BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of a Working Case to Consider Proposals to Create a Revenue Decoupling Mechanism for Utilities	)))	**File No. AW-2015-0282**

MISSOURI DIVISION OF ENERGY'S RESPONSE TO COMMISSION QUESTIONS

COMES NOW, the Missouri Division of Energy ("DE"), by and through the undersigned counsel, and for its *Response to Commission Questions,* states:

a) Please comment on the legality of decoupling in Missouri.

Missouri law allows for certain Commission-approved decoupling mechanisms such as those allowed under Section 386.266.1. The Commission also has broad authority under MEEIA to approve cost recovery mechanisms which promote efficiency.

The Commission asked for stakeholder input on the legality of decoupling electric utility revenues from rates in EW-2011-0372. In that working case stakeholders focused on subsection 5 of the MEEIA statute and in particular the question of whether decoupling could be considered a "rate design modification". Several stakeholders stated that decoupling was a rate design modification, which would allow the Commission to institute decoupling mechanisms for electric utilities, while several other stakeholders stated that decoupling was not a rate design modification and therefore illegal because decoupling generally calls for annual adjustments to rates outside a rate case, which in the opinion of its opponents is retroactive ratemaking. DE, then under the Department of Natural Resources, stated that decoupling was not a rate design modification, but may be considered a "cost recovery mechanism" under subsection 5 of MEEIA as that term is not specifically defined in the statute or the Commission's MEEIA rules. Subsection 5 states in part:

> To comply with this section the commission may develop cost recovery mechanisms to further encourage investments in demand-side programs *including*, in combination and

without limitation: capitalization of investments in and expenditures for demand-side programs, rate design modifications, accelerated depreciation on demand-side investments, and allowing the utility to retain a portion of the net benefits of a demand-side program for its shareholders. *(Emphasis added).*

DE emphasizes the word "including" and the phrase "without limitation" because these words are generally held to be illustrative, not restrictive. Black's Law Dictionary states, "The participle *including* typically indicates a partial list <the plaintiff asserted five tort claims, including slander and libel>. But some drafters use phrases such as *including without limitation* and *including but not limited to* — which mean the same thing."[1] Since the list of cost recovery mechanisms following the phrase "including without limitation" is not an exhaustive list, decoupling need not be a rate design modification to be legal in Missouri. Decoupling would have to be considered a cost recovery mechanism as that term appears in the MEEIA statute to be legal in Missouri.

The MEEIA statute does not specifically define the term "cost recovery mechanism". Subsection 5 of the statute does describe a cost recovery mechanism as a mechanism that will "further encourage investments in demand-side programs". The subsection then provides a nonexhaustive list of cost recovery mechanisms including, "allowing the utility to retain a portion of the net benefits of a demand-side program for its shareholders". To date the Commission has utilized a Throughput Disincentive-Net Shared Benefits cost recovery mechanism which allows utilities to retain a portion of the net benefits of demand-side programs for its shareholders.

Under the Throughput Disincentive-Net Shared Benefits cost recovery mechanism, in addition to recovering explicit costs of providing service, the electric utility's shareholders are allowed to retain a portion of the utility's avoided costs attributable to the utility's energy efficiency programs by collecting the value (deemed or measured) of these savings from its customers. The Throughput Disincentive-Net Shared Benefits cost recovery mechanism compensates the utility for the implicit

[1] Black's Law Dictionary (10th ed. 2014), include, Bryan A. Garner, Editor in Chief.

opportunity costs of providing utility-sponsored energy efficiency programs rather than directing capital to alternative investments.

A properly designed revenue decoupling mechanism can be similar to a Throughput Disincentive-Net Shared Benefits mechanism. Both mechanisms can further encourage investments in demand-side programs by ensuring that service costs are recovered and compensating the utility for the lost earnings associated with investing in energy efficiency programs. Because both a revenue decoupling mechanism and a Throughput Disincentive-Net Shared Benefits mechanism further encourage investments in demand-side programs by compensating the utility for the explicit and implicit costs associated with providing energy efficiency programs it would be reasonable for the Commission to conclude that a revenue decoupling mechanism is a cost recovery mechanism which the Commission may develop under subsection 5 of the MEEIA statute.

