

[Service Date November 4, 2010]

**BEFORE THE WASHINGTON STATE
UTILITIES AND TRANSPORTATION COMMISSION**

In the Matter of the Washington) DOCKET U-100522
Utilities and Transportation)
Commission’s Investigation into)
Energy Conservation Incentives.) 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.

DOCKET U-100522

PAGE 2

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

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 obligation⁷ 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

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

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.

(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.

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

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,

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

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

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.

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.

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.

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

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

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

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.

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

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 EIA⁵³ 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.

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.

DOCKET U-100522

PAGE 23

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