STATE OF MICHIGAN

BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter, of the application of CONSUMERS ENERGY COMPANY for reconciliation of its 2017 demand response program costs.	)))))	Case No. U-20164

NOTICE OF PROPOSAL FOR DECISION

The attached Proposal for Decision is being issued and served on all parties of record in the above matter on May 20, 2019.

Exceptions, if any, must be filed with the Michigan Public Service Commission, 7109 West Saginaw, Lansing, Michigan 48917, and served on all other parties of record on or before June 10, 2019, or within such further period as may be authorized for filing exceptions. If exceptions are filed, replies thereto may be filed on or before June 24, 2019.

At the expiration of the period for filing exceptions, an Order of the Commission will be issued in conformity with the attached Proposal for Decision and will become effective unless exceptions are filed seasonably or unless the Proposal for Decision is reviewed by action of the Commission. To be seasonably filed, exceptions must reach the Commission on or before the date they are due.

MICHIGAN OFFICE OF ADMINISTRATIVE HEARINGS AND RULES
For the Michigan Public Service Commission

Sally L. Wallace

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Sally L. Wallace
Administrative Law Judge

May 20, 2019
Lansing, Michigan

S T A T E O F M I C H I G A N

MICHIGAN OFFICE OF ADMINISTRATIVE HEARINGS AND RULES

FOR THE MICHIGAN PUBLIC SERVICE COMMISSION

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In the matter, of the application of CONSUMERS ENERGY COMPANY for reconciliation of its 2017 demand response program costs.	)))))	Case No. U-20164

PROPOSAL FOR DECISION

I.

HISTORY OF PROCEEDINGS

On May 31, 2018, Consumers Energy Company (Consumers) filed an application, with supporting testimony and exhibits, requesting authority to reconcile its demand response (DR) costs and revenues in accordance with the September 15, 2017 order in Case No. U-18369.[1]

A prehearing conference was held on July 24, 2018, at which Consumers and the Staff appeared. The Natural Resources Defense Council (NRDC) also appeared, and its petition to intervene was granted.

On January 24, 2019, the Staff and the NRDC filed testimony and exhibits, and on February 19, 2019, Consumers filed rebuttal testimony and exhibits. An

[1] In that order, the Commission agreed with the Staff's proposal to use a three-phase method for reviewing and approving recovery of DR costs, including a transitional reconciliation process involving standalone cases (like this one), to be applied until the three-phase procedure can be fully implemented.

evidentiary hearing was held on February 28, 2019, at which one company witness was cross-examined, and the testimony and exhibits of the remaining four witnesses were bound into the record. On March 29, 2019, the parties filed briefs, and on April 26, 2019, the parties filed reply briefs. The record in this case consists of 118 pages of testimony and 21 exhibits admitted into evidence.

II.

OVERVIEW OF THE RECORD

Patrick C. Ennis, Executive Director of Industrial Products for Consumers, provided an overview of the company's request, which includes: (1) approval to reconcile projected capital expenditures and operations and maintenance (O&M) expenses from the company's previous two rate cases[2] with actual costs incurred in the 2017 DR program year; (2) approval of a regulatory liability of $489,633 reflecting actual DR capital and O&M spending compared to the authorized revenue requirement, with approval to defer the refund of this liability to a future electric rate case; and (3) approval of regulatory accounting treatment for the company's proposed DR financial incentive of $1,461,181, creating a regulatory asset, and deferring recovery to a future electric rate case.[3]

Mr. Ennis testified that Consumers' DR portfolio contains programs for both business and residential customers,[4] explaining that "[t]his portfolio acts as a

[2] Case Nos. U-17990 and U-18322, both of which had portions of test periods during 2017.
[3] 2 Tr 18.
[4] Mr. Ennis described Consumers' business DR programs at 2 Tr 19-22 and the company's residential DR programs at 2 Tr 22-26. In addition, Exhibits A-3 and A-4 are evaluations of the company's air conditioning (AC) peak cycling and residential dynamic peak pricing (DPP) programs respectively.

virtual power plant that can be used during times of peak electricity demand to mitigate system constraints, ensure adequate power is available, and ultimately reduce costs paid by customers[,]"[5] adding that, "[t]he intent of the DR portfolio is that collectively the reduction in peak load will relieve stress on the electric system in a more cost-effective manner than purchasing capacity from the market or building additional generation resources to meet peak demand."[6]

Mr. Ennis testified that total DR program capital costs were $7,463,707 and total O&M costs were $7,582,403 for 2017. "Based on amounts approved in Case Nos. U-17990 and U-18322, the Company's actual 2017 DR spending was, in total, $4,708,763 higher in capital spending (Exhibit A-1 (PCE-1), lines 18, column (c)) and $677,500 lower than approved amounts for O&M spending (Exhibit A-1 (PCE-1) line 17, column (c))."[7]

David B. Hays, a Senior Business Support Consultant II for Consumers, described the procedure the company uses for calling peak events as well as the results of those events in terms of demand reductions, for the June through September peak period. Mr. Hays explained that DR is credited by the Midcontinent Independent System Operator (MISO) under three types of planning resources: capacity resources; load modifying resources (LMRs); and energy efficiency resources.[8] Mr. Hays further testified:

> Demand Resources that can commit to responding to MISO emergencies are considered an LMR, which is any resource that reduces load by a specific amount or reduces load to a defined

[5] 2 Tr 19.
[6] Id; Exhibit A-2.
[7] 2 Tr 26. Mr. Ennis provided a breakdown of 2017 residential and business capital and O&M costs at 2 Tr 27-29.
[8] 2 Tr 39-40.

