MEMORANDUM

To: Commissioners and Advisors

From: Brian Rounds, Tim Binder and Karen Cremer

RE: GEO9-001 In The Matter of the Filing by NorthWestern Corporation d/b/a NorthWestern Energy for Approval of its South Dakota Demand Side Management Plan.

April 29, 2010

On October 1, 2009, NorthWestern Energy (NWE) filed a proposal regarding their implementation of a new Demand Side Management (DSM) Plan. The filing was a result of the Commission's approval of similar programs and associated incentives for three other regulated South Dakota utilities. In each case the utility filed a plan proposing to create a set of cost effective energy efficiency programs and recover the costs along with a small incentive by placing an energy efficiency surcharge, or rider, on customer bills. The rider is only adjusted as a result of commission approval, and the included incentive attempts to compensate the utility for lost revenue as a result of the programs' success. NWE's DSM Plan is modeled on both the previously approved utilities' plans and their own experience in Montana.

DSM PROGRAMS

Overall, Staff is pleased with the portfolio of programs that NWE is proposing here. Although small, the initial range of programs focuses mostly on equipment rebates and energy audits, something the Commission and Staff have agreed are cost effective measures.

However, Staff is concerned about NWE's request to implement a compact fluorescent light (CFL) rebate program. Included in the proposed budget is a Residential Lighting Rebate Program that encourages residential customers to switch to CFLs. As Staff has mentioned in previous dockets, although we agree that CFLs are a great way to conserve electricity, we do not believe rebating, subsidizing or handing out CFLs is an effective use of ratepayer dollars. CFLs are obviously superior to incandescent bulbs on an energy efficiency basis, and in the past programs like this have been the cornerstone of many DSM Plans. However, Staff believes that their use has become nearly ubiquitous as a result of the tremendous education efforts made over the past decade. The United States has already enacted legislation that is likely to phase incandescents out over the next couple of years. When we talk to South Dakotans at outreach events, attempting to convince them to replace their incandescent bulbs, the answer is a resounding, "We already did that." As a result, we believe a $246,900 budget (including only $75,800 in rebates and incentives; $18,500 in marketing) would be filled with free riders and therefore highly ineffective as well as potentially disruptive to the current easy-to-read market signals that CFLs are basically a "lucrative" investment opportunity for any homeowner.

RECOMMENDATION: Staff recommends NWE implement the programs as filed, with the exception of the Residential Lighting Rebate Program.

COST RECOVERY

NWE proposes to recover program costs by expensing and recovering them over the period they are incurred. This has been the preferred method with the other three currently operating programs. In every case, the Commission has approved a budget for a portfolio of programs prior to implementation. Once the programs go into effect, the utility recovers the expenses of the programs through an energy efficiency rider that is separated out on the customers' bill. After the budget period is over, the balance is trued-up.

RECOMMENDATION: Staff recommends NWE recover expenses through an energy efficiency rider, approved annually by the Commission, and placed as a separate line item on customers' bills. Additionally, a separate rider should be made for gas and electric customers, each corresponding to program expenses allocated to those customers. Staff recommends NWE file a budget for calendar year 2011 on July 1, 2010. On July 1, 2011, NWE would then file a plan for calendar year 2012. Then, on July 1, 2012, NWE would make one filing that includes a true-up of the 2011 calendar year and a plan for the 2013 calendar year. On July 1, 2013, NWE would make one filing that includes a true-up of the 2012 calendar year and a plan for the 2014 calendar year. This pattern would continue as long as the programs were in place.

UTILITY INCENTIVE

In South Dakota there is no requirement for utilities to provide energy efficiency programs. Utilities are not required to file an integrated resource plan (including demand side efforts) with the Commission, either. In addition, there is an inherent disincentive to offering programs aimed at reducing volumetric sales when a large portion of a utility's revenue requirement must be met through volumetric rates. Thus, the three DSM plans approved so far in South Dakota have all included an "incentive mechanism" meant to compensate for potential lost revenues.

In NWE's initial filing, the requested incentive mechanism included two parts: the recovery of lost revenues and a performance incentive. In one of the three programs currently operating, the Commission approved a performance incentive *in lieu of* lost revenues. In the other two plans, the Commission approved an incentive mechanism in which the utility is simply given a return on their investment (expenses). Staff prefers this mechanism because the incentive amount is easy to calculate and measurement and verification of actual savings (which are expensive to evaluate) become less contentious.

