NorthWestern Energy
Delivering a Bright Future

December 29, 2017

Via Email - Trevor.Graff@mt.gov

Trevor Graff
Research Analyst
Montana Legislative Environmental Policy Office
P.O. Box 201704
Helena, MT 59620-1704

RE: Decoupling Study

Dear Trevor:

Attached is NorthWestern Energy's response to your November 16, 2017, email sent to David Hoffman requesting input to the 2018 Montana Legislative Decoupling Study.

As you know, I will be NorthWestern's representative for the Decoupling panel discussion at the January 16, 2018, ETIC meeting.

Thank you for the opportunity for NorthWestern to provide input to the Decoupling Study. If you need additional information or have any questions in advance of the meeting, please contact me.

Sincerely,

/s/ Heather H. Grahame /gv

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Enclosure

2018 Montana Legislative Decoupling Study
Montana Energy and Telecommunications Interim Committee
NorthWestern Energy Response
December 29, 2017

On November 16, 2017, Mr. Trevor Graff, Research Analyst with the Montana Legislative Environmental Policy Office, requested NorthWestern Energy's (NorthWestern) input on a range of Decoupling issues. NorthWestern is pleased to participate in this process. In **Section I** below, we provide a short summary of our position on Decoupling. In **Section II**, we provide background on Decoupling. In **Section III**, we respond to Mr. Graff's questions, and in **Section IV**, we provide a wrap-up of our position.

I. Summary of NorthWestern's Position.

NorthWestern strongly supports implementing Full Decoupling. It reconciles policy goals and Montana law requiring NorthWestern to facilitate energy efficiency programs and savings with the utility's incentive to sell more electricity or gas. Decoupling is the dominant revenue regulation tool being successfully utilized across the country by numerous electric and natural gas utilities for these purposes. Full Decoupling ensures that NorthWestern can continue to provide safe, reliable, and affordable utility services through providing revenue certainty for all of our public utility services and rate stability for our customers. It also helps NorthWestern continue to attract and maintain the type of long-term investors needed to support our on-going capital intensive utility service needs.

II. Background.

"Decoupling" is a tool that is intended to break the link between utility sales volumes and utility revenues.[1] In the United States, some form of Decoupling has been adopted in 30 states, and at least 12 others are considering some form of it.[2]

Under the typical volumetric rate structure used for billing customers in Montana, NorthWestern's electric and natural gas revenues are directly tied to the volume of its

[1] *Revenue Regulation and Decoupling: A Guide to Theory and Application*, at 2 (November 2016).

[2] *Id*. at iv.

retail sales.[3] Most costs of providing electric and natural gas service are largely fixed in nature (physical infrastructure, employees, operating expenses, etc.), but almost all revenues are tied to customer consumption. Therefore, reductions in electric and natural gas consumption by NorthWestern's customers directly reduce the level of revenues that NorthWestern receives. These revenues are needed to both cover the costs of providing service and to produce an appropriate return to the shareholders who fund investments in NorthWestern's electric and natural gas utility businesses. This creates a financial disincentive for NorthWestern to fully support energy efficiency programs, promote customers' own load reductions (e.g. solar panels), invest in electric and natural gas system infrastructure, and offer innovative utility services and rate design. Put another way, NorthWestern has a direct financial incentive to encourage energy consumption – the "throughput" incentive.[4]

A Decoupling mechanism does not change the basic utility rate structures. It removes the disincentives described above by "decoupling" or separating the link between electricity and natural gas consumption and revenue. Under Decoupling, instead of establishing a utility's level of revenues, and therefore utility profits, based on the amount of energy sold, reported revenues are commonly set based on the number of customers served, which is a relatively stable number.

A well designed Decoupling or revenue adjustment mechanism does not shift financial risks from utilities to consumers, but simply changes the variables that determine the level of reported utility revenues necessary to support the utility's financial health and enable the provision of safe, reliable, and affordable electric and natural gas utility

[3] A company that is not price-regulated sets prices to both cover its costs and maximize its profits. A regulated utility, such as NorthWestern, has a very specific and limited opportunity to earn a profit: it is allowed to recover its prudently incurred expenses including depreciation and the cost of debt that funds its capital investments – all without a profit. Its only profit comes through a "rate of return" on the portion of capital investment funded with shareholder equity.

