To: State of Michigan
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Q17. What "decoupling mechanisms" have been used by Michigan and other jurisdictions as part of an energy efficiency standard? What have been the costs and benefits associated with those mechanisms?

Michigan has significant experience with decoupling, both having decoupled the gas utilities, and having had pilot decoupling programs for the electric utilities until recently. This answer describes decoupling and its history in other jurisdictions first, and then drills down into Michigan's history to date.

Under traditional utility financial regulation, a utility earns more revenue when it sells more electricity, creating a strong disincentive to energy efficiency, notwithstanding policies to promote efficiency. Typically, rate cases seek to determine how much revenue a utility is entitled to recover, and then to set rates at a level that will result in this level of recovery, using an estimate of future sales. If sales are higher than this projection, the utility earns more than its authorized recovery level, and if sales are lower than the projection it can earn less than its fixed costs to operate the system.

"Decoupling" seeks eliminate this so-called "throughput-incentive" by breaking the link between a utility's revenue recovery and the volume of electricity it sells. It does so through periodic true-ups that ensure that the utility earns exactly the amount authorized during the rate case – no more and no less.

At the present, 25 states have adopted decoupling for at least one electric or natural gas utility. In a recent report for the American Council for an Energy-Efficient Economy (ACEEE), the Regulatory Assistance Project, and NRDC, industry expert Pamela Morgan reviewed how many states and utilities had moved to adopt this vital reform over the past decade, how it affected utility rates, and how often regulators combined decoupling with earnings adjustments for the utilities involved (as some have advocated).[1] Based on 1,244 separate rate adjustments produced by all the decoupling mechanisms since 2005, Morgan concluded annual rate changes were "small to miniscule" and did not exceed 2 percent for 85 percent of the electric and 75 percent of the gas rate adjustments, with 38 percent involving refunds to utility customers. Put another way, the typical electric rate adjustment under decoupling averaged about seven cents a day (up or down). For natural gas utilities, it was less than five cents a day.

[1] Morgan, Pamela. ***A Decade of Decoupling for U.S. Energy Utilities, Rate Impacts, Designs and Observations,*** December 2012.

Alternative forms of decoupling and mechanisms to address the throughput incentive have been advanced, but each has serious drawbacks. Specifically:

- Lost revenue adjustment mechanisms: These mechanisms attempt to determine the level of revenues "lost" to the utility as a result of energy efficiency programs, and restore those revenues. However, it does not address the core problem -- higher sales between rate cases will still lead to higher revenues, so the throughput incentive remains. Moreover, lost revenue mechanisms do not require a finding that the revenues were actually lost, and do not symmetrically require the utility to refund "found" revenues that they earn when, for example during a hot summer, sales exceed projections. The upshot is that lost revenues can result in windfall payments to a utility that has already earned more than its revenue requirement as determined through a rate case.
- Higher fixed charges: One form of decoupling simply moves more of the revenue recovery into fixed monthly charges that are not dependent on sales. The problem here is that while you may have partially eliminated the utility's aversion to efficiency programs, you have created a barrier to efficiency for the customer. The higher fixed charges diminish the "price signal" to customers to conserve energy, and increase the payback period for a customer investment in energy efficiency, which makes customer participation in energy efficiency efforts less likely and less beneficial. If the goal is to align utility and customer financial incentives so that both are motivated to save energy, higher fixed charges are counterproductive.

In 2010 and 2011, the Michigan PSC authorized decoupling for both electric IOUs. However, the resulting adjustments never occurred because the Court of Appeals determined that the PSC lacked and needed specific legislative authorization to authorize decoupling. Nonetheless, we do know what the adjustments would have been for each utility. Specifically:

- In 2011, Consumers Energy rate adjustments for each customer class were all less than one one-hundreth of a percent, except one, which was less than one-tenth of a percent.
- By far the largest adjustment came in Detroit Edison's 2011 residential rate adjustment which would have ***reduced*** rates to households by 12 percent to refund over-earnings that resulted from an unusually hot weather and high sales. The commercial and industrial class adjustments would have changed rates by 0.4% and 0.5% respectively.
- In 2012, Detroit Edison made no filing, and the Consumers Energy filing proposed adjustments that would have changed rates by less than one-tenth of one percent for every customer class. (cites)

The adjustments for gas utilities in Michigan have ranged from a downward rate adjustment of 6.6% for MichCon's multifamily customer class in 2011 to an upward adjustment of 3% for Michigan Gas Utilities' s small general service customers in that same year. That said, the majority of the adjustments have been less than 1 percent in either direction.

It is worth noting that, while decoupling is essential for eliminating a utility's throughput incentive, it is not, by itself, sufficient to put energy efficiency on an equal footing with other resource choices. As described in the National Action Plan for Energy Efficiency[2], decoupling must be used in combination with certain recovery of program costs, as well as a mechanism that would allow utilities to earn a return on their investments in energy efficiency.

[2] National Action Plan for Energy Efficiency, November 2009, *Aligning Utility Incentives with Investment in Energy Efficiency*, ES-2.