ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF SOUTHERN INDIANA GAS AND ELECTRIC COMPANY d/b/a VECTREN ENERGY DELIVERY OF INDIANA, INC. ("PETITIONER") FOR APPROVAL OF AND AUTHORITY FOR (1) AN INCREASE IN ITS RATES AND CHARGES FOR ELECTRIC UTILITY SERVICE INCLUDING A SECOND STEP THAT WILL INCLUDE THE REVENUE REQUIREMENT FOR ITS DENSE PACK PROJECTS; (2) NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO; (3) THE SHARING OF WHOLESALE POWER MARGINS BETWEEN PETITIONER AND ITS ELECTRIC CUSTOMERS; (4) A SALES RECONCILIATION ADJUSTMENT TO DECOUPLE FIXED COST RECOVERY FROM THE AMOUNT OF CUSTOMER USAGE FOR CERTAIN RATE CLASSES; (5) A DEMAND SIDE MANAGEMENT PROGRAM WHICH WILL INCLUDE A MECHANISM FOR THE TIMELY RECOVERY OF COSTS RELATING THERETO AND PERFORMANCE INCENTIVES BASED ON ACHIEVED SAVINGS; (6) AN ALTERNATIVE REGULATORY PLAN ALLOWING PETITIONER TO RETAIN ITS SHARE OF WHOLESALE POWER MARGINS AND DEMAND SIDE MANAGEMENT PERFORMANCE INCENTIVES; AND (7) APPROVAL OF VARIOUS CHANGES TO ITS TARIFF FOR ELECTRIC SERVICE INCLUDING NEW NET METERING, ALTERNATE FEED SERVICE, TEMPORARY SERVICE, AND STANDBY OR AUXILIARY SERVICE RIDERS, REVISIONS TO ITS EXISTING ECONOMIC DEVELOPMENT AND AREA DEVELOPMENT RIDERS, REVISIONS TO ITS EXISTING MISO COST AND REVENUE ADJUSTMENT AND RELIABILITY COST AND REVENUE ADJUSTMENT (INCLUDING THE ADDITION OF A COMPONENT TO TRACK VARIABLE PRODUCTION COSTS) AND REVISIONS TO ITS GENERAL TERMS AND CONDITIONS FOR SERVICE.	CAUSE NO. 43839 APPROVED: APR 27 2011

BY THE COMMISSION:
James D. Atterholt, Chairman
Jeffery A. Earl, Administrative Law Judge

FINAL ORDER

moving from three blocks to two blocks or one block in future rate cases. The resulting rate increases for customers purchasing in the last block are still reasonable compared to the class increase.

Mr. Ulrey also elaborated on the reason for separating Rate DGS into three separate size categories based on Maximum Demands. He said this change continued changes begun in the Company's last rate case and sets the stage for continuing differentiation for Rate DGS customers in the future. To simplify rate design and be better able to respond to the needs of individual classes, the Company intends to move Rate DGS toward a more straightforward Demand/Energy rate design. Creating separate DGS size categories will make this change easier to accomplish.

In response to Mr. Sommer, Mr. Ulrey stated that the Company is not at this time proposing nor intending to propose in the future that Rate MLA-2 accounts be placed in a rate class of their own for purposes of the Sales Reconciliation Adjustment calculations. Mr. Ulrey also identified a correction the Company was making to its proposed MLA rate schedule to prevent inadvertent migration among MLA rate group or perhaps out of Rate MLA altogether.

(6) Commission Findings. We find Vectren South's rate design proposals are reasonable and should be approved. Including a separate Variable Production Charge and a separate Fuel Charge on the rate schedules will increase transparency of charges representing variable costs that are affected by usage and charges representing fixed costs which are not affected by usage. Terminating the availability of Rate RS-Transition (now Rate EH) and Rate OSS beginning one year from the effective date of new rates is reasonable to allow current installation plans to proceed while eliminating discounts from standard rates for space heating customers who have not yet made such installation plans. Rather than establish at this time a fixed transition plan to gradually move these customers to RS-Standard or Rate DGS rates, we find the Company should file for the Commission's consideration within two years of the date of this order rate design analyses for both Rate RS and Rate OSS that provide revenue neutral transition plans and any required alterations to the rates of the standard customers on these rate schedules.