> baseline level during MISO emergencies. However, the Company is not required to offer an LMR as a “must offer obligation” similar to Capacity Resources. Zonal Resource Credits (“ZRC”) are awarded by MISO for LMRs, which Load Serving Entities (“LSE”) such as Consumers Energy can use to meet their respective Planning Reserve Margin Requirement (“PRMR”).
>
> Although Demand Resources that cannot commit to responding to MISO emergencies are not awarded LMR status, they can be used by LSEs in the day-ahead market to reduce load during days with high prices and a high probability of coincident peak demand. The Company’s Residential Dynamic Pricing Program falls in this category. The Company reduces its peak load forecast by the amount of [megawatts] MW from the Dynamic Pricing Program, thereby reducing its PRMR.[9]

Mr. Hays testified that Consumers implements DR in the day-ahead or in the real-time energy markets based on an analysis of the least-cost resource mix by the company’s Electric Supply Operations Planning Department. “To accomplish this, the Company developed market price and load levels that, when exceeded, indicate that DR resources should be considered and dispatched.” According to Mr. Hays, “[f]or the summer of 2017, the Company calculated the trigger condition based on market prices of $45/[megawatt-hour] MWh and a 4-hour load forecast exceeding 25,000 MWh or an 8-hour load forecast exceeding 50,000 MWh.”[10]

Mr. Hays testified that Consumers used DR during the summer of 2017, calling nine business economic events, 10 residential AC cycling events, and 11 residential DPP events. Mr. Hays noted that MISO did not call any emergencies in 2017, however, had it done so, “the Company would have dispatched its business DR Program (50.1 MW), interruptible tariffs Rate GI (112.2 MW) and Rate

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[9] Id. at 40.
[10] Id. at 41.

EIP (48.1 MW), and residential AC Peak Cycling Program (8 MW) in response."[11] Mr. Hays added that for AC cycling and residential PP, Consumers assumed reductions of 1.12 kilowatts (kW) and 0.63 kW respectively. After the 2017 peak season, Consumers undertook a comparison of usage by participating and non-participating customers to adjust its future estimates of residential demand response.[12] Finally, Mr. Hays testified that, based on a value of 75% of MISO's 2017 cost of new entry (CONE) for Michigan, the total market value of Consumers' DR portfolio was $15,544,620.

Hubert W. Miller III, Reporting Manager for Clean Energy Products for Consumers, testified regarding the company's proposed financial incentive. Mr. Miller explained that Consumers is proposing a two-part incentive designed to (1) foster additional development of DR resources and (2) "optimize[] the use of the [DR] resource by allowing a return on the payments used to prompt customer action to shift and shed load during peak system hours[.]" As Mr. Miller described it:

> The first part of the incentive would allow utilities to earn a financial incentive of 20% on all operational and capital expenses to implement, manage, and enroll customers (incentive to build) in the DR programs. To minimize customer rate impacts, the Company proposes recovering its DR financial incentive through a regulatory asset based on the deprecation rate of 3.84% approved in Case No. U-18322. The second part of the incentive is referred to as a Payment for Performance ("P4P"), and would allow utilities to earn an incentive of 20% on payments to cost effectively use the DR resources (incentive to use). Combined, these two parts of the DR financial incentive will encourage utilities to build, use, and expand the DR virtual power plant in Michigan.[13]

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[11] Mr. Hays provided the results of the DR events that the company called in 2017 in Exhibit A-5.
[12] 2 Tr 43.
[13] 2 Tr 51-52; Exhibit A-7.

After providing an overview of previous DR proceedings and Commission determinations, Mr. Miller testified that the Commission found that a financial incentive for DR was appropriate and could be proposed in a DR reconciliation.[14] With respect to the desirability of a financial incentive, Mr. Miller explained:

> [H]aving a stable regulatory framework is a necessary condition for implementing the minimum level of DR resources, but it is not a sufficient condition for encouraging utilities to maximize their use of these resources. In its Comments on the DR regulatory framework, the Advanced Energy Management Alliance mentioned the disparity that exists between the necessary and sufficient conditions for encouraging investments in DR resources. In their Comments filed on August 31, 2017 in Case No. U-18369, they assert that "...demand-response will not truly be on equal footing with generation, even if there is a comparable consideration in the regulatory process. From a utility's perspective, they are worse off if they invest in a program for which they cannot earn a return than if they invest in a capital project where returns are guaranteed. Given a fiduciary duty to shareholders [investing in DR resources] may be an imprudent choice for the utility even if it is the best choice for their customers."
>
> While the Company does consider the cost impact of its actions on customers, it has traditionally used supply-side resources to address increases in customer demand. Indeed, prior to 2017, the Company only had a relatively small amount of DR resources enrolled under its standard interruptible tariff. The Company had focused its efforts on resources that satisfied both its regulatory requirement of providing affordable service to customers, and its fiduciary requirement of providing a return-on-investment to shareholders. But much like energy efficiency, which was not used by utilities in Michigan until a stable regulatory framework <u>and financial incentive</u> was established under Public Act 295 of 2008, the Commission now has an opportunity to approve a DR financial incentive to promote utility investments in cost effective demand-side resources.[15]

Mr. Miller explained that MCL 460.6x provides for a tiered shared savings mechanism for energy efficiency and DR, and MCL 460.6a(13) authorizes the

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[14] 2 Tr 53.
[15] Id. at 54-55.

Commission to approve an alternative savings mechanism. Mr. Miller testified that although the mechanism described in Section 6x is appropriate for incentivizing energy efficiency savings, "it is not an appropriate structure for promoting DR programs designed to reduce peak capacity requirements during the few summer hours a year of high system demand."[16] Accordingly, Mr. Miller recommended an alternative mechanism under MCL 460.6a(13) for DR.

Mr. Miller presented a table of DR financial incentive structures divided into (1) mechanisms designed to incentivize construction of DR (i.e., bonus rate of return, percent of program costs, and regulatory asset treatment of all program costs); (2) those designed to incentivize the use of DR (i.e., pay for performance, return on avoided costs, and shared savings); and (3) mechanisms designed to incentivize both the construction and use of DR (i.e., P4P, regulatory asset plus P4P, and regulatory asset plus shared savings).[17] Mr. Miller stated his views on the advantages and disadvantages of the different mechanisms, testifying that the financial incentives described in 2016 PA 341 and 342 (Acts 341 and 342), provide either an incentive to build, or an incentive to use DR, but not both.

