



August 22, 2008

The Honorable Michael W. Sole, Secretary
Florida Department of Environmental Protection
Florida Governor's Action Team on Energy and Climate Change
3900 Commonwealth Blvd., MS49
Tallahassee, Florida 32399

Re: Florida Action Team's Proposed Policy on Decoupling

Dear Secretary Sole,

I write to comment on the letter of August 1 written by Armando Olivera, on behalf of Florida Power and Light Company (FPL), which responded to the Florida Action Team's Proposed Policy on Decoupling (ESD-23). The letter raised several objections to the concept of "decoupling," a simple ratemaking mechanism that prevents unexpected fluctuations in retail energy sales from affecting utilities' ability to recover their authorized fixed costs of serving customers. Identified concerns included burdens to customers, reduced utility incentives to keep costs as low as possible, unresolved market barriers to energy efficiency, and potential reversion "to a regulatory model that employs an ongoing system of frequent, highly administrative rate reviews focused on return on equity, which would detract from the ultimate objective of maximizing energy efficiency results." The letter concluded that "Florida has achieved tremendous results [in energy efficiency] without the need for decoupling (p. 3)."

Let's start with points on which Mr. Olivera and I agree: like FPL, I too "regard energy efficiency as the 'first fuel,'" (p. 2) and I applaud FPL's goal of "proactively seek[ing] to implement all known cost-effective energy efficiency and DSM programs" (p. 3). I also appreciate any efforts that FPL has made historically to help customers manage and reduce their energy needs, although I think we might agree that the current ten-year goal of reducing FPL's future growth in capacity needs by 20 percent (p. 4) does not exhaust all that the company and its customers could achieve. Finally, I agree that decoupling doesn't create any new earnings opportunity for utilities, although I would analogize the creation of such opportunities in the absence of decoupling to trying to drive with one foot on the accelerator and the other on the brake.

I have worked with utilities across North America on energy efficiency programs and I am a

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strong believer in decoupling, although I certainly share Mr. Olivera's view that it does not remove all obstacles to accelerated electricity progress. I am hoping I can persuade Florida and FPL to carefully examine the issue. I do so with some optimism about the result, because Mr. Olivera's objections rest primarily on a misunderstanding of the way decoupling works. This is hardly surprising, since Florida has no experience with the mechanism. I invite further discussion by phone or in person at your convenience.

It is important first to clarify how decoupling works: it can either lower or raise customers' rates, it has no effect whatever on utilities' incentives to control costs, and it does not require "frequent, highly administrative rate reviews focused on the return on equity."

I begin with the financial problem that decoupling aims to solve, which is nowhere disputed in the letter. Electric utilities almost always recover most of their fixed costs through the rates they charge per kilowatt-hour. In other words, a part of the cost of every kWh represents the system's fixed costs of existing plant and equipment, while the rest of the charge per kWh collects the variable cost of producing that kilowatt-hour. After approving a fixed-cost revenue requirement, the Commission sets rates based on assumptions about annual kilowatt-hour sales. If sales lag below those assumptions, the company will not recover its approved fixed-cost revenue requirement. By contrast, if the companies were successful in promoting consumption increases above regulators' expectations, shareholders would earn a windfall in the form of cost recovery that exceeded the approved revenue requirement. And whether consumption ends up above or below regulators' expectations, every reduction in sales from efficiency improvements yields a corresponding reduction in cost recovery, to the detriment of shareholders.

Decoupling mechanisms introduce modest, regular true-ups in rates to ensure that any fixed costs recovered in kilowatt-hour charges are not held hostage to sales volumes. The state regulatory community has more than two decades of experience with such mechanisms, which involve a simple comparison of actual fixed cost revenues to authorized revenues, followed by an equally simple true-up calculation to reconcile the difference. The result is then either refunded to customers or restored to the Company. Note that the true-up can go in either direction, depending on whether actual fixed-cost revenues are above or below the authorized level, and typically these rate impacts are in the range of two percent or less. There are no "highly administrative rate reviews focused on the return on equity," just a regular comparison of actual versus authorized fixed-cost recovery. Regulators have approved various indices to adjust authorized fixed costs between rate cases, reflecting changes in economic conditions and customer growth rates.

Mr. Olivera's letter expresses some worry that decoupling will "subject customers to revenue shortfalls due to weather and other factors" (p. 3). Yet in Florida at least, decoupling would typically moderate the impact on customers of extreme weather in a warming world, by generating refunds when hotter and more humid conditions pushed electricity consumption above expected levels. If for some reason this result seems inappropriate, sales can be

weather-adjusted before decoupling calculations are performed (a common practice in other states). If the concern is potentially inequitable insulation of utilities from economic downturns, decoupling mechanisms can be designed to adjust fixed-cost recoveries between rate cases based on changes in the utility's customer count or an index of economic growth.

Finally, in or out of recessions, decoupling will only raise rates at a time when bills are declining as consumption drops; it is of course utility bills, not rates, that matter to customers. And the best way to protect customers from unaffordable bills is to maximize cost-effective energy efficiency investment, which decoupling promotes and its absence discourages.

Decoupling would not guarantee any particular level of "profit", or in any way insulate FPL against the risk that internal inefficiencies will prevent management from achieving profitability objectives. With or without decoupling, the company keeps any operating savings that it achieves between rate cases and absorbs any cost overruns. If FPL wanted to continue sharing such savings with its customers (p. 4), it could certainly do so.

There really is only one energy efficiency scenario under which decoupling doesn't matter much: where a utility does not expect its efforts materially to affect growth in electricity use. I can't believe that FPL fits that description. As an illustration, I encourage you to investigate the cumulative impact on FPL's finances of five years of electricity savings equal to one percent of systemwide electricity use in each year (which probably doesn't come close to exhausting your and my aspirations). Similar assessments have persuaded many of FPL's utility industry colleagues to support decoupling proposals, including but not limited to Idaho Power Company, Pacific Gas & Electric, Pepco, Portland General Electric, and the Southern California Edison Company. We would welcome a chance to work with you and other interested parties on specific solutions to the objections raised in the letter, and very much hope that you will be willing to make the effort.

Best regards,

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