# Revenue Decoupling Mechanisms

*The New York State Experience*

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# Overview

- **Description of RDMs**
- **History of RDMs in New York State**
- **Current Status of RDMs in NYS**
  - **Outstanding issues**

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# Impediments to Energy Efficiency

- Traditional Cost of service regulation
  - **R = B*r + O**
- Fixed costs (depreciated over time) + commodity costs (recovered as expenses)
  - **If sales are not realized, will not recover their fixed costs – lost margin, net loss for the utilities**
- Creates **throughput incentive**

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# Revenue Decoupling

- Does not incentivize, but should remove the disincentive
- Eliminates the link between volumetric sales and utility revenues/profits
  - Otherwise, lost margins, EE cost recovery for the program, and opportunity costs
  - **E.g. 2% reduction in sales can lead to 20% reduction in shareholder earnings**

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# Revenue Decoupling (cont'd)

- Decoupling is achieved by adjusting the rate per unit of commodity sold in proportion to the amount of sales lost by decreased or increased demand
- Reduces regulatory lag between rate cases
- Utilities can still increase profits by adding more customers

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# Revenue Decoupling Mechanism Variations

- Revenue per Customer
- Sales margin per customer
- Total margin revenue
- Total class revenue
- Usage per customer

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# Alternatives to RDM and Comparative Advantages

- Lost Revenue Adjustment Mechanism
- Straight fixed variable rate design
- Fully cost-based service

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# Utility Approach to RDMs

- Issues that utilities have to consider:
  - Type of mechanism (based on rate filing)
  - Service classifications
    - Should certain SCs be exempt?
  - Treatment of customers switching SCs
  - How to assure data quality & accuracy
    - Forecasting customers and their average usage

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# RDMs in Practice

- Benefits for EE achieved
- Customer satisfaction with RDMs
  - JD Power & Associates
- Weather and recession normalization?
  - **Otherwise holding utilities harmless no matter the cause or whether related or not to energy efficiency**

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# Other Regulatory Considerations*

- **Balancing/Carrying Accounts**
- **Revenue Banding**
- **Rate banding**
- ***Ad hoc* adjustments**

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*Source: NARUC, Decoupling FAQ (2007)

# RDM History in New York State

- Originally mandated around 20 years ago, then PSC backed off
- James Gallagher, from the NYC Economic Development Council:
  - RDM "could not be isolated as a factor driving the increase in DSM expenditures"
    - **State EE goals + DSM incentives?**
  - Other concerns included skewed price signals, large accruals, volatility, reduced development incentives

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# RDM Implementation Order

- In April 2007, the NY PSC directed all public utilities to

  "develop and implement mechanisms that true-up forecast and actual delivery service revenues and, as a result, significantly reduce or eliminate any disincentive caused by the recovery of utility fixed delivery costs via volumetric rates or marginal consumption blocks."

- PSC revisited RDM as the best option to sever the throughput incentive

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# RDMs Implemented:

| Company | Type | PSC Status |
|---|---|---|
| Consolidated Edison | Electric & Gas | Approved |
| Orange & Rockland Utilities | Electric | Approved |
| Central Hudson Gas & Electric | Electric & Gas | Approved |
| National Fuel Gas Distribution Corporation | Gas | Approved |
| National Grid/Niagara Mohawk (Keyspan) | Gas | Pending |
| New York State Electric & Gas | Electric & Gas | Developing |
| Rochester Gas & Electric | Electric & Gas | Developing |

# *Progress?*

- Consolidated Edison
  - Electric
  - Gas
- National Grid/Keyspan
- National Fuel Gas
- NY PSC actually seems to prefer hybrid approach:
  - RDM for large market customers (residential) **+**
  - Fully cost-based rates for Industrial/commercial customers

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# Recurring Problems

- Return on equity (ROE) problems – should ROE be reduced proportionately to the risk reduction?
  - Reduces risk & makes cost of capital cheaper – some advocate reduction of allowed ROE, balanced by improvement in credit rating
- Rate impacts – is volatility unfair for customers?
- Supports poor management?
  - Only interim measure though

