

IN THE SUPREME COURT OF OHIO

The Office of the Ohio Consumers')
Counsel,) Case No. 08-1837
)
Appellant,) Appeal from the Public
) Utilities Commission of Ohio
)
v.) Public Utilities Commission
) of Ohio Case Nos. 07-589-GA-AIR,
) et al. 07-590-GA-ALT, and
The Public Utilities Commission of Ohio,)
Appellee) 07-591-GA-AAM

AMICUS BRIEF OF NATURAL RESOURCES DEFENSE COUNCIL
IN SUPPORT OF THE APPELLANT OHIO CONSUMERS' COUNSEL

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INTRODUCTION:

The Natural Resources Defense Council files this brief in support of the positions taken in the above-captioned case by the Office of the Ohio Consumers' Counsel and respectfully asks this Court to reverse and remand to the Public Utilities Commission of Ohio (hereinafter "PUCO" or "the Commission") its order dated May 28, 2008 (hereinafter, "Order").¹

As Ohio and the nation struggle with the triple challenges posed by an economic recession, global warming, and threats to our national security, encouraging both utilities and utility customers to invest in energy saving technology is among our highest public policy goals. The Ohio General Assembly has acted to ensure that this public policy imperative is reflected in the laws of Ohio, as described further below.²

To that end, each party in this case has laudably expressed support for implementing ratemaking policies that eliminate widely acknowledged disincentives for utilities to promote energy efficiency. These disincentives result from traditional rate design in which reduced natural gas consumption erodes the utility's revenues and higher gas consumption increases those revenues, thereby creating a strong motivation on the part of the utility to increase sales.

In this case, the Commission had before it two means of addressing the disincentive. One of these eliminates the disincentive entirely and leaves customers with all of the incentives they currently have to make individual investments in energy efficiency. The other does not entirely eliminate the disincentive for utilities and creates new problems for customers in the process.

Duke Energy Ohio (hereinafter DEO) proposed a decoupling mechanism by which the Commission would periodically approve small adjustments to DEO's rates to ensure that it recovered no more and no less than the level of fixed costs the Commission had last approved for

¹ *In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Rates*, Case No. 07-589-GA-AIR, Opinion and Order, May 28, 2008.

² R.C. 4905.70, 4928.66 and 4929.02(12).

it, regardless of the amount of natural gas its customers consumed over a given period (hereinafter referred to as “decoupling”).³ This is the option that eliminates the utility’s disincentive to conserve and leaves customers with the greatest incentives to make individual energy efficiency investments. The PUCO staff responded with its own proposal for a straight-fixed variable (SFV) rate design, under which customers must pay the same amount each month for the short-term fixed costs of receiving utility service, regardless of the amount of natural gas they use. This is the option that dramatically increases this fixed portion of the bill, does not fully address the utility’s disincentive, and reduces an individual customer’s incentive to invest in energy efficiency.

The Commission acknowledged the importance to state energy policy of eliminating the utility’s disincentives to promote consumption. (Order at P. 17-18.) Unfortunately, the Commission approved the SFV rate design. In doing so, the Commission acknowledged that DEO will still face under-recovery of its authorized fixed costs if it encourages and provides incentives to its customers to use less. (Order at P. 19.) The Commission acknowledged that customers will have less incentive to invest in energy efficiency. (Order at P.19.) And the Commission acknowledged that low-use customers will pay proportionately more, with the costs shifting from high-use customers. (Order at P. 19.) The reasons it chose SFV over decoupling are either unsupported or far less compelling than the reasons to choose decoupling, or both. SFV does not result in more equitable cost allocation; it shifts short-term costs to those who use less gas either because they have invested in energy saving measures, or because they live in smaller quarters or set their thermostats at lower temperatures to save energy. SFV does not send better price signals; it eliminates what signals about the long-term costs of increased natural

³ *In the Matter of the Application of Duke Energy Ohio, Inc. for an Approval of An Alternative Rate Plan for Its Gas Distribution Service*, Case No. 07-590-GA-ALT, Application, July 18, 2007.

gas consumption the prior rate design achieved. SFV is no easier to understand than decoupling, but has a far greater negative impact on customer decisions to conserve.