B. Decoupling. Vectren South proposes to implement revenue decoupling through a Sales Reconciliation Adjustment ("SRA") rate design mechanism that will adjust the rates of certain rate classes (Rates RS, B, SGS, DGS-1 DGS-2, MLA-2 and OSS) for differences between fixed costs approved for recovery in this proceeding, adjusted for changes in the number of customers, and fixed costs actually recovered by the Company. These differences would be deferred on a monthly basis for subsequent inclusion in an annual SRA filing which would recover from or pass back to customers the accumulated deferred decoupling amounts. Vectren South sought a decoupling mechanism in Cause No. 43427, and we rejected the request, finding that any decoupling mechanism should be pursued in the context of a base rate case. *S. Ind. Gas & Elec. Co.*, Cause No. 43427, 2009 Ind. PUC LEXIS 495, at *90-93 (IURC Dec. 16, 2009).

(1) Vectren South's Evidence. Vectren South Witness Ulrey described the Company's proposal to implement the SRA. Mr. Ulrey stated Vectren South is proposing a decoupling mechanism to recover the difference between actual fixed cost recovery for certain rate classes and the fixed costs approved by the Commission for recovery from those rate classes

in the Company's most recent general rate proceeding. Fixed costs are those costs included in Vectren South's approved revenue requirement that do not vary based on units produced or sold to customers. Therefore, fixed costs that would be decoupled under the Company's proposal include costs such as return, depreciation, labor costs, other O&M expenses, property taxes, and revenue taxes that are incurred irrespective of actual production or sales units. Variable costs - those costs the Company incurs that do vary with actual sales units or units of production - are excluded from the revenues to be considered in the decoupling amount calculations as described below.

Mr. Ulrey explained that decoupling eliminates the Company's disincentive to help its customers reduce their electric usage. In order to aggressively pursue programs that help customers reduce usage or take advantage of the most efficient use of energy, the Company must not suffer the adverse financial impacts of lower use. Based on its current largely volumetric rate design, the Company would forfeit fixed cost recovery as it helped its customers reduce their actual usages. This misalignment of Company and customer interests can be mitigated with a decoupling mechanism which assures that the Company will recover the amount of fixed costs per customer approved by the Commission in the most recent rate proceeding for the applicable rate classes.

Mr. Ulrey stated that each month, for each of the applicable rate classes, the Company would first calculate the actual fixed costs recovered that month. Then, the fixed costs recovered would be compared to the monthly portion of fixed costs approved for recovery in the most recent rate case, as adjusted for the actual number of customers. The differences between these calculated amounts would be the decoupling amounts for the rate classes for such month. The monthly decoupling amounts for all rate classes would be summed and deferred for subsequent inclusion in an annual SRA filing, which would recover from or pass back to customer classes the accumulated deferred decoupling amounts.

To determine actual fixed costs recovered each month, the Company would deduct from total costs recovered for each rate class the non-SRA Adjustment revenues and variable cost revenues recovered. The Company will allocate annual fixed costs for each rate class to each of the months based on test year and proforma adjustment data as approved by the Commission to determine monthly fixed costs per customer. The monthly per customer amount will be multiplied by the number of actual customers in each rate class for each month to obtain the "order-granted" fixed costs. Finally, to the order-granted fixed costs will be added a prorated portion of the annual return amount reflected in Qualified Pollution Control Property - Construction Cost Adjustment ("QPCP-CC"), if then in effect, which is fixed cost recovery approved by the Commission between rate cases, to achieve the monthly fixed costs approved for recovery. The net result of the SRA is that over a year's time the Company would realize the fixed costs approved for recovery by the Commission - both in the most recent rate case and in subsequent QPCP-CC filings, if any - as adjusted for actual number of customers.

Mr. Ulrey testified Vectren South previously implemented a decoupling mechanism for its gas utility. The Sales Reconciliation Component of the Vectren South-Gas Energy Efficiency Rider is essentially identical to that proposed herein for the electric utility. The major difference between the gas and electric mechanisms is the existence of significant variable costs in the revenue requirement for the electric utility, while the gas utility has virtually no non-fuel variable

costs in its revenue requirement. According to Mr. Ulrey, that difference requires the treatment of variable costs as described above for the electric decoupling mechanism.

Vectren South Witness Chapman testified working with customers to reduce energy consumption is the right response to both volatile fuel costs and to the rising costs associated with controlling emissions created by production of electricity to meet demand. He stated Vectren made the decision to wholeheartedly sponsor energy efficiency a few years ago when its gas utilities implemented DSM programs and began educating customers regarding conservation. He testified Vectren has been a consistent and vocal advocate of energy efficiency efforts, noting that employees have been challenged to hand out energy conservation materials to customers, neighbors, and family members. He stated Vectren's gas DSM programs have exceeded targeted savings. According to Mr. Chapman, the cultural change from the traditional utility role of encouraging energy sales to becoming a conservation advocate has largely occurred.

