



# UTILITY DECOUPLING: MONTANA UTILITY PROS AND CONS

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# UTILITY DECOUPLING: MONTANA UTILITY PROS AND CONS

In October 2016, the Montana Public Service Commission (PSC) held a roundtable discussion on decoupling in an effort to explore how revenue regulation works, how it differs from traditional rate regulation, options for designing revenue regulation mechanisms, and how revenue regulation works in states that implement it. Senate Joint Resolution No. 31, which passed in the 2017 Legislative Session, directs the committee to further investigate utility decoupling in Montana.

As the next step in the 2017-18 Energy and Telecommunications Interim Committee’s study, members turned to NorthWestern Energy (NWE) and Montana Dakota Utilities (MDU) to gain local utility perspective on the merits and drawbacks of implementing decoupling policy in the state. Both utilities submitted answers to a questionnaire relating to

## INTRODUCTION

Decoupling policy separates a regulated utility’s profits from its total electric or gas sales so a utility is not incentivized to sell more electricity or gas. The implementation of decoupling policy is most often discussed by the commissions that regulate utilities and often in terms of ratemaking. The policy is a mechanism to encourage regulated utilities to support energy efficiency, but it is not a tool for increasing energy efficiency. Instead, it is a ratemaking mechanism that removes what can be seen as a utility’s incentive to discourage energy efficiency.

A utility collects revenues based on a revenue requirement that is typically determined by a regulatory commission and is typically on a per-customer basis. Regulatory commissions set rates every few years that allow a utility to recover costs and to earn a fair return on investment. The actual revenue earned by a utility, however, varies based on how much energy customers use each month, which results in the utility earning either more or less than the established rate. With decoupling, utility revenue is established based on an amount needed to cover established costs. Rates are then allowed to change with consumption to meet the revenue target. To further simplify, under decoupling, a utility’s fixed costs (transmission lines and other infrastructure) are allocated on a per-customer basis for customers. Rates are set by the commission to cover those costs. Then each year, the commission reviews actual costs and the number of customers. Rates are adjusted upward to pay extra costs if the per-customer cost is more than originally estimated. Rates are reduced for the next year if the fixed costs are less than estimated. The utility is then able to recover those costs, regardless of how much electricity or gas a customer uses.

### Merits

“There is an inherent conflict between traditional regulation, and Montana public policy that compels NorthWestern to encourage and support energy conservation, distributed generation by customers, and other measures that consistently reduce customer loads.”

Both NWE and MDU noted several merits to implementing a decoupling policy in Montana. Those included in the companies’ responses include:

- Providing a more stable cost recovery environment for years in which heating or cooling costs are above or below long-term averages;
- The mitigation of financial challenges surrounding the further implementation of distributed generation and conservation programs;
- The opportunity to stabilize non-gas revenues required to recover the cost of natural gas distribution; and
- A possibility for less frequent rate cases to make adjustments for conservation programs or distributed generation.

The utilities each view decoupling policy as a means to remove the “throughput incentive” and further enable each company to embrace conservation programs and distributed generation. In NWE’s response, company experts say decoupling is an essential tool to address, “an inherent conflict between traditional regulation, and Montana public policy that compels NorthWestern to encourage and support energy conservation, distributed generation by customers, and other measures that consistently reduce customer loads.<sup>1</sup>”

## Drawbacks

Both utilities see no significant challenges to implementing decoupling in Montana. MDU currently operates under decoupling policy in jurisdictions outside of its Montana service territory. However, the company notes that public perception could see decoupling policy as an earnings guarantee for the utility and noted that opposition from that perspective could create challenges to implementation.

NWE cited the termination of the Lost Revenue Adjustment Mechanism in 2015 as a financial disincentive to embracing conservation programs. The company views decoupling as a method to remove similar financial disincentives and allow the company to support efficiency programs, conservation, and distributed generation without incurring financial harm.

## Ratemaking impacts

Both utilities anticipate no changes to the basic rate structures or allowed revenue requirements under decoupling. However, MDU anticipates fewer, less controversial rate cases as a result of decoupling.

## Decoupling structures

Both companies support full decoupling policy examples for implementation in the state.