Mr. Miller testified that there is little available information on utility incentives for DR in other states; however, of the 20 states he identified with DR financial incentives, the most common is a shared-savings mechanism (eight of 20), with the remainder fairly equally divided among the mechanisms described previously in Mr. Miller's testimony.[18] Mr. Miller opined that the predominance of the shared

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[16] 2 Tr 55.
[17] Id. at 56.
[18] Id. at 58-59; Exhibit A-6.

savings mechanism resulted from an historical focus on energy efficiency in demand-side management efforts.[19]

Mr. Miller reiterated that Consumers believes that a regulatory asset plus P4P is the most appropriate approach to incentivize the company to build and use DR. Mr. Miller noted that regulatory asset treatment, where the company would earn a 20% return on all operating and capital expenses to develop, implement, market, evaluate, test, and administer its DR programs, "will encourage the Company to increase investments in DR opportunities that are typically cheaper and less capital intensive than supply-side options."[20] In addition, the company will be incentivized to maximize the economical use of its DR resources by earning a return on customer payments. Mr. Miller explained that the financial incentive should be based on the amount of DR enrolled, so that, "the Company would be eligible to earn a 20% financial incentive on its payment to customers if the percent of the DR enrolled in its programs exceeded 1.5% of the [three-year] average system peak."[21]

Mr. Miller testified that although the financial incentive is based in part on payments to customers, the company would not be encouraged to inflate payment levels or use DR in an inefficient manner because the number of events that can be called is limited, and the Commission can cap customer payment levels.[22]

Mr. Miller explained the calculation of the proposed $1,461,181 financial incentive, shown in Exhibit A-7, noting, "[f]or purposes of calculating the financial

[19] 2 Tr 60.
[20] 2 Tr 60-61.
[21] 2 Tr 60; Exhibit A-7.
[22] 2 Tr 61-62.

incentive, the Company proposes amortizing its operating expenses based on the depreciation rate of 3.84%, proposed in Case No. U-18322, and to earn an annual return of 20% on the regulatory balance."[23] Mr. Miller further testified that "[t]he enhanced return on DR capital expenses is intended to partially rectify the disparity that exists between investing capital in demand-side versus supply-side resources. That is, a 20% return on $10 million is much less attractive to shareholders than a 10% return on $500 million."[24] Finally, Mr. Miller testified that Consumers was proposing to implement several new DPP programs and pilots as part of its then-ongoing electric rate case;[25] however, these new resources are not included as part of this reconciliation.[26]

Katie J. Smith, an Economic Specialist in the Resource Adequacy and Retail Choice Section of the Commission's Energy Resources Division, testified that because this proceeding is Consumers' first DR reconciliation, the reconciliation period should be 2015-2017, rather than calendar-year 2017, as the company proposes. Ms. Smith testified that Consumers' DR program began in 2015, when the Commission authorized $5.2 million in capital expense and $3.7 million in O&M expense for the company's proposed AC cycling program. However, "[t]he Company only enrolled 10 customers in the program from June 2015 through May 2016 and spent $553,989 in capital and $497,958 in O&M during that period." Ms. Smith further testified that, "[i]n its 2016 general rate case

[23] 2 TR 62.
[24] Id. at 63.
[25] Case No. U-20134 was resolved by a settlement agreement approved by the Commission on January 9, 2019.
[26] 2 Tr 63.

(U-17990), the Commission granted the Company an additional $4,892,000 in capital and $1,845,667 in O&M to expand the AC Peak Cycling program. While the Company did spend the approved amounts during the year between September 2016 and August 2017, they fell short of achieving the proposed enrollments by 11,448 and short 13.3 MWs of savings."[27]

In light of Consumers' underperformance in DR implementation, Ms. Smith testified that the Commission provided guidance for future funding in the March 29, 2018 order in Case No. U-18322, where the Commission stated: "Given the Commission's prior approvals, Consumers is expected to have at least 42 MWs of ratepayer-funded AC switch DR available by May 2018, to use as a substitute for more costly market energy. . . . The Commission has been supportive of Consumers' efforts to expand its DR portfolio, but after increasing funding levels in the past two rate cases, it is clear that results need to be demonstrated first before additional funding can be authorized."[28] Ms. Smith explained:

> The Commission has been both supportive and clear in its expectations for the Demand Response programs. The sequence of annual rate cases, starting with U-17735, provide important history about the Company's shortcomings early in the Demand Response program roll-out. The Commission provided clear goals that the Company was expected to achieve with each approved spending. In light of this history, Staff believes it is most appropriate to reconcile calendar years 2015-2017 in this case.[29]

Ms. Smith testified that the Staff conducted a financial audit, including a review of confidential materials at the company's office, and recommended the

[27] 2 Tr 88-89; Exhibit S-1.
[28] 2 Tr 89, quoting March 29, 2018 order in Case No. U-18322, pp. 27-28.
[29] 2 Tr 89.

company's proposed $489,633 regulatory liability be recalculated and adjusted to reflect the entire DR program from 2015 through 2017.[30]

With respect to a financial incentive, Ms. Smith testified that the Staff agrees that the Commission found it reasonable for providers and others to propose a financial incentive as part of a DR reconciliation proceeding; however, Ms. Smith disagreed with both the mechanism and the timing of the financial award proposed by Consumers. Ms. Smith testified that no incentive should be awarded for 2017, and the Staff "strongly advises the Commission to reject the Company's proposal to earn an incentive until a going-forward financial incentive mechanism has been approved by the Commission."[31] With respect to the structure of the financial incentive as proposed by Consumers, Ms. Smith stated:

> Staff believes the Company's proposed mechanism is far too generous and it does not promote aggressive, positive, and balanced actions by the Company to appropriately harness the benefits of DR. For instance, an incentive based on annual incentive payments to customers may result in the Company maximizing those payment amounts to be higher than necessary to develop or maintain a certain level of DR, which would not necessarily be cost-effective nor in the best interests of its customers. Staff does support incentivizing the Company to have effective DR programs. Thoughtful DR programs are beneficial to the Company, their customers, and the stability of the electric grid. Staff does not want costs to exceed benefits however and would prefer to start out with a more conservative mechanism that will allow both the Company and Staff to assess the appropriate level of outcomes for these programs. If the Company demonstrates they have worked earnestly to provide DR programs to customers which result in meaningful outcomes, Staff is willing to discuss the adjustment of any approved financial mechanism parameters in future DR reconciliations.[32]

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[30] 2 Tr 90.
[31] Id.
[32] Id. at 90-91.