Mr. Chapman testified that in approving decoupling for Vectren North and Vectren South-Gas, the Commission found that it is now widely recognized that decoupling margin recovery from sales volume is necessary to enable a partnership to reduce usage through energy efficiency. Mr. Chapman indicated this same need of electric utilities to recover fixed costs while encouraging energy efficiency has been expressly supported in the Energy Independence and Security Act of 2007 (the "EISA").

Mr. Chapman described the multiple financial challenges facing the Company regarding customer count, wholesale sales, large customer use and potential GHG legislation. Mr. Chapman emphasized that to the extent a utility in these circumstances would attempt to further reduce its sales to small customers through DSM programs and other efficiency efforts in the absence of a rate design that provides protection of fixed cost recovery, it would further undermine ongoing financial stability that is already under extreme pressure, and would add yet another negative issue to the Company's financial profile. It is important that the Company have an opportunity to collect previously approved revenues to support its operations. Decoupling, for at least half of retail sales, provides this necessary support. He also described the importance rating agencies and investors place on the perceived quality of regulation and constructive regulation that supports reasonable cost recovery and mechanisms that provide cash flow to support investment. He said having a rate design consistent with efficiency efforts will be a big part of the Company's message to that community.

Vectren South Witness L. Douglas Petitt, Vice President of Marketing and Conservation, explained the need for a rate design in the form of "decoupling" that supports the Company's efforts and makes sponsorship of energy efficiency a sustainable long-term objective of Vectren South. Mr. Petitt stated that public policy recognizes the importance of implementation of rate design mechanisms that align the increased use of energy efficiency as a resource alternative, citing the Indiana Strategic Energy Plan, the Commission's Phase II Order in Cause No. 42693 and federal legislation. He described Vectren South's efficiency efforts in the past several years and proposed for the future. He also described Vectren South's efforts to encourage the direct use of natural gas as a more efficient and environmentally friendly alternative to electricity.

(2) **OUCC's Evidence.** OUCC Witness Dr. Dismukes recommended the Commission reject Petitioner's revenue decoupling proposal because it is based upon faulty

premises that are unsupported by any credible evidence, inconsistent with sound regulatory principles, and contrary to the public interest. These premises, as discussed in detail in his testimony, include the faulty argument that traditional utility regulation is deficient and in need of a complete overhaul, especially regarding the traditional risk/reward relationship between a utility and its ratepayers. Another faulty premise identified by Dr. Dismukes is the premise that revenue trackers, like revenue decoupling, will somehow better align the interests of electric utilities and their customers.

Dr. Dismukes testified that Petitioner's revenue decoupling proposal would shift revenue recovery risk associated with changes in the weather, economy, and other factors away from the Company and its shareholders and onto ratepayers. The mechanism would provide guaranteed revenues to the Company whether or not it meets any verifiable performance-based energy efficiency goals or standards. The mechanism, as proposed, will make Petitioner whole for changes in sales that have absolutely nothing to do with its energy efficiency efforts and more to do with the recent economic recession. Additionally Dr. Dismukes explained why revenue decoupling is especially inappropriate for a vertically-integrated electric utility.

Dr. Dismukes opined that revenue trackers like Petitioner's proposed decoupling mechanism ultimately lead to higher utility costs compared to traditional regulation because they eliminate the positive incentives attendant to the regulatory process. He testified that it is a basic economic fact that rational utility management has little incentive to control costs if it has no effect on the utility's profits. Another disincentive that arises with revenue trackers like decoupling is that utilities are less likely to take steps that reduce price volatility for their customers through reasonable risk management practices in fuel supply procurement. Dr. Dismukes observed that Vectren South, like many utilities, has faced investment and operational challenges over the past few years. Some utilities have done a better job at reacting to these challenges. The optimal regulatory solution to Vectren's problems, however, is not to provide a series of revenue and cost trackers, but to promote a ratemaking framework that is based upon performances and accountability, not guarantees.

Another criticism Dismukes posits regarding revenue decoupling is that reduced revenues associated with energy efficiency programs are quite small. Other factors such as weather or the economy result in greater changes in energy usage. Vectren's decoupling mechanism would allow it to recover lost margins associated with energy reductions not associated with its energy efficiency efforts. Dr. Dismukes states that a regulatory framework, like Indiana's, that allows lost revenue recovery with an opportunity to earn shareholder savings is sufficient to incent a utility to pursue energy efficiency opportunities. He stated that, according to his analysis, in 60% of the cases he studied decoupling cost ratepayers more money than they would have paid under a standard lost margin mechanism. In fact, Dr. Dismukes demonstrated that had Vectren South's decoupling mechanism been in place during the test year utilized in this Cause, ratepayers would have seen additional rate increases of some $4.1 million without any hearing or investigation regarding whether Vectren South's costs had changed during the same time period.

