

Frequently Asked Questions About Decoupling:



**Environment
Northeast**

A Mechanism for Aligning Utility Incentives With Consumer and Environmental Goals

Why would a public utility commission change the way utilities earn money?

Under our current system, the more energy a customer uses, the more money a utility makes. Because utility revenues are generated in part through rates that are multiplied by energy usage (kWh or therms), utilities have a financial *disincentive* to encourage their customers to conserve energy. “Decoupling” refers to a mechanism that removes this disincentive by separating utility revenue from its energy sales. Under a decoupling mechanism, a utility would NOT make more money when its customers use more energy, nor would it lose money when its customers use less energy. Implementing a decoupling mechanism is essential to getting utility incentives aligned with the opportunity to increase energy efficiency investments and lower customers’ bills.

Is it true that decoupling doesn’t actually do anything to promote efficiency?

Decoupling is a necessary ingredient to strong utility investment in efficiency, as it removes a major disincentive. Without decoupling, successful efficiency programs hurt utilities because the less energy customers use, the less money utilities make. When combined with strong efficiency programs, decoupling allows utilities to become efficiency partners with their customers without suffering financial harm if the efficiency programs are successful.

Is it true that decoupling guarantees utility profits?

No. Decoupling only permits a utility to recover an amount of revenue that has been approved by the public utility commission. This amount is calculated to allow for reasonably foreseeable costs as well as a fair rate of return on shareholder investment. Without decoupling, a utility can collect more than its allowed revenue if it sells more energy; under

decoupling, a utility would no longer be able to recover revenues in excess of its allowed revenue. Moreover, like any business, if a utility fails to manage its costs, its profits will decrease because a larger than expected portion of its allowed revenue will go to pay for costs, rather than to rewarding its shareholders.

Why are utilities now supporting decoupling?

Utilities have almost uniformly opposed decoupling for many years. Very recently, utilities have begun to embrace the idea of decoupling because of a changing economic and regulatory landscape. Utilities understand that public policymakers are increasingly considering climate change and energy independence when weighing energy policy decisions. In addition, energy markets have become volatile in recent years. Swings in fuel prices, climate variability and dramatic weather changes have led to unpredictable energy costs, customer frustration and calls for change. In addition, utilities can no longer count on steady load growth (or increased energy use) as a source of revenue. Because of these changes, energy efficiency and demand response are seen as the best solutions for meeting our current energy and environmental needs. Decoupling allows utilities to have greater certainty over revenue streams while opening the door for greater efficiency investment.

Does decoupling harm customers?

No. Under decoupling, customers will pay no more than the revenues allowed by the utility commission. In addition, decoupling should help customers reduce their bills by enabling utility companies to expand cost-saving efficiency programs without losing money. With larger investments in efficiency, customers will have increased opportunities to take advantage of efficiency programs, such as lighting retrofits or upgrades to more efficient appliances or equipment. In addition, by spurring investment in

energy efficiency, demand response and other demand-side programs, decoupling will help boost local economies, create local jobs, and reduce energy deficits caused by buying out-of-state fossil fuels.

Shouldn't efficiency programs be run by a third party administrator, not the utilities?

It depends. Some states, like Connecticut and Massachusetts, have very successful utility-run efficiency programs. These programs, which rank among the best in the country, use the utility contact with customers, knowledge of the industry and years of expertise to administer effective programs; they have achieved demonstrable results. Other states have third party administrators. Vermont, which has over 20 electric utilities, has a successful program that is centrally run by an "efficiency utility" called Efficiency Vermont. Whether a program should be run by a utility or by a third party administrator depends on the circumstances of the state in question. Among the considerations should be (1) the number of utilities operating in a state; (2) the quality and performance of current programming; (3) the experience of potential utility and third party administrators; and (4) the time, resources, and opportunity costs required to make a transition from one to the other.

If decoupling eliminates the disincentive to efficiency, should we eliminate performance incentives for efficiency?

No. Decoupling removes a significant disincentive for utility investment in energy efficiency and demand-side programs—it makes a utility economically neutral to efficiency investments. To fully realize all cost-effective efficiency opportunities, utilities will need economic *incentives* to make efficiency investments. If utilities see efficiency programs as profit centers, their willingness to partner with consumers to maximize cost-effective efficiency investments and lower customer bills will be enhanced. Incentives should continue to be based on the level of the utility's performance in achieving customer savings.

Should a decoupling mechanism include a weather normalization mechanism?

No. Weather adjustments are unnecessary because the utility and its ratepayers face opposite risks with respect to weather. That is, under traditional rates,

an unusually cold winter will cause a natural gas utility to over-collect distribution revenues at the expense of its ratepayers, while during a warm winter, the utility under-collects. Implementing a decoupling mechanism reduces the risk both parties face under traditional rates because utility over-collections caused by severe weather would be refunded back to the customer and, by contrast, under-collections due to mild weather would be reconciled through rate adjustments. Thus, weather would no longer affect utility distribution revenues or customers' distribution charges.

