New Jersey Board of Public Utilities

Energy Efficiency Transition

Cost Recovery Mechanism Draft

Draft for Public Comment

January 22, 2020

Executive Summary

In May 2018, Governor Murphy signed into law the Clean Energy Act of 2018 ("CEA"), which calls for a significant overhaul of New Jersey's energy system while growing the economy, building sustainable infrastructure, creating strong local jobs, reducing carbon emissions, and improving public health through a cleaner environment and better air quality. The CEA plays a key role in achieving the State's goal of 100% clean energy by 2050 by establishing aggressive energy reduction requirements, among other clean energy strategies. The CEA emphasizes the importance of energy efficiency and calls upon New Jersey's public utilities to play an increased role in delivering energy efficiency and peak demand programs to customers.

Through the CEA, New Jersey's path to achieving energy savings has been established through an Energy Efficiency Resource Standard ("EERS"). The CEA requires that each electric public utility achieve annual energy use reductions of two percent (2%) or greater and that each gas public utility achieve annual energy use reductions of three-quarters of a percent (0.75%) or greater in the prior three (3) years within five (5) years of their respective program implementation in their service territories. The CEA requires that each electric and gas public utility establish energy efficiency and peak demand reduction programs in order to reduce energy use in its service territory. The CEA further directs the New Jersey Board of Public Utilities ("Board") to establish quantitative performance indicators ("QPIs") to evaluate each utility's achievement of the energy use reduction targets, as well as to apply performance incentives and penalties, which are tied to the achievement of each utility's specific targets.

New Jersey's energy efficiency transition cost recovery mechanism proposal ("proposal") summarizes one possible approach for the cost recovery structure for the administration of energy efficiency and peak demand reduction programs and proposes a possible incentive and penalty structure for the implementation of programs under the new administrative framework.

The proposal is intended to provide an opportunity for stakeholder feedback, with the goal of creating an equitable cost recovery framework that enables the State to reach its ambitious efficiency goals while being protective of ratepayers.

Background – CEA Cost Recovery and Performance Incentives and Penalties

The CEA calls for the following:

Each electric public utility and gas public utility shall file an annual petition with the board to demonstrate compliance with the energy efficiency and peak demand reduction programs, compliance with the targets established pursuant to the QPI's, and for cost recovery of the programs, including any performance incentives or penalties, pursuant to section 13 of P.L. 2007, c. 340 (C.48:3-98.1). Each electric public utility and gas public utility shall file annually with the board a petition to recover on a full and current basis through a surcharge all reasonable and prudent costs incurred as a result of energy efficiency programs and peak demand reduction programs required pursuant to this section, including but not limited to recovery of and on capital investment, and the revenue impact of sales losses resulting from implementation of the energy efficiency and peak demand reduction schedules, which shall be determined by the board pursuant to section 13 of P.L. 2007, c. 340 (C.48:3-98.1).

If an electric public utility or gas public utility achieves the performance targets established in the quantitative performance indicators, the public utility shall receive an incentive as determined by the board through an accounting mechanism established pursuant to section 13 of P.L. 2007, c. 340 (C.48:3-98.1) for its energy efficiency measures and peak demand reduction measures for the following year. The incentive shall scale in a linear fashion to a maximum established by the board that reflects the extra value of achieving greater savings.

If an electric public utility or gas public utility fails to achieve the reductions in its performance target established in the quantitative performance indicators, the public utility shall be assessed a penalty as determined by the board through an accounting mechanism established pursuant to section 13 of P.L.2007, c.340 (C.48:3-98.1) for its energy efficiency measures and peak demand reduction measures for the following year. The penalty shall scale in a linear fashion to a maximum established by the board that reflects the extent of the failure to achieve the required savings.

The adjustments made pursuant to this subsection may be made through adjustments of the electric public utility's or gas public utility's return on equity related to the energy efficiency or peak demand reduction programs only, or a specified dollar amount, reflecting the incentive structure as established in this subsection. The adjustments shall not be included in a revenue or cost in any base rate filing and shall be adopted by the board pursuant to the "Administrative Procedure Act."

