Policy and Implementation Issues Surrounding Revenue Decoupling

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Decoupling Stakeholder Summit

Richmond, Virginia
November 8, 2007

Problems with the Standard Two-Part Tariff

- Gas utilities using the two-part rate structure recover much, if not most, of their fixed costs (including the allowed rate of return) in the volumetric charge
- Recovery of fixed costs, consequently, depends upon a number of factors, including weather, economic conditions, price elasticity and energy efficiency initiatives
- Because earnings fall with lower usage, the utility has a disincentive to promote energy conservation between rate cases

Basic Operation of Revenue Decoupling (RD)

- Outside of rate-case price adjustments (i.e., true-up) for distribution non-gas service based on the difference between actual revenues and some specified revenue baseline (e.g., rate case-determined revenues per customer)
- Revenue shortfalls or surpluses placed in an account balance for later recovery by the utility or reimbursement to customers
- Recovery of fixed costs determined by baseline revenues, not actual sales, hence the term “decoupling”
- A (hard or soft) revenue cap, on either a per customer basis or total customer-class basis (e.g., test-period revenues adjusted for changes in the number of customers)

Rationale for Revenue Decoupling

- Utility-initiated energy conservation, induced by RD, can benefit customers and society in both the short and long run
- The prevailing rate design gives a utility a disincentive to promote energy conservation
- Gas usage per residential customer (adjusting for weather) has continuously fallen over the past 25+ years in most parts of the country, and this trend will likely continue in the future

Rationale for Revenue Decoupling - - *continued*

- Determining future gas sales is a contentious part of a rate case, which RD would extenuate
- Gas sales are highly volatile from year-to-year, and difficult to predict, due to different factors (e.g., weather), most of which fall outside a utility's control
- Under traditional rate design, variations in sales directly affect a utility's earnings and its ability to recover its prudent capital cost

Rationale for Revenue Decoupling
-- *continued*

- Almost all of a utility's short-run non-gas costs stay constant when usage varies
- Full recovery of fixed costs depends on actual gas usage (total or on a per customer basis) being no less than the level assumed in the last rate case
- As a utility recovers more of its fixed costs in the customer charge, customers would have a weaker incentive to conserve on the their use of gas (an argument against straight-fixed variable [SFV] rate design or increasing the customer charge)

Expected Outcomes from Revenue Decoupling

- Reduced business risk for the utility
- Less incentive for a utility to promote gas usage, and weaker disincentive to promote energy conservation
- Base rates can change (up or down) between rate cases
- Little effect on customer-initiated energy conservation
- Effect similar to shifting recovery of all fixed costs to the customer charge, except for an intra-class effect
- Uncertainty over the risk and overall welfare effect on customers

Arguments for Revenue Decoupling

- No other ratemaking method achieves the dual objectives of revenue stability and stimulation of energy efficiency
- Without RD, a utility would not have a reasonable opportunity to earn its authorized rate of return
- Regulators should not expect a utility to promote energy efficiency when it would be contrary to shareholders' interest
- RD preferred to SFV rate design and other approaches for assuring sufficient revenue recovery by the utility

Arguments for Revenue Decoupling -- *continued*

- RD satisfies the customary 3-part regulatory test for the acceptability of trackers (i.e., predictability, controllability and effect on earnings)
- RD would reduce the frequency of future rate cases
- RD would assist in stabilizing winter gas bills
- Limited evidence points to generally favorable outcomes from RD for gas utilities (e.g., Northwest Natural [OR], Baltimore G&E)
- RD does not affect rate design and would have only an incremental effect on rates

Arguments against Revenue Decoupling

- Even with declining average gas usage, a utility can earn its authorized rate of return between rate cases by adding new customers and improving its productivity
- RD makes a utility less aggressive in controlling its costs because of revenue protection
- RD is not needed to get a utility seriously involved in promoting energy efficiency
- No convincing rationale for utility involvement in promoting energy efficiency

Arguments against Revenue Decoupling -- *continued*

- Declining average gas usage has not substantially affected a utility's past earnings
- Question of whether declining average gas usage will continue in the future
- Adjusting rates for other than utility-initiated conservation improvements is unreasonable and imposes excessive risk on customers
- Reducing future rate cases could cause a utility to over-earn in the future from a mismatch of revenues with costs

Arguments against Revenue Decoupling -- *continued*

- Alternatives to RD are superior for addressing the downward trend of gas usage per customer
- RD represents “piecemeal regulation”
- RD shifts business risk to customers without any apparent benefits to them

Design and Implementation Issues

- Limits on periodic rate adjustments (“rate collar”)
- Rate classes affected (e.g., residential and small commercial only)
- Forum for consideration (part of rate case filing, stand-alone docket)
- Gas usage factors considered in the RD mechanism (e.g., weather, economic conditions, price, utility-funded energy efficiency programs)
- Need for cost of capital adjustments (e.g., effect on a utility’s total risk as measured by cash flow liquidity)
- Accounting for overall utility earnings (“earnings test”)

Design and Implementation Issues
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- Utility commitment to, and performance in, promoting energy efficiency (e.g., targeted energy savings versus actual savings)
- Frequency of rate adjustments (e.g., monthly, annually)
- Pilot or permanent (e.g., 3-year pilot with annual reviews)
- Treatment of new customers (e.g., allowed total revenues by customer-class or allowed revenues per customer)
- Determination of the baseline level of gas usage (e.g., historical or forecasted incorporating a price-elasticity effect)

Policy Options

- Acceptance of revenue decoupling as a concept, with details worked out among stakeholders
- Acceptance of an alternative ratemaking mechanism, for example a straight-fixed variable rate design or earnings sharing, achieving similar objectives
- Acceptance of revenue decoupling with its gradual phase-out over time concurrent with a movement toward a more optimal rate design
- Rejection of all new ratemaking proposals, with the continuation of the status quo

What's in the Public Interest?

- What are the objectives of ratemaking and their relative importance?
- What ratemaking mechanism or group of mechanisms best balances those objectives?
- What ratemaking mechanism, for example, would be both fair or compensatory to the utility and most beneficial to customers? In the context here, how can RD produce a non-zero sum outcome, relative to the status quo?

Key Factors for the Acceptance of Revenue Decoupling

- A commitment by the utility to promote cost-effective energy efficiency
- Demonstration of benefits, or at least no harm, to customers
- Showing of the standard rate design leading to insufficient future earnings for the utility, including an estimate of the magnitude of those insufficient earnings
- Consumer and public education of the rationale for RD and its likely effects in advancing the public interest