

## Regulatory Reform: Removing the Disincentives To Utility Investment in Energy Efficiency

**U**tilities lose revenues and profits when they or their customers invest in cost-effective energy efficiency. In 1989, The National Association of Regulatory Utility Commissioners (NARUC) adopted a resolution that expressly recognized this serious impediment to greater use of the energy efficiency resource, and recommended a simple and unequivocal response: Reform regulation to align the utility's financial interest with the interests of its customers in having energy efficiency integrated into the utility's resource portfolio.

Interest in addressing the regulatory disincentives to energy efficiency investments flagged during the past decade due to low natural gas prices, which made efficiency a lower priority, and the general turmoil of restructuring. During that time, energy efficiency moved from being regarded an important energy resource to being perceived as a social program supported by System Benefit Funds. Today, with the steep increase in natural gas prices and a growing concern regarding carbon emissions, tapping the energy efficiency resource has once again moved to the forefront of the working agenda for many utility regulators. Under-

in this under-used, environmentally clean, bill-reducing resource.

Every regulatory system creates a set of incentives and disincentives. Some are deliberate, and others are unintended but just as effective. Traditional ratemaking results in some strong disincentives to acquiring energy efficiency. These include:

1. Utilities lose revenues and profits from sales not made as a result of successful energy efficiency programs.
2. By devoting resources to efficiency programs rather than to other profit-making activities, utilities forego earning opportunities.
3. Utilities are often restricted in how they can recover efficiency program expenses.

It is incumbent upon regulators to recognize what disincentives in the traditional ratemaking process make energy efficiency investments financially objectionable to utilities and decide whether incentives should be instituted. Regulators cannot police every decision utility management makes. Aligning a utility's financial

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standing the regulatory disincentives to utility investment in energy efficiency is essential for regulators who want to see greater investment

interest with articulated public policy objectives is a powerful means of encouraging utilities to make decisions in a manner that is consistent with policy objectives.

### How Lost Revenues Occur

THE TRADITIONAL REGULATORY SYSTEM produces very powerful incentives for utilities to increase electricity and **gas** sales and correspondingly large disincentives to pursue energy efficiency. For example, on a national average, each additional kWh a utility sells contributes 5¢ to its bottom line profit (before income taxes). Thus, if the current rate setting process is viewed as an incentive plan, the “incentive” or “reward” for each kilowatt hour the utility sells is a nickel. Likewise, a nickel comes off a utility’s bottom line each time a kilowatt hour is conserved. To put the magnitude of this incentive in perspective, a one percent change in a utility’s sales has about a 100 basis point impact on its return on equity.

The reason for this is that traditional rate setting is based on the following formula:

$$\text{Revenue Requirements} = \text{Expenses} + (\text{Rate Base} * \text{Rate of Revenue})$$

The utility’s revenue requirement is the total dollar amount the utility needs to operate, including a fair return on shareholders’ investment. In effect, this is the amount of money regulators determine the utility needs. The next step in a rate case is to set rates. This is done by dividing revenue requirements by **expected** sales.

$$\text{Rates} = \frac{\text{Revenue Requirement}}{\text{Sales}}$$

This derives a price per kWh (or Ccf) which customers are charged. Regardless of what level of revenues the commission decides was needed, once rates are set, the utility’s actual revenues are linked to and driven by sales until the next case. The more sales a utility makes, the more revenue it receives. Every lost sale means less revenue.

Profits and revenue, however, are not the same. Profits are the difference between revenues and costs. Thus to know how increased sales affect profits, one needs to know how increased sales affect costs. The answer is simple. The only costs that significantly increase with increased sales, at least in the period between rate cases, are fuel and purchased power costs. In most states, fuel and purchased power costs are subject to fully reconciled, automatic adjustment clauses. These adjustment clauses have the effect of making fuel costs the customer’s, not the utility’s, responsibility. This means that higher fuel costs have no impact on utility earnings.

The problem of lost profits is much worse for stand-alone distribution companies (a typical structure for most gas companies and for several electric companies in restructured states) because the ratio of fixed costs to avoidable costs is much higher for distribution companies.

The relationship between profits, rates and costs can be distilled into two formulas, one for states with fuel clauses and one for states without them:

**States with fuel clause:**

$$\text{Increased Profit} = \text{Retail Rate} - \text{Average Fuel Cost}$$

**States without fuel clause:**

$$\text{Increased Profit} = \text{Retail Rate} - \text{Marginal Fuel Cost}$$

If utilities profit by increasing sales, successful efficiency programs that result in a customer using fewer kWhs cause the utility to lose profit that it would have otherwise received. That is hardly an encouragement to implement efficiency. Even when reductions due to efficiency investments are factored into the expected sales, it is still not in the utility's real financial interest to pursue vigorously programs which decrease customer usage. These lost revenues inevitably undermine a commission's best efforts to compel a utility to use all cost-effective energy efficiency as a viable alternative to more costly new generation.

