BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Washington Utilities and Transportation Commission's Investigation into Energy Conservation Incentives.	)	DOCKET U-100522
	)	REPORT AND POLICY STATEMENT ON REGULATORY MECHANISMS, INCLUDING DECOUPLING, TO ENCOURAGE UTILITIES TO MEET OR EXCEED THEIR CONSERVATION TARGETS

I. INTRODUCTION

1 Since April 2010, the Washington Utilities and Transportation Commission (Commission) has undertaken an inquiry into improving performance of investor-owned electric and natural gas utilities (IOUs) in the delivery of conservation resources to customers. Specifically, the inquiry in this docket examined whether the Commission should adopt new or modified regulations, or otherwise adopt policies, to address declines in revenues due to utility-sponsored conservation or other causes of conservation. The Commission filed a Preproposal Statement of Inquiry (CR-101) with Office of the Code Reviser setting forth these broad areas of inquiry and soliciting comments and a "Statement of Issues" from all interested participants.

2 In response, the Commission received extensive and detailed comments from all natural gas and electric utilities under its jurisdiction, the Public Counsel Section of the Attorney General's Office (Public Counsel), and a number of additional stakeholders.[1] Some comments opposed the adoption of new regulatory mechanisms to address revenue declines from conservation. Other comments proposed a wide range of regulatory responses believed necessary to improve utility performance related to conservation. All interested participants were allowed a second round of comments to refine their positions. To elicit a thorough discussion of the subject

[1] A list of stakeholders who submitted written comments in the proceeding is attached as Appendix 1.

matter, the Commission sponsored two work sessions at which stakeholders engaged each other and the Commission in discussions that explored the concepts and comments previously submitted.[2] The Commission then solicited, and a number of parties submitted, further comments on several specific proposals for regulatory mechanisms.[3]

3 To address the comments submitted and issues raised in this proceeding, the Commission issues this policy statement pursuant to RCW 34.05.230(1)[4] and WAC 480-07-920. This policy statement identifies the general components of selected regulatory mechanisms that may be proposed to assist in setting fair, just, reasonable and sufficient rates as both electric and natural gas utilities under our jurisdiction acquire all available, cost-effective conservation resources. The Commission includes a number of appendices with the policy statement to identify the stakeholders participating in the proceeding, provide a summary of the discussion on the questions and comments received from stakeholders, present background information about the Commission's efforts over the last twenty years in addressing conservation incentives for IOUs, and provide a summary of decoupling in other jurisdictions. All documents and comments submitted in this proceeding, and the Commission's research and investigation into the issues are on file in the Commission's Record Center and available on the Commission's website.[5]

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[2] A list of stakeholders attending the work sessions is attached as Appendix 2.

[3] A summary of issues and stakeholder positions expressed in the proceeding is set forth in Appendix 3.

[4] RCW 34.05.230(1) states: "An agency is encouraged to advise the public of its current opinions, approaches, and likely courses of action by means of interpretive or policy statements. Current interpretive and policy statements are advisory only. To better inform and involve the public, an agency is encouraged to convert long-standing interpretive and policy statements into rules." Consistent with this provision, the Commission may, after some experience with the mechanisms we describe, consider modifying this policy or converting it into a rule.

[5] *See* www.utc.wa.gov/100522. Commission Orders referenced in this policy statement and documents filed in other dockets before the Commission are also available on the Commission's website at www.utc.wa.gov.

II. STATUTORY FRAMEWORK

4 Washington's Energy Independence Act (EIA), enacted by the voters as Initiative 937 and codified as RCW 19.285, requires electric utilities to "pursue all available conservation that is cost-effective, reliable, and feasible."[6] The EIA provides the Commission with various tools to ensure that investor-owned electric utilities meet this obligation[7] and to provide incentives to encourage those utilities to exceed their EIA obligations.[8]

5 Also relevant is the Commission's longstanding requirement that electric utilities develop and file plans with the Commission every two years reflecting their assessment of the mix of supply-side generating resources and conservation resources that will meet current and projected needs at the lowest reasonable cost and risk to the utilities and taxpayers.[9] In 2006, the Legislature enacted a similar requirement, which it applied to both public and private utilities.[10] Subsequently, the Commission amended its rules for utility integrated resource plans (IRPs) for both electric and gas utilities.[11]

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[6] RCW 19.285.040(1).

[7] For example, RCW 19.285.060(1) generally provides that failure to meet a utility's conservation target established under the EIA results in the utility being fined $50 for every megawatt hour (MWh) of conservation shortfall below its target. The Commission is charged with determining compliance with the EIA, including assessing these penalties for investor-owned utilities that fall out of compliance. RCW 19.285.060(6).

[8] RCW 19.285.060(4) allows the Commission to "consider providing positive incentives for an investor-owned utility to exceed the targets established in RCW 19.285.040."

[9] Re Electric Utility Least Cost Planning, Docket U-86-141, General Order No. R-273 (May 18, 1987).

[10] RCW 19.280.030(1)(e). The IRP must also include a short-term plan identifying the specific actions to be taken by the utility consistent with the long-range integrated resource plan. RCW 19.280.030(f).

[11] WAC 480-100-238(1) ("Each electric utility regulated by the commission has the responsibility to meet its system demand with a least cost mix of energy supply resources and conservation."); WAC 480-90-238(1) ("Each natural gas utility regulated by the commission has the responsibility to meet system demand with the least cost mix of natural gas supply and conservation.").

6 The Legislature has also authorized the Commission to encourage investment in energy conservation by both electric and natural gas utilities and to help ensure that the utilities are protected financially from reductions in short-term earnings that are a "direct result of utility programs to increase the efficiency of energy use."[12] We interpret the financial protection of utilities in the quoted provision to be consistent with our ongoing statutory obligation to set rates for IOUs that are "just, fair, reasonable and sufficient"[13] regardless of the rate making policies used to achieve that protection.

III. STATEMENT OF THE REGULATORY ISSUE TO BE ADDRESSED

7 This inquiry arose, in part, from debate in the 2010 legislative session over a proposal for utility recovery of lost margin related to conservation efforts, specifically decoupling mechanisms, which are a means to separate a utility's recovery of costs and return from the amount of energy it sells.[14] During the 2010 legislative session, a

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[12] RCW 80.28.260 provides the Commission with the discretion to adopt a variety of regulatory mechanisms:

> (2) The commission shall consider and may adopt a policy allowing an incentive rate of return on investment in additional programs to improve the efficiency of energy end use or other incentive policies to encourage utility investment in such programs.
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> (3) The commission shall consider and may adopt other policies to protect a company from a reduction of short-term earnings that may be a direct result of utility programs to increase the efficiency of energy use. These policies may include allowing a periodic rate adjustment for investments in end use efficiency or allowing changes in price structure designed to produce additional new revenue.

[13] RCW 80.28.020. The term "sufficient" means that a utility is entitled to such rates as will permit it to earn a return on the value of its property necessary to "assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *POWER v. Utils & Transp. Comm'n,* 104 Wn.2d 798, 813, 711 P.2d 319 (1985), *quoting Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923).

[14] *See* The National Association of Regulatory Utility Commissioners, Grant & Research Department, *Decoupling For Electric & Gas Utilities: Frequently Asked Questions (FAQ)*, at 2 (September 2007). Fixed costs are those costs that a utility incurs to render service and can expect to remain fairly constant. *Id.*, n.1. These costs can include employee payroll, interest on debt, and maintenance expenses for power plants, gas pipelines. *Id.*

number of bills were introduced to promote conservation and energy efficiency. House Bill 2853 and Senate Bill 6656, would have, among other things, required the Commission to approve a rate adjustment mechanism to allow an electrical or natural gas company to recover all cost effective conservation expenses and non-fuel revenue requirements the company would have recovered absent conservation savings.[15] The Commission raised concerns about these provisions and suggested that it conduct a proceeding to review the issues surrounding conservation incentives in general, including decoupling, and report to the Governor and the Legislature.

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[15] The relevant sections of the bills would have amended RCW 80.28.260, in relevant part, as follows:

> (1)(a) Upon application by an electrical or gas company, the commission shall ((~~adopt a policy allowing an incentive rate of return on investment (a) for payments made under RCW 19.27A.035 and (b) for programs that improve the efficiency of energy end use if priority is given to senior citizens and low-income citizens in the course of carrying out such programs. The incentive rate of return on investments set forth in this subsection is established by adding an increment of two percent to the rate of return on common equity permitted on the company's other investments.~~
> ~~(2) The commission shall consider and may adopt a policy allowing an incentive rate of return on investment in additional programs to improve the efficiency of energy end use or other incentive policies to encourage utility investment in such programs.~~
> ~~(3) The commission shall consider and may adopt other policies to protect a company from a reduction of short-term earnings that may be a direct result of utility programs to increase the efficiency of energy use. These policies may include allowing a periodic rate adjustment for investments in end use efficiency or allowing changes in price structure designed to produce additional new revenue))~~ approve rate adjustment mechanisms to: (i) Provide full and timely recovery of all prudently incurred cost-effective expenditures for conservation; and (ii) ensure that utilities recover authorized nonfuel revenue requirements that would have been recovered absent conservation savings.

SB 6656, Sec. 8(1)(a); HB 2853, Sec. 8(1)(a). These provisions were removed from the bills, as other provisions relating to financing energy conservation continued to be debated. Also in 2010, the Legislature enacted Engrossed Second Substitute House Bill 2658 (ESSHB 2658) which, among other things, directed the reorganized Department of Commerce to revise the state's energy strategy and outlined nine guiding principles that the plan should follow, including the pursuit of "all cost-effective energy efficiency and conservation as the state's preferred energy resource, consistent with state law." ESSHB 2658, Sec. 403. The Commission has participated with the Department in the development of the energy strategy update concurrent with this proceeding.

8 In a letter to the chairs of the Senate Committee on Energy, Water and the Environment, and the House Committee on Technology, Energy and Communications, the Chairman of the Commission expressed the Commission's view that regulatory treatment of a utility's lost revenue due to conservation is an important and complex issue that deserved substantial study. Accordingly, with the support of other government officials and a number of stakeholders, the Commission agreed to convene a larger policy inquiry with broad stakeholder participation.[16] The Commission's goal in initiating the proceeding was "to develop a better understanding of the balance between the recovery of a utility's lost revenue due to conservation and the benefits and costs to ratepayers."[17] The proceeding and this policy statement explore these issues in detail.

9 During the course of this proceeding, the IOUs, both electric and natural gas, expressed concern that conservation efforts, both those sponsored or encouraged by the utility and those motivated solely by the customer, have led to "lost margin" from a decrease in either per-customer use or use by a particular class of customers (*e.g.*, residential, commercial or industrial).[18] The Commission defines "lost margin" as a reduction in revenue during a rate-effective period due to a reduction in usage, from the level of usage determined using a modified historic test year in a general rate case.[19] As such, lost margin is one decrease in revenue among many decreases and

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[16] See Appendix 4, Letter from Chairman Jeffrey D. Goltz, Washington State Utilities and Transportation Commission, to Senator Phil Rockefeller and Representative John McCoy (March 31, 2010).

[17] *Id.* at 2.

[18] Comments of Puget Sound Energy, Inc., at 6 (June 4, 2010); Comments of Avista Utilities at 4 (June 4, 2010); PacifiCorp Comments at 2 (June 4, 2010).

[19] Consistent with the practice of most states, the Commission uses a modified historic test year. The utility seeking a rate increase reports its results of operations, both expenses and revenues, for a given "test year." As stated in a recent rate case:

> [I]n Washington, we use a modified historic test year approach. We start with audited results from a recent 12 month period, but we modify those results to reflect changes that substantial evidence, timely presented, shows have occurred during the pendency of a rate case, or will occur in the rate year that begins at the conclusion of the proceeding. We have found this forward looking approach

increases in revenues and expenses. Under existing rate structures, the utilities recover some portion of their fixed costs through a volumetric charge. If the magnitude of reductions in customer use lowers revenues below the level an efficiently and economically managed utility can be expected to manage, the reductions can lead to the utility not earning its authorized rate of return (ROR).

10 The IOUs expressed a desire for the Commission to establish a rate mechanism that would allow them, between general rate cases, to recover all or a portion of their lost margin. Other commenters, particularly ratepayer advocates, questioned whether lost margin was a problem of sufficient magnitude to warrant an additional regulatory solution.[20]

11 Though the impact of lost margin was articulated by the utilities, others, including ratepayer advocates and the Natural Resources Defense Council (NRDC), expressed the need to consider the effects of so-called "found margin."[21] Just as reduced usage per customer may lead to lost margin, increased per-customer usage or the addition of new customers can lead to additional revenues ("found margin"), possibly resulting in a utility earning more than its authorized ROR.[22] The potential for found margin,

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> more appropriate when considering both power costs and production related assets. ... This approach reduces regulatory lag without burdening ratepayers with unnecessary costs determined on the basis of the more speculative future test year approach to ratemaking that is used in some jurisdictions. Our approach strikes a balance that motivates PSE and the other utilities subject to our jurisdiction to carefully manage their costs and revenues going forward and take full advantage of their opportunity to recover fully all fixed and variable costs including a reasonable return on capital investments.

WUTC v. Puget Sound Energy, Order 11, Dockets UE-090704 and UG-090705 (consolidated) at ¶ 23 (April 2 2010).

[20] Comments of Public Counsel, ¶¶ 15, 16, 20, 21 (June 4, 2010); Comments of Industrial Customers of Northwest Utilities at 4 (June 4, 2010).

[21] Comments of Public Counsel, ¶¶ 16, 21 (June 4, 2010); Comments of Industrial Customers of Northwest Utilities at 8 (June 4, 2010); Comment of the Natural Resource Defense Council at 1-4 (July 14, 2010).