Ms. Smith proposed an alternative financial incentive mechanism which, she stated, is designed to incentivize Consumers to both invest in DR and use DR resources in a cost-effective manner. Ms. Smith explained that under the Staff's mechanism, "[t]he Company would earn the normal rate of return on DR capital costs. Regarding all non-capitalized costs, the Company could receive up to a 10% incentive reward of those non-capitalized costs (based on a sliding scale), for reaching up to 100% of the incremental DR goal in MWs."[33] Ms. Smith added that additional incentive payments are available for the economic dispatch of DR "equal to the lesser of 10% of cost savings or 3% of total non-capitalized costs incurred each year."[34] Ms. Smith testified that Consumers could receive an additional incentive payment of 2% of non-capitalized costs for assessments of DR as part of a non-wires alternative (NWA) solution for at least five transmission and distribution projects.

In rebuttal, Mr. Ennis disputed the Staff's recommendation to expand the reconciliation period from 2015 through 2017. Mr. Ennis quoted the Commission's September 15, 2017 order in Case No. U-18369, which states in pertinent part:

> Rather than reconcile capital and O&M costs approved in [integrated resource plans] IRPs and rate cases, respectively, until an IRP is approved by the Commission, there shall be annual, stand-alone reconciliation cases as explained by the Staff, that match actual spending on DR programs with the amounts approved in the previous general rate cases. This mechanism will apply to all ongoing and future rate case applications.[35]

[33] 2 Tr 91; Exhibits S-2 and S-3 (Revised).
[34] 2 Tr 92.
[35] Order, pp. 9-10.

According to Mr. Ennis, "[t]his language in the Commission order establishing the DR reconciliation process does not provide for a reconciliation period beginning with the start of a utility's DR program," (i.e., the DR program approved in Case No. U-17735), instead, the order applies to "ongoing" rate cases which, at the time the order was issued, was Case No. U-18322 that included October through December 2017 as part of the test period.[36] "However, in order to permit review of a full year of DR data in this proceeding, the Company included costs approved in the Company's previous rate case in Case No. U-17990 for the period January 1 through September 30, 2017."[37]

Mr. Ennis disagreed with Ms. Smith's reliance on the language in the March 29, 2018 order in Case No. U-18322 (which limited funding for DR to the levels authorized in the company's previous rate case) arguing that the order did not provide any specific guidance about the DR reconciliation period. However, Mr. Ennis pointed out that the order in Case No. U-18369 was specific that the reconciliation should apply to "ongoing and future" rate cases.

Chris Neme, a Principal of Energy Futures Group, a consulting firm that provides expertise on clean energy markets, programs, and policies, testified regarding Consumers' proposed financial incentive mechanism. Mr. Neme explained that although a financial incentive is a reasonable means "to put DR on the same conceptual footing as the alternative of new supply investments," the mechanism proposed by Consumers "is insufficiently tied to achievement of DR

[36] 2 Tr 33-34.
[37] Id. at 34.

performance objectives[]" and "[i]t can result in an incentive payment from customers to shareholders that is unreasonably large."[38]

Mr. Neme explained that the two regulatory assets in the company's proposal, which represent the majority of the total incentive that Consumers could earn, provide financial compensation simply for spending money on DR. Mr. Neme added, "although the Company has stated that the P4P component of its proposed DR incentive mechanism would be conditioned on achieving a performance target, that performance target – the peak savings potential associated with its DR enrollment exceeding 1.5% of the Company's average system peak – is effectively meaningless."[39] According to Mr. Neme, "Consumers' peak demand averaged about 7338 MW over the three-year period from 2015 through 2017. Thus, Consumers would simply need to maintain an annual DR capacity on the order of 110 MW in order to earn its P4P incentive."[40]

Mr. Neme explained that Consumers' metric for the P4P incentive is not related to using DR; it actually reflects the amount of DR capacity that the company has built. As noted above, according to Mr. Neme, Consumers is only required to maintain 110 MW of DR capacity to earn the P4P incentive, despite the fact that the company's 2018 IRP calls for 349 MW of DR to be enrolled in 2019, with an additional 49 MW per year added through 2030. Thus, "the Company's proposed performance metric for the P4P incentive is only a very small fraction (about one-third) of its current (2019) need, and an even smaller fraction of what it forecasts it

[38] 2 Tr 105.
[39] Id. at 105-106.
[40] 2 Tr 106; Exhibit NRD-2.

will need in future years."[41] Mr. Neme testified that, "[u]nder the Company's proposal, it would earn a substantial incentive on DR capacity it builds and/or maintains, regardless of how much it builds and whether or not the amount that it builds is consistent with its IRP."[42]

Following this critique of Consumers' proposal, Mr. Neme recommended that the "incentive to build" should be tied to the company's IRP goal of an incremental increase of approximately 49 MW of DR capacity per year, with the condition that the full incentive, whatever it may be, cannot be earned unless the company meets or exceeds its IRP target:

> For example, if the shareholder incentive is structured as a bonus rate of return for a Regulatory Asset, the maximum rate of return should not be earned unless the full incremental annual growth in DR capacity forecast to be needed in a given year (i.e., about 49 MW of growth per year on average) is achieved; the rate of return should decline as the gap between the desired DR capacity growth and the actual capacity growth increases. Similarly, if the shareholder incentive to build is structured as a one-time annual payment expressed as a percent of DR participant acquisition costs, that percentage should be maximized only if the desired DR capacity growth of 49 MW (or whatever the precise amount forecast to be needed for a given year in the IRP) is achieved; the shareholder incentive percentage should decline as the gap between the desired DR capacity growth and the actual DR capacity growth increases.[43]

