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- conducting in-depth technical & policy analyses
- advising policymakers, energy professionals & utilities
- working collaboratively with businesses & other organizations
- organizing conferences
- publishing conference proceedings and reports
- educating consumers & businesses

Collaboration is key to ACEEE's success. We work with organizations around the globe including federal, state, and local government agencies, utilities, research institutions, businesses, and public interest groups. Our focus is on 6 primary program areas:

- Energy Policy
- Economic Analysis
- Buildings, Appliances, & Equipment
- Utilities
- Industry & Agriculture
- Transportation

ACEEE is leading the development of technology and policy solutions that ensure the security of our energy systems. As energy leaders, we promote the vibrancy of the American economy and the sustainability of the environment world-wide.

Utility Initiatives: Alternative Business Models and Incentive Mechanisms

ACEEE RECOMMENDATIONS

Congress should...

- Recommend and encourage decoupling and shareholder incentives as part of a strong federal energy efficiency resource standard (EERS).
- Monitor state performance to follow-up and verify that states are implementing commitments they made on these issues (e.g., in connection with ARRA funding)

THE ISSUE

Under typical regulatory structures, utilities do not have an economic incentive to help their customers be more energy efficient because reducing energy sales reduces utility revenues and earnings (profits). By separating utility revenues from energy sales and providing performance incentives, utilities and their shareholders, as well as utility customers, are more likely to benefit from increased energy efficiency.

SUMMARY

Under traditional rate-of-return regulation, utilities have an economic disincentive to provide programs to help their customers be more energy efficient. Because a utility's earnings are based on the total amount of capital invested and the amount of electricity sold, increased energy sales generally increase utility profits.

Experience suggests that enacting regulatory reforms such as decoupling and performance incentive mechanisms helps overcome those inherent disincentives regarding energy efficiency. Decoupling removes the disincentive of lost sales, while providing performance incentives creates a mechanism by which utilities can actually generate earnings from energy efficiency. Properly designed incentives can spur utilities or other program providers to meet or exceed established goals for their energy efficiency programs. Both of these regulatory mechanisms are valuable strategies, capable of addressing utility financial concerns regarding energy efficiency and helping to align utility financial interests with energy efficiency program objectives.ⁱ

Alternative Business Models

Decoupling creates an alternative business model for utilities by breaking the relationship between energy sales volumes (kilowatt-hours of electricity or therms of natural gas) and revenue, eliminating the disincentive to using energy efficiency programs to help meet customers' energy service requirements. A utility's revenue requirements are set using traditional rate case methods, but without linking profits to sales. Decoupling provides a symmetrical mechanism to adjust revenues to account for electricity and gas sales that are above or below forecasted levels. The profitability of the utility is determined by how well it operates within the revenue requirement, not by how much energy it sells.ⁱⁱ

Incentive Mechanisms

A variety of incentive mechanisms expand upon the traditional regulation model in which investor-owned utilities earn returns on capital invested in generation, transmission, and distribution. The three major types of incentive mechanisms are performance target incentives, shared savings incentives and rate of return adders. With performance targets, a utility earns a financial incentive by exceeding some specified energy savings target, and then receives a defined amount of economic incentive in return. With a shared savings

mechanism, the utility shares the net benefits resulting from successful implementation of energy efficiency programs with ratepayers. The utility typically receives a specified percentage of the net benefits. Under the rate of return adder mechanism, utilities are allowed an increased return on investment for energy efficiency investments or are offered a bonus return on total equity investment for superior energy efficiency performance.ⁱⁱⁱ

FOR MORE INFORMATION:

- The Regulatory Assistance Project (RAP) is a noted authority on decoupling mechanisms. See their website at: www.raonline.org.
- Kushler, M., D. York, and P. Witte. 2006. *Aligning Utility Interests with Energy Efficiency Objectives: A Review of Recent Efforts at Decoupling and Performance Initiatives*. Washington, D.C.: American Council for an Energy-Efficient Economy. www.aceee.org/pubs/u061.htm.

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ⁱ <http://aceee.org/pubs/u061.pdf?CFID=1691700&CFTOKEN=51181430>

ⁱⁱ http://www.raonline.org/Pubs/MN-RAP_Decoupling_Rpt_6-2008.pdf

ⁱⁱⁱ National Action Plan for Energy Efficiency (2007). *Aligning Utility Incentives with Investment in Energy Efficiency*. Prepared by Val R. Jensen, ICF International. <http://www.epa.gov/cleanenergy/documents/incentives.pdf>

