

Utility Initiatives: Alternative Business Models and Incentive Mechanisms

JUNE, 2014

CONGRESS SHOULD:

- Recommend and encourage decoupling and shareholder incentives as part of a strong federal energy efficiency resource standard (EERS).

STATE LEGISLATORS AND REGULATORS SHOULD:

- Create regulatory frameworks that align utility financial objectives with saving energy through customer energy efficiency programs.

THE ISSUE:

Under typical regulatory structures for determining utility rates, utilities do not have an economic incentive to help their customers be more energy efficient, because reducing energy sales reduces utility revenues and earnings (profits). By separating utility revenues from energy sales and providing performance incentives, utilities and their shareholders, as well as utility customers, are more likely to benefit from increased energy efficiency.

SUMMARY:

Under traditional rate-of-return regulation, utilities have an economic disincentive to provide programs to help their customers be more energy efficient. Because a utility's earnings are based on the total amount of capital invested and the amount of electricity sold, increased energy sales generally increase utility profits.

Experience suggests that enacting regulatory reforms such as decoupling and performance incentive mechanisms help overcome those inherent disincentives regarding energy efficiency. Decoupling removes the disincentive of lost sales, while providing performance incentives creates a mechanism by which utilities can actually generate earnings from energy efficiency, similar to other utility investments, such as in new power generation plants. Properly designed incentives can spur utilities or other program providers to meet or exceed established goals for their energy efficiency programs. Both of these regulatory mechanisms are valuable strategies, capable of addressing utility financial concerns regarding energy efficiency and helping to align utility financial interests with energy efficiency program objectives.¹

ALTERNATIVE BUSINESS MODELS

Decoupling creates an alternative business model for utilities by breaking the relationship between energy sales volumes (kilowatt-hours of electricity or therms of natural gas) and revenue, eliminating the disincentive to using energy efficiency programs to help customers save energy. A utility's revenue requirements are set using traditional rate case methods, but

¹ For more information see *Aligning Utility Interests with Energy Efficiency Objectives: A Review of Recent Efforts at Decoupling and Performance Initiatives* <http://aceee.org/research-report/u061>

without linking profits to sales. Decoupling provides a symmetrical mechanism to adjust revenues to account for electricity and gas sales that are above or below forecasted levels. The profitability of the utility is determined by how well it operates within the revenue requirement, not by how much energy it sells.²

INCENTIVE MECHANISMS

A variety of incentive mechanisms expand upon the traditional regulation model in which investor-owned utilities earn returns on capital invested in generation, transmission, and distribution. The three major types of incentive mechanisms are performance target incentives, shared savings incentives and rate of return adders. With performance targets, a utility earns a financial incentive by exceeding some specified energy savings target, and then receives a defined amount of economic incentive in return. With a shared savings mechanism, the utility shares the net benefits resulting from successful implementation of energy efficiency programs with ratepayers. The utility typically receives a specified percentage of the net benefits. Under the rate of return adder mechanism, utilities are allowed an increased return on investment for energy efficiency investments, or are offered a bonus return on total equity investment for superior energy efficiency performance.

FOR MORE INFORMATION:

- The Regulatory Assistance Project (RAP) is a noted authority on decoupling mechanisms. See their website at: www.raponline.org.
- ACEEE State Policy Database: Learn about current state-level utility policies, including alternative business models: <http://database.aceee.org/>
- York, D. and M. Kushler. 2011. The Old Model Isn't Working: Creating the Energy Utility for the 21st Century. <http://www.aceee.org/white-paper/the-old-model-isnt-working>
- Hayes, S., Nadel, S., Kushler, M., and D. York. 2011. Carrots for Utilities: Providing Financial Returns for Utility Investments in Energy Efficiency. Washington, D.C.: American Council for an Energy-Efficient Economy. <http://www.aceee.org/research-report/U111>
- ACEEE Toolkit: Incentivizing Utility-Led Energy Efficiency Programs. <http://aceee.org/sector/state-policy/toolkit/utility-programs>
- Kushler, M. and M. Suozzo. 1999. Regulating Electric Distribution Utilities As if Energy Efficiency Mattered. Washington, D.C.: American Council for an Energy-Efficient Economy. <http://www.aceee.org/research-report/u993>
- Kushler, M., D. York, and P. Witte. 2006. Aligning Utility Interests with Energy Efficiency Objectives: A Review of Recent Efforts at Decoupling and Performance Initiatives. Washington, D.C.: American Council for an Energy-Efficient Economy. www.aceee.org/pubs/u061.htm
- National Action Plan for Energy Efficiency (2007). Aligning Utility Incentives with Investment in Energy Efficiency. Prepared by Val R. Jensen, ICF International. <http://www.epa.gov/cleanenergy/documents/incentives.pdf>

² For more information see <http://www.raponline.org/featured-work/utility-business-models-providing-incentives-for-energy-savings>

ACEEE CONTACTS

Marty Kushler
mgkushler@aceee.org
517-655-7037

Dan York
dwyork@aceee.org
608-243-1123