Stakeholder Process

In December 2018, in order to fulfill the CEA's requirements, the Board authorized the Division of Clean Energy ("DCE") to enter into a contract with Optimal Energy, Inc. ("Optimal") to complete a market potential study that would aid in determining the energy savings potential in New Jersey and develop recommendations consistent with implemented law. In developing the study, Optimal solicited data inputs from the state's electric and gas public utilities. The State also hosted four (4) stakeholder meetings to develop the draft "Energy Efficiency Potential in New Jersey" study, which was issued on May 9, 2019. The Board accepted public comments on the draft potential study through May 16, 2019. All public

comments[1] and the final "Energy Efficiency Potential in New Jersey"[2] study are available on the New Jersey Clean Energy Program website.

The Board solicited input related to the implementation of the energy efficiency and peak demand program requirements outlined in the CEA at a technical meeting on February 1, 2019 and accepted written comments through February 15, 2019. The public notice invited stakeholders to respond to a series of questions related to New Jersey's energy efficiency and peak demand reduction programs.

On May 28, 2019, following both broad public input and feedback specific to the "Energy Efficiency Potential in New Jersey" study, the Board preliminarily adopted the energy savings targets for both electric and gas public utilities and the QPIs provided in the study, pending a final Board Staff ("Staff") recommendation. The Board also established the Energy Efficiency Advisory Group ("Advisory Group") as an advisor to Staff. The Board further directed Staff to initiate a stakeholder proceeding to receive comments and recommendations from interested parties related to the establishment of energy efficiency and peak demand reduction programs to meet the targets outlined in the CEA.

During the summer of 2019, Board President Fiordaliso, in coordination with the entire Board, appointed members of the Advisory Group in order to provide additional guidance to Staff, with particular emphasis on ensuring that Staff heard concerns and received recommendations from representatives of the utilities, the New Jersey Division of Rate Counsel, environmental advocates, and consumer organizations, including those representing both residential and commercial/industrial customers.

Following input from the Advisory Group, Staff initiated the next phase of stakeholder engagement and technical meetings, henceforth referred to as the energy efficiency transition, in order to engage the public broadly on critical topics related to the next generation of energy efficiency and peak demand reduction, pursuant to the CEA.

The two (2) technical meetings in the energy efficiency transition focused on the subject of cost recovery, lost revenues, performance incentives and penalties. The first technical meeting on October 31, 2019 engaged stakeholders on the following key questions and included discussion among stakeholders presenting various perspectives:

- Should recovery mechanisms be the same or different for programs administered or implemented by utilities versus non-utility parties?
- Should costs be associated with efficiency program investments be expensed or amortized? If amortized, what is the appropriate amortization period, and what should the rate for the carrying costs be?
- Should costs be allocated by sector (e.g., residential, commercial, industrial)?
- Should there be a mechanism to recover lost revenues?
- If the Board allows for recovery of lost revenues, what should the lost revenue recovery mechanism be?
- If the Board allows for recovery of lost revenues:

[1] Energy Efficiency Public Comments: https://www.njcleanenergy.com/main/njcep-policy-updates-request-comments/policy-updates-and-request-comments
[2] Energy Efficiency Market Potential Study, May 24, 2019: https://s3.amazonaws.com/CandI/NJ+EE+Potential+Report+-+FINAL+with+App+A-H+-+5.24.19.pdf)

    - I. What methods should the Board employ to calculate lost revenues associated with energy savings?
    - II. Should other factors (e.g., weather, non-program-related reductions) be taken into account?
- If the Board allows for recovery of lost revenues, should authorized return on equity be subject to adjustment based on reduced risk?
- How should performance incentives be structured? How should performance penalties be structured?
    - I. Should incentives and penalties be handled as a percentage adjustment to earnings or as specific dollar amounts? Why? How?
    - II. Should incentives and penalties be scalable based on performance? If so, in what manner?
- How should incentives and penalties be reconciled? Should incentives and penalties be "refunded" to ratepayers through rate reduction?
- If the Board establishes performance incentives and penalties, what level of total incentives and penalties is reasonable?

In addition to offering comments and asking questions in person, stakeholders were able to submit written comments on these topics through November 14, 2019.