[22] Found margin includes new customer usage as well as increased usage by existing customers, such as that due to use of additional appliances or charging electric vehicles.

which is essentially the flip side of the impact of lost margin, led some to advocate that any regulatory mechanism designed to make the utilities whole for lost margin should also work to recognize found margin and return it to ratepayers.[23] Termed "full decoupling," such a mechanism would truly separate or "decouple" the utility's earnings from its sales.

IV. STATEMENT OF COMMISSION POLICY

12 Based on the information received in the course of this proceeding, on experience gained from prior proceedings involving conservation incentives,[24] and on additional research and investigation, the Commission has determined it is appropriate to set forth policy guidance on selected regulatory mechanisms designed either to remove barriers to utilities acquiring all cost-effective conservation or to encourage utilities to acquire all cost-effective conservation. Specifically, we articulate policy regarding three types of regulatory mechanisms that will be discussed in turn below:

1. Limited decoupling, frequently described in the proceeding as a lost margin recovery mechanism, would permit the utility, subject to conditions designed to protect ratepayers, to recover lost margin due only to the conservation efforts of the utility including educational and informational efforts; [25]
2. Full decoupling, designed to minimize the risk to both the utilities and to ratepayers of volatility in average use per customer by class regardless of cause, including the effects of weather; and

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[23] Comments of Public Counsel, ¶ 21 (June 4, 2010); Comments of Industrial Customers of Northwest Utilities at 8 (June 8, 2010); Natural Resource Defense Council Comments at 1-4 (July 14, 2010); ("A full per-customer decoupling mechanism without weather adjustment ensures that utilities can recover their allowed fixed costs while protecting customers from utility over recovery when sales exceed expectations because of 'found revenues,' whether they result from extreme weather events, increased consumption due to changes in technology, economic changes or demographic shifts.") *Id.*, at 3.

[24] See Appendix 5 for a discussion of the history of the Commission's consideration of conservation incentives.

[25] There is a distinction between "limited decoupling" and "partial decoupling." A limited decoupling mechanism is designed to make a utility whole from the effects of one or more specific influences on sales, such as conservation, weather or growth. In contrast, a partial decoupling mechanism allows recovery of less than 100 percent of the decline in customer use that is the subject of the mechanism. We here endorse a limited decoupling mechanism.

3. Specific incentives, including those authorized by the EIA for use by the Commission, to reward utilities for either acquiring cost-effective conservation that exceeds their conservation targets or meeting their targets earlier than required by the EIA.

A. Limited Decoupling for Gas Utilities

13 *Discussion.* On December 22, 2009, the Commission approved a limited decoupling mechanism for Avista Corporation's (Avista) natural gas utility in the context of a general rate case.[26] There, Avista requested, and the Commission approved, a mechanism that allowed Avista to recover lost margin attributable to company-sponsored conservation programs, including those designed to educate its customers on the value of conservation and to influence customer behavior.[27] Our approval included a requirement that Avista meet certain targets demonstrating the success of its conservation programs and dictated an improvement in the tools used to evaluate, measure and verify the actual impact of its conservation programs.[28]

14 In 2007, the Commission also authorized a three-year pilot decoupling mechanism for Cascade Natural Gas Corporation (Cascade), the terms of which were agreed to in a multi-party settlement.[29] This pilot mechanism was designed to take into account the found margin from new customer growth.[30] Under the terms of the settlement, the pilot "may only be extended as part of a general rate case, and only after a thorough

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[26] *WUTC v. Avista Corporation,* Dockets UE-090134 and UG-090135 (consolidated), Order 10 (December 22, 2009). Avista sought to make permanent its pilot decoupling program, which the Commission approved in 2007.

[27] *Id.* at ¶ 256. Avista's decoupling proposal did not include the effects of weather or customer growth in the determination of lost margin recoverable by the utility.

[28] *Id.* at ¶ 305; *see also* Appendix 5 at 7-8.

[29] *WUTC v. Cascade Natural Gas Corporation*, Docket UG-060256, Order 05, (January 12, 2007).

[30] In its implementation, Cascade's decoupling mechanism compares all revenue for the rate effective period to the authorized revenue requirement in its last general rate case. As noted above, Avista's decoupling mechanism removes the utility's revenue from new customers when comparing revenue levels.

evaluation of the mechanism performed by an independent consultant."[31] By its terms, the pilot ended on September 30, 2010, as Cascade did not seek to extend the mechanism as a part of a general rate case filing. Cascade did file a petition on October 1, 2010, seeking to extend the pilot mechanism through other means.[32] The Commission will address this petition at a future date.

15 Nevertheless, we believe it reasonable to articulate now our support for limited decoupling designed to compensate a natural gas utility for the effects of its conservation program. After our evaluation of the Cascade pilot and the company's recent filing, we may revisit the natural gas limited decoupling principles enunciated in this policy statement.

16 We also deem it useful to articulate now our policy on this type of lost margin recovery mechanism because the Legislature has directed us to consider policies that address the revenue impacts of utility-sponsored conservation programs. RCW 80.28.260(3) states:

> The commission shall consider and may adopt other policies to protect a company from a reduction of short-term earnings that may be a direct result of utility programs to increase the efficiency of energy use. These policies may include allowing a periodic rate adjustment for investments in end use efficiency or allowing changes in price structure designed to produce additional new revenue.

17 It is precisely this type of mechanism – designed to protect a company from loss of earnings that are a "direct result" of the company's conservation programs, both programmatic and educational – that we adopted in the *Avista* case and we endorse here for all gas utilities.

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[31] *WUTC v. Cascade Natural Gas Corporation*, Docket UG-060256, Order 05, ¶ 70 (January 12, 2007).

[32] *Petition of Cascade Natural Gas Corporation for an accounting order authorizing deferred accounting treatment of loss in margin due to Company sponsored conservation programs, or, in the alternative, the continuation of the pilot decoupling mechanism that was approved in Docket UG-060256*, Docket UG-101656 (October 1, 2010).

Description of Mechanism

18 In the context of a general rate case,[33] the Commission will consider a limited decoupling mechanism for natural gas utilities where, over time, existing customer use by class drops from that determined by the Commission when setting rates. Revenue recovery under the mechanism will be conditioned upon a utility's level of achievement with respect to its conservation target. A utility's request for a limited decoupling mechanism must be made in its direct testimony in the rate case filing and include, at a minimum, the following elements:

1. *True-up Mechanism.* The company may recover in an annual true-up mechanism the reduction in sales volume by affected class that is directly attributable to the utility's conservation efforts.[34]

2. *Impact on Rate of Return.* Evidence evaluating the impact of the proposal on risk to investors and ratepayers and its effect on the utility's ROE.

3. *Earnings test.* A proposed "earnings test" to be applied at the time of the true up.

4. *Offsets or Found Margin.* Evidence of any source of found margin that could make the adoption of a limited decoupling mechanism unfair to ratepayers. Such found margin could include, but is not limited to, a growing customer base or any other foreseeable increase in customer use by class.

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[33] In the past, the Commission has indicated that it may consider a decoupling mechanism outside the context of a general rate case. *In the Matter of the Petition of Avista Corporation, d/b/a Avista Utilities, For an Order Authorizing Implementation of a Natural Gas Decoupling Mechanism and to Record Accounting Entries Associated With the Mechanism,* Docket UG-060518, Order 04 (February 1, 2007). However, as was discussed at some length in this proceeding, because a decoupling mechanism may provide reduced risk for the company, it stands to reason that such reduced risk may impact the company's appropriate return on equity. *WUTC v. Avista Corporation,* Dockets UE-090134 and UG-090135 (consolidated), Order 10, ¶ 308 (December 22, 2009).

[34] We remain concerned that a limited decoupling mechanism may result in cross-subsidies among rate classes. A reasonable mechanism would balance conservation program achievements by class with the revenue recovery expected from that class under the mechanism.

5. *Impact on Customer Rates.* Evidence that evaluates the proposed mechanism's impact on rates.

6. *Weather adjustment mechanism.* Evidence demonstrating the soundness of its weather normalization methodology, and how the mechanism's design effectively removes weather as a factor influencing the results of its lost margin analysis.

In addition to assuring that the elements above are included and demonstrated to be in the public interest, a limited decoupling mechanism should conform to the following criteria:

1. *Relationship of Found Margin to Lost Margin.* The Commission will consider limited decoupling only where found margins are not significant in comparison with lost margins.

2. *Conservation Measures Covered.* The Commission remains receptive to recovery of lost margin attributable to company-sponsored conservation programs and company-sponsored education and information programs. The Commission generally will not consider approving mechanisms that permit recovery of lost margin not attributable to a company's conservation efforts, such as conservation not supported by a utility's above–stated conservation efforts, customer-initiated fuel substitution and other responses to price elasticity, or increased stringency of energy or building codes and standards.[35]

3. *Application to Customer Classes.* A limited decoupling proposal should cover all customer classes, so long as use by those affected classes drops, over time, from that determined by the Commission when setting rates.

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[35] To illustrate, in Docket UG-101463, Avista's recovered approximately $610,000 due to the operation of its decoupling mechanism for the one year period ending June 10, 2010. While the testimony in response to Avista's filing generally supported its approval, concerns were raised as to the size of the recovery and the company's ability to separate the effects of its conservation program from other causes of declining natural gas use (*e.g.*, general price elasticity and the economic downturn). We will continue to monitor Avista's limited decoupling mechanism and continue to refine it to better isolate the effects of conservation.

4. *Incremental Conservation.* Evidence describing the incremental conservation the company may achieve in conjunction with the proposed mechanism.

5. *Duration.* The Commission will generally approve a limited decoupling mechanism for the period required to achieve its objectives or until the filing of a utility's next general rate case. Under either circumstance, the burden is upon the utility to demonstrate the continued need for the mechanism.

6. *Low-income.* A utility proposing a limited decoupling mechanism must demonstrate whether or not its conservation programs provide benefits to low-income ratepayers that are roughly comparable to other ratepayers and, if not, it must provide low-income ratepayers targeted programs aimed at achieving a level of conservation comparable to that achieved by other ratepayers, so long as such programs are feasible within cost-effectiveness standards.

7. *Other Factors Impacting the Public Interest.* The criteria listed above are not intended to limit the Commission's authority to review other factors affecting its analysis of full decoupling as a regulatory tool, including whether it remains in the public interest to continue its use by a particular utility.

Application of the Mechanism to Certain Utilities

19 At this time, and for the reasons expressed below, we propose to confine the limited decoupling option to natural gas utilities.

20 First, and most important, this mechanism only makes sense when sales to existing customers are declining. The evidence from recent proceedings indicates that per customer use is declining in the natural gas industry. Although more anecdotal than empirical in character, our utilities point to conservation, a progressive trend upward for seasonal temperatures, and price elasticity in an environment of increased natural gas prices (*e.g.*, customers turning down the thermostat to reduce monthly bills) as the most likely causes of reduced sales. Should utility conservation increase as we expect under our directives and encouragement, we foresee a further reduction in natural gas sales over time. While this reduction would be accounted for by resetting the sales

levels in a utility's next general rate case, the utility would experience pressure on earnings between rate cases due to the decline in consumption.

21 This scenario leads us to consider the balance of equity between the shareholder and the ratepayer. After our review in the *Avista* case and further informed by this proceeding, we presume generally that customer use patterns tilt the balance narrowly away from natural gas utility shareholders.[36] By allowing the utility to recover revenue (represented here by lost margin) affected by its conservation programs, we recognize the impact of conservation on earnings and the natural gas utility's inability to bring its earnings into balance with its allowed rate of return given the trend in customer use.[37] While our experience with *Avista* indicates that natural gas conservation has a small effect on the utility's ability to achieve its earnings and consequently on rates,[38] we do not foreclose the potential for greater impacts. For this reason, we will continue to review a utility's risk profile with a limited decoupling mechanism in place when setting rates.

22 While customer use of natural gas has been declining in recent years, this does not appear to be the case for electric utilities. Our experience and understanding informs us that electricity use per customer has been either steady or even increasing. We attribute this use trend generally to the addition of so-called "plug load" associated with increased consumer use of appliances and electronic devices. Such increased usage could become more pronounced in the future should consumers shift away from automobiles powered by petroleum and toward electric vehicles. Because the increased electric load per customer reduces the potential adverse impact of increased

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[36] Such a presumption is always subject to the particular circumstances presented by individual utilities.

[37] In other words, the utility is constrained by customer behavior from selling more therms than that saved through conservation.

[38] *WUTC v. Avista Corporation*, Docket UG-090134, Exh. No. BJH-2-A (Titus Report) at 2 and 4(8/10/09 revision). The Titus Report lists lost margin due to company sponsored conservation for 2008 at $204,934. This equates to approximately ten cents per month for the average residential customer. *See also*, n.36 above for the results of the 2009-10 period. As noted, Avista's results likely included lost margin not associated with its conservation program. Due to the imprecision of the existing tools used to determine such results, we continue to examine better methods of insuring the mechanism's accuracy.

conservation efforts on utility revenues, we believe lost and found margins are likely to be in better balance for electric utilities, which argues against using a limited decoupling mechanism for such companies to address the revenue impacts of conservation.

23 A second reason why we do not favor using a limited decoupling mechanism to address the financial impacts of electric utility conservation is the potential availability of other offsetting revenue. Like the potential for found margin, we see electric conservation as enabling electricity sales (or avoiding purchases) that can offset the financial impact of conservation. This is because an electric utility experiencing reduced load will either be able to sell the energy that it is not using to serve existing load or will not need to acquire on the short-term market energy it would otherwise have to purchase to meet planned loads. In either case, the electric utility would have an offset against lost margin. Again, the potential for additional revenues can help bring into balance the financial tension between conservation and utility revenues.

24 Finally, we give weight to the requirements of the EIA, which requires electric utilities to obtain all cost-effective conservation that is feasible or face penalties for failure to do so. Therefore, there is less of a need to provide an incentive to electric utilities given that the EIA already provides ample incentive.