In *State ex rel. Public Counsel v. PSC,* 397 S.W.3d 441, 452 (Mo. App. W.D. 2013) the Court of Appeals stated that under MEEIA's plain language "the phrase 'recovery of all reasonable and prudent costs of delivering cost-effective demand-side programs' refers to all amounts charged or paid in delivering cost effective demand- side programs as well as *whatever a utility sacrifices or foregoes in delivering cost-effective demand-side programs*." *(Emphasis added).* In denying OPC's assertion that the Commission lacked the statutory authority to promulgate rules permitting the recovery of lost revenues, the Court of Appeals held that because utilities forgo or sacrifice revenue as a result of delivering demand-side programs, lost revenues can be construed as a cost of delivering demand-side programs and therefore the recovery of lost revenues is authorized under MEEIA.[2] Like lost revenue recovery mechanisms, decoupling mechanisms compensate utilities for the sacrificed or forgone revenue associated with delivering demand-side programs; therefore decoupling mechanisms, which allow recovery of a cost of delivering demand-side programs are also authorized under MEEIA.

[2] Id. at 452-453.

MEEIA requires the Commission to ensure that the Missouri electric utilities' financial incentives are aligned with helping customers use energy more efficiently. Properly designed decoupling mechanisms can contribute to this objective by removing the utility's financial incentive to maintain or increase sales volumes between rate cases by ensuring that the utility recovers no more and no less than its authorized revenue requirement. It is legal for the Commission to authorize properly designed decoupling mechanisms for electric utilities because decoupling mechanisms are a cost recovery mechanism which further encourage investments in demand-side programs and align utilities' financial incentives with helping customers use energy more efficiently.

One of the objections opponents of decoupling have is that in general, revenue decoupling mechanisms allow for rate adjustments outside a rate case, which in the opinion of its opponents is retroactive ratemaking. If the Commission has concerns about retroactive ratemaking the Commission may authorize a two way tracker as an alternative. As an example, Missouri American Water Company ("MAWC") proposed a Revenue Stabilization Mechanism ("RSM") in WX-2015-0209. In its *Response to Staff and MIEC Recommendations* MAWC characterized the RSM as a tracker which would book revenues below and above the Commission's authorized revenue requirement on an annual basis. The net of the booked amounts would then be considered for recovery or reimbursement through an amortization in MAWC's next rate case. MAWC cited the Commission's authority under Section 393.140.4, RSM, to prescribe uniform methods of keeping accounts, records and books, which the Commission has used to authorize various cost trackers.

MAWC also cited *State ex rel Noranda Aluminum, Inc. v. PSC*, 356 S.W.3d 293, 320 (Mo.App.S.D. 2011), where the Southern District Court of Appeals held that a Commission-approved two-way cost tracker for vegetation management and infrastructure replacement was not retroactive ratemaking. In *Noranda Aluminum,* Appellants asserted that the Commission erred in authorizing recovery through amortization of past expenses and in instituting a tracking mechanism by which excess costs are tracked for collection in future rate cases, in that these rulings were unlawful and

unreasonable, because the amortization of past expenses constitutes unlawful and unreasonable retroactive ratemaking.[3] In affirming the order of the Commission, the Court stated a utility cannot go back in time and adjust the rates charged to past customers to reflect increased expenses; however, because these authorized additional expenses were considered through the procedures of the instant rate case for future rates, amortization recovery of the expenses does not constitute retroactive ratemaking.[4] The Court also stated that the tracking provision does not simply set up a future situation where rates will be set retroactively; rather the tracking mechanism works to account for both under and over expenditures, the net result of which the Commission will consider in the next rate case, in which it may be possible for the utility to prospectively recover additional expenses.[5]

DE does not see any legal barrier to approving a two-way revenue tracker under the Commission's current statutory authority. Similar to the trackers the Commission has authorized for various utility expenses, a revenue tracking mechanism would account for both under and over recovery of revenues using the Commission's authorized revenue requirement as the target amount. On an annual basis, the Company will book the amount of revenue either under collected as an asset or over collected as a liability. The Commission will then consider the net of these booked amounts in the utility's next rate case, where the utility may be able to prospectively recover a net under collection or customers may be able to prospectively recover a net over collection. Amortized recovery of net revenues over or under the Commission's authorized revenue requirement does not constitute retroactive ratemaking because the assets and liabilities would be booked in a Commission-authorized revenue tracker and be considered through the procedures of the utilities next rate case for inclusion in future rates.