Dr. Dismukes also testified that Vectren, as a regulated public utility, operates in the public interest. It extracts and utilizes valuable natural resources. Regardless of what type of incentive the Company would like to be awarded for its conservation efforts, it already has an obligation to use natural resources efficiently.

Dr. Dismukes concluded that the SRA should not be approved for the following reasons: (1) it would shift risk from the Company to ratepayers; (2) no review or analysis prior to permanent implementation has been performed; (3) it is not tied to verifiable efficiency goals; and (4) it is likely to make the Company whole for changes in sales having nothing to do with efficiency efforts.

As an alternative to the Company's decoupling proposal, Dr. Dismukes proposed an Efficiency Incentive Mechanism ("EIM") to promote effective provision of DSM programs and improved efficiency and competitiveness in power production. His proposed EIM would use gains from off-system sales made possible by "freed-up" generation to offset stranded costs created by energy efficiency.

(3) Industrial Group's Evidence. Industrial Group Witness Mr. Phillips examined the policy implications of adding electric decoupling and recommended the proposed decoupling mechanism not be approved. Mr. Phillips asserted decoupling departs from traditional ratemaking principles and is not needed to correct alleged deficiencies in the incentives created by the base ratemaking process. He testified the SRA should be rejected because it would frustrate the voluntary efforts of customers to reduce energy consumption, transfer traditional utility business risks to customers, reduce the Company's motivation to be responsive to the needs of its customers, and create unnecessary rate volatility and uncertainty.

Industrial Group Witness Mr. Gorman testified that the decoupling mechanism lowers Vectren South's operating risk for providing service to its customers because it provides a mechanical means to ensure that the Company will more likely earn its authorized return on equity. As such, he said this decoupling mechanism mitigates Vectren South's operating risk, and will strengthen its earnings and cash flow in support of its utility operations. He explained that credit agencies view decoupling mechanisms credit supportively, because they shift the risk from the utility to the ratepayers and gave several examples. He also explained that several other jurisdictions have recognized that decoupling mechanisms do reduce risk to investors by shifting risk from investors to customers. He noted that some commissions have made return on equity adjustments to reflect reduced operating risk by the implementation of decoupling programs. Based on an analysis of the market-required return available for an investment that produces a higher probability of cost recovery, the normal bond yield spread between an "A" rated utility bond and a "Baa" rated utility bond, Mr. Gorman recommended a 25 basis point reduction to Vectren South's ROE if decoupling were approved.

(4) CAC's Evidence. CAC Witness Mr. Hornby stated it is appropriate to allow the Company to make a limited change in rate design to collect the revenues it would otherwise lose due to those new, future reductions in sales. He opined that the Company's proposed SRA would do much more than simply collect the lost revenues resulting from reductions in future sales due to new DSM programs. He testified that the SRA would eliminate the Company's existing revenue risk from all factors that affect its sales as well as eliminate its financial disincentive to promote sales of electricity to customers in those rate classes.

Mr. Hornby testified a Lost Revenue Adjustment Mechanism ("LRAM") would achieve those energy policy and ratemaking objectives in a balanced manner. He said an LRAM would only adjust the Company's rates for the reduction in sales from the new DSM programs under

the Phase II Order and would benefit the Company by preventing an increase in revenue risk from the new DSM programs and would benefit ratepayers by limiting the amount of revenue risk shifted to them. Mr. Hornby recommended the Commission deny the Company's decoupling proposal but allow the Company to implement an LRAM on a three-year trial basis.

(5) NRDC's Evidence. NRDC Witness Ms. Morgan testified NRDC supports the Company's decoupling request. She stated decoupling is the only regulatory policy that eliminates a utility's incentive to increase sales of electricity, as well as ensures that the savings it helps its customers achieve do not come at the cost of its bottom line. She asserted decoupling is best for utility customers because it does not compensate the utility for revenue "lost" through the operation of energy efficiency programs that was actually not lost because of increases in usage elsewhere in the system and does not deprive customers of the highest possible short-term economic benefits of energy efficiency. She stated decoupling permits utilities to stop focusing on selling more and more electricity and permits them to begin orienting their business to helping customers use energy wisely instead. She described the deficiencies of the LRAM approach and provided information on the number of states using gas and electric decoupling.

NRDC Witness Mr. Dylan E. Sullivan testified as an advocate for revenue decoupling. He provided testimony about the OUCC's EIM proposal and CAC's LRAM proposal. Mr. Sullivan explained that CAC's proposed LRAM is a poor alternative to the SRA because it does not remove a utility's disincentive to help its customers become more efficient in every possible way, does not remove a utility's incentive to increase sales between rate cases, is costly, restores revenue to the utility that might never have been lost, creates new perverse incentives, and adds needless contention to the process of evaluating and measuring the impacts of energy efficiency programs. He argued that the OUCC's proposed EIM is also a poor alternative to the SRA because it is based on a misunderstanding of decoupling, would not remove the disincentive of the Company to help its customers become more efficient, includes an LRAM that is subject to the same problems noted concerning the CAC's proposed LRAM, would worsen the Company's incentives to engage in energy efficiency compared to current practice under some scenarios, and would make an unsupported connection between off-system sales and energy efficiency performance.