B. Full Decoupling for Electric and Gas Utilities

25 *Discussion.* Though we recognize the potential benefits to ratepayers, adoption of full decoupling gives us some pause for two reasons. First, relatively few other state commissions have adopted any form of decoupling for electric utilities, and only some of those mechanisms were full decoupling mechanisms.[39] So, adopting such a mechanism for Washington's electric utilities would put the Commission in the company of a relatively small minority of commissions nationwide. This means that the Commission does not yet have the benefit of lessons learned in other jurisdictions as it develops and refines a full decoupling mechanism.

[39] See Appendix 6 for a discussion of decoupling mechanisms in other jurisdictions.

26 Second, with full decoupling comes a concern that, by eliminating the risk of recovery of declines in revenue, combined with an energy cost recovery mechanism that reduces an electric utility's financial risk due to changes in power costs, the utility could lose some of its incentive to manage the company in a manner that constantly looks to reduce costs.[40] Indeed, some experts in the theory and practice of regulation caution commissions to engage in regulation that constantly provides incentives for a utility to cut costs.[41] Such prudent actions on the part of the utility serve to benefit the utility as well as, in the long run, the ratepayers. Because of our lingering concerns regarding possible reduced incentives for companies to manage in an efficient manner, we will require evidence and argument from the parties on this issue in the context of a request for a full decoupling mechanism.[42]

27 Nevertheless, while a close call, we believe that a properly constructed full decoupling mechanism that is intended, between general rate cases, to balance out both lost and found margin from any source can be a tool that benefits both the company and its ratepayers.[43] By reducing the risk of volatility of revenue based on customer usage, both up and down, such a mechanism can serve to reduce risk to the company, and therefore to investors, which in turn should benefit customers by reducing a company's debt and equity costs. This reduction in costs would flow through to ratepayers in the form of rates that would be lower than they otherwise

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[40] Requiring a utility to manage variations in sales and energy costs (as in the power cost adjustment mechanisms) or declines in sales due to conservation rather than passing the costs or surcharges directly to the ratepayer, provides an incentive for the utility to manage costs in response to those conditions.

[41] *See* Leonard S. Goodman, *The Process of Ratemaking* 930 (1998) ("Certainly one of the goals of agency ratemaking will be the encouragement of efficient performance [by company management]. The agency may encourage the regulated company to reduce the costs of service, or the capital devoted to the service.... An agency's testing for company efficiency may be done independently of the costing process, and either superimposed on the costing of the company's services or made part of the costing process.").

[42] The stakeholders who commented on this issue had widely disparate views on how a decoupling mechanism would impact the utility's incentive to manage the utility in an efficient manner. *See* Appendix 3 at 6-7.

[43] *See* Natural Resource Defense Council Comments at 1-4 (July 14, 2010).

would be, as the rates would be set to reflect the assumption of more risk by ratepayers.

28 *Description of Mechanism.* In the context of a general rate case, the Commission will consider a full decoupling mechanism for electric and natural gas utilities, which will allow a utility to either recover revenue declines related to reduced sales volumes or, in the case of sales volume increases, refund such revenues to its customers. Revenue recovery by the company under the mechanism will be conditioned upon a utility's level of achievement with respect to its conservation target. A utility's request for a full decoupling mechanism must be made in its direct testimony of its rate case filing, and include, at a minimum, the following elements:

1. *True-up Mechanism.* Where, between general rate cases, customer use by class deviates either higher or lower from that determined by the Commission when setting rates, a utility can seek an annual true-up of revenue attributed to each affected class of customer.[44]

2. *Impact on Rate of Return.* Evidence evaluating the impact of the proposal on risk to investors and ratepayers and its effect on the utility's ROE.

3. *Earnings test.* A proposed earnings test to be applied at the time of the true-up.

4. *Accounting for Off-System Sales and Avoided Costs.* A description of the method the company intends to use to determine the financial benefits associated with off-system sales or avoided costs attributable to the utility's conservation efforts and then to net these benefits against the true-up provided in this mechanism.[45]

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[44] We recognize that revenue associated with new customers is offset by the costs to serve those customers. If these revenues and costs are not in reasonable balance, we would consider excluding all or some new customer revenue from the mechanism or some other tool (*e.g.*. modifying a utility's line extension tariffs) to correct any demonstrated inequity.

[45] In principle, for every megawatt hour saved through the operation of the utility's conservation program, it has the opportunity to either sell the same in the appropriate market (off-system sales), or avoid having to purchase or produce electricity to meet its load requirements. The accounting of this form of found revenue differs between electric utilities with power cost

Criteria for Approval. In addition to assuring that the elements above are included and demonstrated to be in the public interest, a full decoupling mechanism should conform to the following criteria:

1. *Application to Customer Classes.* Generally, a full decoupling proposal should cover all customer classes. However, where in the public interest and not unlawfully discriminatory or preferential, the Commission will consider a proposal that would apply to fewer than all customer classes.[46]

2. *Weather adjustment mechanism.* We generally would support including the effects of weather in a full decoupling proposal.

3. *Incremental Conservation.* Evidence describing any incremental conservation the company intends to pursue in conjunction with the mechanism.

4. *Low-income.* A utility proposing a full decoupling mechanism must demonstrate whether or not its conservation programs provide benefits to low-income ratepayers that are roughly comparable to other ratepayers and, if not, it must provide low-income ratepayers targeted programs aimed at achieving a level of conservation comparable to that achieved by other ratepayers, so long as such programs are feasible within cost-effectiveness standards.

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adjustment mechanisms and those without. After rates have been set for an electric utility that does not have a power cost adjustment mechanism, the marginal avoided cost of producing or buying electricity, or the marginal revenue (net of marginal cost) from the sale of electricity made surplus by conservation not incorporated into the calculation of the power costs, is a direct benefit to the utility shareholders. For utilities with a power cost adjustment mechanism, loads are projected in a future test year, with reductions in the load for the expected conservation levels. Consequently, for the effective rate year following the setting of rates, only conservation above the expected level of conservation would result in an opportunity to reduce power costs or realize additional revenues from incremental sales. In the years after the projected rate year, the marginal avoided cost of producing or buying electricity, or the marginal revenue (net of marginal cost) from a sale of electricity made surplus by conservation, is a direct benefit.

[46] As noted in note 33 above, a limited decoupling mechanism may result in cross-subsidies among rate classes. A reasonable mechanism would balance conservation program achievements by class with the revenue recovery expected from that class under the mechanism.

5. *Duration of Program.* The Commission will generally approve a full decoupling mechanism for the period required to achieve its objectives or until the filing of a utility's next general rate case. Under either circumstance, the burden is upon the utility to demonstrate the continued need for the mechanism.

6. *Reports.* For companies authorized to implement full decoupling, the Commission may require the utility to file periodic reports so the Commission may evaluate the success and impact of the program. The reported information must be made available to representatives of customer groups, and other interested parties, so they too can evaluate the program and its impact on the utility and its ratepayers.

7. *Other Factors Impacting the Public Interest.* The criteria listed above are not intended to limit the Commission's authority to review other factors affecting its analysis of full decoupling as a regulatory tool, including whether it remains in the public interest to continue its use by a particular utility.

Application of Full Decoupling to Electric and Gas Utilities

29 For the reasons expressed above, the Commission is receptive to applying a well-designed full decoupling mechanism to either electric or gas utilities. However, a dual fuel utility may propose full decoupling for its electric utility and limited decoupling for its natural gas utility, so long as the combined mechanisms in their application do not create unreasonable administrative burdens (*e.g.,* different returns on equity for the natural gas and electric utilities under common ownership) and otherwise remain in the public interest.

C. Direct Conservation Incentives

30 *Discussion.* The Commission may approve direct conservation incentives for both electric and natural gas utilities.[47] The Commission approved an electric-only

[47] *See* RCW 80.28.260(2), which provides that the Commission "shall consider and may adopt a policy of allowing an incentive rate of return on investment in additional programs to improve the efficiency of energy end use or other incentive policies to encourage utility investment in such programs."

mechanism for Puget Sound Energy (PSE) that provided the company with a direct bonus for exceeding pre-established conservation targets.[48] That mechanism, and its accompanying targets, was approved prior to the establishment of the formal targets required under the EIA.[49] Prior to the incentive mechanism and the penalties under EIA for a utility not achieving its conservation target, the Commission approved a settlement establishing penalties for PSE for missing its conservation targets.[50] The penalty for electric conservation has been eliminated and replaced by the penalty under the EIA.[51]

31 The EIA mandates that electric utilities acquire all cost-effective conservation that is feasible and reliable, or face penalties for failure to do so.[52] One may therefore ask legitimately why it would be desirable to provide incentives for electric IOUs to acquire more conservation than is already required by statute since the implication is that conservation beyond the target would not be available. However, the EIA, in RCW 19.285.060(4), provides us with the express authority to provide such incentives: "The commission ... may consider providing positive incentives for an investor-owned utility to exceed the targets established in RCW 19.285.040."

32 We do not read this provision to permit us to provide incentives to acquire conservation that is not cost-effective. Rather, we read this to suggest that, between the biennial conservation targets designed to determine what cost-effective conservation can be required, the electric utility may be able to acquire additional conservation as technology is improved, federal or other matching funds become available, or for other reasons that were not known at the time of the setting of the target. Accordingly, we here suggest how an electric utility can propose such an

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[48] *WUTC v. Puget Sound Energy*, Dockets UE-060266 and UG-060267 (consolidated), Order 08, ¶ 156 (January 5, 2007).

[49] *Id.*

[50] *WUTC v. Puget Sound Energy*, Dockets UE-011570 and UG-011571 (consolidated), Order 12 (June 20, 2002).

[51] *WUTC v. Puget Sound Energy*, Dockets UE-011570, UG-011571 and UE-100177 (consolidated), Order 05 (September 28, 2010).

[52] RCW 19.285.040(1).

incentive mechanism in conjunction with its proposal to establish its biennial conservation target under the EIA[53] and how a gas utility may likewise request an incentive mechanism.

33 *Description of Mechanism.* In addition to the measures designed to recover lost margins, as discussed above, the Commission will consider mechanisms pursuant to RCW 19.285.060(4) to provide electric utilities incentives to exceed their conservation targets adopted pursuant to RCW 19.285.040. Pursuant to RCW 80.28.260(2), the Commission also will consider incentive mechanisms for gas utilities. Any such incentive mechanism should contain the following minimum elements:

1. *Appropriate Proceeding for Proposing Incentives.*

   a. *Electric Utilities.* An electric utility must propose such an incentive mechanism in conjunction with the required biennial filing under the EIA that sets the conservation target. The conservation incentive mechanism should be proposed at least 120 days earlier than the EIA target filing to provide adequate time for the Commission and interested parties to evaluate the proposal, but must be consolidated with the docket of the proposed biennial conservation target.

   b. Gas Utilities. If it also provides electric service, it should propose the incentive mechanism at the time it proposes such a mechanism for electric service. A gas utility should propose such an incentive mechanism in conjunction with a request in a general rate case.

2. *Cost-Effective Conservation.* All conservation eligible for incentives must be shown by the utility through direct evidence to be cost effective, even when the incentive mechanism payments under the proposal are included in the analysis of cost-effectiveness.

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[53] One concern, of course, is whether permitting such an incentive mechanism could motivate the company to state a less ambitious conservation target so that it would be easier to exceed that target and thereby reap the benefits of whatever reward mechanism is in place. Because of this concern, the Commission will examine any proposed incentive mechanism thoroughly and encourage stakeholder participation to ensure that the established targets adequately fulfill the intent of the EIA.

3. *Innovation.* For electric utilities, when demonstrating achievement above the target, the utility must present direct evidence identifying actions it took to exceed the target that were not part of its conservation program at the time the Commission set the biennial conservation target. Further, it must also show why these actions were not included in its initial forecast of achievable energy efficiency for the target period. The proposal must separately identify incentives to increase participation in existing measures versus implementing new measures.

4. *Other.* The requesting utility must describe and justify in its direct case any variable incentive levels above the conservation target that it proposes. If it seeks incentives to achieve its conservation targets early, it should describe any proposed levels of achievement.

D. Other Mechanisms

34 The guidance provided in this policy statement does not imply that the Commission would not consider other mechanisms in the context of a general rate case, including an appropriate attrition adjustment designed to protect the company from lost margin due to any reason.

V. FURTHER STEPS

35 As stated above, the Legislature has specifically authorized policy statements as tools for agencies to state their current intentions without committing to a binding and perhaps inflexible rule. In our view, this policy statement is a more appropriate means to express our current thinking on decoupling and conservation incentive mechanisms than either a rule or a formal order in an adjudicative proceeding. A rule is too inflexible, while an adjudication does not enable us to evaluate, as we did here, the many facets of the issue of incentives to ensure that utilities acquire all achievable, cost-effective conservation and are not unduly impacted by lost margin attributable to those conservation efforts.

36 However, within the parameters discussed above, we expect utilities to propose limited decoupling or full decoupling mechanisms in the context of a general rate case and to propose direct incentives in the context of their conservation target filings or in the case of gas utilities in the context of a general rate case. In those proceedings, we encourage the companies, Commission Staff, Public Counsel, and other parties to test, and help us improve, the policy we here describe and adopt.

DATED at Olympia, Washington, and effective November 4, 2010.

WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION

JEFFREY D. GOLTZ, Chairman

PATRICK J. OSHIE, Commissioner

PHILIP B. JONES, Commissioner

APPENDIX 1

ORGANIZATIONS FILING COMMENTS

Statements of Issues,
May 23, 2010

Avista Corporation
Cascade Natural Gas Corporation
Cost Management Services, Inc.
Industrial Customers of Northwest Utilities
Northwest Energy Coalition
Northwest Industrial Gas Users
Northwest Natural Gas Company
PacifiCorp
Public Counsel, Attorney General of Washington
Puget Sound Energy
The Energy Project
Washington Department of Ecology

Comments and Responses to Statements of Issues,
June 4, 2010 and June 7, 2010

Avista Corporation
Cascade Natural Gas Corporation
Cost Management Services, Inc.
Industrial Customers of Northwest Utilities
Northwest Energy Coalition
Northwest Energy Efficiency Alliance
Northwest Industrial Gas Users
Northwest Natural Gas Company
PacifiCorp
Public Counsel, Attorney General of Washington
Puget Sound Energy
The Energy Project

Reply Comments and Responses to Initial Comments,
June 11, 2010 and June 18, 2010

Avista Corporation
Industrial Customers of Northwest Utilities
Northwest Energy Coalition
Northwest Industrial Gas Users
OPower
PacifiCorp
Public Counsel, Attorney General of Washington
Puget Sound Energy

Final Comments,
July14, 2010

Avista Corporation
Cascade Natural Gas Corporation
Cost Management Services, Inc.
Industrial Customers of Northwest Utilities
Mountaineers
Natural Resources Defense Fund
Northwest Energy Coalition
Northwest Energy Efficiency Alliance
Northwest Industrial Gas Users
Northwest Natural Gas Company
Northwest Region of the Laborers International Union of North America
PacifiCorp
Public Counsel, Attorney General of Washington
Puget Sound Energy

APPENDIX 2

ORGANIZATIONS ATTENDING WORKSHOPS

May 4, 2010

Alliances Northwest
Avista Corporation
Cascade Natural Gas Corporation
Cost Management Services, Inc.
Industrial Customers of Northwest Utilities
Northwest Energy Coalition
Northwest Industrial Gas Users
Northwest Natural Gas Company
Northwest Power and Conservation Council
OPower
PacifiCorp
Public Counsel, Attorney General of Washington
Puget Sound Energy
Staff, Washington State House of Representatives
Staff, Washington State Senate
The Energy Project

June 29, 2010

Avista Corporation
Cascade Natural Gas Corporation
Cost Management Services, Inc.
Fluid Market Strategies
Industrial Customers of Northwest Utilities
Natural Resources Defense Council
Northwest Energy Coalition
Northwest Energy Efficiency Alliance
Northwest Industrial Gas Users
Northwest Natural Gas Company
Northwest Power and Conservation Council
Public Counsel, Attorney General of Washington
Puget Sound Energy
Staff, Washington State House of Representatives
The Energy Project
The Mountaineers
Washington Department of Commerce

APPENDIX 3

STAKEHOLDER ISSUES & POSITIONS

During the course of the Conservation Incentives inquiry in Docket U-100522, stakeholders proposed several types of approaches to either facilitate or create incentives for increased conservation investment on the part of utilities, including: full decoupling, lost-margin recovery, attrition adjustments, and transferring conservation responsibilities to an independent conservation provider. In order to investigate the strengths and weaknesses of these approaches, the Commission asked stakeholders a series of questions aimed at identifying the magnitude and main causes of lost margin from conservation, and to gauge the efficacy of each proposal type to recover lost margin. Stakeholder responses to these questions are discussed below by topic. Stakeholders fall into four general categories: investor-owned utilities (IOUs), ratepayer advocates, members of state government agencies, and energy efficiency and conservation advocates.[1]

A. Does the development of conservation resources deny the utility an opportunity to earn its allowed rate of return?

1. Investor Owned Utilities

All five IOUs in Washington participated in this inquiry and responded similarly to this question. Northwest Natural Gas (NW Natural) stated that in the conventional rate structure, "[for] a non-decoupled utility, rates are set in such a way that the utility will recover its fixed costs and allowed rate of return if customers consume forecasted volumes," and argued that "[i]f customers do not consume those volumes, the utility will be unable to recover its fixed costs and earn its allowed rate of return, all else being equal. This structure creates a clear incentive for the utility to push consumption of volumes."[2] Puget Sound Energy (PSE) asserted that the financial consequences stemming from the development of conservation resources result in a downward pressure on a utility's opportunity to earn its allowed rate of return.[3] Cascade Natural Gas (Cascade) echoed this position, stating that "the acquisition of conservation resources can deny the utility the opportunity to earn its allowed rate of

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[1] See Appendix 1 for a list of organizations that submitted statements of issues, comments, and responses. See Appendix 2 for a complete list of the organizations that participated in each of the two work sessions held during this inquiry.

[2] Comments of Northwest Natural Gas Company (June 4, 2010).

[3] Comments of Puget Sound Energy, Inc. (June 4, 2010).

return."[4] Avista stated that recovery of all costs (including fixed costs and a return) are currently not allowed in Washington state.[5] Finally, PacifiCorp also indicated that conservation activities have resulted in a lost margin for that utility.[6]

2. Energy efficiency advocates

The Energy Project did not agree with the IOUs assertion that the development of conservation resources automatically denies a utility an opportunity to earn the allowed rate of return.[7] The Northwest Energy Efficiency Alliance (NEEA) stated that there is no intrinsic reason that a utility would be denied the opportunity to achieve its allowed rate of return solely because it develops conservation resources.[8] However, NEEA did note that without an incentive structure the absolute dollar value of the rate of return would be less with conservation resources when compared to a similar investment in generation.[9] On the other hand, the Northwest Energy Coalition (NWEC) stated that conservation programs could adversely impact a utility's ability to earn its allowed rate of return, but that conserved energy could be sold on the market and could potentially add revenue.[10]

3. Industrial customers

The Industrial Consumers of Northwest Utilities (ICNU) stated that utilities have never provided sufficient evidence demonstrating that the "amount of lost margins related to utility conservation programs has any significant impact upon the utilities' opportunity to earn their rate of return, especially in comparison to the other risks the utilities are expected to manage, including loads, weather, hydro conditions and market prices."[11] ICNU went on to say that the risk to utilities' earnings posed by reductions in load from conservation programs is mitigated by annual rate proceedings, and in the cases of PSE and Avista, power cost

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[4] Comments of Cascade Natural Gas Company (June 7, 2010).

[5] Comments of Avista Corporation (June 4, 2010).

[6] Comments of PacifiCorp (June 4, 2010).

[7] Comments of the Energy Project (June 4, 2010).

[8] Comments of the Northwest Energy Efficiency Alliance (June 4, 2010).

[9] *Id.*

[10] Comments of the Northwest Energy Coalition) (June 4, 2010).

[11] Comments of Industrial Consumers of Northwest Utilities at 4 (June 4, 2010).

adjustment mechanisms, which shield utilities against regulatory lag and from significant differences between actual costs and the costs assumed in rates.[12]

4. Public Counsel

Public Counsel also argued that utilities have not been able to demonstrate that they are denied the opportunity to earn their allowed return as a result of developing conservation resources.[13] Public Counsel argued that conservation as a resource is economically beneficial to utilities, citing PSE's 2009 Integrated Resource Plan which said that conservation is a least-cost resource that presents lower financial risk and a lower emissions risk.[14]

Public Counsel also replied to Avista's statement that all costs, including fixed costs and a return, are not fully recoverable under Washington's current ratemaking process. Public Counsel stated that regulation seeks to emulate the effects of competition, which does not guarantee returns or cost recovery for firms in the marketplace. Instead, Public Counsel emphasized that regulation seeks to set rates at levels that allow a utility company the *opportunity* to recover its fixed costs and a return if the utility is prudently and efficiently managed.[15]

B. How much lost margin can be attributed to the utility's conservation program?

1. Investor Owned Utilities

PSE provided a calculation of its estimate of unrecovered fixed costs attributable to its electric conservation programs for the first year of conservation savings, monthly accumulations, and cumulatively since 2004.[16] Avista stated that its lost margin due to programmatic DSM in 2009 was approximately $1.6 million.[17] PacifiCorp offered cost

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[12] *Id.* at 5.

[13] Comments of Public Counsel (June 7, 2010).

[14] *Id.*, at 9, citing Puget Sound Energy 2009 Integrated Resource Plan, Chapter 1 at 2.

[15] Reply Comments of Public Counsel at 7-8 (June 18, 2010).

[16] Comments of Puget Sound Energy, Inc., Attachment B, "Electric Lost Margin Analysis" (June 4, 2010). For 2007, PSE calculated its lost margin due to its electric conservation program at approximately $9.4 million, $15.1 million in 2008, and $15 million in 2009.

[17] Comments of Avista Corporation at 5 (June 11, 2010).

estimates of the lost margins associated with its conservation activities, ranging from $0.8 million to $1.2 million per year.[18]

NW Natural commented that it could not clearly separate natural gas consumption declines from utility-sponsored programs from declines due to other factors, but the company did include estimates of per-customer reductions in use of natural gas in its 2009 Integrated Resource Plan.[19] It estimated that residential use would drop 3.9 percent over a five year period, 7.9 percent for commercial customers, and 0.4 percent for industrial users.[20] Cascade also stated that measuring lost margins due only to its conservation programs is difficult, and that the savings resulting from each conservation measure undertaken by the company can only be established on a generic basis.[21]

2. Energy efficiency advocates

NWEC did not directly respond to this question,[22] and the Energy Project stated that it was not aware of analysis that provides a comparative risk evaluation between conservation undertaken by the utility and conservation undertaken elsewhere, but it did see such a comparison as important.[23]

NEEA commented that identifying lost margins due to utility-sponsored DSM programs is complex, because a variety of factors intertwine to result in decreased sales.[24] As an example, NEEA pointed to the interaction of company-based informational mailings on energy efficiency that might result in independent customer conservation efforts that do not include direct rebates or other utility assistance.[25] NEEA commented that these confounding factors need not be separated from one another in order to provide adequate incentives to Washington's IOUs. Instead, NEEA asserted that incentives should be specifically designed

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[18] Comments of PacifiCorp (June 4, 2010).

[19] Comments of Northwest Natural Gas Company at 2-3 (June 4, 2010).

[20] *Id.*

[21] Comments of Cascade Natural Gas Company at 3 (June 7, 2010).

[22] Responsive Comments re: Consolidated Issues of the Northwest Energy Coalition (June 4, 2010).

[23] Responsive Comments re: Consolidated Issues of the Energy Project at 3 (June 4, 2010).

[24] See NEEA's full discussion of these factors and interactions. Comments of the Northwest Energy Efficiency Alliance at 2-3 (June 4, 2010).

[25] *Id.* at 2-4.

to counter utility disincentives to conservation investments, not to generally assure a sufficient rate of return, which is the function of the existing regulatory rate case process.[26]

3. Industrial customers

Stakeholders representing industrial users of electricity and natural gas repeatedly emphasized the importance of identifying utilities' true lost margins and their causes before adopting any mechanism that would disconnect utility revenues from sales.[27] ICNU argued that Washington law already requires utilities to invest in a minimum amount of conservation and that utilities should not be allowed to benefit from a decoupling program for conservation efforts that they would already invest in regardless of whether the Commission adopted decoupling.[28]

4. Public Counsel

Public Counsel argued that the ratio of lost margin resulting from utility-sponsored DSM programs represents only a small portion of the total amount that might be subject to recovery in a decoupling program because the majority of lost margins consist of usage reductions from causes other than company-sponsored conservation programs.[29]

Public Counsel also questioned PSE's lost margin estimates, stating that the cumulative sum of lost margins since 2004 did not account for intervening rate cases since that time or factors that might offset losses, such as increasing load. Public Counsel referred to a report by Blue Ridge Consultants, which found that in the five preceding years PSE's actual sales exceeded the company's load forecast.[30] Public Counsel also criticized Avista's 2009 lost margin estimates, citing inconsistencies between the company's figures for programmatic DSM in 2009 ($1.45 million) versus the component line-items provided for each corresponding tariff ($310,613).[31]

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[26] *Id.* at 3.

[27] Comments of Industrial Consumers of Northwest Utilities at 6 (June 4, 2010); comments of Northwest Industrial Gas Users at 5 (June 4, 2010).

[28] Comments of Industrial Consumers of Northwest Utilities at 6 (June 4, 2010).

[29] Reply Comments of Public Counsel at 9-10 (June 18, 2010).

[30] *Independent Third-Party Evaluation of PSE's Electric Incentive Mechanism*, prepared by Blue Ridge Consulting Services, Inc., at 66 (October 24, 2009) (Blue Ridge Phase I Report). Piliaris, Exh. No. JAP-6, filed in Docket UE-090704 (December 17, 2009). The Phase I Report covered the first two years of the pilot that concluded December 31, 2009.

[31] Reply Comments of Public Counsel at 10 (June 18, 2010).

Public Counsel rebutted the utilities' assertions that quantifying the portion of lost margins attributable to utility-sponsored DSM was unduly difficult or unnecessary, stating that, for example, Avista included a specific calculation of the losses stemming from conservation in its last decoupling proposal.[32] Public Counsel stated further that this calculation is critical because, "[i]f not limited to company programmatic DSM, decoupling is simply a crude catchall that recoups and compensates the utility for usage declines that occur for any reason, most of which, by definition, have no connection to utility conservation activities."[33]

C. Does the recovery of lost margin from conservation provide an incentive for the utility to control costs?

1. Investor Owned Utilities

PSE concluded that full recovery of lost margins associated with conservation does not affect a utility's incentive to control costs.[34] Avista also stated that incentives, lost margin recovery or other mechanisms play no role in the Company's responsibility to control costs because the incentive to control costs for the benefit of its shareholders always exists.[35] Similarly, Cascade[36] and NW Natural[37] both stated that a utility always has an incentive to control costs, regardless of the presence or absence of decoupling or incentive mechanisms.

2. Energy efficiency advocates

The Energy Project stated that lost margin recovery might lead a utility to be less rigorous about controlling costs, but that outcome would be dependent on how the recovery mechanism was designed.[38]

NWEC stated that utilities always have an incentive to reduce costs below those assumed in the rate case regardless of whether or not a decoupling or lost margin mechanism is in

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[32] *Id.* at 11.

[33] *Id.*

[34] Comments of Puget Sound Energy, Inc., at 14 (June 4, 2010).

[35] Comments of Avista Corporation at 13 (June 4, 2010).