[3] *Id*. at 318.
[4] *Id*. at 319-320.
[5] *Id*. at 320.

DE emphasizes that while a decoupling mechanism may be legal it must be designed and implemented in a manner that achieves the intended policy objective and is in the public interest. Decoupling mechanisms remove the throughput incentive --the incentive the utility has to sell more units of its commodity. However, to be effective, decoupling mechanisms must be linked with performance metrics to encourage or require the utility to achieve efficiencies. DE's comments supporting the potential legality of decoupling should not be construed as support for the reasonableness of any particular decoupling mechanism in any current or subsequent case before the Commission.

b) Please comment on your interests and preferences for any of the various aspects related to revenue regulation and decoupling contained in "Revenue Regulation and Decoupling: A Guide to Theory and Application, June 2011, The Regulatory Assistance Project". (A copy of that document is available in the EFIS file for this case.).

DE's current review of the Regulatory Assistance Project's "Revenue Regulation and Decoupling: A Guide to Theory and Application" is not an endorsement of any of the topics presented therein, unless otherwise stated. Rather, it is DE's intention to highlight aspects of decoupling as presented by RAP that we believe should be explored during the course of a meaningful discussion of decoupling.

RAP states that decoupling is in fact only a "slight modification" of traditional regulatory practice, but that "care must be taken in designing and implementing a decoupling regime, and the regulatory process should strive to yield for both utilities and consumers a transparent and fair result".[6] DE is concerned about the magnitude of the rate impacts that would result were decoupling to be adopted in Missouri and believes that accurate quantification of these impacts is necessary. DE agrees with RAP that the implementation of decoupling must be done in a manner that is transparent and fair to both consumers and utilities. Adequate consumer protection and education must be a priority when implementing decoupling.

[6] The Regulatory Assistance Project. Revenue Regulation and Decoupling: A Guide to Theory and Application. RAP Online, 2011. p.2

RAP presents four decoupling methodologies: 1. accrual revenue per customer, under which allowed revenue is computed on a revenue-per-customer basis and adjustments are made once per year; 2. current revenue per customer, under which allowed revenue is calculated on a revenue-per-customer basis and adjustments are made each billing cycle to avoid deferrals; 3. accrual attrition, under which the allowed revenue is adjusted once per year based on annual attrition reviews of specified factors; and 4. distribution only, under which only distribution costs are included in the mechanism, leaving all power costs (fixed and variable) to be recovered outside the decoupling mechanism.[7] DE believes it would be beneficial to consider the relative advantages and disadvantages of these methods in the context of Missouri utilities, accounting for factors such as economic growth and usage trends in the utilities' service areas. Specifically, DE would like to explore whether decoupling based on revenue-per-customer or total revenue more accurately accounts for the cost of the infrastructure required to provide service. Additionally, DE believes it will be important to assess the impact on ratepayers of the frequency of decoupling adjustments.

When discussing decoupling adjustments, RAP states that "there are, however, good reasons to seek to limit the magnitude of deviations from the reference price".[8] RAP explains that significant variability in price may threaten public acceptance of decoupling. DE believes that the size and frequency of decoupling adjustments should be studied with the goal of determining which decoupling mechanism designs would better provide consumer protections and fair rates.

RAP notes that full decoupling eliminates the throughput incentive by separating revenue from sales. In theory, this separation of revenue from sales should eliminate a strong disincentive to invest in efficiency.[9] DE concurs with this in theory and would like to see empirical examples of effective efficiency programs being run in service areas where decoupling has been instituted and compare the results of those programs to similar programs in areas without decoupling.