On cross-examination, Mr. Sullivan acknowledged that he is not an expert in regulatory accounting or finance and that he has never performed a load forecast or electric utility benchmarking analysis. He also acknowledged that he did not review Dr. Dismukes' workpapers. Mr. Sullivan also explained during cross-examination that he does not want to limit Vectren South's ability to recover lost margins to those actually caused by its efforts. He believes this would discourage the Company from implementing "high value but difficult to evaluate activities." One of the limitations he sees with a standard lost margin recovery program is the difficult task of verifying and measuring savings.

(6) Vectren South's Rebuttal Evidence. In rebuttal, Mr. Petitt stated that under a traditional volumetric rate design, if a utility sells its customers the exact amount of adjusted test year kWh, it will receive the amount of revenue needed to recoup its approved costs. The concept of decoupling, which each year retrospectively trues-up actual sales revenue to the rate case level of sales revenue, is that rather than having a rate design that creates a "throughput incentive," the utility is freed of a sales mindset and can partner with customers to reduce energy

use without being concerned that it will lose revenue necessary to cover its costs. Often, the result is referred to as an alignment of interests of the customer and the utility in efficiency. Mr. Petitt argued that the OUCC's position on this issue flies in the face of the agency's own support of gas decoupling to create alignment of interests. Mr. Petitt testified if the throughput incentive is a recognized obstacle to efficiency, then a known means of eliminating that incentive should be favorably received. If the throughput incentive remains, then every action the Company takes will have to be assessed in terms of how harmful it will be to the Company's financial performance.

Dr. McDermott responded to criticisms of the proposed SRA. He said decoupling rectifies a rate design issue that has traditionally required utilities to attempt to recover a large portion of fixed costs in volumetric charges. While this problem has existed for years it has become more problematic as the system has expanded, costs have increased, and energy efficiency has taken a more important role in providing reliable and reasonably priced service to customers. If parties want utilities to continue to move toward a conservation ethic, decoupling is a tool that can be used to induce utilities to undertake expenditures and actions that serve broader public interests.

Dr. McDermott also contended decoupling's effect on the traditional regulatory lag incentive is overstated. This is because the utility will continue to have the incentive to undertake cost saving actions, as those actions will increase utility profits in the same manner as under traditional regulation, and the success or failure to control costs goes directly to the utility's bottom line. He further asserted decoupling does not remove Commission oversight, ex post prudence reviews, or other methods regulators use to ensure that only approved, prudently incurred costs are paid by customers. Moreover, Indiana is unique in that it includes a statutory earnings test that protects against over-earnings.

Dr. McDermott testified rate cases will continue to provide the main focus of regulatory review; decoupling only serves as a stop gap to provide utilities with a reasonable opportunity to recover the level of fixed costs that have already been approved by the Commission. He expressed the opinion that the OUCC's proposed EIM alternative and the lost revenues approach are both unworkable and do not address the fundamental issue related to decoupling - changing the utility's sales ethic to a conservation ethic.

The Commission questioned Mr. Chapman during his rebuttal testimony, asking whether Vectren South looked to a particular state or other electric utility company as a model for its decoupling proposal. Mr. Chapman responded, "I don't think there was a particular company. I think we've more general in looking at what's been going on. There's no doubt that the gas drove it more than looking at other electrics." Tr. at R-101. Similarly, the Commission questioned Mr. McDermott, asking: "Which state or particular utility's decoupling model has been deemed most successful." *Id.* at U-36. Mr. McDermott answered: "Well, I mean, California has done wonderful stuff, and if you look at the level of consumption per household in a place like California, it has come down dramatically over the last 20 years." *Id.*

(7) Commission Discussion and Findings. Throughout its testimony, Petitioner contends that its proposed decoupling mechanism is reasonable and necessary because it: (1) removes the Company's disincentive to pursue energy efficiency initiatives by removing the

relationship between collecting revenues and making sales; and (2) aligns the interest of the Company with its ratepayers in attempting to promote conservation of natural resources. After careful review of the evidence outlined herein, we reject Vectren South's decoupling proposal for the reasons discussed below.