After discussions with Staff, NWE declined to adopt Staff's preferred mechanism, but agreed to lower their requested incentive mechanism to only include the recovery of lost revenues. Although this is a step in the right direction, Staff still has major concerns with the calculation of lost revenues. Once savings are calculated using this mechanism, they accumulate year after year, until rates are readjusted to match demand. If NWE does not come in for a rate case or perform a cost of service study for a long period of time the incentive could become as high as the budget itself. The perception alone of such a large incentive would not be positive to the ratepayer. Staff is hesitant to allow lost revenue recovery, but willing to make a cautious attempt.

RECOMMENDATION: Staff recommends allowing NWE a fixed return on expenses, similar to the incentive approved for both MidAmerican and Montana-Dakota Utilities. If the Commission decides to focus on a lost revenue incentive mechanism, as proposed, Staff would support it under the following conditions: NWE would calculate lost revenues using factors from the NEXANT DSM Evaluation Final Report, adjusted by Staff, and approved by the Commission. Additionally, the recovery of lost revenues would be done through the energy efficiency rider and would lag the offending programs by one year to allow sufficient data for their calculation, which would include responses to a survey approved by Staff and collected from customers over the year to be reconciled. Awarding and recovering lost revenues would fall into the same filing cycle mentioned in cost recovery above. In the July 1, 2012 filing, NWE would include their calculation of lost revenues from the improvements made in the 2011 calendar year to be approved by the Commission and recovered in the 2013 calendar year. A proposed filing timeline is listed in the final recommendation below.

SUMMARY

NWE has obviously put a lot of thought and hard work into their proposed DSM Plan. Although they had not filed a plan before this, they have been offering some energy efficiency programs for years. Programs such as "Calc-U-Pal" and the Home Suite Home contest in addition to their extensive education and outreach efforts have been very successful. Recently, NWE also launched "Bright Future Challenge", a contest encouraging residential customers to install CFLs. It is great to see that NWE is already providing some of these programs without seeking recovery of costs and lost revenues.

Ideally, Staff would like to see NWE's DSM Plan following the same principles set forth in the programs approved for MidAmerican and Montana-Dakota Utilities. NWE should file an annual budget for Commission approval and be allowed to recover program expenses plus a fixed rate of return, as determined by the Commission, through an energy efficiency rider.

If the Commission decides that the fixed return incentive mechanism should be replaced by the recovery of lost revenues, Staff would have a difficult time supporting such an incentive mechanism. The annual calculation of lost revenues will become a contentious and time-consuming yearly filing, in which Staff will likely bring lower numbers to the Commission than the utility, and the Commissioners will be left to decide. Also, Staff considers such a Plan to be a "pilot" program, putting the utility at risk for recovering projected lost revenues should the Commission decide to discontinue the DSM Plan. Despite those concerns, Staff would cautiously support a lost revenue incentive if the following recommendations were adopted:

1. On July 1, 2010, NWE would file a proposed budget to implement their original Plan, minus the Residential Lighting Rebate Program, over the 2011 calendar year. The filing would also include tariff sheets describing the energy efficiency rider that will go into effect on January 1, 2011, recovering expenses related to the program.

2. On July 1, 2011, NWE would file a proposed budget to implement their modified (if necessary) Plan for the 2012 calendar year, including any tariff changes to the energy efficiency rider required to recover expenses in the 2012 calendar year.
3. On July 1, 2012, NWE would file a proposed budget to implement their modified (if necessary) Plan for the 2013 calendar year. This filing would also include a true-up of expenses for the 2011 calendar year, a calculation of lost revenues from improvements made during the 2011 calendar year, and tariff changes to recover those expenses over the 2013 calendar year.
4. On July 1, 2013, and annually thereafter, NWE would file a request similar to their 2012 filing.

Under this timeline, the energy efficiency rider would accrue expenses year after year, until NWE filed for a review of their rates. Below is a summary of what costs would be included in the rider if NWE filed for a rate case in 2016:

2011 – 2011 Expenses
2012 – 2012 Expenses
2013 – 2013 Expenses + True-up of 2011 Expenses + 2011 Lost Revenues
2014 – 2014 Expenses + True-up of 2012 Expenses + 2011, 2012 Lost Revenues
2015 – 2015 Expenses + True-up of 2013 Expenses + 2011, 2012, 2013 Lost Revenues
2016 – 2016 Expenses + True-up of 2014 Expenses[1]
2017 – 2017 Expenses + True-up of 2015 Expenses
2018 – 2018 Expenses + True-up of 2016 Expenses + 2016 Lost Revenues
2019 – 2019 Expenses + True-up of 2017 Expenses + 2016, 2017 Lost Revenues
2020 – 2020 Expenses + True-up of 2018 Expenses + 2016, 2017, 2018 Lost Revenue

[1] New rates would include 2011, 2012, 2013, and 2014 Lost Revenues that would have been collected in 2016