[4] The Montana Public Service Commission ("MPSC") approved a Lost Revenue Adjustment Mechanism ("LRAM") to address under recovery of fixed costs associated with energy savings produced by NorthWestern's energy efficiency programs for its electric utility starting in 2004 and its natural gas utility starting in 2005. Under the LRAM, NorthWestern computed "lost" fixed cost revenues due to its energy efficiency programs and recovered them from customers through its electric and natural gas supply trackers. The MPSC terminated the LRAM effective November 30, 2015. Lost revenues accumulate incrementally year-over-year between general rate cases due to ongoing energy efficiency program activities. As a result, from December 1, 2015 through June 30, 2017, NorthWestern estimates that its energy efficiency program related electric utility lost revenues were $29.1 million. During its operation, the LRAM mitigated the financial disincentive associated specifically with customer actions taken as a result of NorthWestern's energy efficiency programs. Decoupling addresses the financial disincentive associated with promoting the efficient use of energy in addition to utility energy efficiency programs.

service. A simple system of periodic "true-ups" in volumetric base rate revenues either restores to the utility or gives back to customers the revenues that are under- or over-collected as a result of fluctuations in retail electric and natural gas consumption. This corrects for disparities between the utility's actual fixed costs and the level of revenues authorized for recovery by utility regulators to cover those costs.

The Regulatory Assistance Project ("RAP") ® is an independent, non-partisan, non-governmental organization dedicated to accelerating the transition to a clean, reliable, and efficient energy future. Its primary role since its inception in the early 1990s has been educating all comers on the concept of Decoupling. The following are links to several key and helpful RAP publications on the subject of Decoupling:

https://www.raponline.org/wp-content/uploads/2016/05/rap-revenueregulationanddecoupling-2011-04.pdf

http://www.raponline.org/wp-content/uploads/2016/11/rap-sedano-migdenostrander-decoupling-design-customizing-revenue-regulation-state-priorities-2016-november.pdf

Note: Certain points or excerpts from the RAP reports listed above were used throughout this material.

III. NorthWestern's responses to the questions posed by Trevor Graff.

Q. In NWE's perspective what opportunities are provided by implementing Decoupling?

A. NorthWestern's current business model — one based historically on covering investments and expenses necessary to provide service and producing an appropriate return to the shareholders who fund investments by selling more electricity and natural gas — does not work anymore. There is an inherent conflict between (1) traditional regulation, and (2) Montana public policy that compels NorthWestern to encourage and support energy conservation, distributed generation by customers, and other measures that consistently reduce customer loads. While NorthWestern strongly supports public policies that promote energy efficiency, and while NorthWestern has been a leader in energy efficiency programs,[5] the result of this leadership ensures less revenue to cover NorthWestern's costs of providing essential electric and natural gas utility service.

Decoupling is a critical tool necessary to address this problem.

[5] Between July 1, 2011 and June 30, 2017, NorthWestern spent an estimated $54.4 million on energy efficiency, and this does not include Universal Systems Benefits funds.

Q. What are the roadblocks to implementation in your view?

A. The LRAM implemented by the MPSC in 2004 for NorthWestern's electric utility and in 2005 for its natural gas utility addressed the under recovery of fixed cost revenues, i.e. the financial disincentive, associated with NorthWestern's energy efficiency programs. The financial disincentive was restored by the MPSC's termination of the LRAM, effective November 30, 2015. As indicated in footnote 4, NorthWestern estimates that, on the electric side alone, its lost revenue attributable to energy efficiency programs were $29.1 million. As described below, Decoupling removes any disincentive to aggressively pursue energy efficiency programs. A well-designed Decoupling mechanism will enable NorthWestern to strongly support policy and an array of associated initiatives aimed at encouraging the efficient use of energy without incurring financial harm. In addition to utility energy efficiency programs, such initiatives could include, for example, promoting/facilitating customers' own actions to improve efficiency and/or reduce their loads through self-generation, and innovative customer services and rate design. The major roadblock to implementation of Decoupling is the lack of a Montana regulatory setting that would lead to a balanced, fair, and equitable Decoupling mechanism that actually achieves its defined purpose. That is, a well-designed revenue adjustment mechanism that does not shift financial risks from utilities to consumers, but simply changes the variables that establish the utility's required level of revenues needed to ensure the provision of safe, reliable, and affordable electric and natural gas utility service.

Q. What benefits might be realized with Decoupling in Montana?

A. A balanced, fair, and equitable Decoupling Mechanism will not shift financial risks from utilities to consumers. It will promote recovery of the level of utility revenues necessary to support the utility's financial health and enable provision of safe, reliable, and affordable, electric and natural gas utility service. The inherent conflict between traditional regulation and Montana public policy is significantly diminished.

Q. What are anticipated drawbacks?

A. NorthWestern does not anticipate drawbacks to a well-designed Decoupling mechanism (i.e. a balanced fair and equitable mechanism that does not shift financial risks from utilities to consumers).

Q. How would a Decoupling policy impact ratemaking?

A. It does not impact ratemaking. Decoupling does not change the basic rate structure(s) or allowed revenue requirements. The purpose of a Decoupling mechanism is to remove the disincentive described above by "Decoupling" or separating the link between electricity and natural gas consumption and revenue. Under Decoupling, instead of establishing the utility's required level of revenues

based on the amount of energy sold, revenues are commonly set based on the number of customers.