In addition, Mr. Neme observed that it would be beneficial to couple the incentive to build with certain geographic locations to help address specific distribution issues, "acquiring DR not just for system capacity needs, but as part of a lower-

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[41] 2 Tr 106.
[42] Id. at 107.
[43] Id. at 107-108.

cost approach to addressing a localized reliability concern (e.g., deferring a more expensive upgrade of a substation as part of a 'non-wires alternative')."[44]

With respect to an "incentive to use," Mr. Neme explained that there are two ways that DR can be used: (1) for reliability generally or for reliability in specific geographical areas under peak demand conditions; and (2) to cost-effectively reduce the amount of electricity that must be purchased under peak demand conditions.[45] Mr. Neme testified that once Consumers has been incentivized to build DR, "it is unclear why the Company would need an incentive to actually use it to address reliability needs[,]"[46] noting that a failure to use DR could result in serious repercussions for the company from the Commission and ratepayers.

Mr. Neme testified that Consumers' proposed shareholder incentive was too large because over time, the company would earn more for its DR incentive than it would for its energy efficiency financial incentive. Mr. Neme explained:

> In Exhibit A-7 (HWM-2), Consumers witness Miller shows how much the Company would earn in shareholder incentives in 2017, if its proposed mechanism were applied retroactively to that year. The total incentive – $1.46 million – represents about 9% of its $16.4 million total DR spending in 2017. However, that is not the total incentive the Company would earn on its 2017 spending because the Company would continue to earn incentives on most of its 2017 DR spending (the 89% of it that would become a Regulatory Asset) for about another 25 years. Indeed, as shown in the table below, I estimate that the net present value (NPV) of the Company's total incentive associated with just its 2017 DR spending would be $18.54 million. That is 113% of its 2017 DR spending, or an incentive that is more than five times what the Company can earn on its annual energy efficiency program spending.[47]

[44] Id. at 108.
[45] Id. at 108-109.
[46] Id. at 109.
[47] 2 Tr 110 (Table on p. 111)

Mr. Neme testified that the key factors that lead to the high NPV for the DR incentive are the inclusion of customer acquisition costs in the regulatory asset; the size of the proposed return (20%); and the depreciation rate that results in payments for the regulatory asset over 26 years. Mr. Neme pointed out that if the capital and customer acquisition costs were depreciated over 10 years, the total amount of the incentive would be cut in half. "However, that is still three times the incentive level – as a percent of annual spending – that the Company can earn for its efficiency programs."[48] Mr. Miller opined that Consumers' proposed incentive is directed toward "parity in the *absolute dollars* of shareholder incentive earned from DR investments versus those earned from the alternative of new generating capacity[,]" explaining that this would be analogous to paying a higher rate of return for a gas plant on grounds that shareholders would earn higher returns on a more expensive nuclear plant.[49] Mr. Neme also opined that because there is a greater disincentive to invest in energy efficiency than there is to invest in DR, due to the higher amount of lost revenues resulting from energy efficiency, the DR incentive should be slightly lower per dollar of spending than the incentive for energy efficiency programs.

Finally, Mr. Neme proposed an alternative mechanism for 2019 and 2020 as follows: (1) normal rate of return on DR capital investments; (2) an annual payment of 13% of O&M costs (i.e., customer acquisition costs and customer incentive payments) if the company reaches 100% of its DR capacity growth target. If the company achieves less than 50% of the target, no payment would be made.

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[48] 2 Tr 111-112.
[49] Id. at 112.

"The Company would earn an incentive equal to 0.26% of its non-capitalized DR costs for every 1% above 50% of its DR capacity growth target that it achieved, up to the 13% maximum incentive for achieving or exceeding its target[;] (2) an annual payment of 2% of DR O&M costs for assessing DR potential in at least five distribution planning projects for possible NWA solutions.[50]

In his rebuttal testimony, Mr. Miller took issue with the Staff's recommendation to apply the financial incentive going forward. According to Mr. Miller, Consumers increased its participation in DR programs by over 2,500% between 2016 and 2017, in anticipation of earning an incentive as provided in Act 341. Moreover, Mr. Miller contended that the Staff's recommendation is contrary to Act 341 and the Commission's order in Case No. U-18369. Mr. Miller added that in 2009, the company was able to earn a financial incentive on energy efficiency programs in the first year, even though the incentive was created after the programs were initiated.

Mr. Miller also disputed the Staff's proposed incentive, contending that the return under the Staff's proposal is 86% less than the return that the company expects to receive for its energy efficiency programs.[51] Mr. Miller testified that "[w]hile the Company is appreciative of Staff's willingness to discuss and explore alternative DR financial incentives, the alternative financial incentive advocated by Ms. Smith will continue to steer utilities toward supply-side options."[52]

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[50] Id. at 114. Mr. Neme described the criteria and recommended analysis for assessment of NWA solutions at 2 Tr 114-115. Mr. Neme also recommended that the DR financial incentive be evaluated and adjusted after 2020, and he made suggestions for possible refinements to the incentive in the future. 2 Tr 115-117.
[51] 2 Tr 69-70; Exhibit A-8.
[52] 2 Tr 70.

With respect to Mr. Neme's contention that it is inappropriate to compare the opportunity cost of a return on supply-side resources to demand-side resources, Mr. Miller posited that:

> Mr. Neme's argument presumes that the Company should ignore the profit component of investing in various resources when deciding the mix of supply-side and demand-side options to meet customer demand. However, as discussed, the Company considers many factors in determining the optimal way in which to provide customers with affordable, safe, and reliable power in a cost effective manner, including the ability to earn a return on the Company's investment. For instance, not only does the Company consider the risks and benefits of investing in a natural-gas plant versus a nuclear plant, but also the long-term profitability of investing in one versus the other. The same applies when evaluating the appropriateness of investing in demand-side resources. In my direct testimony, I was not implying that the Company should earn the same profit as it would by investing in a supply-side option; simply that any DR financial incentive should consider the divergence in profitability between investing in supply-side and demand-side options. [53]

Mr. Miller continued, testifying that the financial incentive proposed by the NRDC results in a return that is "95% less than the return the Company could earn by investing in a similar sized solar facility, 93% less than the return associated with a combustion turbine, and 90% less than the incentive the Company can earn under energy efficiency."[54] Thus, according to Mr. Miller, NRDC's proposed incentive is insufficient to promote significant investment in DR.