The second technical meeting on December 13, 2019 continued the cost recovery conversation, but focused the dialogue on hypothetical cost recovery scenarios related to: Asset/Investment Treatment, Recovery Period, Lost Revenues, Incentives/Penalties, Carrying Costs on Over/Under Recovery, Carrying Costs on Program Investment, and Potential Rate Caps. On December 19, 2019, Staff invited comments on additional hypothetical scenarios on these same topics. The Board accepted written comments on these hypothetical scenarios through January 3, 2020.

Through the energy efficiency transition technical meetings, in addition to extensive research by Staff into best practices for developing a cost recovery mechanism, Staff has solicited public input on recovering costs associated with energy efficiency and peak demand reduction programs in New Jersey. In particular, Staff has invited experts, as well as New Jersey program participants and service providers, to discuss how best to recover costs associated with energy efficiency programs and to meet New Jersey's energy savings goals while satisfying the state's policy objectives. These discussions have allowed Staff to better understand stakeholder priorities and perspectives in the context of cost recovery for energy efficiency.

Stakeholder feedback gathered over the two (2) technical meetings and from the written comments has provided valuable input and helped to shape this proposal. Based on Staff's review of recommendations from stakeholders, Staff herein proposes a framework for the cost recovery mechanism. While further discussion of the future of New Jersey's energy efficiency and peak demand reduction programs – including on application of the CEA-mandated targets – will take place throughout the remainder of the energy efficiency transition, Staff has developed this proposed approach to cost recovery to aid in the progression of the transition.

Staff received near unanimous input supporting amortization of program investment. Stakeholders were also mostly in agreement about the inclusion of a dead band, or buffer, in the incentive and penalty structure. Stakeholders had varying opinions on most other cost recovery decisions such as: lost revenue treatment, ranging from no lost revenue to full decoupling; risk adjustments, ranging from no

adjustment to an adjustment representing several hundred basis points; rate constraints, ranging from hard rate caps to no rate caps. In addition to extensive review of best practices, other state experiences, NJ's familiarity with limited decoupling such as the Conservation Incentive Program ("CIP"), Staff reviewed stakeholder input, comments and concerns, and submit the following as an initial cost recovery mechanism.

Investment Treatment

Program investments – that is, expenditures other than those incurred for operations and maintenance – will be amortized over a seven (7) year period. Utilizing this treatment is necessary as it reduces potential rate shock associated with energy efficiency transition programs and spreads the cost of measures over a period of time to better match program costs with program benefits.

The carrying cost for these investments will utilize the capital structure established in each utility's most recent base rate case, incorporating both (a) the cost of debt and (b) the return on equity ("ROE") less 200 basis points. The 200 basis point adjustment reflects the risk reduction associated with the contemporaneous recovery provided for by the cost recovery mechanism. This modified ROE was selected because this number would result in the appropriate Weighted Average Cost of Capital ("WACC") for the return on these types energy efficiency programs recovered through a surcharge. There is an inherent reduction in risk associated with the contemporaneous recovery available in this mechanism, where utilities are recovering a portion of costs as they are being incurred, as opposed to recovery in base rates where the utility may not be able to recover costs for years after they are incurred. The energy efficiency programs are also less risky than traditional infrastructure investment found in a base rate case because, generally, energy efficiency programs will not undergo several years of construction and spend with the risk that the Board will find the investment not to be used and useful. If these energy efficiency programs were accounted for in base rate ROE, which looks at a totality of utility investment not included in clauses, Staff expects that each utilities' base rate ROE would be reduced.

This proposed mechanism is modeled on other states and districts such as Maryland and Washington D.C. which similarly allow for a return on energy efficiency investments, but modify that ROE based on the lowered risk. As New Jersey currently allows for return of and on energy efficiency investments and the Clean Energy Act requires incentives and penalties, Staff recommends similar measures to ensure that we protect against potential over-earning.

In order to encourage reaching energy efficiency goals, initially, there will not be a cap, or a constraint, on the customer distribution rate or customer bill. Rate impacts will be closely monitored, and a cap on either rates or on customer bill impacts may be instituted two (2) years after the approval of energy efficiency transition programs.

Over and under recoveries will have a carrying cost of the 2-year Treasury bill rate plus 60 basis points. This will correct for errors in sales projections.