[36] Comments of Cascade Natural Gas Company at 6 (June 7, 2010).

[37] Comments of Northwest Natural Gas Company at 7 (June 4, 2010).

[38] Responsive Comments re: Consolidated Issues on behalf of the Energy Project at 9 (June 4, 2010).

place.[39] NWEC warned that lost-margin recovery mechanisms could be effectively manipulated, however, because lost margin recovery only addresses utility-sponsored programs and thus biases the utility in favor of utility-based programs over "do-it-yourself" efficiency measures, especially if programs saved little or no energy in practice.[40]

3. Industrial customers

NWIGU stated that a utility always has an incentive to control distribution service costs between rate cases because any gains go directly to shareholders. Because decoupling would stabilize utilities' earnings, NWIGU recommended an earnings sharing mechanism in conjunction with any lost margin mechanism so that ratepayers could share the savings that result from utilities' cost control measures.[41]

ICNU stated that decoupling encourages poor utility management, in part because it does not provide any incentive to control costs since the utility is indifferent to selling more or less electricity.[42]

4. Public Counsel

Public Counsel rebutted the position that lost margin recovery has no effect on the incentive to control costs, arguing that in the absence of decoupling or lost margin recovery, utilities "must operate in the most efficient way possible, through cost control, in order to earn a reasonable return at authorized revenue levels . . . ."[43] Public Counsel stated that a decoupling or lost margin mechanism that automatically replaces declining revenues would reduce the utilities' incentive to control costs.[44]

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[39] Responsive Comments re: Consolidated Issues of the Northwest Energy Coalition at 10 (June 4, 2010).

[40] *Id.*

[41] Comments of Northwest Industrial Gas Users at 14 (June 4, 2010).

[42] Comments of Industrial Consumers of Northwest Utilities at 10 (June 4, 2010).

[43] Reply Comments of Public Counsel at 18 (June 18, 2010).

[44] *Id.*

D. In light of the statutory requirement that electric utilities pursue all available, cost-effective conservation, is it necessary to provide the utility with an incentive to conserve?

1. Investor Owned Utilities

PSE stated that an incentive to achieve conservation beyond mandated compliance levels is appropriate because it would allow utilities to accelerate energy efficiency acquisitions whenever possible (and receive compensation for these acquisitions) rather than simply meeting their targets and waiting to deploy new programs until the next target is set.[45] In its comments, Avista did not respond directly to this question, but instead stated that incentives should be calculated based on savings in excess of the levels required by law.[46]

2. Energy efficiency advocates

NWEC argued in favor of providing incentives to electric utilities to promote conservation,[47] as did the Energy Project.[48] NEEA stated that it is appropriate to provide incentives to electric utilities beyond the statutory requirement, because 1) the statutory target is too low and can be easily achieved, 2) achieving conservation ahead of schedule wherever possible will allow greater conservation gains overall, and 3) incentives have the potential to result in more resources being applied to conservation than in the absence of incentives.[49]

3. Industrial customers

ICNU stated that it is not necessary to provide utilities with incentives beyond the statutory conservation requirement. ICNU stated that Washington utilities have historically invested

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[45] Comments of Puget Sound Energy, Inc., at 14 (June 4, 2010).

[46] Comments of Avista Corporation at 13 (June 4, 2010).

[47] Responsive Comments re: Consolidated Issues of the Northwest Energy Coalition at 11 (June 4, 2010).

[48] Responsive Comments re: Consolidated Issues of the Energy Project at 10 (June 4, 2010).

[49] Comments of Puget Sound Energy, Inc., at 9 (June 4, 2010); comments of Northwest Energy Efficiency Alliance, June 29, 2010, Work Session Audio Recording, 04:30:00. NEEA later clarified these comments, stating that it does view the statutory requirements as too easily achieved, but instead meant that incentives would be useful in *accelerating* acquisition of all cost-effective conservation.

in conservation resources in the absence of decoupling and reiterated that decoupling should not be adopted.[50]

4. Public Counsel

Public Counsel stated that the statutory requirement already provides incentives to utilities to achieve conservation: the legal obligation and penalties for non-compliance. Public Counsel stated that by following the law and acquiring cost-effective conservation, using ratepayer funds, utilities are provided with a least-cost and lower-risk resource (compared to constructing new generation).[51]

E. Should conservation responsibilities be transferred to a third-party conservation provider?

1. Investor Owned Utilities

PSE opposed transferring conservation responsibilities to a third party.[52] PacifiCorp and Avista[53] stated that they were neutral toward this option. However, PacifiCorp added that conservation programs provide the company with positive interactions with customers and the community, and that, in the event that conservation responsibilities are moved away from utilities, the conservation provider program should be designed to maintain and leverage the utility's existing interface with customers.[54] NW Natural and Cascade also stated that they are neutral toward this approach.[55] Among other attributes, Cascade stated that an independent conservation provider should be established first as a pilot program and should meet or surpass the cost-effectiveness of current programs run by utilities.[56]

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[50] Comments of Industrial Consumers of Northwest Utilities at 11 (June 4, 2010).

[51] Reply Comments of Public Counsel at 32 (June 18, 2010).

[52] Comments of Puget Sound Energy, Inc., at 2 (July 14, 2010).

[53] Comments of Avista Corporation at 3 (July 14, 2010).

[54] Comments of PacifiCorp at 2 (July 14, 2010).

[55] Comments of Northwest Natural Gas Company at 2 (July 14, 2010). NW Natural pointed out that in Oregon utility conservation programs are administered by such a third party provider, the Energy Trust of Oregon (ETO). NW Natural, with Commission approval, has contracted with the ETO to administer its conservation programs in Washington. *Id.*

[56] Comments of Cascade Natural Gas Company at 3 (July 14, 2010).

2. Energy Efficiency Advocates

NEEA stated that it has evaluated conservation programs from a variety of providers, and that successful programs depend less upon the institution in which the program is housed, and more upon the program design, implementation, and evaluation practices. In NEEA's view, these best practices include a market-based focus, strong partnerships with key stakeholders, and real-time feedback mechanisms in which performance information can be used to correct ineffective program components.[57] The Natural Resources Defense Council also expressed support for the option of transferring conservation to a third-party provider.[58] NWEC supported consideration of an independent conservation provider if utilities do not uphold their commitments to significantly increase the energy savings from conservation efforts.[59] Finally, OPower also supported the establishment of an independent effort to analyze savings from conservation programs, especially programs targeted toward behavior-based energy savings.[60]

3. Industrial Customers

Cost Management Services stated that it does not believe that utilities should play the role of conservation providers and instead these responsibilities should be transferred to a third party, in part because providing incentives to utilities to undercut their sales is contradictory.[61] ICNU expressed neutrality toward this option, stating that an independent conservation provider has no disincentive to acquiring conservation resources, and therefore, if the Commission does not anticipate that utilities will continue their current practices of acquiring conservation resources at the appropriate levels, it should consider an independent provider in lieu of incentives, decoupling, or lost-margin recovery mechanisms.[62] NWIGU

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[57] Comments of the Northwest Energy Efficiency Alliance at 3 (July 14, 2010).

[58] Additional comments of the Natural Resources Defense Council at 6 (July 14, 2010).

[59] Additional comments of the Northwest Energy Coalition at 3 (July 14, 2010).

[60] Comments of OPower at 1 (June 11, 2010).

[61] Comments of Cost Management Services at 3 (July 9, 2010).

[62] Additional comments of the Industrial Customers of Northwest Utilities at 4 (July 14, 2010).

responded that it did not have enough information on the overall reduction in administrative expenses achieved by independent conservation providers to support this option.[63]

4. Public Counsel

Public Counsel stated that it was neutral toward this approach. Public Counsel tentatively supported the concept of creating an independent conservation provider, but only after comprehensive review of the rate impacts and other ramifications that might result.[64]

F. How should we measure the effectiveness of conservation measures? Evaluation, Measurement & Verification protocols?

1. Investor Owned Utilities

PSE stated that Evaluation, Measurement, and Verification (EM&V) responsibility should remain with utilities, coupled with review and input by each utility's stakeholder advisory group. PSE also supported the formation of a collaborative working group with both utility and non-utility stakeholders represented to create consistent EM&V protocols.[65]

Avista supported adoption of a use-per-customer metric to identify conservation results with peer-recognized standards.[66] The company argued in favor of third-party evaluation of each utility's EM&V results as well.[67]

2. Energy efficiency advocates

NWEC stated that the Commission should establish a method or general guidelines for EM&V to ensure that all utility conservation efforts are evaluated using the same protocols.[68] NEEA recognized the Commission's role in setting standards by which achievements are measured for purposes of regulatory incentives, but recommended the Commission rely on existing sources for such standards where possible.[69]

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[63] Closing comments of Northwest Industrial Gas Users at 3 (July 14, 2010).

[64] Additional comments of Public Counsel at 4 (July 14, 2010).

[65] Comments of Puget Sound Energy, Inc., at 17 (June 4, 2010).

[66] Comments of Avista Corporation at 15 (June 4, 2010).

[67] *Id.* at 16.

[68] Responsive Comments re: Consolidated Issues of the Northwest Energy Coalition at 14 (June 4, 2010).

[69] Comments of the Northwest Energy Efficiency Alliance at 10 (June 4, 2010), citing the International Performance Measurement and Verification Protocol and California's *Protocols for Evaluators*.

With regard to third-party evaluation, NEEA considered a third party to be useful but argued that effective EM&V depends more upon creating a process that is transparent, includes oversight, and in which a knowledgeable staff member of the energy efficiency organization has responsibility for ensuring objective and replicable results.[70]

3. Industrial customers

NWIGU recommended using the EM&V protocols that will be generated by a collaborative as ordered in Avista's last general rate case.[71]

4. Public Counsel

Public Counsel argued against a use-per-customer metric to identify the effects of conservation programs, but supported the formation of a collaborative to adopt a set of EM&V protocols and methodologies for all Washington utilities, and stated that such a collaborative would help standardize EM&V methods "and ensure confidence and transparency in savings associated with utility conservation programs."[72]

G. If decoupling or lost margin recovery is implemented, should the utility's ROE be reduced?

1. Investor Owned Utilities

PSE asserted that an incentive mechanism or a lost margin recovery or decoupling mechanism does not materially impact a company's business risk and, therefore, should not require a downward adjustment in the utility's return on equity because ROE is a function of many factors and is addressed during a utility's general rate case.[73] Avista and Cascade also disagreed that an incentive or lost margin/decoupling mechanism requires a downward adjustment in the utility's return on equity.[74] However, Avista later commented that the company is aware that decoupling would reduce its risk under a full decoupling mechanism, and agreed therefore that "it would be reasonable to consider a reduction to [Avista's]

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[70] *Id.* at 11.

[71] Comments of Northwest Industrial Gas Users at 16 (June 4, 2010).

[72] Reply Comments of Public Counsel at 37 (June 18, 2010).

[73] Comments of Puget Sound Energy, Inc., at 19 (June 4, 2010).

[74] Comments of Avista Corporation at 17 (June 4, 2010); comments of Cascade Natural Gas Company at 7 (June 7, 2010).

authorized return on equity to reflect the decreased risk."[75] NW Natural also did not believe adoption of an incentive or lost margin/decoupling mechanism should include an automatic downward adjustment to the utility's rate of return, and instead a utility's allowed rate of return on equity should be determined with reference to a peer group of utilities. NW Natural stated that when comparing a utility without decoupling to a peer group of utilities with decoupling, the utility without the mechanism should be awarded a higher return on equity than the peer group.[76]

2. Energy efficiency advocates

NWEC stated that any mechanism that is found to significantly increase or decrease shareholder risk should potentially include an appropriate increase or decrease in the allowed shareholder return. NWEC qualified that principle with the idea that an evaluation must be conducted to determine whether a mechanism (e.g., a pilot decoupling mechanism), that is time-limited and of sufficient duration, impacts shareholder risk and affects investment community perceptions such that an adjustment in ROE would be appropriate.[77]

The Energy Project recommended that the utility's return on equity should reflect the risk the utility undertakes; if an incentive or lost margin recovery lowers that risk, there should be a commensurate lowering of ROE.[78]

3. Industrial customers

ICNU stated that decoupling shifts the risk of changes in load from the utility shareholders to the customer and the Commission should reduce the utility's authorized rate of return to reflect this shift, in part because rating agencies recognize the reduced risk and view decoupling as a positive development from a credit perspective.[79]

NWIGU stated that it is beyond dispute that any mechanism that makes a utility whole for losses in conservation revenue makes the utility less risky, and adds that a thorough analysis to develop a properly structured mechanism would include complete scrutiny of the utility's

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[75] Additional Comments of Avista Corporation at 2 (July 14, 2010).

[76] Comments of Northwest Natural Gas Company at 10-11 (June 4, 2010); comments of Northwest Natural Gas Company, June 29, 2010, Work Session Audio Recording, 01:30:20. At the June 29, 2010, work session, Northwest Natural Gas Company commented further on this issue, clarifying its position on risk and ROE by stating that decoupling does stabilize revenues and therefore lowers risk.

[77] Responsive Comments re: Consolidated Issues of the Northwest Energy Coalition at 15 (June 4, 2010).

[78] Responsive Comments re: Consolidated Issues of the Energy Project at 12 (June 4, 2010).

[79] Comments of Industrial Consumers of Northwest Utilities at 12-13 (June 4, 2010).

operations, the development of a sharing and quality control mechanism, the determination of the appropriate revenue requirement benchmark, and the measure or measures by which the company's performance would be judged.[80]

4. Public Counsel

Public Counsel stated that decoupling or lost margin recovery mechanisms shift risk from shareholders to ratepayers by stabilizing utility revenue, effectively guaranteeing a certain level of cost recovery and causes the shifting of risk to ratepayers. In contrast, Public Counsel stated that an incentive mechanism does not necessarily require a downward adjustment to the return on equity if the incentive is independent of any calculation of lost margin and not designed to replace lost margin.[81]

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[80] Comments of Northwest Industrial Gas Users at 17 (June 4, 2010).