Mr. Miller also took issue with the claim that Consumers is obliged to provide service at the lowest cost, reiterating that the company takes a number of factors, including cost, risk, portfolio diversity, and return on investment, into account in determining the appropriate mix of resources to serve customer demand.[55] Mr.

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[53] Id. at 71.
[54] Id.
[55] Id. at 72

Miller also took issue with Mr. Neme's claim that the incentive for DR should be less than the incentive for energy efficiency. Mr. Miller pointed out that on January 30, 2019, the company implemented DR when market prices spiked at over $560 per MWh. Alternatively, the company could have built supply-side resources or purchased expensive market power to maintain electric supply stability.

According to Mr. Miller:

> The Company has taken a transformative stand for customers and the environment as part of its IRP by aggressively pursuing demand-side resources. The Company simply asks that the Commission recognize this and support demand-side resources by approving a transformative DR financial incentive.

Mr. Miller added that "the avoided cost of capacity from DR is $30.3 million per year based on the DR resources and MISO annual capacity prices included in the IRP. This suggests the value to customers is approximately 19 times greater than the DR financial incentive proposed by both Staff and NRDC and 1.8 times greater than the incentive proposed by the Company in this case."[56]

III.

<u>POSITIONS OF THE PARTIES</u>

The parties' briefs largely rely on the testimony of their respective witnesses. In sum, Consumers requests that the Commission grant its application and approve a regulatory liability of $489,633, to be recovered in a future rate case, as well as a financial incentive of $1,461,181, booked as a regulatory asset, also to be addressed in a future rate case.

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[56] 2 Tr 74-75; Exhibit A-8.

With respect to the Staff's proposals, Consumers disagrees that the reconciliation period should begin in 2015, when DR funding was first approved. Consumers points to the September 15, 2017 order in Case No. U-18369, pp. 9-10, where the Commission found that the standalone reconciliation cases, "will apply to all ongoing and future rate case applications." Consumers notes that at the time that order was issued, the company's "ongoing" rate case was Case No. U-18322, which included a test year beginning in October 2017. Consumers contends that, consistent with the Commission's directive, it could have reconciled only the October-December 2017 period, but to allow for a review of a full year, the company included DR costs approved in Case No. U-17990 for January-September 2017. Consumers reiterates that the Commission did not require any costs prior to 2017 to be reconciled.

Consumers summarizes the advantages of its proposed financial incentive structure, again stating that its mechanism provides an incentive to both build DR resources and to use them, unlike incentives that are applied in other jurisdictions. Consumers disagrees with the Staff's and the NRDC's proposed mechanisms, contending that neither incentive provides sufficient compensation for the company to make significant investments in DR resources. Consumers adds that NRDC's claim that DR should earn a lower return than energy efficiency is incorrect because energy efficiency and demand response provide different types of value to customers:

> EWR programs are primarily valued for the long-term energy savings they deliver, and thus are seen as a disincentive because they reduce the Company's ability to collect revenues through the sale of energy. On the other hand, DR programs modify the Company's

> system load during peak hours and system emergencies and are primarily valued for the quick, low risk capacity reduction the resource provides.[57]

The Staff asserts that the reconciliation should include costs and revenues from the time Consumers' DR program was first approved in 2015. The Staff admits that it is not unusual for reconciliations to cover one-year periods; however, in light of Consumers' past underspending on DR, it is appropriate to include a reconciliation of DR capital and O&M amounts that were approved in 2015 but that were not spent.

The Staff also recommends that the Commission reject Consumers' proposed financial incentive mechanism on grounds that it is far too generous, and it may not achieve the desired results for DR program investment and use. The Staff is particularly concerned that capitalization of customer acquisition and incentive costs could lead to payments that are higher than necessary in order to boost the company's returns. Accordingly, the Staff recommends that the Commission approve its proposed incentive mechanism, which is based on the incentive for energy efficiency, including a goal for demand reduction. In its reply brief, the Staff observes that while the DR incentive is currently less than the incentive the company expects to earn on its energy efficiency programs, it should be recognized that the energy efficiency incentive evolved over time. The Staff therefore recommends that its proposed incentive be revisited in the future.

Finally, the Staff recommends that any financial incentive operate on a going-forward basis. The Staff points out that although the Commission

[57] Consumers' initial brief, p. 18, quoting 2 Tr 72.

determined that it was reasonable for a party to propose a financial incentive in a reconciliation proceeding, it does not follow that an incentive must be applied for the reconciliation period. The Staff maintains that "[i]t is incongruous to incentivize the Company to do something that has already been completed."[58] The Staff further notes that the company's investments in DR should be driven by the need to incorporate the most reasonable and prudent resources into its portfolio, "with or without an incentive, as required by . . . MCL 460.6(t)."[59]

The NRDC takes the position that a shareholder incentive for DR is reasonable and appropriate; however, the incentive proposed by Consumers should not be approved. The NRDC reiterates that the company's proposed incentive is not tied to any DR performance objectives "[i]t is simply . . . rewarding the Company for spending money 'regardless of how much [DR capacity] it builds and whether or not the amount that it builds is consistent with its IRP.'"[60] The NRDC adds that the company's proposed incentive is unreasonably large, and it appears to be designed to address the difference, in absolute dollars, between the returns from more expensive supply side resources versus returns from DR investments. The NRDC emphasizes that for energy efficiency, the company earns a one-time payment equal to 20% of program spending, whereas for DR Consumers is requesting a rate of return of 20% over a 26-year depreciation period. "The 20% rate of return the Company is requesting on the capitalized DR

[58] Staff's initial brief, p. 9.
[59] Id. at 10.
[60] NRDC's initial brief, p. 6, quoting 2 Tr 107.

assets would end up being worth more than five times the one-time annual 20% payment for EWR spending."[61]

The NRDC describes its proposed financial incentive, contending that its proposal links shareholder returns to actual performance by the company and the goals set forth in the company's IRP. The NRDC also argues that its recommended approach better reflects the intent of the shared savings mechanism under MCL 460.6x(1).