Lost Revenue Treatment

The proposal in this draft builds on what the State has learned through our experience with the gas CIP, a limited decoupling mechanism currently in place in the State. The CIP is an incentive-based program that requires participating utilities to implement conservation programs funded by their shareholders. The CIP is designed to aid customers in reducing their costs associated with natural gas consumption and to reduce each utility's peak winter as well as design day system. The CIP program requires participating utilities to reduce gas supply related costs and allows the recovery of certain non-weather margin revenue loss that are limited to the level of gas supply cost savings achieved. At technical working group meetings, Staff heard from stakeholders that the CIP has contributed to shifts in utility behavior and culture, allowing for efficiency and conservation to be supported at all levels of utility management. While the below mechanism differs from the CIP because the CEA, and the QPIs, do not specifically call upon the utilities to shed capacity, Staff hopes the limited decoupling mechanism below will provide all utilities similar freedom to aggressively pursue and endorse energy efficiency.

This proposed mechanism is the first step in the State's energy efficiency transition cost recovery. Given the rapidly changing market and the impacts of the 2019 Energy Master Plan, electric vehicles, building electrification, and other federal and state market changes, Staff suggests this mechanism be reviewed three (3) years after the approval of utility energy efficiency transition programs to ensure that this method is appropriately incentivizing energy efficiency programs.

Utilities will be able to recover lost revenues in the amount that they can demonstrate were attributable to the utility-run energy efficiency and peak demand reduction program(s) ("energy efficiency transition program(s)") and will be reviewed and recovered annually.

Only lost revenues associated with the utility's distribution base rates will be recoverable. Utilities will be required to file a base rate case no later than five (5) years after the commencement of an approved energy efficiency transition program, in order to ensure usage projections are updated and to reset lost revenues.

This lost revenue treatment is intended to prevent energy efficiency transition program(s) from harming a utility's ability to pay for its fixed costs. This treatment is also designed to prevent accumulation of lost revenue related costs from multiple energy years and thus provide protection for ratepayers.

An earnings test shall be required, through which Return on Equity ("ROE") shall be determined based on the actual net income of the utility for the most recent 12-month period divided by the average of the beginning and ending common equity balances for the corresponding period. For any energy efficiency transition program approved by the Board, if the calculated ROE exceeds the allowed ROE from the utility's last base rate case by 50 basis points or more, recovery of lost revenues shall not be allowed for the applicable filing period. This will prevent utilities earning greater than their allowable return, established in the utilities most recent base case, from receiving lost revenues.

Performance Incentive and Penalty Treatment

The performance incentive and the performance penalty will both take the form of a return on equity adjustment applied to energy efficiency transition program investment, similar to the structure in place in Illinois. This is illustrated in the graphic "Figure 1."

There will be a performance penalty if a utility achieves between 50% and 90% of its QPI achievement.

There will be a neutral area, or buffer, within which there will be no incentive awarded or penalty assessed, ranging from 90% to 110% of the QPI achievement. The WACC used as a utility's carrying cost will be comprised of (a) the cost of debt and (b) the return on equity less 200 basis points, as established in the Investment Treatment. This is further illustrated in the graphic "Figure 2."

There will be a performance incentive awarded if a utility achieves between 110% and 150% of the QPI achievement.

The performance incentive and penalty structure will be reviewed three (3) years after the approval of utility energy efficiency transition programs, along with the utility's QPIs. Utility QPIs are being discussed in a separate portion of the energy efficiency transition and will be the primary focus of an upcoming stakeholder meeting.

The performance penalty will scale linearly from the cost of debt established in the utility's most recent base rate case (if the utility reaches 50% or more of QPI achievement) to the return on equity established in the utility's most recent base rate case less 200 basis points (starting at 90% and up to 110% of QPI achievement). This lowered return on equity will be utilized as part of the carrying cost of energy efficiency transition program investment occurring in the following year.

The performance incentive will scale linearly from the return on equity established in the utility's most recent base rate case less 200 basis points (starting at 110% of QPI achievement) to the return on equity approved in the most recent base rate case (up to 150% of QPI achievement).