[81] Reply Comments of Public Counsel at 41-42 (June 18, 2010).

APPENDIX 4

STATE OF WASHINGTON

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

1300 S. Evergreen Park Dr. S.W., P.O. Box 47250 • Olympia, Washington 98504-7250
(360) 664-1160 • TTY (360) 586-8203

March 31, 2010

The Honorable Phil Rockefeller
Chair, Committee on Energy, Water, and
the Environment
Washington State Senate
Post Office Box 40600
Olympia, Washington 98504-0600

The Honorable John McCoy
Chair, Committee on Technology, Energy,
and Communications
Washington State House of Representatives
Post Office Box 40600
Olympia, Washington 98504-0600

Re: UTC Interim Reviews on Conservation Incentives and Renewables

Dear Chairman Rockefeller and Chairman McCoy:

As we have discussed earlier with you, the Utilities and Transportation Commission (Commission) intends to undertake two reviews over the interim on energy matters. One will review incentives, and disincentives, for investor-owned utilities (IOUs) to engage in conservation, and the other will review policy options for the Commission to encourage IOUs to acquire electric energy from renewable sources. I write to outline what we have in mind for these processes and to invite you and your staff to participate.

CONSERVATION INCENTIVES

Our decision to commence a process to review conservation incentives for IOUs arose out of the debate in the 2010 legislative session on Senate Bill 6656 and House Bill 2853, which would have authorized municipalities to provide energy conservation services through newly-created conservation utilities. Section 8 of both bills addressed the topic of conservation incentives and would have required the Commission to approve, upon request, a rate adjustment mechanism to allow an electrical or natural gas company to recover: (1) all cost-effective conservation expenditures; and (2) non-fuel revenue requirements that would have been recovered by the company absent conservation savings. We had expressed to you and your committees that the

regulatory treatment of a utility's lost revenue due to conservation is an important and complex issue, and one that in our view deserves substantial study, more than could be done during this past expedited legislative session. Further, because an aspect of this issue is currently before the commission in the Puget Sound Energy rate case, we thought it more useful to convene a larger policy discussion with stakeholders about these issues after completion of that rate case in April.

Specifically, we intend to establish a Commission docket to review the issue. We would convene at least two open work sessions to include utility representatives and stakeholders and solicit two rounds of written comments on possible conservation incentive mechanisms and the pros and cons of each. The primary goal will be to develop a better understanding of the balance between the recovery of a utility's lost revenue due to conservation and the benefits and costs to ratepayers. However, the understanding gained from a "sleeves-rolled up" examination of the issues could lead to a rule or policy statement to guide an implementation of a fair and equitable balancing of interests – promoting utility-based conservation while considering ratepayer interests. Because such a rule or policy statement is one possible outcome, we intend to file a Statement of Inquiry under the Administrative Procedure Act, RCW 34.05.310.

The stakeholder list will include utilities, Public Counsel, environmental groups, and industrial customers, among others. Specific issues to be examined include the effects of conservation on utility service and revenues, how "lost margin" may affect a utility's ability or willingness to engage in conservation efforts, what principles should govern recovery for lost margin, what impacts recovery of lost margin may have on residential and industrial ratepayers, the adequacy of evaluation, measurement and verification of achieved conservation, and whether there exist options other than regulatory incentives for achieving conservation. We hope to schedule the first work session for late April or early May, with deadlines for written comments and for additional work sessions through the spring and early summer. Based on what is learned from this process, we expect the Commission to reach consensus on one or more of the possible outcomes by late summer, if not before.

RENEWABLES POLICY OPTIONS

Parallel, in process and structure, but staggered by at least one month, the Commission will also open a docket and convene work sessions to consider policy options on renewable energy. The work will begin with a review of the Commission's existing authority to ensure utilities meet their renewable portfolio standards (RPS) and to create incentives for utilities to go beyond the RPS standard. With stakeholder input, the Commission will identify any perceived statutory or regulatory barriers to utilities meeting their RPS requirements including examination of the application of the statutory "used and useful" requirement and the ability of utilities to consider inclusion of externalities in the least cost analysis during the resource selection process. Careful consideration will be given to the impact these policies will have on customer rates. Finally, the work sessions will include a discussion of possible regulatory mechanisms and new legislation to encourage acquisition of renewable energy resources.

Like the work sessions on conservation incentives, we envision at least two public work sessions and two rounds of written comments. We hope to schedule the first work session for late May, with the process concluding in the late summer. Because a rule or policy statement is one possible outcome, we intend to file a Statement of Inquiry under the Administrative Procedure Act, RCW 34.05.310.

We have discussed these processes with the Governor's Office, utilities, the Northwest Energy Coalition, the Industrial Customers of Northwest Utilities, and others. All have indicated that they see value in the discussion and will assist or participate. We would also welcome the participation of members and staff of your committees. We intend to brief policy makers on these discussions before the 2011 legislative session.

We will send you and your staff members the schedule as it is finalized. Please call me at (360) 664-1173 if you have any questions. The staff lead on this effort will be Steve Johnson. He can be reached at (360) 664-1346.

Sincerely,

Jeffrey D. Goltz
Chairman

cc: The Honorable Christine O. Gregoire, Governor
The Honorable Ed Murray
The Honorable Christine Rolfes

APPENDIX 5

REGULATORY HISTORY OF ACTIONS RELATING TO ENERGY CONSERVATION

Through a variety of investigations, rule-making proceedings and general rate cases over the last twenty years, the Washington Utilities and Transportation Commission (Commission) has addressed the legislative policy to promote conservation and renewable energy by considering conservation incentives, and decoupling mechanisms. Most recently, the Commission has approved a limited decoupling mechanism for Avista's natural gas operations, and has approved PSE's, Avista's and PacifiCorp's conservation targets under the Energy Independence Act (EIA).[1] In the *Avista* case, the Commission has described the importance of conservation efforts:

> Conservation is one of our cornerstone missions. Consequently, we encourage and support efficiency programs as one of the key objectives in our ratemaking. We have long recognized that conservation is, under almost all circumstances, the least cost energy resource available to a utility and its ratepayers. To further its development, we enable company spending on conservation resources by allowing our utilities to collect all costs associated with their respective conservation programs from ratepayers, subject to an annual reconciliation or 'true-up.' In addition, we have provided financial incentives for meeting and exceeding conservation targets and have approved pilot programs for the purpose of determining whether mechanisms, such as the one we have before us, would support a "conservation" culture within our regulated utilities.[2]

The Commission's actions in the area of conservation incentives are discussed in detail in this appendix to the policy statement.

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[1] *WUTC v. Avista Utilities*, Docket UE-093014 and Docket UG-090135 (consolidated) Order 10, ¶ 290 (December 22, 2009); *Approval of Company's Ten-year Achievable Conservation Potential and Biennial Conservation Target Pursuant to WAC 480-109-010(3)* (PacifiCorp), Docket UE-100170, Order 2 (July 29, 2010); *Company's Ten-year Achievable Conservation Potential and Biennial Conservation Target for 2010 and 2011 Pursuant to WAC 480-109-010(3)* (Avista), Docket 100176, Order 1 (May 13, 2010); and *Ten-year Achievable Conservation Potential and Biennial Conservation Target Pursuant to WAC 480-109-010(3)* (Puget Sound Energy), Docket 100177, Order 5, Amended (October 13, 2010).

[2] *WUTC v. Avista Utilities*, Docket UE-093014 and Docket UG-090135 (consolidated) Order 10, ¶ 289 (December 22, 2009).

While this history focuses on recent actions on this subject, we note that the Commission first approved a decoupling mechanism, paired with a conservation incentive mechanism, for Puget Sound Energy (then Puget Sound Power and Light) in 1990.[3] The Commission-approved Periodic Rate Adjustment Mechanism (PRAM) incorporated principles now featured in recent decoupling proposals and discussions, including a rate adjustment based upon change in customer usage, which is the foundation for all decoupling mechanisms. In 1995, Puget Sound Energy withdrew its PRAM program citing difficulties in its operation given the complexity of the mechanism.[4]

In 2002 the Commission approved a settlement establishing electric and gas conservation targets with penalties for Puget Sound Energy designed to achieve all conservation savings that are cost-effective to the Company and economically feasible for the customer.[5] The targets and penalties for the electric conservation portion of the settlement as well as other parts of the electric portion of the settlement approved in 2002 were replaced as part of the settlement approved by the Commission in Docket UE-100177 that established the first biennial target under the Energy Independence Act.[6]

In 2005, and at the request of the regulated utilities, the Commission conducted a rulemaking inquiry in Docket UG-050369 on whether to adopt rules to allow natural gas utilities to decouple revenues from sales. By and large, the companies approached the Commission

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[3] *WUTC v. Puget Sound Power & Light Company, In the Matter of the Petition of Puget Sound Power & Light Company for an Order Approving a Periodic Rate Adjustment Mechanism and Related Accounting,* Dockets UE-901183 and UE-901184 (consolidated) (April 1, 1991). The decoupling mechanism was part of larger annual periodic rate adjustment mechanism (PRAM) that included adjustments for power cost variations caused by hydrological conditions, weather, and new resource costs (including conservation programs). The utility's conservation performance improved dramatically, but it was not possible to determine whether that performance was due to decoupling, or whether it was due to the $7 million of direct incentive payments the utility received. In the end, the PRAM, including its decoupling component, was terminated in 1995.

[4] On May 31, 1995, while filing tariff sheets for the PRAM, PSE also proposed to eliminate the mechanism, in part because the collaborative evaluating the PRAM's effectiveness held the view that it did not provide an incentive for the company to manage costs. *See WUTC v. Puget Sound Power & Light Company, Third Supplemental Order Approving Stipulations; Rejecting Tariff Filing; Authorizing Refiling*, Docket UE-950618, at 6 (September 21, 1995).

[5] *WUTC v. Puget Sound Power & Light Company, Twelfth Supplemental Order, Settlement Stipulation for Electric and Common Issues*, Dockets UE-011570 and UG-011571(consolidated), Exhibit F at 1 (June 6, 2002).

[6] *WUTC v. Puget Sound Energy, Inc., Final Order Consolidating Dockets for Limited Purpose; Approving and Adopting Settlement Agreement; Approving PSE's Revised Report Identifying its Ten-year Conservation Potential and Biennial Target, Subject to Conditions; and Granting Joint Motion to Modify Twelfth Supplemental Order in Dockets UE-011570 and UG-011571,* Docket UE-100177, Order 05 (September 28, 2010).

with the proposition that they would improve their conservation programs should the Commission approve some form of decoupling mechanism. The companies argued that, without such a mechanism, there existed a disincentive to improve their conservation programs, asserting the programs reduced sales and cut revenues.[7]

The Commission ultimately withdrew the rulemaking inquiry, determining, after taking stakeholder comment and conducting a workshop, that

> [g]iven the wide variety of alternative approaches to the various issues that have been identified and the significant geographic, economic and technological differences between the four natural gas companies doing business in Washington and the populations they serve, the Commission is of the opinion that it does not make sense to pursue a rulemaking addressing this subject, at least at the present time.[8]

In the alternative, the Commission recommended that decoupling proposals be included in general rate case filings because the fundamental design of any decoupling mechanism incorporates a company's revenue requirement and expected sales volumes, both of which are set in a general rate case.[9]

The following year, in Docket UE-050684, the Commission considered, and ultimately rejected as inadequate in scope and detail, a decoupling proposal jointly advocated by the Natural Resources Defense Council (NRDC) and PacifiCorp.[10] In its final order, the Commission confirmed the purpose of decoupling and stated:

> Decoupling is a way to break the link between a utility's revenues and retail sales levels, and to reduce the utility's risk associated with recovering its fixed costs when retail sales decrease due to customer conservation.[11]

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[7] *For example, see Rulemaking to Review Natural Gas Decoupling,* Docket UG-050369, Cascade Natural Gas Corporation, "Decoupling through a Payment Stabilization Mechanism," at 1 (filed April 21, 2005).

[8] *Rulemaking to Review Natural Gas Decoupling*, Docket UG-050369, Notice of Withdrawal of Rulemaking (October 17, 2005).

[9] Furthermore, parties to the inquiry, notably Public Counsel and the Industrial Customers of Northwest Utilities, argued that a decoupling mechanism reduced a utility's financial risk and would, therefore, reduce its return of equity, which is also set in a general rate case.

[10] *See WUTC v. PacifiCorp*, Docket UE-050684, Order 04, ¶¶ 108-110 (April 17, 2006), setting out the Commission's basis for rejecting PacifiCorp's decoupling proposal.

[11] *Id.*, ¶ 102.

The Commission identified the specific issues a utility must address in requesting authorization to implement a decoupling program, including:[12]

- The scope of risk to be covered by the mechanism – conservation, weather, or both;
- The scope of fixed costs included;
- The customer classes to be included and whether the baseline would be on an individual or class basis;
- Complete detail of the accounting for and calculation of any true-up;
- Rate of return implications;
- Method of cost recovery;
- Design of pilot test period and evaluation of the mechanism before determining whether to make it permanent;
- Timing and calculation of rate adjustments;
- Impact of new customers on revenue recovery under the mechanism;
- Impact of the mechanism on low-income customers;
- Identification of incremental conservation measures expected to be undertaken, and;
- Development of a target for energy conservation to be achieved through this mechanism relative to the baseline conservation programs currently in rates and the Company's Integrated Resource Plan.

The Commission undertook a more extensive general discussion of decoupling the following year in PSE's general rate case in Docket UG-060267. PSE sought approval of a decoupling mechanism for its natural gas utility.[13] The Commission ultimately rejected PSE's decoupling proposal, concluding that the company had failed to link its approval to improvements in its conservation program.[14]. Examining PSE's historic conservation performance without decoupling and its projected performance should decoupling be in place, the Commission found decoupling offered no conservation benefit. To this point it said:

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[12] *WUTC v. PacifiCorp*, Docket UE-050684, Order 04, ¶ 109.