IV.

DISCUSSION

A. Reconciliation Period

As stated above, Consumers contends that the reconciliation period should encompass only DR revenues and expenses for 2017, as approved in Case Nos. U-17990 and U-18322. The Staff, however, recommends that Consumers should be directed to recalculate its reconciliation to include DR amounts approved and spent beginning in Case No. U-17735, when the Commission first authorized the company's DR program.

In Case No. U-17735, the Commission approved a test year capital expense amount of $5.2 million for AC direct load administration (DLA) switches, and an additional $3.7 million in O&M expense for marketing and enrolling customers in DR, specifically focused on the DLA program.[62] Additional review of the record in that case indicates that the $5.2 million expense in the test year was part of a total

[61] NRDC's initial brief, p. 10, citing 2 Tr 110, 114.
[62] November 19, 2015 order in Case No. U-17735, pp. 22-24, 58-59.

$33.3 million investment in AC load control for approximately 110,000 customers projected to enroll from 2015-2019.[63]

In Consumers' next rate case, Case No. U-17990, the Commission partially rejected the Staff's proposed $10.05 million disallowance for the DLA switch program, noting, "[t]he Staff's adjustment was based on its determination that, in connection with Commission-approved capital expenditures for DLA switches in Consumers' last rate case, the company installed none of the 8,300 switches proposed in 2015 and only six of those switches in 2016."[64] Nevertheless, the Commission found it reasonable to approve additional capital expenses of $4.9 million for DLA switches, explaining:

> This approved amount is predicated on 20.69 megawatts (MW) of demand savings for customer installations through the test year ending August 31, 2017. This additional funding, combined with the 22 MW of demand savings from the amounts approved for Consumers' DLA program in its last rate case, represents a fully funded commitment by the company of 42 MW of DR savings.[65]

Then, in Case No. U-18322, the Commission concurred with the ALJ that Consumers' request to increase funding for AC switches by $8.2 million was in part a request to replace funding authorized in Case No. U-17735. The Commission therefore determined that because the company had yet to achieve the 42 MW in DR savings that was projected to result from the funding approved in the previous two rate cases, no additional capital expense amounts for DR should be approved.

As Consumers points out, in Case No. U-18369, the Commission found that interim DR reconciliation proceedings were to apply to "ongoing and future" rate

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[63] Case No. U-17735, PFD p. 50, citing 6 Tr 940-941.
[64] February 28, 2017 order in Case No. U-17990, p. 39.
[65] Id.

cases, and Case No. U-18322 was ongoing at the time that order was issued. However, the same paragraph of the order states more generally that "there shall be annual, stand-alone reconciliation cases . . . that match *actual spending on DR programs* with the amounts approved *in the previous general rate cases*."[66] This statement introduces some ambiguity into the Commission's intent with respect to the time period to be considered, at least in the first DR reconciliation.

In addition, in the orders issued in Case Nos. U-17990 and U-18322, the Commission reaffirmed its expectation that the DR expense of $5.2 million, first approved in Case No. U-17735, should be spent to achieve a certain level of DR, and it incorporated that expectation into the DR expense approvals in the two subsequent rate cases. Consistent with what appears to be the Commission's intention in Case No. U-18369, as well as Case Nos. U-17790 and U-18322, this PFD finds that Consumers should be directed to recalculate its regulatory liability to include the capital and O&M amounts approved and spent in Case No. U-17735, along with those additional amounts approved and spent in Case Nos. U-17790 and U-18322.

B. Financial Incentive Mechanism Structure

As explained above, Consumers proposes a financial incentive mechanism that the company contends will encourage investment in DR as well as the use of DR resources. Consumers points out that the company has traditionally used supply-side resources to address increased customer demand, noting that, "[t]he addition of these supply-side resources has enabled the Company to both provide

[66] September 15, 2017 order in Case No. U-18369, pp. 9-10 (emphasis supplied).

affordable service to its customers and meet its fiduciary duty to provide a return on investment to shareholders." [67] Thus, Consumers requests that the Commission approve the company's proposed regulatory asset plus P4P mechanism.

The Staff maintains that the company's proposal is too generous, and it raises additional concerns that an incentive based on the amount of payments to customers could result in the company overpaying for optimal levels of DR. The Staff recommends that the Commission adopt its alternative mechanism, which is structured in a similar manner to the financial incentive for energy efficiency.

The NRDC likewise opposes Consumers' proposed financial incentive mechanism on grounds that it is overly generous and that it is insufficiently tied to DR performance objectives. The NRDC proposes an alternative mechanism that, it contends, provides meaningful performance goals for increasing DR capacity, along with a shareholder incentive. Both the NRDC and the Staff recommend that an additional incentive for evaluation of NWAs in certain geographic areas as a means to avoid expensive distribution system upgrades.