Accordingly, the decision to approve SFV rate design violated R.C. 4909.19 which requires rates to be set in a manner that is "just and reasonable" and the Ohio statutory mandate at R.C. 4905.70 and R.C. 4929.02(12) to promote energy conservation. As described further below, the reasons the Commission cited for their decision are unfounded and unsupported by the evidence in the record.

For the foregoing reasons, we urge the Court to reverse the Commission's order and remand the case back to the PUCO for reconsideration by the PUCO.

A. Ohio law acknowledges the growing imperative for energy efficiency and requires the Commission to encourage energy savings.

Capturing the vast potential for cost-effective energy savings has emerged as a top public policy priority as state and federal policymakers face the enormous challenges posed by climate change, national security and the lagging economy. This was very recently in evidence as President-elect Obama made it clear in his December 7 radio address that energy efficiency will be one of the cornerstones of his economic recovery plan, saying "First, we will launch a massive effort to make public buildings more energy efficient. Our government now pays the highest energy bills in the world. We need to change that. We need to upgrade our federal buildings by replacing old heating systems and installing efficient light bulbs. That won't just save you, the American taxpayer, billions of dollars each year. It will put people back to work."

President-Elect Obama's commitment to energy efficiency echoes the actions of Governors and state legislatures who have embraced energy efficiency because it is both the least expensive and cleanest way of meeting demand for energy. By adopting standards for buildings and appliances, and by requiring electric and gas utilities to offer energy efficiency to energy

consumers, the states, including Ohio, are tapping into the large reserves of cost-effective energy efficiency potential to capture enormous employment, economic development, and environmental benefits. In 2007-2008 ten states, including Michigan, Illinois, Ohio, New Mexico, New York, Colorado, Minnesota, Virginia, North Carolina and Maryland each adopted energy efficiency standards requiring their electric and/or gas utilities to meet a growing portion of their customers' energy needs with energy efficiency resources, rather than with traditional energy supply.⁴ These states joined eight states that already had such policies on the books.

Ohio is on the forefront of that movement having established a set of policies aimed at deploying energy efficiency resources through both electric and gas utilities. Ohio state law dating back to January 2001 requires the public utilities commission to, "initiate programs that will promote and encourage conservation of energy and a reduction in the growth rate of energy consumption, promote economic efficiencies, and take into account long-run incremental costs."⁵ As noted above, upon the adoption of Sub. S. Bill 221 in May of 2008, Ohio joined with seventeen other states that have adopted utility energy efficiency standards requiring electric utilities to meet an increasing proportion of their customers' energy needs with energy efficiency instead of with supply-side resources.⁶ In the same Act, the Ohio General Assembly revisited the language of the statutory policy of the state regarding natural gas services, and added a clause proclaiming it to be the policy of the state to "Promote and alignment of natural gas company interests with consumer interest in energy efficiency and energy conservation."⁷

⁴ ACEEE, State Energy Efficiency Resource Standard Activity, November 2008, available at <http://www.aceee.org/energy/state/policies/utpolicy.htm>

⁵ Ohio Revised Code Section 4905.70.

⁶ Ohio Revised Code Section 4928.66

⁷ Ohio Revised Code Section 4929.02(12).

The Commission's agreement with the parties that it was time to address the disincentives DEO faced in helping its customers increase their energy efficiency, thus, was timely and appropriate.

B. Aligning utility interests with energy efficiency goals is a critical and laudable objective shared by all parties to this case.