NWE said full decoupling insulates a utility’s revenue collections from deviations of actual sales from expected sales, often caused by increased investment in energy efficiency or weather variations.

Both companies support full decoupling on a revenue-per-customer basis similar to the full decoupling example of Avista Energy in Washington provided during the September 2017 ETIC meeting. Avista Utilities’ natural gas division in Washington implemented an Accrual Revenue Per Customer (RPC) mechanism and provides an example of how decoupling works in the natural gas sector, as well as an example of partial decoupling. To calculate the monthly-allowed delivery revenue per customer (RPC), the WUTC utilizes a seven-step formula.

1. Determine the Total Normalized Revenue - The Total Normalized Revenue is equal to the final approved base rate revenue approved in the Company’s last general rate case.
2. Determine Variable Gas Supply Revenue - The Normalized terms by rate schedule from the last approved general rate case are multiplied by the approved Schedule 150 PGA rates to determine the Variable Gas Supply Revenue.
3. Determine Delivery Revenue – To determine the Delivery Revenue, the mechanism subtracts the Variable Gas Supply Revenue from the Total Normalized Revenue.
4. Remove Basic Charge Revenue – included in the Delivery Revenue is revenue recovered from customers in Basic fixed charges. Because the decoupling mechanism only tracks revenue that varies with customer energy usage, the

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<sup>1</sup> NorthWestern Energy, “2018 Montana Legislative Decoupling Study NorthWestern Energy Response.”

revenue from Fixed Charges is removed. The number of Customer Bills, multiplied by the applicable Fixed Charges determines the total Fixed Charge revenue by rate schedule.

5. Determine Allowed Decoupled Revenue – Allowed Decoupled Revenue is equal to the Delivery Revenue (Step 3) minus the Basic Charge Revenue (Step 4).
6. Determine the Allowed Decoupled Revenue per Customer – To determine the annual per customer Allowed Decoupled Revenue, divide the Allowed Decoupled Revenue by the Rate Year number of Customers to determine the annual Allowed Decoupled Revenue per Customer (by Rate Group).
7. Determine the Monthly Allowed Decoupled Revenue per Customer - to determine the monthly Allowed Decoupled Revenue per customer, the annual Allowed Decoupled Revenue per customer is shaped based on the monthly therm usage from the rate year.

Once monthly allowed delivery revenue per customer is calculated, Avista recognizes actual revenue with authorized revenue on a monthly basis by multiplying the number of customers by the monthly-allowed decoupled revenue per customer, to find the allowed decoupled revenue for that month. The remaining balance of actual decoupling revenue and allowed decoupled revenue is calculated and deferred to a balancing account. Based on the realized surplus or deficit at the end of the process, Avista Utilities files a request annually with the WUTC to either surcharge or rebate, over the following year, the amount accumulated in the balancing accounts. Rate increases are capped at 3 percent annually.<sup>2</sup>

## Policy needs

Both utilities do not anticipate additional policy changes needed to implement decoupling in the state. NWE encouraged the Legislature to set, “proper public policy and enact a law(s) that adequately lays the regulatory foundation for the implementation of fair and equitable decoupling.”<sup>3</sup>

NWE focuses on the following objectives when discussing revenue-based regulation. In the company’s view decoupling policy should:

- Better align and reconcile the current utility business model with existing and emerging public policy objectives;
- Support the ongoing provision of safe, reliable, and affordable utility services;
- Provide revenue certainty for all of our public utility services and rate stability for our customers; and
- Sustain the financial strength of utilities in order to continue to attract and maintain the type of long-term investors needed to support on-going capital-intensive utility service needs.

## Conclusion

Both utilities view decoupling as a policy tool that reduces volatility in utility revenues, eliminates the “throughput incentive” to increase volumetric sales, and provide the potential for less frequent and less contentious rate cases.

MDU notes the potential for customer confusion and added administrative work for utilities.

NWE experts consider the utility’s current business model ineffective in the changing energy market and encouraged implementation of full decoupling.

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<sup>2</sup> Schedule 175, Avista Corporation

<sup>3</sup> NorthWestern Energy, “2018 Montana Legislative Decoupling Study NorthWestern Energy Response.”