

Energy Efficiency Question 17: 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?

Executive summary

1. Energy efficiency reduces the sale of utilities’ products, electricity and natural gas. Some form of adjustment mechanism is required to counter this disincentive for utilities to support energy efficiency
 2. Decoupling is one mechanism used to remove this disincentive, by separating the amount of revenue a utility receives from the amount of electricity or natural gas it sells. Decoupling has been described as a “win-win strategy to both utility companies and their customers” in encouraging energy efficiency
 3. However, decoupling is just one possible component of a comprehensive set of policies to support utility-driven energy efficiency. Sound policy needs to remove the disincentive for utilities to support energy efficiency through a combination of program cost recovery, lost margin recovery, and performance incentives
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- 1. Energy efficiency reduces the sale of utilities’ products, electricity and natural gas. Some form of adjustment mechanism is required to counter this disincentive for utilities to support energy efficiency**

When utilities encourage and support customers to reduce electricity and natural gas usage, they are effectively helping customers buy less of their product. Some kind of adjustment mechanism is needed to remove the disincentive that utilities have to reducing sales of their product.

As the Center for Climate and Energy Solutions explains,

“Under the present rate structures in U.S. energy markets, utilities’ revenues depend on the amount of energy they produce and deliver to consumers. This type of system makes utilities averse to conservation and efficiency measures because their implementation ultimately cuts into profits by decreasing sales and therefore revenues.”

[Source: Center for Climate and Energy Solutions, “Decoupling in detail”, <http://www.c2es.org/us-states-regions/policy-maps/decoupling/detail>]

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The National Renewable Energy Laboratory defines decoupling as,

“A rate adjustment mechanism that breaks the link between the amount of energy a utility sells and the revenue it collects to recover the fixed costs of providing service to customers.”

[Source: National Renewable Energy Laboratory, “Decoupling policies: Options to encourage energy efficiency policies for utilities”, 2009]

Decoupling can be used broadly to remove revenue variability due to fluctuations in sales of electricity (influenced by weather, macroeconomic conditions, etc.) or more narrowly to account for only specific, selected impacts (like decreased sales due to energy efficiency measures).

Decoupling can provide many benefits and be a “win-win” solution:

“A well-designed decoupling policy... reduces the costs of the ratemaking process [and] reduces costs to consumers without affecting the profit rate to investors.”

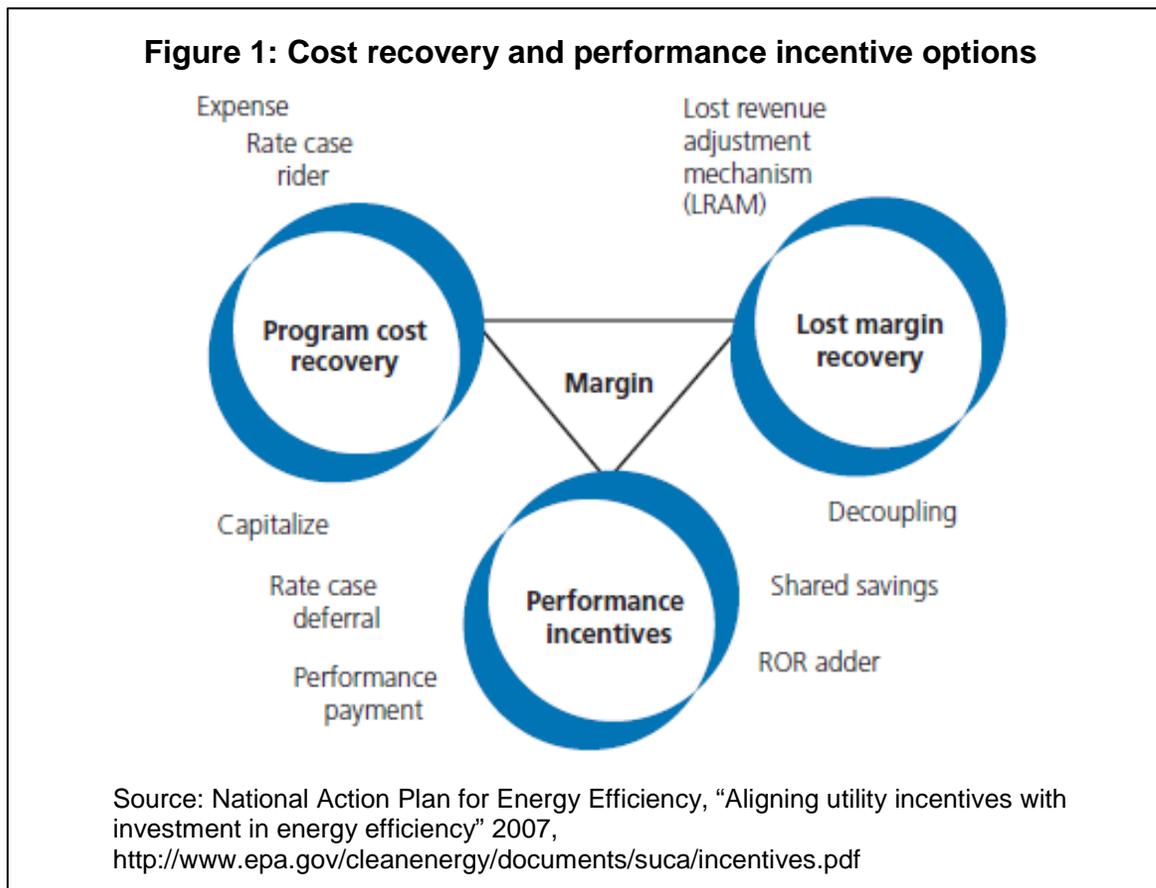
[Source: National Renewable Energy Laboratory, “Decoupling policies: Options to encourage energy efficiency policies for utilities”, 2009]