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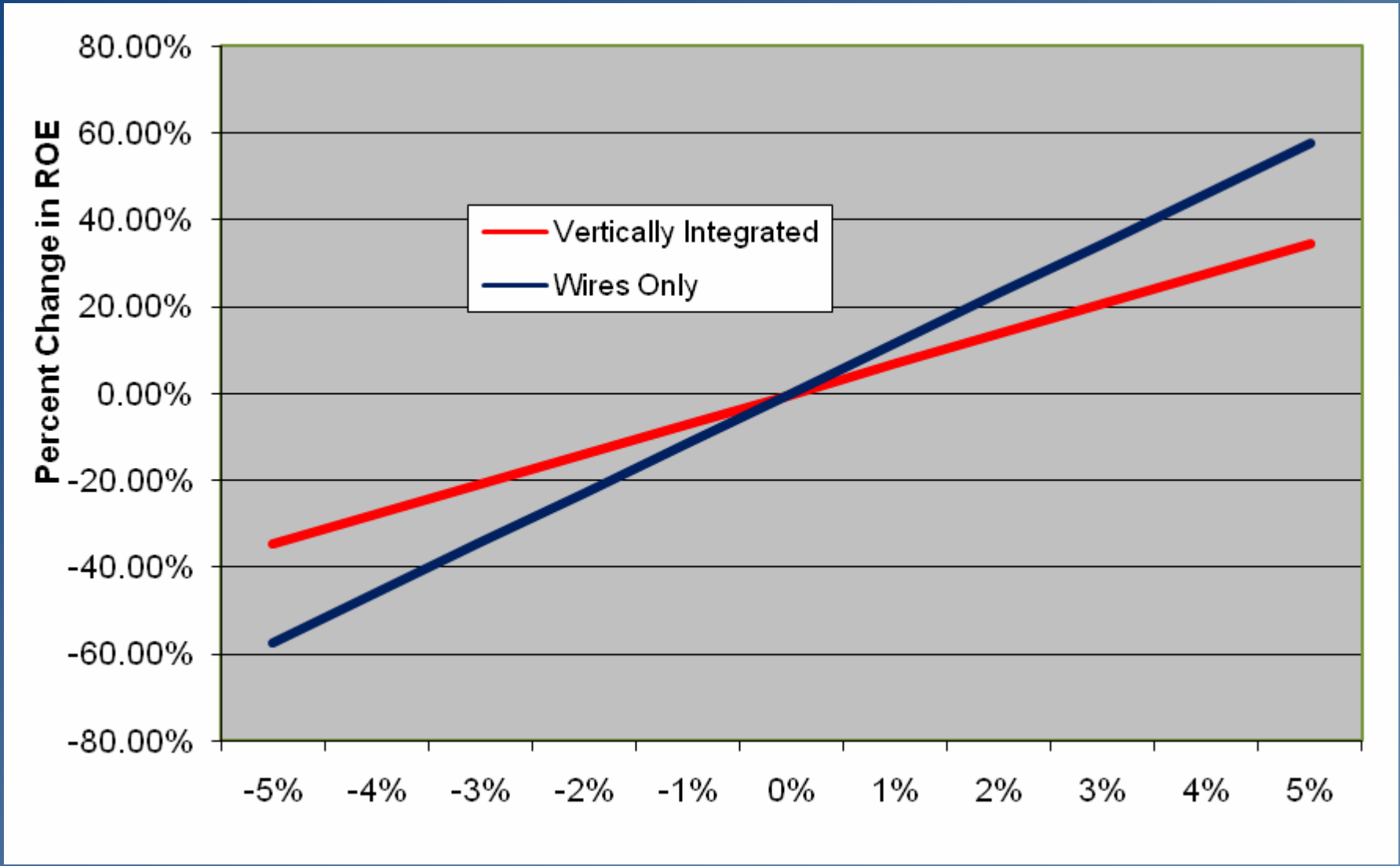
# Figure: Impact of Revenue Change on Return on Equity (ROE)




Source: SEPA, *Decoupling Utility Profits from Sales*

# Decoupling = Profitability?

- Utilities can still increase profits, even when revenues are trued-up:
  - (1) Adding customers – utilities are familiar
  - (2) Continuing allowed rate of return
  - (3) Improving efficiency lowers cost of service
  - (4) Decreased cost of capital
    - With unchanged ROE, even greater profitability
  - In the end, utilities are insulated from most common profit shocks

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# Issues for Utilities

- Return on equity issues – should be encouraging higher ROE?
  - Weather normalization vs. ROE reduction
- Still does not actively incentivize EE
  - Should utilities be the ones promoting EE?
- Requires investment of resources – opportunity cost issue again
- Better to be discussing true-ups in general rate cases?

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# Questions?

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