### **Regulatory Solutions: Adjustable Revenue Caps Or Lost Revenue Adjustments?**

ADJUSTABLE REVENUE CAPS (also known as decoupling or conservation tariffs) and Lost Base Revenue Adjustments (LRAs) are the two approaches generally used to eliminate the disincentives and address the issue of demand-side profitability. Using a lost base revenue adjustment,<sup>1</sup> one calculates how many dollars a utility has lost due to its energy efficiency programs, then increases revenues by that amount. For example, suppose a utility has a program to replace existing electric motors with more efficient ones. The utility estimates that its electricity sales will fall by 100 million kWh by pursuing this replacement effort. If each kWh produced 2¢ in revenue net of fuel and any

<sup>1</sup> The phrase lost *base* revenues is used to distinguish fuel revenues from base revenues. Fuel revenues comprise nearly all of a utility's variable costs. In most states, fuel revenues are fully recovered on a reconciled basis in fuel adjustment factors. Fuel revenues are not lost as a result of energy efficiency investments.

other variable costs, the utility would lose \$2 million in net revenue to this program. Under a LRA approach, this amount would be subsequently recovered.

An Adjustable Revenue Cap (ARC) approach operates differently by severing a utility's allowed revenue from its sales. To do this, the commission determines during a normal rate case how much revenue a utility needs to cover its expenses and sets an electric rate which is expected to produce that level. Later, perhaps at the end of a year, the commission and the utility see whether, in fact, that revenue has been generated or whether, due to fluctuations in sales from the expected level, some greater or lesser amount has been realized. When the utility has received too little, the error is corrected through a surcharge. If the utility has received too much, the error is corrected through a rebate.

In principle, both approaches address the existing disincentive to utility energy efficiency, but in fact the results from the two approaches are quite different. LRA limits itself to changes in revenues resulting from specific efficiency measures. The ARC approach is applied to *all* changes in utility sales and therefore removes the utilities' incentive to promote new sales. LRAs are not capable of removing existing incentives to increase sales.

Because ARCs separate profits from fluctuating sales levels regardless of the cause of the changed sales volumes, it addresses efficiency impacts resulting from all effects including:

- rate design
- all utility-sponsored energy efficiency activities
- energy efficiency achieved through standards and other means

- energy efficiency measures undertaken by consumers directly, without any utility involvement.

At the moment, all of California gas and electric utilities and one of Oregon's gas utilities have ARC mechanisms in place. Other states such as Montana and Washington are considering them. Prior to the intense restructuring of the electric industry in the 1990's, seven states, California, New York, Washington, Kentucky, Oregon, Montana and Maine had adopted decoupling mechanisms. Historically, the apparent simplicity and perceived effectiveness of the more narrowly circumscribed LRAs led many more states (including Massachusetts, Rhode Island, Michigan, Ohio and Indiana) to implement LRAs.

### Rate Design

WHEN MARGINAL COSTS are rising, inverted block rates and time-of-use (TOU) rates clearly provide better price signals to consumers than declining block or flat rates. But utilities oppose these price structures because of the risk that customer response to the price signals will significantly reduce utility revenues and earnings. With TOU rates, for example, customers respond to high on-peak rates by investing more heavily in energy efficiency or shifting electricity use from on-peak to off-peak periods. These responses to better price signals result in substantially diminished utility earnings (for example, an on-peak kWh price of 10¢ can produce two and a half times the incremental earnings as an off-peak kWh priced at 5¢). Utilities have had TOU rates imposed against their resistance and have experienced significant revenue and earnings losses. To a utility rate department, the first priority of "getting prices right" is to assure stable revenue flows. Rates which signal customers to reduce use during high cost periods jeopardize stable revenues. ARCs hold utilities harmless from revenue losses resulting from consumer response to better prices and as a result aid in the effort to improve pricing. LRAs, on the other hand, do not address revenue losses associated with implementation of rate design changes.

### Concern with Measurement And Evaluation of Efficiency

VERIFYING THE PERFORMANCE of energy efficiency investments is as important a responsibility of regulators as verifying power plant performance. Measurement and program evaluation techniques for energy efficiency activity have been steadily improving, but the field is

	Adjustable Rate Caps	Lost Revenues
<b>Sales</b>	Removes sales incentive and all energy efficiency disincentives.	Removes some energy efficiency disincentives, does not remove sales incentives.
<b>M &amp; E</b>	Does not require sophisticated measurement and/or estimation	Requires sophisticated measurement and/or estimation.
	Utility does not profit from energy efficiency which does not actually produce savings.	Utility may profit from energy efficiency which does not actually produce savings.
<b>Scope</b>	Rate design All energy efficiency programs Customer energy efficiency Efficiency standards	Addresses revenues lost due to utility energy efficiency programs only.
<b>Other</b>	Eliminates load forecast gaming.	No direct effect on subsequent rate cases.
	Low litigation potential, low administrative cost.	Cost recovery uncertainty, litigation prone, high administrative cost.
	Reduces volatility of utility revenue resulting from many causes.	No effect on the volatility of utility

developing, and uncertainties persist. LRAs rely heavily on accurately measuring the savings actually produced by energy efficiency measures. In order to estimate lost revenues, one must first determine how many kilowatt-hours of energy and kilowatts of peak demand were actually saved. While these saving estimates are typically made as part of the ongoing evaluation of energy efficiency programs, a LRA greatly increases the burden placed on measurement because so many additional dollars depend on the measurement outcomes.