If the utility fails to reach 50% of the target, they will be deemed non-compliant and will be assessed a penalty of 0.75% of the base rate distribution revenue in the previous year. While some other states, such as Pennsylvania, have instituted set monetary penalties of tens of millions of dollars in order to assure a minimum level of achievement, it is more appropriate, with the great size disparity among New Jersey utilities, to pursue a mechanism able to incent larger utilities while not capriciously punishing smaller ones. This penalty will scale to utility size in a way that a set monetary penalty could not.

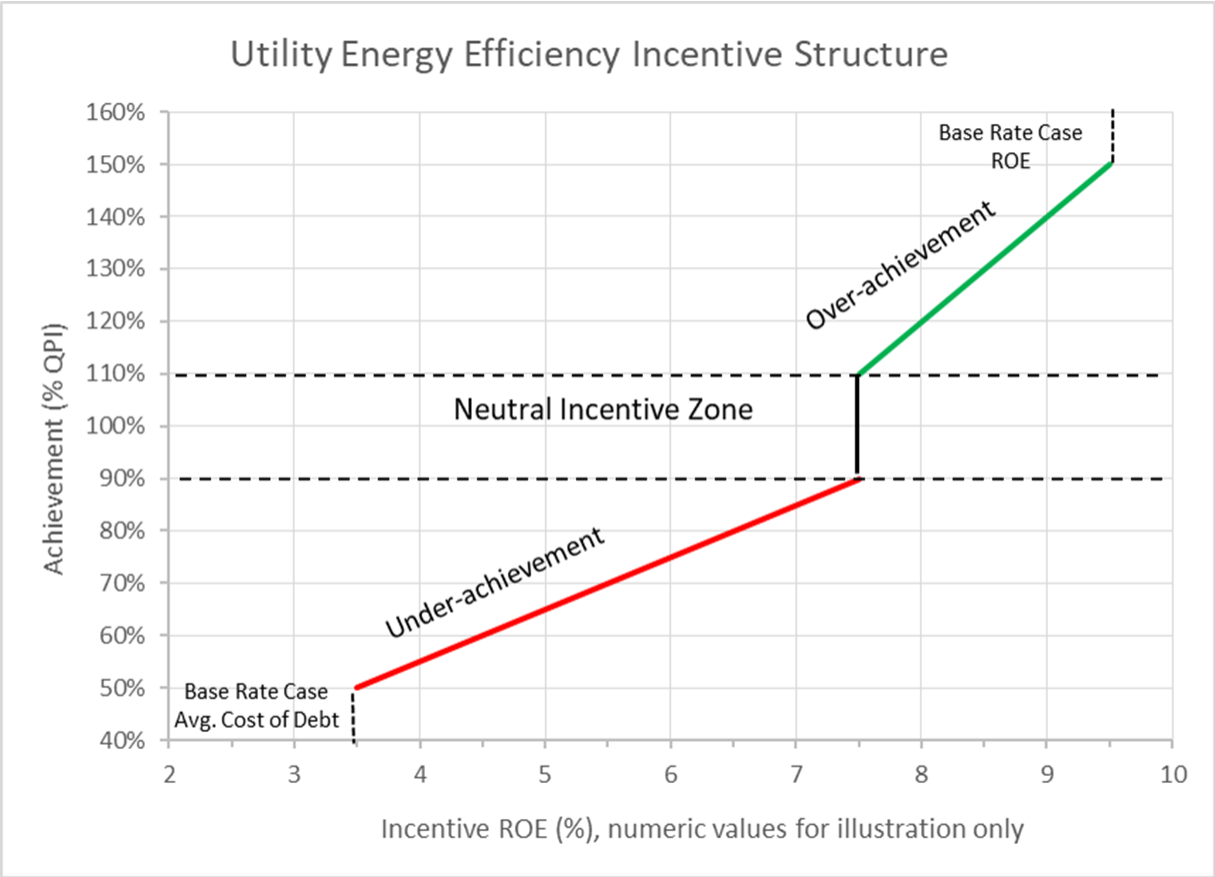

Figure 1. *The values used in this graph are purely hypothetical in nature and used for illustrative purposes.*