[7] Ibid. p.8
[8] Ibid. p. 10, footnote 14
[9] Ibid. p. 12

RAP notes that one of the benefits of decoupling is the potential for reducing the frequency of rate cases.[10] DE believes that a discussion of decoupling should include an analysis of the advantages and or disadvantages that a decrease in the frequency of rate cases would entail for utilities and consumers.

RAP states that very large industrial customers are sometimes excluded from decoupling schemes because their rates are often contractually determined, resulting in little or no throughput incentive for utilities.[11] DE would like to study this idea further to determine its applicability in Missouri.

RAP details several rate-design opportunities under decoupling. Among these, RAP states that time-of-use rates can convey to consumers that usage during on-peak hours puts the entire system under stress and causes investment in new peaking capacity.[12] DE agrees with this description and believes that decoupling offers the opportunity to explore rate-design opportunities in a way that does not negatively impact consumers or utility earnings.

RAP discusses the impacts of decoupling on the utility's cost of capital.[13] RAP's comments remain mostly hypothetical, equating a decrease in the volatility of earnings with a potential decrease in the cost of capital. DE believes that a discussion of decoupling should include empirical data that shows the effect of the implementation of decoupling on utilities' cost of capital. DE has reviewed a study of the impact of decoupling on the cost of capital by the Brattle Group[14] which determined that no downward adjustment to the return on equity was warranted, but DE would like the opportunity to review additional studies submitted by diverse stakeholders.

c) For responding utility stakeholders, assuming that your preferred revenue regulation decoupling mechanism described in your response to b) will result in a change in the rates of

[10] Ibid. p. 14
[11] Ibid. p. 19
[12] Ibid. 29
[13] Ibid. pp. 36-39
[14] Vilbert, Michael J.; Wharton, Joseph B.; Gibbons, Charles; Rosenberg, Melanie; and Neo, Yang Wei. The Impact of Revenue Decoupling on the Cost of Capital for Electric Utilities: An Empirical Investigation. The Brattle Group, 2014.

certain, if not all, customer rate classes, what is your estimate of the change in residential rates and rate impact resulting from your preferred mechanism? Would you expect those changed rates to be collected through a customer charge or a usage charge?

A ten-year study of decoupling conducted by Pamela Morgan of Graceful Systems LLC revealed that 64 percent of all decoupling rate adjustments are within plus or minus two percent of retail rates. According to the study, this amounts to approximately $2.30 per month for the average electric customer, and $1.40 for the average natural gas customer. Furthermore, when considering decoupling adjustments across all electric and gas utilities and all adjustment frequencies, Morgan found that 63% of the adjustments were surcharges and 37% were refunds.[15] NARUC, in its Decoupling for Electric & Natural Gas utilities: Frequently Asked Questions (FAQ) 2007, reports that in the experience of New York, California, and Oregon, decoupling rate adjustments were typically less than one percent, and never exceeded four percent. DE believes that rate-impact studies specific to Missouri need to be conducted. In addition to the average impact of adjustments, the range of impacts should also be quantified. DE would expect decoupling adjustments to be collected through changes made to rates (and thus collected through usage) rather than through a customer charge.

d) Please provide sources or papers on alternative rate mechanisms, revenue decoupling, or similar topics that will further the Commission's knowledge on the subject of this case.[16]

1. Morgan, Pamela. A Decade of Decoupling for U.S. Utilities: Rate Impacts, Designs, and Observations. Graceful Systems LLC, 2013.

2. Vilbert, Michael J.; Wharton, Joseph B.; Gibbons, Charles; Rosenberg, Melanie; and Neo, Yang Wei. The Impact of Revenue Decoupling on the Cost of Capital for Electric Utilities: An Empirical Investigation. The Brattle Group, 2014.

[15] Morgan, Pamela. A Decade of Decoupling for U.S. Utilities: Rate Impacts, Designs, and Observations. Graceful Systems LLC, 2013. pp. 4-5

[16] DE has provided these references because we believe they are pertinent to the issue; however, we do not necessarily endorse the ideas presented within.

WHEREFORE, DE respectfully files its *Response to Commission Questions*.

Respectfully submitted,

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