honolulu, Hawaii 96813

H. A. Dutch Achenbach
President and CEO
Kauai Island Utility Cooperative
4463 Pahee Street
Lihue HI 96766-2032

Joseph McCawley
Regulatory Manager
Kauai Island Utility Cooperative
4463 Pahee Street
Lihue, HI 96766-2032

Kent D. Morihara
Morihara Lau & Fong LLP
Davies Pacific Center Suite 400
841 Bishop Street
Honolulu, HI 96813

Jim R. Yates
President
The Gas Company
P.O. Box 3000
Honolulu HI 96802

Steven P. Golden
Director External Affairs & Planning
The Gas Company
P.O. Box 3000
Honolulu HI 96802

E. Kyle Datta
Managing Director
Rocky Mountain Institute
P.O. Box 390303
Keauhou, HI 96739

Carl Freedman
Haiku Design & Analysis
4234 Hana Highway
Haiku HI 96708

Henry Q Curtis
Vice President for Consumer Issues
Life of the Land
76 North King Street, Suite 203
Honolulu, HI 96817

Mr. Richard R. Reed
President
Hawaii Solar Energy Association
c/o Inter-Island Solar Supply
761 Ahua Street
Honolulu, HI 96819

Warren S. Bollmeier, II
President
Hawaii Renewable Energy Alliance
46-040 Konane Place, #3816
Kaneohe, HI 96744

Brian T. Moto, Esq.
Cindy Y. Young, Esq.
Department of the Corporation Counsel
County of Maui
200 South High Street
Wailuku, Maui, HI 96793

Kal Kobayashi
Energy Coordinator
Department of Management
County of Maui
200 South High Street
Wailuku, HI 96793

Glenn Sato, Energy Coordinator
c/o Office of the County Attorney
County of Kauai
4444 Rice Street, Suite 220
Lihue HI 96766

Lani D.H. Nakazawa, Esq.
Office of the County Attorney
County of Kauai
4444 Rice Street, Suite 220
Lihue HI 96766

DATED: Honolulu, Hawaii, 25 October, 2006.

RANDALL Y.K. YOUNG
Associate Counsel
Naval Facilities Engineering Command, Pacific

QUALIFICATIONS OF MAURICE BRUBAKER

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Maurice Brubaker. My business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141.

Q PLEASE STATE YOUR OCCUPATION.

A I am a consultant in the field of public utility regulation and President of the firm of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A I was graduated from the University of Missouri in 1965, with a Bachelor's Degree in Electrical Engineering. Subsequent to graduation I was employed by the Utilities Section of the Engineering and Technology Division of Esso Research and Engineering Corporation of Morristown, New Jersey, a subsidiary of Standard Oil of New Jersey.

In the Fall of 1965, I enrolled in the Graduate School of Business at Washington University in St. Louis, Missouri. I was graduated in June of 1967 with the Degree of Master of Business Administration. My major field was finance.

From March of 1966 until March of 1970, I was employed by Emerson Electric Company in St. Louis. During this time I pursued the Degree of Master of Science in Engineering at Washington University, which I received in June, 1970.

In March of 1970, I joined the firm of Drazen Associates, Inc., of St. Louis, Missouri. Since that time I have been engaged in the preparation of numerous studies relating to electric, gas, and water utilities. These studies have included analyses of the cost to serve various types of customers, the design of rates for utility services, cost forecasts, cogeneration rates and determinations of rate base and operating income. I have also addressed utility resource planning principles and plans, reviewed capacity additions to determine whether or not they were used and useful, addressed demand-side management issues independently and as part of least cost planning, and have reviewed utility determinations of the need for capacity additions and/or purchased power to determine the consistency of such plans with least cost planning principles. I have also testified about the prudency of the actions undertaken by utilities to meet the needs of their customers in the wholesale power markets and have recommended disallowances of costs where such actions were deemed imprudent.

I have testified before the Federal Energy Regulatory Commission (FERC), various courts and legislatures, and the state regulatory commissions of Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Guam, Hawaii, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Missouri, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Virginia, West Virginia, Wisconsin and Wyoming.

The firm of Drazen-Brubaker & Associates, Inc. was incorporated in 1972 and assumed the utility rate and economic consulting activities of Drazen Associates, Inc., founded in 1937. In April, 1995 the firm of Brubaker & Associates, Inc. was formed. It includes most of the former DBA principals and staff. Our staff includes consultants with backgrounds in accounting, engineering, economics, mathematics, computer science and business.

During the past ten years, Brubaker & Associates, Inc. and its predecessor firm has participated in over 700 major utility rate and other cases and statewide generic investigations before utility regulatory commissions in 40 states, involving electric, gas, water, and steam rates and other issues. Cases in which the firm has been involved have included more than 80 of the 100 largest electric utilities and over 30 gas distribution companies and pipelines.

An increasing portion of the firm's activities is concentrated in the areas of competitive procurement. While the firm has always assisted its clients in negotiating contracts for utility services in the regulated environment, increasingly there are opportunities for certain customers to acquire power on a competitive basis from a supplier other than its traditional electric utility. The firm assists clients in identifying and evaluating purchased power options, conducts RFPs and negotiates with suppliers for the acquisition and delivery of supplies. We have prepared option studies and/or conducted RFPs for competitive acquisition of power supply for industrial and other end-use customers throughout the Unites States and in Canada, involving total needs in excess of 3,000 megawatts. The firm is also an associate member of the Electric Reliability Council of Texas and a licensed electricity aggregator in the State of Texas.

In addition to our main office in St. Louis, the firm has branch offices in Phoenix, Arizona; Corpus Christi, Texas; and Plano, Texas.

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