Having established a statutory mandate to promote energy efficiency, it becomes a clear obligation on the part of the Commission to ensure that ratemaking policy supports this objective. Effective energy efficiency programs require the active participation of both consumers and the gas and electric utilities that provide Ohio's energy services working in partnership. One major barrier to creating this partnership is that traditional ratemaking, under which the utility's revenue can only increase if sales volume expands, results in a strong disincentive to conservation on the part of the utilities, and sets up a dynamic whereby this critical partner is at best internally conflicted and at worst actively undermining progress toward lowering energy demand. This dynamic has been widely acknowledged and discussed among regulators and other stakeholders throughout the nation.⁸

There is no dispute among the parties in this case as to the importance of using ratemaking policy, along with savings mandates established by Ohio law, to ensure that utilities rely on energy efficiency as a significant and increasing part of their resource mix. The Commission rightly summarizes this point saying:

Under traditional rate design, the ability of a company to recover its fixed costs of providing service hinges in large part on its actual sales, even though the company's costs remain fairly constant regardless of how much gas is sold. Thus, a negative trend in sales has a corresponding negative effect on the utility's

⁸ See, e.g. The National Action Plan for Energy Efficiency. *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. www.epa.gov/ceactionplan; and National Association of Regulatory Utility Commissioners, *Resolution on the Second Joint Statement of the American Gas Association and the Natural Resources Defense Council In Support of Measures to Support Increased Energy Efficiency and Reduction in Greenhouse Gas Emissions*, July 23, 2008.

ongoing financial stability, its ability to attract new capital to invest in its network, and its incentive to encourage energy efficiency and conservation. (Order at P. 17.)

However, the Commission must not address the Company's incentive in a vacuum.

There must be a balance struck in the approved rate design which also addresses the customers' incentives.

C. Straight fixed variable rate design undercuts energy efficiency goals.

While it is critical to design rates so that electric and gas utilities will be willing and able partners in the quest to capture all cost-effective energy efficiency potential, it is equally important that *customers* are able to reap substantial cost-saving rewards from their investments in energy savings technologies and through their participation in energy efficiency programs. Therefore, a ratemaking policy that provides the right incentives to utilities and the wrong incentives to customers fails to meet the statutory requirements in the State of Ohio which require the commission to, "Promote and alignment of natural gas company interests *with consumer interest* in energy efficiency and energy conservation."⁹

The Commission acknowledges that SFV will make energy efficiency and conservation less appealing to customers by reducing the proportion of their energy bill that can be impacted by reducing consumption and thereby increasing the length of time over which an up-front investment in new insulation or a new, efficient furnace would pay for itself with bill savings. (Order at P. 19.) The Commission asserts that this impact would be "modest" without reference to any data in evidence to quantify the impact or any evidence to assess the extent to which customers will choose not to invest in those efficiency measures as a result of the longer payback. The Commission simply did not have the basis for concluding that the customer

⁹ Ohio Revised Code Section 4929.02(12) (emphasis added).

incentive impact of SFV will be modest or that a modest increase in payback period would have a commensurately modest impact in customer participation in energy efficiency programs. In the absence of data upon which to base this conclusion, and in the presence of a statutory imperative to align utility and customer incentives toward conservation¹⁰ the Commission's adoption of SFV was unreasonable and in violation of R.C. 4929.02.

D. Straight Fixed Variable Rate Design Creates Unacceptable Inequities.

The Commission supports choosing SFV rate design over decoupling on the grounds that this rate design promotes a more equitable cost allocation among customers regardless of usage. (Order at P. 19.) This conclusion inappropriately isolates just one of many cross-subsidies inherent in utility rate design and ignores the question of equity between utilities and customers, an equally if not more important charge of the Commission.

The Commission implicitly concludes that the fairest way to allocate all of the short-term fixed costs of a natural gas distribution utility is on the basis of the meter. Regardless what size, type, or characteristics of the residential structure attached to that meter, the meter should bear the average fixed cost of the entire system. This ignores significant utility cost differences that may exist with respect to the installation of these meters and the system on the utility side of them. One of the largest of these difference is simply when the meter was installed. Because utility rates include investment at embedded cost – or original cost less accumulated depreciation – the lowest costs are almost always associated with the meters that have been on the system the longest. Cost differences may also exist based on where on the utility's system the meter is. Customers in easier-to-serve parts of the system may subsidize customers in harder-to-serve areas; customers in areas in which the local community is static may be subsidizing customers in

¹⁰ Id.

local communities that are engaging in public works that require a lot of utility relocation work. And these cross-subsidies arise only with respect to the utility's physical distribution system.

