

Ratemaking and the Regulatory Balancing Act: The Case of Revenue Decoupling

Ken Costello
Senior Institute Economist
The National Regulatory Research Institute

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Topics

- Summary of revenue decoupling (RD) activities
- Reasons for the recent interest in RD
- State commission responses so far
- An assessment of RD applying the “balancing act” model for regulatory decision-making

Recent Activities

- Lot of activity on the natural gas side for RD and other revenue stabilization mechanisms (e.g., SFV rate design, earnings sharing)
- Beginning to see renewed interest in the electricity sector and somewhat less for the water sector
- Revenue stabilization has become an important goal for gas utilities, who have proposed different ratemaking mechanisms, other than revenue decoupling, to achieve revenue stabilization (e.g., SFV rate design, earnings sharing, higher customer charges, declining block rate)
- Implementation issues have received greater attention (e.g., demand factors included in an RD mechanism, the need for cost of capital adjustments)

The Rationale for Revenue Decoupling

- Eliminates the disincentive for utilities to promote energy efficiency
- Standard rate design places the utility at risk for recovering its fixed costs, with the risk increasing in recent years
- RD superior to alternative rate designs in achieving revenue stability and promoting energy efficiency
- Represents an incremental change in ratemaking practices that would significantly advance some regulatory objectives at little cost to other objectives

State Commission Responses So Far

- Generally receptive to RD proposals
- Some commissions have rejected RD for various reasons
- Some state legislatures are requiring commissions to either consider or accept RD
- Some commissions favor RD to promote energy efficiency while others have emphasized the revenue stability effect

Elements of the Balancing Act

- Traditionally, symmetry of consumer and investor interests
 - Consumers want protection against unreasonable prices for monopoly services
 - Investors want an opportunity to earn a return commensurate with risks
- Balancing can involve regulatory objectives rather than stakeholder interests, although both tend to overlap

Elements of the Balancing Act -- *continued*

- Regulatory objectives of ratemaking
 - A prudent or cost-efficient utility
 - Cost-based rates
 - No undue price discrimination
 - Public acceptability
 - Rate stability and gradualism
 - Equity or fairness
 - Affordable utility service
 - Efficient consumption
 - Efficient competition
 - Moderate regulatory costs
 - Promotion of specified social goals

Elements of the Balancing Act -- *continued*

- Fairness to consumers and investors achieved by expert, disinterested regulatory bodies acting solely in the “public interest”
 - A commission balances the interests of different stakeholders, subject to legal mandates and the political environment, so as to promote the public interest or the general welfare
 - To serve the public interest, a commission needs unbiased information or else it will react to biased information by making distorted decisions even if the commission is fair-minded

Elements of the Balancing Act -- *continued*

- A commission need to know what constitutes the public interest and how to conceptualize it
 - For ratemaking, this involves a commission identifying the objectives of ratemaking, weighing those objectives, and making the inevitable tradeoffs
 - The public interest can reflect a composite indicator of the public well-being derived from the individual effects of an action

Elements of the Balancing Act -- *continued*

- A commission rejects those positions and arguments of stakeholders deemed not to be in the public interest
 - Are the positions taken by special interests representative of the general public interest and are intellectually and analytically well-founded?

The Expected Outcomes of Revenue Decoupling

- More earnings stability for the utility
- More utility indifference as to its sales and throughput levels, at least for existing customers
- Changing base rates between rate cases, although likely small compared with PGA rate changes
- Minuscule effect on customer-initiated energy conservation
- No direct effect on utility incentives for cost control
- No perverse incentives, unless one includes the lack of incentives to promote sales and throughput
- Uncertainty over overall effects on consumers

An Assessment of Revenue Decoupling

- RD avoids the perverse incentives of cost riders
- By itself, RD probably does not cause a utility to initiate energy efficiency actions
- RD does not cause a utility to earn excessive returns
- RD avoids the problem of determining test-year sales and throughput
- RD would seem to coincide better with the “gradualism” and “public acceptability” objectives of regulation than (say) straight-fixed variable rate design

An Assessment of Revenue Decoupling -- *continued*

- Some bad arguments on both sides of the debate
- Adverse effects on consumers are small or nonexistent
- Focus is on helping the utility financially and eliminating barriers to utility-initiated energy efficiency
- Benefits to consumers contingent on whether (1) lower risk to the utility translates into lower rates and (2) the utility implements cost-effective energy efficiency programs
- Even in the absence of utility energy-efficiency initiatives, RD arguably can represent a valid ratemaking mechanism; but the utility would have to show, at the minimum, that the standard rate design would erode its earnings “materially” in the short term

Conclusion

- RD has gained widespread acceptance for three major reasons
 - The arguments for it seem to be stronger than the opposing arguments
 - RD does not violate seriously any generally accepted ratemaking principles while advancing some regulatory objectives held by commissions, namely revenue sufficiency and the promotion of energy efficiency
 - The adverse effects on consumers would be minimal at most
- Thus, commissions tend to view RD as in the public interest

Conclusion -- *continued*

- One option is to accept RD but phase it out as rate design moves toward a more efficient structure
 - After all, RD involves tinkering with an inefficient rate design that has come under scrutiny for its deficiencies in advancing certain regulatory objectives
- Commissions need to look harder at making sure that consumers benefit from a ratemaking mechanism where the utility becomes less risky and less opposed to undertaking energy-efficiency initiatives
- Otherwise, RD might breach the “balancing act” goal of regulation