[13] *WUTC v. Puget Sound Energy, Inc.*, Dockets UE-060266 and UG-060267, Order 08, ¶¶ 53-69 (January 5, 2007).

[14] *Id.*, ¶¶ 145-158.

> While we commend the Company's efforts and success in [achieving conservation], and recognize the apparent irony in its effect on our analysis, it is nevertheless true that if there is little or nothing to be gained from implementing a decoupling mechanism in terms of increased Company conservation efforts, then there is no conservation rationale to approve a program. Decoupling is a means to an end, not an end in itself. [15]

The Commission went on to note:

> [The Company] testified that [it] has an active conservation program on the gas side that developed without decoupling. Significantly, it appears from [the] testimony that the Company has exploited, for the time being at least, most or all of the cost-effective gas conservation programs available. Nevertheless, the Company continues to pursue every possibility for cost-effective gas conservation measures. PSE's performance in this regard is confirmed by Staff. While decoupling might in theory remove any disincentive that arguably is a barrier to PSE investing in more gas energy efficiency measures, if there are not additional cost-effective measures in which to invest, no conservation benefit is gained by implementing decoupling.[16]

On a related topic, the Commission addressed whether decoupling was necessary to improve PSE's corporate culture with regard to conservation:

> Some parties argue that decoupling is an important tool in shaping corporate culture so that utilities will aggressively implement, or at least be open to pursuing conservation measures. This makes sense in the abstract, and may prove to be true in the case of individual companies. Decoupling, however, is not necessary to infuse PSE's corporate culture with such an attitude. PSE's corporate culture insofar as conservation is concerned is strongly favorable, and has been for many years.[17]

In that same order, the Commission took the step of approving a three-year pilot electric energy efficiency incentive program for the Company, which directly linked conservation performance with significant monetary awards:[18]

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[15] *Id.*, ¶ 65.

[16] *Id.*, ¶ 67.

[17] *Id.*, ¶ 66.

[18] *Id.*, ¶ 54. In 2007, PSE received approximately $3.5 million from the conservation incentive program, and approximately $4.4 million in 2008, and approximately $4.3 million in 2009. *See* Docket 090314, "Open Meeting Memo," March 26, 2009. *See also* Docket UE-970686, Puget Sound Energy, "Energy Efficiency Services Program Results January – December 2009," at 2 (filed February 16, 2010).

> We acknowledge that improved energy savings from cost-effective conservation, which we strongly support, is a highly appealing rationale for decoupling on its face. We emphasize, however, that decoupling is merely one regulatory tool in a larger toolbox of devices we might use to promote greater conservation. Indeed, as discussed separately below, we consider and approve in this proceeding an alternative means to promote conservation of electricity through the use of direct incentives and disincentives to the Company—rewards for reaching, and penalties for failure to reach conservation targets.

Shortly after the PSE order, however, the Commission conditionally approved a multi-party settlement in a rate case involving Cascade Natural Gas (Cascade) that included a three-year natural gas pilot decoupling project.[19] Again linking decoupling to increased conservation performance, the Commission noted the possibility for improvement in Cascade's corporate culture regarding conservation and its overall conservation performance.[20] Finding that the decoupling pilot program offered these benefits, the Commission approved the mechanism, requiring the company to set specific targets for conservation performance and including provisions for penalties for failure to perform as expected. In contrast to the Avista pilot decoupling mechanism described next, Cascade's pilot program rolls in revenues from new customers as an offset to conservation-related sales declines.

In February that same year (2007), the Commission approved a multi-party settlement concerning Avista's pilot decoupling mechanism.[21] Like the Cascade settlement, the Commission concluded that Avista's decoupling mechanism had the potential to "increase Company conservation," allowing for the testing of the "hypothetical benefits of decoupling," while providing sufficient "safeguards to [protect the customer]."[22]

To receive the financial benefits offered by decoupling, the Company was required to meet or exceed the conservation potential identified in its most recent Integrated Resource Plan.[23]

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[19] *See WUTC. v. Cascade Natural Gas Corp.*, Docket UG-060256, Order 05, ¶¶ 67-85 (January 12, 2007); *see also* Order 06 in that same docket (August 16, 2007) which approved the Conservation Plan required in the conditional approval of the decoupling pilot and Order 07 (October 1, 2007) which accepted an addendum to the Conservation Plan.

[20] *Id.*, ¶¶ 76-77.

[21] *WUTC v. Avista Corporation*, Docket UG- 060518, Order 04 (February 1, 2007).

[22] *Id.*, ¶¶ 23, 31.

[23] *Id.*, ¶ 23.

This feature directly linked conservation performance with the receipt of benefits, and with the expectation that the Company would improve its conservation programs and the implementation of them. In addition, the Commission imposed an earnings cap to prevent the possibility of windfall profits from the operation of the mechanism, and limited annual rate increases of the mechanism to two percent of the annual revenue requirement.[24] The pilot mechanism only applied to Avista's residential customers, excluded commercial and industrial enterprises. As mentioned earlier, it differs from the Cascade decoupling pilot, in that it does not offset recoveries by revenues from new customers.[25]

In Avista's most recent rate case, the Commission gave final approval to Avista's decoupling program and made it a permanent feature of the company's regulatory structure. In that case, the Commission found that Avista's decoupling pilot enhanced the company's conservation performance, and tied its recovery under the mechanism to its conservation efforts, which constituted 45 percent of its lost margin[26] during the test year. The pilot mechanism's impact to customers for the year 2008 was determined to be $0.10 per month for a total contribution to company revenue of $204,934.[27]

As to the permanent program's features, they largely remained the same as those under the pilot program. However, the Commission required the company to remove the impacts of its Idaho jurisdiction from the mechanism's targets and achieved savings results. Finally, the Commission required the company to improve its Evaluation, Measurement and Verification (EM&V)[28] process, address inclusion of other customer classes in the mechanism's

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[24] *WUTC v. Avista Corporation*, Docket UG- 060518, Order 04, ¶ 15 (February 1, 2007).

[25] *Id.*, ¶ 29.

[26] *WUTC v. Avista Corporation*, Docket UG- 090134, Order 10, ¶ 322 (December 22, 2009). Approximately 30 percent of the lost margin can be attributed to Avista's programmatic or direct conservation efforts (e.g., weatherization and appliance improvements) and 15 percent can be attributed to the impacts from its non-programmatic or indirect programs (e.g., education and advertising).

[27] *WUTC v. Avista Corporation*, Docket UG- 090134, Order 10, ¶ 291 (December 22, 2009).

[28] Evaluation, Measurement, and Verification (EM&V) is a general catchall for determining energy efficiency program and project impacts, wherein "evaluation" means determining the effects of a program through "measurement and verification" activities such as data collection, monitoring, and analysis associated with the calculation of gross energy and demand savings from individual sites or projects. See *Evaluation, Measurement, and Verification of Energy Efficiency Programs: An Overview. Rep. Dover, DE: Delaware Energy Office, 2009.*

operation, and study the barriers to low-income customer participation in its conservation programs.[29]

In addition to the regulatory policy the Commission has in place and is scheduled to review, the first compliance period for conservation achievement under the EIA began in 2010. The EIA requires utilities to pursue all available conservation that is cost-effective, reliable, and feasible to achieve.[30] The Commission's evaluation of utilities compliance with that requirement will occur in 2013 when the first two year compliance period ends. The EIA provides penalties for non-compliance.

In summary, the Commission has a long history of embracing conservation as a resource that must be acquired by its regulated utilities, and supports regulatory mechanisms that enhance the acquisition of cost-effective conservation resources and reasonably protect the ratepayer from harm. Specifically, decoupling has now been made a permanent feature in the regulatory landscape, having met the Commission's tests as to conservation enhancement and ratepayer protection. The Commission has continued to refine its treatment of lost margin due to conservation through filings made by our regulated utilities. In this inquiry, we further our analysis and treatment of decoupling and other conservation incentive mechanisms.

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[29] *WUTC v. Avista Corporation*, Docket UG- 090134, Order 10, ¶ 306 (December 22, 2009).

[30] *WUTC v. Puget Sound Energy, Inc., Docket UE-100177, Order 04, ¶ 33 (June 04, 2010), citing* RCW 19.285.040(1).

APPENDIX 6

DECOUPLING IN OTHER JURISDICTIONS

Our research shows that Washington's use of decoupling mechanisms generally tracks the decisions of other states around the country. We found that several states have adopted a variety of decoupling mechanisms for both natural gas and electric utilities. Some mechanisms have been in place for many years while others are pilot programs lasting only a few years and subject to review at the end of the pilot period. In some states, such as Maine, pilot programs from years past have expired and have not been renewed. While some state commissions have recently approved decoupling proposals, several states have rejected them outright. As of October 2010, 12 states plus the District of Columbia have adopted some type of decoupling mechanism for their electric utilities[1] and 18 states (including Washington) have done so for their gas utilities.[2]

The purpose of this section is not to catalog exhaustively all decoupling programs and mechanisms that have been employed in states around the country. Rather, we offer a brief overview of approaches to decoupling, and summarize recent decisions on decoupling from other state public utility commissions in an effort to put Washington's experience with decoupling into a nationwide context. We focus primarily on states with electric decoupling mechanisms or decoupling mechanisms for both electric and gas utilities. As this section shows, all states confront the same issues and challenges in considering decoupling mechanisms.

California The California Public Utility Commission has permitted multiple iterations of decoupling over the last three decades. Accordingly, discussions of decoupling around the nation often refer to California's experiences. California has three investor-owned electric utilities that all have similar decoupling schemes in place: Pacific Gas and Electric, Southern California Edison, and San Diego Gas and Electric. In current form, the electric revenue-sales decoupling mechanism caps revenues during a conventional rate case and is paired with

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[1] *See* The Edison Foundation Institute for Electric Efficiency, "State Electric Efficiency Regulatory Frameworks," at 5 (July 2010).

[2] In addition to Washington, the following states also have gas decoupling mechanisms in place: Arkansas, California, Colorado, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Nevada, New Jersey, New York, North Carolina, Oregon, Utah, Virginia, Wisconsin, and Wyoming. Natural Resources Defense Council, "States with Natural Gas Revenue Decoupling As of June 2010." *See* http://www.aga.org/Legislative/RatesRegulatoryIssues/ratesregpolicy/Issues/Decoupling/ (accessed October 20, 2010). See Appendix 5 for a full discussion of conservation incentives and decoupling proposals considered and adopted in Washington state.

an annual attrition adjustment.[3] Though California has employed decoupling for many years, the structure and effects of the decoupling mechanism are obscured to some extent by the complex nature of California's larger utility regulatory structure. It contains as many as seventeen distinct adjustment mechanisms operating between rate cases,[4] complicating attempts to successfully adapt (or even compare) California's decoupling approach to other applications.

Massachusetts The Massachusetts Department of Public Utilities required in 2008 that each of its gas and electric utilities submit decoupling proposals in its next rate case. The Department approved an electric decoupling mechanism for National Grid in November 2009.[5]

New York Beginning in 2007, New York gas and electric utilities were required to submit decoupling proposals during rate cases. Decoupling mechanisms are now in place for several New York public utilities, including Consolidated Edison and Orange & Rockland.[6]

Connecticut Connecticut law requires the state's public electric and gas utilities to propose revenue-sales decoupling mechanisms. The Connecticut Department of Public Utility Control has already adopted a full decoupling mechanism proposed by one electric utility,

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[3] *Application for Pacific Gas and Electric Company for Authority, Among Other Things, To Increase Revenue Requirements for Electric and Gas Service and to Increase Rates and Charges for Gas Service,* California Public Utilities Commission Decision 04-05-055 (May 27, 2004); *Application of Southern California Edison Company to Adopt a Performance Based Ratemaking Mechanism,* California Public Utilities Commission Decision 02-04-055 (April 22, 2002); and *Application of San Diego Gas & Electric Company for Authority to Update its Gas and Electric Revenue Requirement and Base Rates,* California Public Utility Commission Decision 05-03-023 (March 17, 2005). *See also* Shirley *et al*, Regulatory Assistance Project, *Revenue Decoupling, Standards and Criteria, A report to the Minnesota Public Utilities Commission*, at 44 (June 30, 2008).

[4] Shirley *et al*, Regulatory Assistance Project, *Revenue Decoupling, Standards and Criteria, A report to the Minnesota Public Utilities Commission*, at 44 (June 30, 2008).

[5] *Petition of Massachusetts Electric Company and Nantucket Electric Company d/b/a National Grid to the Department of Public Utilities for a General Increase in Electric Rates and Approval of a Revenue Decoupling Mechanism*, Massachusetts Department of Public Utilities Docket 09-39 (November 30, 2009); and *Investigation by the Department of Public Utilities on its own Motion into Rate Structures that will Promote Efficient Deployment of Demand Resources*, Massachusetts Department of Public Utilities Decoupling Order I, Docket 07-50 (July 16, 2008).

[6] *Proceeding on Motion of the Commission to Investigate Potential Electric Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation*, New York Public Service Commission Order, Docket 03-E-0640 (April 20, 2007).

United Illuminating,[7] but did not authorize a decoupling proposal submitted by Connecticut Light & Power in 2007.[8]

Maryland The Maryland Public Service Commission has approved per-customer decoupling for Maryland's three investor-owned utilities, and reduced return on equity by 50 basis points to reflect reduced utility risk.[9]

District of Columbia The District of Columbia Public Service Commission authorized an electric decoupling mechanism for Potomac Electric Power Company ("Pepco"), effective November 1, 2009. The mechanism is similar to that adopted for Pepco by the Maryland Public Service Commission and shares the same reduced return on equity of 50 basis points.[10]

Wisconsin Wisconsin has a four-year pilot program in effect currently, with annual true-ups. The pilot also includes dead-bands for over- or under-collection.[11]

Michigan Michigan has several limited decoupling pilot programs currently in effect for both gas and electric utilities. The Michigan Public Service Commission authorized an

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[7] Connecticut Public Act No. 07-242, *An Act Concerning Electricity and Energy Efficiency* (Effective July 1, 2007).