Other cross-subsidies may exist based on how differences between how much contact customers have with the utility. And it is likely that summer natural gas users subsidize winter natural gas users, unless the utility differentiates its commodity costs by season.

The record contained no evidence quantifying any of these likely cross-subsidies. Nor did the record indicate how changing to an allocation based solely on the meter would affect the cumulative effect of such differences. The order's conclusion that SFV is "more equitable" is unsupported in the record.

Moreover, with respect to equity between the utility and customers, SFV fares worse than decoupling. With decoupling, the utility will collect no more and no less than its authorized short-term fixed costs. With SFV, the utility will collect more than its authorized short-term fixed costs whenever the number of customer accounts exceeds that number used in the ratemaking process.

E. The Commission's conclusions regarding the effect of decoupling on customer incentives and understanding are unfounded.

The Order reaches a puzzlingly contradictory conclusion about the effects of the choice between SFV and decoupling on customers' incentive to conserve. On the one hand, the Commission concludes that it would be difficult for a customer to understand why they would have to pay more because of a decoupling adjustment. (Order at P. 18.) On the other hand, the Commission argues that, because the commodity portion of the bill remains variable under SFV rate design, customers will still have incentive to conserve to avoid the per-therm costs of consumption. (Order at P. 19.) The reason these conclusions conflict requires some explanation.

First, with respect to the conclusion regarding the effect of decoupling on a conserving customer's bill, there is no evidence in the record to support the implicit conclusion that decoupling adjustments will always raise rates, never lower them. In contrast to SFV, decoupling works both ways. Even with an aggressive conservation program, a utility may still have experienced higher revenues than used in ratemaking and, through the decoupling mechanism, would be returning to customers the amount recovered beyond their authorized fixed costs to customers. Even if the net effect of consumption increases and decreases is a decoupling surcharge per therm consumed, however, the customer that has conserved will pay less of the decoupling surcharge because of his or her conservation efforts. Given the Commission's own findings that the utility's short-term fixed costs, on average, are only about 20 to 25 percent of the total bill and that the difference in one year between the consumption used in ratemaking and the consumption that actually occurred is likely to be small even with the best of programs, it is hard to imagine that the conserving customer will notice much of an increase or decrease in his or her bills in that second year except for the benefits of having invested in energy efficiency. Thus, the Commission appears concerned about a miniscule affect on conserving customers' bills from those decoupling adjustments that are actually positive.

The effect on customers' incentive to conserve from moving to the SFV rate design, however, is much clearer and stronger. There is no "maybe" about it: conserving customers will face longer paybacks for their investments in energy efficiency. For the highest usage customers, with the 6 to 21 percent rate decrease previously noted, the payback could be much longer than with the rate design prior to this change. The Order contains no findings about the relative size of the effects of SFV; the Commission concludes only that it is "modest." Had the Commission insisted upon analysis of the magnitude of this impact, based on evidence submitted

in similar inquiries in other states, there is ample reason to suspect that the magnitude of the impact is not modest. For example, in a recent docket before the Wisconsin Public Service Commission (WPSC), the commission staff offered an exhibit showing that SFV rate design for Wisconsin Power and Light company's gas customers would increase the average total (fixed and variable) monthly bill for the smallest users by 62.27%, while lowering the monthly bill for the company's largest users by 11.18%. Obviously this shift which is not modest would likely have a significant dampening effect on motivation of the company's gas customers to conserve energy.¹¹

The Order's conclusions about customer understanding must be read in light of the disproportionate effect of the choice of a SFV rate design on a customer's conservation incentives. Almost any customer contemplating investing in energy efficiency is likely to ask how long it will take to recoup the investment through bill savings. The utility, or the utility's contractor, will provide an answer and customers are likely to understand that answer. From years of energy efficiency efforts, we know that customer payback requirements are often woefully short. The only logical conclusion to reach is that the choice of a SFV rate design will lessen customer incentives to conserve, and that disincentive, coupled with utility programs urging them to save energy, will be less and not more comprehensible.