Decoupling has been on the rise in the United States over the last several years. In 2010, the Michigan Public Service Commission (MPSC) approved an electric decoupling mechanism for DTE Electric and Consumers Energy, but in 2012 the Michigan Court of Appeals disallowed it, saying that the MPSC did not have authority to approve it (although it is still permitted and used for natural gas). The future of decoupling in Michigan is still in question.

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2. **However, decoupling is just one possible component of a comprehensive set of policies to support utility-driven energy efficiency. Sound policy needs to remove the disincentive for utilities to support energy efficiency through a combination of program cost recovery, lost margin recovery, and performance incentives**

Sound energy efficiency policy includes a combination of multiple types of cost recovery and incentives. Figure 1, below, highlights the three key components and some potential mechanisms to incentivize (or remove disincentive for) utility-supported energy efficiency.



“Program cost recovery” refers to reimbursement of the utility’s expenses associated with energy efficiency programs, such as the staff to operate them and the cost of energy-savings products offered to customers. Program cost recovery is what the National Action Plan report calls a “necessary condition” for utility energy efficiency efforts, since the costs of running energy efficiency programs are a direct hit to utilities’ financial performance.

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“Lost margin recovery” refers to compensation for the profit lost as a result of reduced sales of electricity or natural gas. Decoupling is one type of mechanism used to achieve lost margin recovery.

Program cost recovery and lost margin recovery mechanisms are generally described as *removing disincentives* for utility investment in energy efficiency. The third category, “performance incentives,” provides positive incentives for investment, with opportunities for utilities to earn more by achieving or exceeding specified energy efficiency targets. Positive incentives can help ensure that utilities put the same kind of effort and investment into energy efficiency as they do into other aspects of their business where better performance leads to better earnings.

Greater detail about these types of cost recovery and performance incentives, and the mechanisms commonly used to achieve them, is available in the National Action Plan for Energy Efficiency report.

As the report explains,

“The relative importance of each of these [cost recovery and performance incentive options] depends on specific context... Comprehensive policies addressing all three levels of impact generally are considered more effective in spurring utilities to pursue efficiency aggressively. Ultimately, however... the same effect can be achieved in different ways.”

As Michigan policymakers consider refining the state’s energy efficiency policies and goals, they will need to study what combination of program cost recovery, performance incentives, and lost margin recovery will best support the amount and type of energy efficiency they wish to see.