This PFD finds that the financial incentive mechanism proposed by NRDC should be approved.[68] As the Staff and the NRDC point out, Consumers' proposal delivers excessive returns to shareholders, and it is insufficiently tied to actual performance as measured against the amount of DR contained in the company's IRP. While the incentive amount proposed by Consumers appears reasonable at

[67] Consumers' initial brief, pp. 7-8.
[68] The Staff's and NRDC's proposals are substantially similar and it would be reasonable for the Commission to adopt either

first blush, the PFD finds persuasive Mr. Neme's explanation of the actual incentive amount:

> The total incentive – $1.46 million – represents about 9% of its $16.4 million total DR spending in 2017. However, that is not the total incentive the Company would earn on its 2017 spending because the Company would continue to earn incentives on most of its 2017 DR spending (the 89% of it that would become a Regulatory Asset) for about another 25 years. Indeed, . . . I estimate that the net present value (NPV) of the Company's total incentive associated with just its 2017 DR spending would be $18.54 million. That is 113% of its 2017 DR spending, or an incentive that is more than five times what the Company can earn on its annual energy efficiency program spending.[69]

In addition, as more DR incentives are presumably earned and amortized year over year, the total amounts at issue continue to escalate under the company's unreasonably lavish proposal. On those grounds alone, this PFD recommends that Consumers' recommended financial incentive be rejected[70]

Consumers' claim, that a failure to provide a generous financial incentive for DR will result in a preference for more costly supply-side investments, is unavailing for several reasons. Mr. Miller testified that "the utility's shareholders would be better off receiving a 10% return on $500 million to build a combined cycle natural gas plant versus a 20% return on $100 million to build the equivalent amount of demand-side resources[,]" thus implying that there is some trade-off between a baseload gas plant and demand response. However, Consumers fails to recognize that it would not be at all reasonable to add a large, expensive, fossil

[69] 2 Tr 110. The ALJ notes that Consumers did not take issue with Mr. Neme's calculation of the total incentive.

[70] This PFD further agrees with Mr. Neme that an "incentive to use" DR is unnecessary in light of the possibility of a power supply cost recovery disallowance for failure to implement DR when market prices are high. Moreover, the ALJ also agrees that the "incentive to use" proposed by the company is virtually "meaningless," as Mr. Neme pointed out, given that payout is assured if the company meets at least one-third of its 2019 DR requirements under its IRP. 2 Tr 106.

plant to provide energy during the 40 to 100 hours per year when DR could be implemented instead. This comparison is therefore misleading. Moreover, as the Staff points out, the increase in Consumers' DR resources is based on the company's IRP, which in turn represents the optimal mix of both supply- and demand-side investments that constitute "the most reasonable and prudent means of meeting the electric utility's energy and capacity needs[]" as required under MCL 460.6t(8)(a). While there is no doubt that Consumers' shareholders would prefer more expensive investments that yield more significant returns, there is no reference in Section 6t(8)(a)-(c) to shareholder earnings as a consideration in determining the most reasonable and prudent resource mix.

The PFD also agrees with NRDC that the incentive for DR should be somewhat less than the financial incentive for energy efficiency. As Mr. Neme pointed out, energy efficiency results in significantly more lost revenues due to its impact on demand year-round and at all hours, versus DR, which typically reduces demand on peak.

Although the Staff's and the NRDC's proposals are substantially similar, the NRDC's proposal recognizes, as discussed above, that an "incentive to use" DR is unnecessary. As the Staff explains:

> The FIM provided by witness Neme is set up similar to Staff's proposed FIM. NRDC did not include a possible bonus incentive for economic dispatch of DR, equal to the lesser of 10% of cost savings (energy cost savings minus cost of dispatch of DR) and 3% of total non-capitalized costs incurred each year as shown in Staff's alternative. But, NRDC did increase the incentive on non-capitalized cost for achieving DR capacity growth targets to 13% as opposed to the 10% offered by Staff. NRDC also offered a 2% incentive on non-

> capitalized DR costs for assessment of DR as part of a potential non-wires alternative.[71]

In addition, the NRDC's recommendation provides more detail on the NWA assessments that Consumers is expected to undertake. Finally, as the Staff and the NRDC recognize, their proposed incentives are conservative at this point, and any financial incentive should be reviewed, and potentially refined, in future DR reconciliation proceedings.

C. Financial Incentive Implementation Timing

Consumers contends that the financial incentive should apply to this initial reconciliation, arguing that the company significantly ramped up its spending and enrollments in DR in anticipation of the incentive provided by MCL 460.6x. Conversely, the Staff maintains that there is no need to incentivize investments that have already been undertaken. Although the NRDC does not squarely address this issue, it does recommend that the financial incentive be implemented in 2019 and 2020 (e.g., for the 2018 and 2019 reconciliations.)

This PFD finds that the financial incentive mechanism approved here should be applied to future DR reconciliations. Consumers contends that the financial incentive should apply to this first proceeding because: (1) the company increased its DR capacity significantly in anticipation of receiving an incentive; and (2) the financial incentive for energy efficiency was applied retrospectively and the same should also be directed here. The ALJ disagrees. As the Staff argues, the purpose of an incentive is to encourage future behavior, and there is no need to incentivize

[71] Staff's initial brief, p. 8.

investments that have already been made.[72] In addition, the financial incentive mechanism for energy efficiency was well delineated in 2008 PA 295, whereas under MCL 460.6a(13) in particular, the language allows for much more discretion in fashioning an appropriate design. Thus, to the extent Consumers relied on the prospect of earning a financial incentive for 2017, the company could not have been certain as to either the structure of the mechanism or the amount that shareholders could earn.

V.

CONCLUSION

Based on the record, the arguments of the parties, and the preceding discussion, this PFD recommends that the Commission adopt the following findings of fact and conclusions of law:

1. Consumers should recompute its reconciliation to include all DR revenues and expenses from the time the company's DR program was first approved in 2015 in Case No. U-17335 and adjust its regulatory liability accordingly.

2. The financial incentive mechanism proposed by NRDC should be adopted for use in 2019 and 2020, including the assessment of NWA opportunities, as set forth in Mr. Neme's testimony.[73] Additional review and possible modification of the DR incentive mechanism should be undertaken in Consumers' 2020 reconciliation proceeding.

3. The financial incentive mechanism for DR investment should apply on a going-forward basis.

[72] Moreover, even if the incentive were to apply to DR investments in 2017, only the period from April 21, 2017 through December 31, 2017 should be covered since the enactments that provided for a new financial incentive for DR, and an additional incentive for energy efficiency, did not take effect until April 20, 2017.
[73] See, 2 Tr 114-115.

MICHIGAN OFFICE OF ADMINISTRATIVE HEARINGS AND RULES
For the Michigan Public Service Commission

Sally L. Wallace

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Sally L. Wallace
Administrative Law Judge

May 20, 2019
Lansing, Michigan