

Elements for Fair and Effective Decoupling

(Adapted from notes provided by Jim Lazar, Consulting Economist)

- 1) Commitment to Invest in Efficiency
- 2) Progressive Rate Design
- 3) Capital Structure Adjustment
- 4) Rate Collar
- 5) Scheduled Periodic Rate Cases

1) A Commitment to Invest in Energy Efficiency.

To be granted a decoupling mechanism a utility needs to make a commensurate commitment to invest in all cost-effective energy efficiency. Decoupling may remove the company's disincentive for conservation, but it doesn't create an incentive for them. *[And it may, in fact, create a disincentive for the customer. - CE]*

2) Progressive Rate Design.

Under decoupling, utilities no longer have concerns about either revenue stability or sales volumes. Therefore they should embrace rate designs that clearly reflect long-run marginal costs for all incremental sales for all classes of customers. The California utilities have done so, with zero monthly basic charges, and with steeply inverted residential rate designs. The highest allowable monthly service charge under decoupling should cover only meter reading and billing expense – about \$5/month.

End-blocks of service *[hit by high users]* should reflect both the long-run incremental cost of peak-period power supply, plus the long-incremental cost of peak-period distribution capacity. For most utilities in the Pacific Northwest, the rate block applicable to electric space heat costs about 10-12 cents/kWh to supply (6-8 cents for peak-oriented power supply and an additional 3-5 cents for the winter-seasonal excess distribution capacity). That should be the range of the target end-block. *[In the NW]* the first block can be a hydro-based rate, perhaps 4 cents – 2 cents for power supply and 2 cents for flat, annual distribution costs.

3) A Capital Structure Adjustment

Utilities typically carry about 45% equity in their capital structure. Like a home mortgage, it's great if you can borrow 80% or more, but the financial markets don't like it. The function of equity is to buffer bondholders from variability in earnings that utilities suffer, protecting them from interruption of debt service payments.

[A utility that is fully exposed to the effects that weather, the business cycle, and other sales volume variations can have on their net earnings must carry more equity than one that has a decoupling mechanism. The rating agencies have recognized this. e.g.,

Standard and Poors gave Northwest Natural Gas their lowest business risk profile rating since the utility's WARM (decoupling) mechanism took effect. Moody's explicitly recognizes the benefit of risk mitigation measures.]

The impact of a lower equity capitalization ratio is to reduce bills to consumers, without reducing the rate of profit that shareholders receive. There are simply fewer shares, because there is less need for equity in the capital structure.

During the recent Washington Pacific Power case, Lazar calculated that a 2% reduction in the equity ratio would be about a \$1 million reduction in electric bills, or about a half percent. That may be a conservative estimate of the benefit on the capital structure from decoupling by itself. If decoupling were combined with a power supply cost adjustment mechanism (PCA), which passes increases in commodity costs through to ratepayers, TWO risk elements would be removed. The equity ratio could be reduced to the 35-40% range, according to Standard and Poor's rating system. Then Washington ratepayers would see something like a \$5 million reduction in the revenues the utility needs each year. That's enough to double the conservation budget at no cost to consumers or shareholders.

4) A Collar on Rates

Decoupling should not result in huge swings in customer bills. It is possible that weather variations WILL cause significant swings in a mechanically implemented decoupling mechanism. *Preferably, swings of more than 3% or so should be spread over a couple of years. That may suggest that, rather than an annual true-up, it might be better to spread the adjustment over a couple of years, avoiding any big swings up or down, yet still providing predictable revenue for the utility.*

5) Scheduled Periodic Rate Cases

Historically, regulation has been based on the cost of providing service, and the "test year" mechanism has worked quite well to keep revenues in line with costs. Decoupling - a "revenue per customer" calculation, instead of a cost-based mechanism - is a significant departure. In order to ensure that costs and revenues do not diverge too much over time under such a mechanism, a decoupling proposal should include scheduled periodic cost reviews. It may not need to be a full-blown rate case, but it needs to look at rate base, expenses, and rate of return, at a minimum. California utilities are required to do full rate cases every three years as part of their decoupling mechanisms. That seems reasonable.