The Commission's argument pertaining to customer understanding of a decoupling mechanism is less compelling for decoupling surcharges arising from energy efficiency activities. Assuming that wildly successful conservation efforts have produced a shortfall of fixed cost recovery in a given calendar year, the Order approving the decoupling surcharge can tout the overwhelming success and the total cost customers saved over that year and that they

¹¹ *In the Matter of the Application of Wisconsin Power and Light Company for Authority to Adjust Retail Electric and Natural Gas Rates*, Docket No. 6680-UR-116, Exhibit 60 (RCB-3) of Witness R.C. Bauer.

will be saving into the future. The amount of fixed cost remaining for collection will appear small by comparison. And as the utility presents energy investment options to more customers, the focus will of necessity be on bill savings at current rates, since the future rates – both the fixed cost component and the volatile natural gas commodity component – are unknown.

F. The Commission erred in concluding that the straight fixed variable rate design will send better price signals to customers.

Among the reasons the Commission gave for favoring the SFV rate design over a decoupling mechanism is that the SFV rate design approach would send “better price signals to consumers.” (Order at P. 19.) This conclusion is valid only with respect to short-run fixed costs and only to the fixed costs of the natural gas distribution utility, not those of the broader system that exists to provide natural gas energy to customers throughout the United States. It fails to consider long-run incremental costs as required by Ohio law.

Retail natural gas prices are a combination of the natural gas distribution utility’s embedded costs of a distribution network, current costs of the personnel needed to operate and maintain that network and provide customer service, and the current costs of acquiring natural gas from the North American market. In the short-term, the embedded costs of the utility’s distribution system, and the people associated with that, do not vary with usage. A utility invariably designs its system to handle the maximum amount of consumption it could expect of customers. Also in the very short-term, the commodity cost of natural gas tends not to vary with increased usage on an individual scale. Spikes in demand over larger areas, however, can easily cause spikes in price to which the utility may or may not be subject depending on its purchasing practices. But these short-term perspectives are insufficient when considering the adequacy of price signals to retail gas customers.

Ohio law requires that the Commission initiate programs that promote conservation and, in doing so, recognizes the importance of the long term:

The public utilities commission shall initiate programs that will promote and encourage conservation of energy and a reduction in the growth rate of energy consumption, promote economic efficiencies, and take into account **long-run incremental costs**.
(R.C. 4905.70, emphasis added)

In the long run, it is consumption of natural gas that drives cost. This is most easily observable with respect to the fixed costs incurred to provide natural gas supply. Increases in consumption require more natural gas wells, more natural gas liquefying and re-gasifying facilities, more and larger gathering systems, more and/or larger natural gas pipelines, more and/or larger natural gas storage capability. The long-run incremental costs of these future investments are not priced into the short-run commodity cost. Nor are externality costs included in this commodity price, neither are the externalities associated with burning natural gas or incurred in exploring, drilling, and moving natural gas. Higher consumption – particularly peak-related space heating consumption – also likely affects the size and number of the facilities a natural gas distribution utility must deploy, operate, and maintain.

A rate design that includes a significant portion of today's short-term, utility specific, fixed costs in the variable rate makes at least some attempt to address the lack of price signals about long-run incremental costs customers will incur if consumption continues to grow. In selecting the SFV rate design, the Commission abandoned this price signal and ignored the long-run incremental costs the Legislature specifically asked that it consider. The highest usage customers (the top 35 percent) will experience a 6 to 21 percent decrease in their bills under the new rate design. OCC Ex. No. 5 (Gonzalez Direct Testimony) at 17 and WG-2 (Supp. XXX).

This price decrease moves in the opposite direction from long-run incremental costs. The Commission erred in finding that SFV sends better price signals.

In contrast to SFV rate design, choosing decoupling would allow the Commission to improve price signals to consumers. Because decoupling assures that the utility can recover its authorized short-run fixed costs regardless of consumption, the Commission could adopt price designs with minimal fixed charges. These rate designs would appropriately signal the long-run incremental cost of increasing consumption and provide the best incentives for customers to avoid this long-run cost by investing in measures that assure them the ability to achieve the results they want with less burning of natural gas.