Initially, it is prudent to start with a discussion of what is called the regulatory "bargain" or regulatory "compact" that exists in this state. Vectren South is provided a monopoly service area in which retail consumers cannot choose to obtain their electric service from another provider. In turn, Vectren South must plan for and serve all of those consumers. Thus, the public is provided reasonable and adequate utility service at reasonable rates and, in exchange, utilities are ensured cost recovery and an opportunity to earn a reasonable return on its investment. We discussed the regulatory compact in some detail in our recent Order in Cause No. 43566:

Indiana law declares this traditional monopoly structure to be "in the public interest" and unalterable by the authority granted to the Commission in Ind. Code § 8-1-2.5 *et seq.* Ind. Code §§ 8-1-2.3-1; 8-1-2.5-11. The Service Area Act is a cornerstone of Indiana's retail electric utility service framework. Assigned service areas were created to provide for the "orderly development of coordinated statewide electric service at retail, to eliminate or avoid unnecessary duplication of electric utility facilities, to prevent the waste of material and resources, and to promote economical, efficient, and adequate electric service to the public." Ind. Code § 8-1-2.3-1.

Commission's Investigation into Any and All Matters Related to Commission Approval of Participation by Indiana End-Use Customers in Demand Response Programs Offered by the Midwest ISO and PJM Interconnection, Cause No. 43566, 2010 Ind. PUC LEXIS 255, at *123-24 (IURC July 28, 2010).

As Dr. Dismukes testified, Vectren South operates "in the public interest" not only because it provides basic and necessary customer service, but also because it extracts and utilizes valuable natural resources in providing that service. He stated further that intentionally wasting those natural resources is inconsistent with this public interest standard and the promotion of inefficient sales for profit is simply inconsistent with an underlying public interest principle of close to 100 years of utility regulation. We agree, whether Vectren South receives a particular cost recovery mechanism or not, it remains obligated to conserve resources as part of its regulatory bargain. *See* Ind. Code § 8-1-2.3-1.

One of the ways that the Commission can ensure that utilities are complying with the mandate to prevent the waste of material and resources is through the Integrated Resource Plan ("IRP") that each utility is obligated to provide. The biennial IRP filing is intended to provide the Commission with the utilities' long-term resource planning. As we stated in our Order in Cause No. 43566:

An integral component of the IRP in Indiana is that the evaluation of supply and demand resources is to be undertaken with cost effectiveness in mind. Specifically, 170 IAC [ ] 4-7-1(s) defines "integrated resource planning" to be "a utility's assessment of a variety of demand-side and supply-side resources to cost-effectively meet customer electricity service needs."

2010 Ind. PUC LEXIS 255, at *128. Therefore, Vectren South, like all other electric utilities in the State, is legally obligated to consider demand side options on a level playing field with supply side options.

Not satisfied with the efforts of many Indiana utilities' conservation efforts, in 2004 the Commission initiated an investigation to examine the overall effectiveness of DSM programs in the state (Cause No. 42693). The Commission designated Testimonial Staff which included Ms. Susan Stratton, Executive Director of the Energy Center of Wisconsin. Ms. Stratton's report stated that Indiana ranked below average for spending for energy efficiency and in savings attained by its energy utilities. *Commission's Investigation, Pursuant to IC § 8-1-2-58, into the Effectiveness of Demand Side Management ("DSM") Programs*, Cause No. 42693, Phase I Order, 2008 Ind. PUC LEXIS 190, at *15 (IURC April 23, 2008). Ms. Stratton also found that Indiana's per-capita energy consumption in 2003 was the highest in the Midwest and well above the national average. *Id.*, at *10-11. Ms. Stratton concluded that increased DSM programs can result in overall cost savings to energy consumers in the state. *Id.*, at *11.

In 2006, Governor Daniels's administration published Hoosier Homegrown Energy: Indiana's Strategic Energy Plan ("Indiana Plan").[5] The Indiana Plan set improvement in energy efficiency as one of three overall State goals. In terms of achieving that goal, the Indiana Plan expressed support for the National Action Plan for Energy Efficiency ("National Action Plan")[6] through gas and electric utilities, regulators, and industry partners to create a sustainable and aggressive commitment to energy efficiency.

Our Phase II Order in Cause No. 42693, advanced the Governor's Plan. *Commission's Investigation, Pursuant to IC § 8-1-2-58, into the Effectiveness of Demand Side Management ("DSM") Programs*, Cause No. 42693, Phase II Order, 2009 Ind. PUC LEXIS 482 (IURC December 9, 2009). We ordered all Indiana jurisdiction electric utilities to create core DSM programs and set an annual energy savings goal of two percent within ten years with interim savings goals for years one through nine. Therefore, Vectren South has been ordered to increase its conservation efforts and the evidence in this Cause demonstrates it appears that it is attempting to comply.