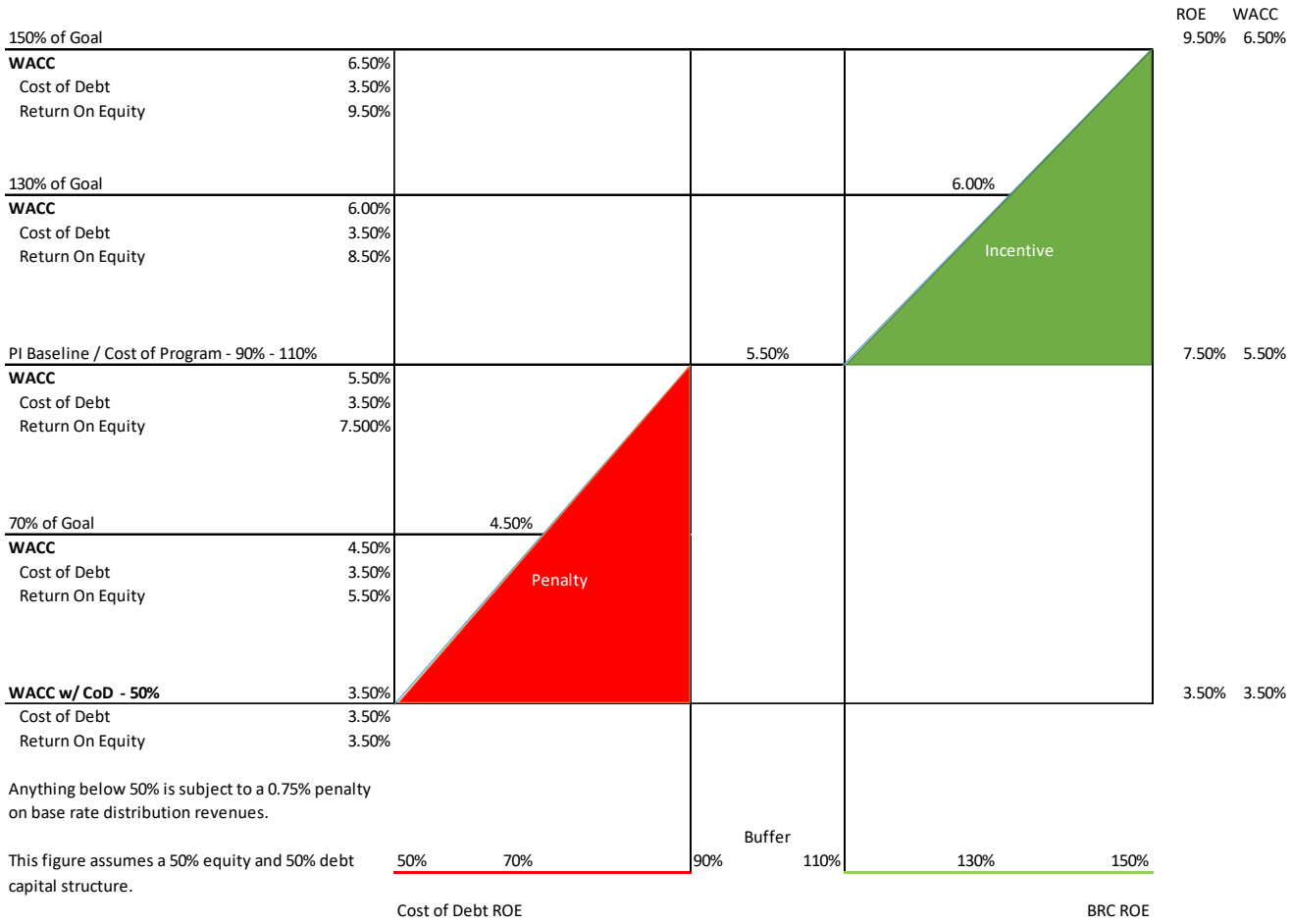

Figure 2. *The values used in this graph are purely hypothetical in nature and used for illustrative purposes.*

Energy Efficiency as a Resource

The utilities will use their best efforts to register, nominate, and/or bid each year's expected megawatt ("MW") reduction resulting from the energy efficiency transition program(s) into any and all PJM market(s) and/or programs for which the energy efficiency transition program(s) are eligible during the life of the energy efficiency transition program(s).