G. The Commission's reliance on the benefits of "levelized" bills is unfounded.

The Commission supports its choice of SFV over decoupling by reasoning that it will produce "more stable customer bills," and is comparable to bills customers see for other services such as telephone, internet, and cable. (Order at P. 18.) Neither conclusion supports its choice or helps this decision meet the statutory standard.

The Commission cites no evidence and there is none in the record supporting a general customer preference for bills that are level over time, instead of bills that they can more effectively control by adjusting their consumption. In the current economy, common sense would suggest that it is more valuable for a residential consumer to be able to turn down the thermostat to save money, than it would be to have less control, but more stable bills from month-to-month.

DEO customers that value stable bills already have an option by which they can achieve that. It is called budget billing, under which customers pay the same amount each month for a quarter or a year, with an adjustment to bring their payments into accordance with actual tariff

charges. (From DEO website). This is actual levelization; the “levelization” under the SFV rate design is only of the 20 to 25 percent of the bill that the Commission notes represents the utility’s short-term fixed costs. It is not a benefit to force the eighty percent¹² of customers who have not chosen budget billing into this partial levelization.

The Commission’s comparison of natural gas bills to telephone, cable or internet, also fails to support the choice of SFV. Telephone, cable and internet service rely almost exclusively on fixed investments. Of greatest importance, they do not involve the substantial use of natural resources and entail significant externalities in their production and use. To treat energy service the way those services are customarily treated would be to create and foster customer *misunderstanding* that energy services share the same attributes as telephone and internet service, for which there is no compelling public interest in curtailing use, rather than understanding of the important differences among these services.

H. Other state utility commissions have rejected straight fixed variable rate design for the following reasons.

On November 14, 2008, the Kansas Corporation Commission issued a final order in its General Investigation Regarding Cost Recovery and Incentives for Energy Efficiency Programs, Docket No. 08-GIMX-441-GIV. In that order, the commission endorses decoupling, and rejects SFV rate making, stating:

Although straight fixed-variable rates are attractive for their relative simplicity and lesser administrative burden, the commission is concerned about their effect on customer inclination to save energy...The Commission is also concerned with the potential impact such rate structures may have on lower-income and fixed-income customers.

¹² According to the transcript in the record, only 20% of DEO’s customers have opted-into the Budget Billing program. Tr. Vol I at p. 38.

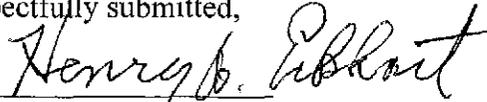
Similarly, on July 16 2008, the Massachusetts Department of Public Utilities issued an order in its Investigation by the Department of Public Utilities on its own Motion into Rate Structures that will Promote Efficient Deployment of Demand Resources. In the order, the Commission endorses decoupling and rejects SFV design saying:

[I]t is possible that setting distribution rates that are closer to the theoretical ideal could mitigate some of the financial disincentives that companies currently face regarding the deployment of demand resources, However, it would not address all such disincentives... Further, as noted by several commenters, the Department must establish rates in a manner that balances a key number of ratemaking principles – principles that reflect and address the practical circumstances attendant to any individual company’s rate case. For example, any attempt to move quickly to full cost-based rates in which a greater portion of distribution costs would be recovered through fixed rates, could have significant impacts on low usage customers, violating the principle of rate continuity, and in the short run reduce the incentive for customers to reduce their energy consumption.

CONCLUSION:

This Commission’s order adopting SFV rate design undermines its statutory duty to ensure that rates are fair and equitable because it both allows the utility to keep excess revenues resulting from unanticipated increased consumption and it shifts a disproportionate amount of fixed costs onto low-use customers. Moreover, the order violates the Commission’s statutory duty to align utility and customer interests toward the goal of increased energy efficiency, by eliminating the barriers on the utility side in a way that creates significant new barriers on the customer side. For these reasons, we urge this Court to reverse and remand the order.

Respectfully submitted,



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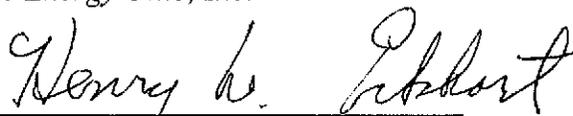
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