[8] *Application of The Connecticut Light and Power Company to Amend Rate Schedules,* Connecticut Department of Public Utility Control, Docket 07-07-01, Final Decision (January 28, 2008).

[9] *In the Matter of the Application of Delmarva Power and Light Company for Authority to Revise its Rates and Charges for Electric Service and for Certain Rate Design Changes*, Public Service Commission of Maryland, Case No. 9093, Order No. 81518 (July 19, 2007).

[10] *In the Matter of the Application of the Potomac Electric Power Company for Authority to Increase Existing Retail Rates and Charges for Electric Distribution Service*, District of Columbia Public Service Commission, Phase II, Formal Case No. 1053, Order No. 15556, at 9 (September 28, 2009).

[11] *Application of Wisconsin Power and Light Company for Authority to Adjust Retail Electric and Natural Gas Rates,* Public Service Commission of Wisconsin Order, Docket 6680-UR-116 (April 26, 2010); and *Application of Wisconsin Public Service Corporation for Authority to Adjust Electric and Natural Gas Rates*, Public Service Commission of Wisconsin Order, Docket 6690-UR-119 (July 13, 2010).

electric decoupling mechanism for the Detroit Edison Company, [12] the Upper Peninsula Power Company,[13] and Consumer's Energy Company.[14]

Idaho The Idaho Public Service Commission approved a three-year pilot electric Fixed-Cost Adjustment decoupling proposal for Idaho Power in March 2007.[15]

Nevada In June 2010, the Public Utilities Commission of Nevada approved a lost-revenue recovery mechanism that established monthly lost-revenue trackers for energy efficiency and conservation programs. Monthly trackers are combined with an annual true-up after measurement and verification.[16]

Vermont Vermont has employed a type of partial decoupling (called an Alternative Regulation Plan) for two of its public electric utilities, Green Mountain Power and Central Vermont Public Service Corporation. This type of regulation allows for quarterly rate adjustments to reflect increases or decreases to the utilities' power costs, annual changes to the base rate to incorporate changes in operating costs, and annual earnings reconciliation adjustments based on whether the utilities earned more or less than the allowed rate of return on equity in the year prior. Green Mountain Power's Alternative Regulation Plan ended on

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[12] *In the Matter of the Application of the Detroit Edison Company for Authority to Increase its Rates, and Amend its Rate Schedules and Rules Governing the Distribution and Supply of Electric Energy*, Michigan Public Service Commission Case No. U-15768, Document No. 0379 at 21 (January 11, 2010).

[13] *In the Matter of the Application of Upper Peninsula Power Company for Authority to Increase Retail Rates*, Michigan Public Service Commission Case No. U-15988, Order Approving Settlement Agreement (December 16, 2009).

[14] In the Matter of the Application of Consumers Energy Company for Authority to Increase its Rates for the Generation and Distribution of Electricity and for Other Relief, Michigan Public Service Commission Case No. U- 15645 at 52 (November 2, 2009).

[15] *In the Matter of the Investigation of Financial Disincentives in Energy Efficiency by Idaho Power Company,* Idaho Public Utilities Commission Case No. IPC-E-04-15, Order No 30267. The Idaho Public Utilities Commission denied Idaho Power Company's application to make the Fixed Cost Adjustment permanent and chose instead to continue the program as a pilot for an additional two years. See *In the Matter of the Application of Idaho Power Company to Convert Schedule 54 – Fixed Cost Adjustment – from a Pilot Schedule to an Ongoing Permanent Schedule,* Idaho Public Utilities Commission Case No. IPC-E-09-28, Order No. 31063 (April 29, 2010).

[16] *Rulemaking to adopt, amend, or repeal regulations regarding electric utility decoupling and other related matters in accordance with Senate Bill 358 (Section 11.3),* Public Utilities Commission of Nevada Docket 09-07016 (June 30, 2010).

September 30, 2010, and became subject to modification or extension upon approval of the Vermont Public Service Board.[17]

Oregon Oregon has taken a case-by-case approach to structuring rates to encourage utility investments in energy efficiency and renewable energy capacity-building. At this time, only one Oregon electric utility has a decoupling program in place (Portland General Electric). The mechanism includes a reduced authorized return on equity of 10 basis points.[18] Natural gas decoupling programs are currently in effect for two Oregon utilities; NW Natural and Cascade Natural Gas. In addition, customers of these three utilities (and other utilities as well) pay a 3-percent public purpose charge added to their bills. The resulting fund supports the Energy Trust of Oregon, a nonprofit organization conceived in 1999 and operating since 2002, which delivers energy efficiency programs and services to consumers and helps enable growth of renewable energy production in Oregon.[19]

Hawaii Most recently, the Hawaii Public Utilities Commission approved a decoupling mechanism for its electric utility companies (Hawaiian Electric Company, Hawaiian Electric Light Company, and Maui Electric Light Company; collectively referred to as the HECO Companies). The decoupling mechanism contains two main elements. The first is a sales-revenue decoupling component called the Revenue Balancing Account. The second is a Revenue Adjustment Mechanism, intended to compensate the HECO Companies for "increases in utility costs and infrastructure investment between rate cases."[20]

The Revenue Balancing Account (RBA) provides the process for capturing the difference between a target revenue requirement, as set in the most recent rate case, and a utility's actual revenues. It contains an adjustment clause that will alter rate levels annually to make

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[17] In October 2010, the Board opened an investigation of Green Mountain Power Corporation's tariff filing for an adjustment of the company's 2011 base rate pursuant to the Alternative Regulation Plan, and the Board may alter the rate increase it authorized in Green Mountain Power's original decoupling proposal. See *Investigation into the 2011 Base Rate Adjustment filed by Green Mountain Power Corporation under the Alternative Regulation Plan,* Vermont Public Service Board Docket No 7673 at 2 (October 5, 2010).

[18] *In the Matter of Portland General Electric Company, Request for a General Rate Revision*, Public Utility Commission of Oregon, Docket UE-197, Order No. 09-020, at 29 (January 22, 2009).

[19] *In the Matter of Portland General Electric Company, Request for a general rate revision.* Public Utility Commission of Oregon Order No 09-020, Docket UE-197 (January 22, 2009).

[20] *Instituting a Proceeding to Investigate Implementing a Decoupling Mechanism for Hawaiian Electric Company, Inc., Hawaii Electric Light Company, Inc., and Maui Electric Company, Limited,* Hawaii Public Utilities Commission Docket No 2008-0274, Final Decision and Order and Dissenting Opinion of Leslie H. Kondo, Commissioner at 4-5 (August 31, 2010).

up the difference.[21] The Revenue Adjustment Mechanism (RAM) provision will replace annual rate cases for the HECO Companies, which are instead anticipated to occur every three years, and will adjust revenues that had been previously decoupled through the Revenue Balancing Account to reflect changes in revenue requirements between rate cases. The RAM consists of a rate base component and an operations and maintenance and "other expense" component.[22] This provision also contains several consumer protection mechanisms, including an Earnings Sharing Revenue Credit to distribute excessive utility earnings back to ratepayers.

The Hawaii Commission did not adopt performance metrics with which to measure the progress of the HECO Companies toward meeting Hawaii's Renewable Portfolio Standard (RPS) or its Energy Efficiency Portfolio Standard (EEPS). Instead, the commission maintained that by adopting decoupling, utilities' disincentive to promote energy efficiency and renewable energy had been removed, and, consequentially, utilities were automatically incented to fully support these two state energy objectives.[23]

All of the parties in the Hawaii docket agreed with the commission's decision to adopt decoupling. However, one of the Commissioners, Leslie H. Kondo, dissented. His dissent summarizes several of the contentious issues that recur when state commissions consider decoupling proposals. According to Mr. Kondo, decoupling will:

- Transfer risk from utility companies to customers;[24]
- Increase the per-unit cost of energy (Kondo was especially concerned with the impact of this change on low-income customers);[25] and
- Remove the disincentive to support the state's renewable energy and energy efficiency goals, but will not *obligate* utilities to do so beyond what is already required by the state's renewable portfolio standard and energy efficiency portfolio standard.[26]

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[21] *Id.*, Final Decision and Order at 24, 33.

[22] *Id.* at 16.

[23] *Id.* at 30.

[24] *Id.*, Dissenting Opinion of Leslie H. Kondo, Commissioner, at 3.

[25] *Id.* at 7.

[26] *Id.* at 5.

Rhode Island In April 2010, the Rhode Island Public Utility Commission (RIPUC) rejected an electric decoupling proposal set forth by National Grid (called the Revenue Decoupling Rate Making Plan, or RDR Plan) as part of a larger docket requesting electric rate increases.[27]

Like the proposal set forth by Hawaii's public electric utilities, National Grid's proposal contained two main components; one mechanism to decouple the utility's revenues from sales (as determined in a traditional ratemaking process), and an annual revenue reconciliation mechanism called the Adjustment Factor.[28] The Adjustment Factor equation reflects the impacts of inflation since the last rate case, cumulative capital additions since the rate case, and the capital expenditures in the current year. The equation first considers the difference between the utility's revenues in the previous year and the Annual Target Revenue the company was permitted to recover in that same year, then considers the impact of net inflation and net capital additions in the year following after these adjustments are scheduled to take effect.[29]

Consistent with Commissioner Kondo's criticisms, the RIPUC did not find sufficient evidence of the benefits of decoupling for ratepayers, nor did the commission find that energy savings would necessarily grow with the advent of a decoupling scheme.[30] Moreover, the commission found that no other state with decoupling programs comparable to National Grid's proposal sanctioned recovery of annual inflation or capital expenses.[31] Rhode Island law already allows the commission to address over- and under-recoveries due to efficiency or conservation as long as recovery is limited to a utility's "reasonable and prudent overhead and fixed costs." The commission found that inflation is not a fixed cost nor is it overhead, and consequently it could not allow for an inflation adjustment within the bounds of Rhode Island law.[32]

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[27] *Narragansett Electric Co. d/b/a National Grid,* Rhode Island Public Utilities Commission, Docket No. 4065, Report and Order at 156 (April 29, 2010).

[28] *Id.* at 134.

[29] Rhode Island AG Brief at 3.

[30] *Narragansett Electric Co. d/b/a National Grid,* Rhode Island Public Utilities Commission Docket No. 4065, Report and Order at 135 (April 29, 2010).

[31] Rhode Island AG Brief at 7.

[32] *Id.* at 7.

Notably, the RIPUC pointed to the limited number of states with electric decoupling mechanisms in place as evidence that state commission support of decoupling remains a minority position.[33] The commission also pointed out that Rhode Island is among the top ten states in achieving energy efficiency targets even in the absence of decoupling.[34]

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[33] *Narragansett Electric Co. d/b/a National Grid,* Rhode Island Public Utilities Commission Docket No. 4065, Report and Order at 136 (April 29, 2010).

[34] *Id.* at 135, citing the American Council for an Energy Efficiency Economy, The 2009 State Energy Efficiency Scorecard, Report number E097, at iv (October 2009). Washington is also in the top ten; ranked seventh nationwide.

APPENDIX 7
GLOSSARY OF TERMS
Docket U-100522

TERM	DESCRIPTION
Attrition	The year-to-year decline in a utility's earnings caused by increased costs which are not offset by increases in rates and sales.
Attrition Adjustment	A mechanism which adjusts certain elements of cost of service between general rate cases for the purpose of maintaining adequate utility earnings.
Conservation	The act of reducing energy use. In this context, conservation also means achieving the same function and benefits while using fewer energy resources.
Dead-band	A range above and below a revenue cap that must be exceeded to trigger a monetary adjustment to utilities or customers.
Decoupling	A ratemaking and regulatory tool intended to break the link between a utility's recovery of fixed costs and a consumer's energy consumption by reducing the impact of energy consumption on a utility's recovery of fixed costs.
Demand-Side Management (DSM)	Activities or programs undertaken by or on behalf of customers to conserve energy or reduce consumption.
Evaluation, Measurement, and Verification (EM&V)	A general term for determining energy efficiency program and project impacts, wherein "evaluation" means determining the effects of a program through "measurement and verification" activities such as data collection, monitoring, and analysis associated with the calculation of gross energy and demand savings from individual sites or projects.
Fixed Costs	Business expenses that do not vary significantly in response to changes in volume of output.
Found Margin	The overall increase in a regulated utility's earnings between rate cases (general factors include growth in customer base, increased plug load, or other increases in customer usage).
Full Decoupling	A mechanism that fully severs the link between utility sales and revenues and reconciles any difference between expected and actual revenues, regardless of the underlying cause of the difference.
Limited Decoupling	A mechanism that reconciles certain differences between a utility's expected sales and its actual sales (e.g., differences caused by conservation, and reconciliation limited to conservation).

Lost Margin	Earnings erosion resulting from decreases in customer use which is severe enough that a utility cannot recover its authorized rate of return.
Margin Revenue	The revenue necessary for a utility to recover its total cost of service net of purchased energy input expenses and other expenses treated as "flow-through" items in rates (*e.g.,* revenue taxes, conservation program riders). A utility's per customer margin revenue is its total cost of service, as determined in the most recent general rate case, divided by the number of customers.
Partial Decoupling	A mechanism that reconciles a portion of the difference between a utility's expected revenues and its actual revenues.
Rate of Return (ROR)	The return earned or allowed to be earned by a utility calculated as a percentage of its fair value or rate base.
Return on Equity (ROE)	The actual or allowed profit earned on the investment made by common shareholders.
True-up	An adjustment to compensate a utility or its customers for over- or under-recovery of the difference between expected revenues and actual revenues.
Variable Costs	Business expenses that vary with changes in volume of output (e.g., fuel costs).