Q. What policy changes would be needed as a result of implementing Decoupling?

A. The Montana Legislature needs to set the proper public policy and enact a law(s) that adequately lays the regulatory foundation for the implementation of fair and equitable Decoupling.

Q. Characterize the impact Decoupling would have on the utility.

A. Decoupling should render a utility indifferent to changes in sales/revenues, regardless of cause. It eliminates the "throughput" incentive. The utility's revenues are no longer a function of sales, and its profits cannot be harmed or enhanced by changes in sales. Profits are impacted primarily by changes in expenditures. Decoupling done right provides revenue certainty and stability in order to ensure the utility can provide safe, reliable, and affordable electric and natural gas utility service for NorthWestern's customers, while providing an opportunity for a reasonable return for NorthWestern's shareholders.

Q. In our last meeting, the committee examined several mechanisms for Decoupling. Is there a specific example that the utility finds favorable to other existing Decoupling mechanisms?

A. There are a number of Decoupling mechanisms described by RAP in its Revenue Regulation and Decoupling publication. NorthWestern prefers the use of a Full Decoupling approach.

Full Decoupling in its essential, most complete form insulates a utility's revenue collections from any deviation of actual sales from expected sales. The cause of the deviation — e.g., increased investment in energy efficiency, weather variations, and/or changes in economic activity — does not matter. Any and all deviations will result in an adjustment ("true-up") of collected utility revenues to the allowed level of Decoupling revenues.

Full Decoupling can be likened to setting a budget. Currently established ratemaking methods are used to determine a utility's revenue requirement using a historic test year — i.e., the total revenues it will need in a period (typically, a year) to provide safe, adequate, and reliable service. As discussed above, Decoupling does not change the method for establishing the revenue requirement.

The most common form of Full Decoupling is revenue-per-customer Decoupling, which NorthWestern also prefers. Allowed per-customer revenues are computed based on the revenue requirement and the test year number of customers. Revenues are then allowed to vary each year between general rate cases based

on the actual number of customers. This is based on the premise that although, in the long run, utility costs are a function of demand for the service they provide, in the short run (i.e., between rate cases) costs vary more because of other factors – primarily changes in the number of customers.

Actual volumetric revenues are tracked on an annual basis, and adjusted to the revenue-per-customer Decoupling level. Annual differences between volumetric revenues and revenue-per-customer revenues are trued-up as a separately tariffed sur-charge if actual revenues are less than allowed Decoupling per-customer revenues, or sur-credit if actual revenues are greater than allowed Decoupling per-customer revenues.

Q. How would Decoupling interact with existing energy efficiency policy and programs?

A. It would support and enhance existing energy efficiency policy and programs. Many utility-sector stakeholders have recognized the conflicts between traditional regulation and contradictory public policy objectives that compel a utility to encourage energy consumption by its customers, and they have long sought ways to properly reconcile the two. Simply put, under traditional regulation, utilities make more money when they sell more energy. This concept is at odds with explicit public policy objectives that utilities and environmental regulators are charged with achieving, including economic efficiency and environmental protection.

Q. In short, list the pros and cons of Decoupling in Montana.

A. A well designed Decoupling mechanism will not shift financial risks for utilities to customers, but will break the link between energy consumption and revenues (i.e. mitigate the throughput incentive), thereby promoting recovery of the level of revenues between general rate cases necessary to support the utility's financial health and enable provision of safe, reliable, and affordable electric and natural gas utility service. This includes enabling NorthWestern's full support of energy efficiency programs, customers' own load reductions (e.g. solar panels), and innovations in services and rate designs without direct financial repercussions. It will diminish the inherent conflict between traditional regulation in Montana and Montana public policy. NorthWestern does not believe there are any cons associated with a balanced, fair, and equitable Decoupling mechanism.

Q. What, if any, additional considerations need to be part of the Decoupling discussion in Montana?

A. These are addressed in responses provided above.

IV. Summary.

NorthWestern's current business model — one in which almost all revenues are tied to customer consumption does not work anymore. Most costs of providing electric and natural gas service are fixed in nature. Reductions in electric and natural gas consumption directly reduce the level of revenues needed to both cover the costs of providing service and produce an appropriate return to the shareholders who fund investments in NorthWestern's electric and natural gas utility businesses.

This creates an inherent conflict between traditional regulation and a Montana public policy that compels NorthWestern to fully encourage and support energy conservation, distributed generation by customers, and other measures that reduce customer loads, thereby automatically ensuring reduced and diminishing revenues to cover its costs of providing essential utility service. Decoupling diminishes this conflict.

NorthWestern focuses on the following objectives when thinking about Revenue-based Regulation. It needs to:

- 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 our utilities in order to continue to attract and maintain the type of long-term investors needed to support our on-going capital intensive utility service needs.

Full Decoupling needs to be implemented. It is the dominant revenue regulation tool being successfully utilized across the country by numerous electric and natural gas utilities in order to promote important policy goals.