The Indiana Plan also included a directive to "support alternative pricing regulatory mechanisms that encourage utilities to promote efficiency and conservation by their customers without incurring negative financial results." Indiana Plan at 14. This directive ties closely to one of the recommendations of the National Action Plan which also identified the modification of policies "to align utility incentives with the delivery of cost effective energy efficiency and modify ratemaking practices to promote energy efficiency investments" as a key objective. Pet. Ex. CX-5 at ES-1.

The Commission has considered "alternative pricing regulatory mechanisms" when they have been brought before us. Notably, Petitioner's gas affiliates Vectren North and Vectren

[5] A copy of the Indiana Plan is available at http://www.in.gov/oed/2384.htm.

[6] Information about the National Action Plan is available at http://www.epa.gov/cleanenergy/energy-programs/suca/resources.html.

South entered into settlement agreements with the OUCC and other intervenors that included a rate decoupling mechanism, and the Commission approved those settlements. *See Ind. Gas Co.*, Cause Nos. 43046 and 43298, 2006 Ind. PUC LEXIS 376 (IURC Dec. 1, 2006). As we evaluate the need for alternative pricing regulatory mechanisms in this case, it is prudent to look at what cost recovery mechanisms are currently available to Vectren South and whether those mechanisms encourage utilities to promote efficiency and conservation by their customers without incurring negative financial results.

Indiana electric utilities, unlike their natural gas counterparts, have specific cost recovery mechanisms in place that provide them the opportunity to not only avoid negative financial results, but to earn incentives on prudently implemented energy efficiency measures. Under the Federal Energy Independence and Security Act of 2007 ("EISA"), States were required to consider modification of rate designs to align utility incentives with the promotion and delivery of energy efficiency resources. *See* 16 U.S.C. § 2621. As we have recently found in addressing this EISA directive, our review of Indiana law and regulations demonstrate that the Commission presently possesses sufficient authority under existing statutes and regulations to ensure that energy efficiency resources are considered by utilities and timely cost recovery provided through rates. *Investigation of the Indiana Utility Regulatory Commission*, Cause No. 43580, 2009 Ind. PUC LEXIS 496, at *82 (IURC December 16, 2009).

170 IAC 4-8 provides Indiana utilities the opportunity to: (1) recover program costs; (2) recover lost revenue caused by the implementation of those programs; and (3) receive shareholder incentives. One of the stated purposes for the development of this regulatory framework is to allow:

> a utility an incentive to meet long term resource needs with both supply-side and demand-side resource options in a least cost manner and ensures that the financial incentive offered to a DSM program participant is fair and economically justified. The regulatory framework attempts to eliminate or offset regulatory or financial bias against DSM or in favor of a supply-side resource, a utility might encounter in procuring least-cost resources.

170 IAC 4-8-3(a).

To balance the interests of both the utilities and their ratepayers, this rule limits a utility's right to seek recovery of lost margins specifically caused by that utility's energy efficiency efforts. In other words, the utility's ratepayers will not be forced to reimburse the utility for revenues lost due to free riders or to reductions in demand caused by other factors not associated with the utility's programs. This is particularly relevant at this time due to the local, national, and global emphasis placed on conservation of natural resources. For example, some of Vectren South's customers are likely taking steps, independent of Vectren South, to reduce their energy consumption. Another factor that contributes to the reduction in demand is the current economic downturn and the necessity of ratepayers to conserve as much money as possible. It would not be equitable to allow Petitioner to recover from its ratepayers for energy savings caused by ratepayers' own responsible efforts to conserve. In addition, Vectren South has already sought and gained approval of its energy efficiency programs and it is entitled to pursue program cost recovery and shareholder incentives. *See S. Ind. Gas & Elec. Co.*, 2009 Ind. PUC LEXIS 495.

Vectren South indicates its desire to pursue energy efficiency efforts in addition to those than have been approved by the Commission to date. We encourage Vectren South to do so, but we do not feel such efforts justify a cost recovery tracking mechanism such as decoupling that differs from the existing mechanisms under Indiana law, which provide a better, more equitable way to reward conservation efforts.

Second, a decoupling mechanism is not well suited for use by a vertically integrated fully regulated electric utility. As we have previously discussed, Vectren's natural gas utilities have pilot decoupling programs in place. The vast majority of decoupling mechanisms that have been approved in this and other jurisdictions were approved on a pilot basis for distribution-only utilities. The differences between decoupling for a gas distribution company, as opposed to a vertically integrated electric utility with generation, transmission, and distribution assets and functions, are considerable. Decoupling became viable when gas prices began rising earlier this decade. This, coupled with increased state-driven energy efficiency requirements, resulted in a consistently decreasing average use per customer. This has generally not been the case for vertically integrated electric companies. In fact, under questioning by the Commission to identify other successful decoupling programs with vertically integrated electric utilities, Mr. Chapman did not identify any other companies or states except for Vectren's gas utility and Mr. McDermott only referred in very general terms to the State of California.