Adding LRAs to program costs can at the very least double and possibly quadruple the total dollars at risk in measurement. (Compare 2¢ program costs with 5¢ of lost revenues.) Under a LRA regime, energy efficiency savings must be separately determined for practically every different rate a utility charges. At a minimum, kWh and kW savings must be separately established for each participating customer class. In addition, depending on the utility's rate structure, separate measurements must be made for the TOU periods, seasons of the year and/or voltage levels at which customers take service. In other words, measurement must be expanded dramatically from what is required for energy efficiency program purposes alone.

Other measurement questions arise:

- How does one determine the effect of lost revenues resulting from an industrial energy efficiency program which, on the one hand, achieves the desired level of energy efficiency improvement? On the other hand, these savings are more than offset by increased levels of industrial production now made possible by the increased competitiveness of the industrial consumer.
- How much revenue is lost to an energy effi-

ciency program when sales exceed forecasted sales due to weather or other factors?

- Do LRAs create an incentive to subsidize customer-initiated energy efficiency so that the utility will be able to recover lost revenues?

While the LRA approach increases the reliance on measurement, it presents the utility with a new set of perverse incentives. After all, utility profits will increase under a LRA in direct proportion to the measured or estimated energy efficiency savings, so the goal will be to maximize the *measured* savings. But revenues are lost only to the extent savings actually occur. For the utility, then, the way to play the LRA game is to maximize *measured* savings but not to actually save anything at all. In principle, such abuse can be policed. In practice, energy efficiency program design and administration result from a large number of small decisions which makes regulatory oversight difficult.

While regulation does a reasonably good job of reviewing the once-in-a-decade, multi-billion dollar decision, it does an inadequate job of overseeing the thousands of daily decisions of utility managers or the tens of thousands of daily customer contacts. Adjustable Revenue Caps do not rely upon measurement of energy efficiency program effectiveness. An effective energy efficiency program will not result in a loss of revenues under an ARC.

### **The Source and Scope of Energy Efficiency Savings**


ARCS ALSO ADDRESS efficiency gains from the full array of utility-sponsored energy efficiency programs. Energy savings from some utility energy efficiency programs, such as educational programs stressing the importance

of energy efficiency are, for practical purposes, difficult or impossible to quantify. Because LRAs are limited to measured energy efficiency improvements, they offer no incentives to provide these programs.

Energy efficiency can occur from legislation such as appliance standards or improved building codes adopted at the state or federal level, or customers may undertake energy efficiency directly. Reduced revenues caused by efficiency improvements originating from activities such as these are automatically covered by decoupling. Because LRAs are limited to quantifiable, utility-sponsored energy efficiency programs, they do not address these types of activities. The implications of this limited scope of LRAs are wide ranging. A wide array of efficiency opportunities can be achieved in a very cost-effective manner through efficiency standards,

do not address energy efficiency implemented by private vendors.

### **Adjustable Revenue Caps As The Favored Alternative**

FOR THE REASONS discussed above, Adjustable Revenue Caps do a better job than the Lost Revenue Adjustments approach in addressing an important frailty of traditional utility regulation. ARCs are not, however, a panacea. An ARC will effectively remove the harmful disincentive to energy efficiency investment but, it does not take the next step and provide a *positive incentive* for those utilities that achieve effective risk reduction and lower bill for their customers through effective use of the energy efficiency resource. Our next **Issuesletter** will discuss the needed second step: *Providing Incentives For Effective Risk Reduction Through Investment in Energy Efficiency*. 

### **For More Information:**

VISIT OUR WEBSITE [www.raponline.org](http://www.raponline.org) and click on *Regulatory Incentives* or *Decoupling*.

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improved customer education and development of energy efficiency infrastructures. In the absence of decoupling, the implementation of energy efficiency in any of these arenas penalizes the utilities. As a result, utilities will frequently oppose legislation and other activities aimed at substantially improving the energy efficiency of their customers.

Without decoupling, the success of energy service providers hurts the utility. Will utilities want to help create an energy efficiency industry if that **industry's** success is adverse to the utilities' interests? LRAs, because they are limited to utility-sponsored energy efficiency,



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