Should a decoupling mechanism include an adjustment mechanism for economic conditions?

No. While decoupling contains the *potential* to shift risk due to changing economic conditions from the utility to its customers, the cure is likely to be worse than the disease, and could lead to "gaming." In order to adjust billed revenues for economic conditions, a decoupling mechanism would need to use a more complicated adjustment equation (or set of equations). Specifically, a statistical study would need to be performed in order to estimate the effect of changes in economic conditions on revenues. There would likely be significant disputes regarding the appropriate methods for estimating this effect. In addition, parties might attempt to game the decoupling mechanism by conducting a search to find the most favorable adjustment factor based on their expectations of future economic conditions. The better and more accurate approach is simply to true up actual billed revenues to the allowed revenue level.

Does decoupling shift risks from utility shareholders onto customers?

Many consumer groups raise concerns that decoupling will dramatically shift risks from utilities to customers. At the outset, it is important to note that reducing risk of one party does not automatically shift it to another and that decoupling reduces risk for both utilities and consumers in several ways. In general, decoupling reduces the risk that utilities will collect less than their allowed revenue; similarly, decoupling reduces the risk that consumers will over pay beyond what utilities are allowed to collect.

Decoupling reduces risk due to weather for both utilities and customers. Because decoupling only permits utilities to collect their allowed revenue, any over-collection due to severe weather (*e.g.*, hot summer, cold winter) would be refunded to customers through a rate reduction. Similarly, under-collections due to mild weather would result in a slight increase in rates.

Should decoupling change a utility's return on equity?

Maybe. Whether a decoupling mechanism will affect a company's risk and how it might affect its capital structure and target return on equity should be carefully studied. Because implementation of a decoupling mechanism would alter a number of counter-balanced risks and opportunities, it is likely that any change in company risk would be modest. Accordingly, changes to the return on equity, if any, should be correspondingly small.

Implementing a decoupling mechanism changes the risk and opportunity for both companies and customers. Utilities would no longer face the risk of under-collection, but conversely, they would no longer have the opportunity to increase profits through keeping revenues generated by over-collection. Customers would no longer have the risk of over-compensating utilities when energy use exceeds expectations, but would no longer benefit from avoiding the costs associated with lower than expected energy use.

In addition, the major purpose of implementing a decoupling mechanism is to change utility incentives so that they are more closely aligned with customer interests, including supporting expanded demand-side investments (*e.g.*, energy efficiency and distributed generation) that will reduce energy bills. Any public utility commission should consider the overall impact of the mechanism on consumers in determining the magnitude of any changes to a utility's capital structure and return on equity.

Decisions on whether the utility's return on equity should be changed due to a decoupling mechanism should be made on a utility-by-utility basis, and should take into account how the financial markets are likely to assess the impact.

Wouldn't a mechanism that allows utilities to collect lost revenues due to efficiency programs be better than full decoupling?

No. Lost-based revenue adjustments compensate utilities for reductions in revenue that are the direct result of efficiency programs. For several reasons, lost-based revenue programs have been all but abandoned by public utility commissions. First, lost based revenue systems do nothing to change a utility's financial incentive to promote sales and its disincentive to increase efficiency investments. Second, lost revenue adjustments create an incentive for utilities to claim that their efficiency programs achieve better than actual results—they create an incentive for utilities to promote programs that look good on paper, but do not achieve significant efficiency gains. Third, lost-based revenue programs lead to time-consuming disputes over the effectiveness of particular programs.

Will customers who have already made efficiency investments lose out under decoupling?

No. For most customers, one of the primary motivations for investing in efficiency is to save money. Many customers who have already made significant efficiency investments have taken advantage of existing state incentive programs. With or without decoupling, efficiency investments will reduce the energy charges on a customer's bill. In addition, under decoupling, these customers would continue to benefit from their efficiency savings in the volumetric portion of their distribution charge, and can capitalize on new efficiency opportunities in the future.

Will decoupling compensate utilities for revenue losses due to customer migration to competitive supply?

No. In states where utilities have divested their generation assets, utilities do not generate any revenue from the commodity (energy) portion of a customer's bill. Utilities provide the service of delivering electricity to all customers, whether the actual electricity is generated through a default service or competitive supplier. Thus, utilities are compensated in the same way regardless of the source of energy, and do not see a change in their revenue when customers migrate to competitive supply.

Should decoupling be implemented if there is not a corresponding commitment to increased efficiency investments?

To achieve investment in all cost-effective efficiency (*i.e.*, efficiency measures that are cheaper than supply) will require policy change on multiple fronts. Decoupling is usually achieved in an administrative proceeding before a public utility commission. By contrast, a commitment to increased energy efficiency investments usually requires legislative action. Because these two essential pieces to an overall strategy occur in different, complementary forums, it is impossible to implement them simultaneously: they occur on different tracks. However, there is no reason that decoupling needs to follow a legislative mandate. As California's experience indicates, there is no policy disadvantage to having decoupling in place in advance of legislation that increases investments in efficiency.



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