Further, distribution-only utilities' fixed costs are considerably less than electric utilities. Since there is no generation function for a distribution-only utility, it simply procures and transports the commodity, natural gas for example, to its end users. The fixed cost component of a typical distribution-only utility's bill is generally around 25% of the total amount. Decoupling the distribution revenues of a distribution-only company from its sales has minimal impact on its customers. A customer, through its distribution-only company or otherwise, who implements efficiency measures can realize significant savings since seventy-five percent of the bill is the commodity that the customer is now using more efficiently. In contrast, the fixed cost component of a typical fully integrated electric utility, such as Vectren South, is approximately 75% of the bill. Since the commodity costs are such a relatively small portion of the bill (25%), a reduction of usage by Vectren South customers will not result in as high a proportional reduction in their bills.

Finally, Vectren South's decoupling proposal would allow the Company to recover revenues for reductions in energy consumption that were not caused by its conservation efforts. Vectren South's proposal is for a "full" decoupling, which means that it will recover its lost margin regardless of causation. Dr. Dismukes testified that a reduction in revenue associated with energy efficiency programs is quite small. Other factors, namely changes in weather, income, commodity prices, or economic conditions, often result in greater reductions in sales. Vectren South has no control over these factors; certainly it cannot control the weather or the economy. The Commission is convinced that its present DSM rules allow for a more reasonable and targeted approach to decoupling a utilities conservation efforts from any related financial harm.

Based upon the discussion above, we find that the proposed decoupling mechanism is not in the public interest. Therefore, we reject Vectren South's proposed SRA. The Commission acknowledges that creative rate designs, which enhance the efficient use of energy such as time-

differentiated rates, may influence the attractiveness of a decoupled rate design. We note, however, that Vectren South's tariff proposals contained no such creativity.

C. Cost and Revenue Tracking Mechanisms.

(1) Use of Cost Tracking Mechanisms. In this proceeding, Vectren South proposed to continue use of several cost tracking mechanisms, including its MCRA, RCRA and DSMA. Both Vectren South and the other parties proposed certain modifications to the trackers as discussed below. In addition, there was debate among the parties as to the magnitude of these non-fuel cost trackers. Currently, the Company's approved tracking mechanisms primarily cover non-fuel MISO costs, purchased power demand costs and DSM costs. Many other utilities also track these types of costs.

(2) FAC.

(a) Base Rate Fuel Level. Vectren South originally proposed to remove all trackable fuel costs from base rates and recover them in the FAC. After the OUCC opposed this proposal, the Company withdrew the proposal in its rebuttal evidence. Consequently, we find Vectren South's base rates shall include a level of fuel costs of $195,533,802 with associated revenue based taxes.

(b) Voltage-Differentiation Line Loss Adjustments. The Company proposed that its FAC be changed to reflect the line loss differentiation by rate schedule to remedy a cost allocation deficiency. The Company's current FAC calculation does not adjust the FAC for individual rate schedules to reflect their different voltage service levels. Mr. Ulrey testified that different voltage service levels result in different line losses being experienced by each rate schedule. Consequently, the amount of generation or purchases, and therefore fuel, necessary to provide kWh of sales varies by rate schedule. Mr. Ulrey stated that revising the FAC to reflect these line losses ensures a more correct allocation of fuel costs and that each rate schedule pays the appropriate per unit fuel cost without subsidizing or being subsidized by other rate schedules. No party disagreed with Vectren South's proposal on line losses and we find this proposal provides a more correct allocation of fuel costs between rate classes and should be approved pending resolution of the issue discussed below in the Company's first FAC filing after this Order goes into effect.

OUCC Witness Eckert did express concern about how the FAC Application schedules and workpapers would reflect the line-loss allocation. Mr. Eckert sought confirmation that this change would not impede the ability of the OUCC to timely perform its fuel cost analysis as required by law. The OUCC raised this concern because the Company did not provide sample FAC Application schedules and workpapers demonstrating how the line-loss percentages would be utilized. On rebuttal, Vectren South Witness Albertson explained that Petitioner's Exhibit JLU-S8 demonstrated how the line-loss adjustment would be projected by rate schedule in the FAC. Mr. Albertson also provided schedules and workpapers illustrating how actual FAC variances will be allocated to the rate schedules.

The Bench questioned Mr. Ulrey and Mr. Albertson about whether Vectren South's rate schedule based adjustment uses actual line losses. Mr. Ulrey responded the adjustment uses the