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### ECONOMIC DEVELOPMENT RATES FOR UTILITIES

By John Wolfram

**E**conomic Development Rates (“EDRs”) are coming back into vogue. EDRs were popular in the electric and gas utility industry in the 1980s, but interest in these tariff structures that provide incentives for business attraction and retention waned during the economic boom of the 1990s. However, the rapid decline and sluggish recovery of the U.S. economy in the last few years have stimulated a renewed interest in EDRs, and they are now experiencing a bit of a renaissance.

The basic idea behind the EDR is that a utility offers a discounted rate in order to induce businesses to locate new facilities or expand existing facilities in the utility service territory. A corollary to the EDR is the Load Retention Rate (“LRR”), which is the same kind of incentive rate aimed at inducing existing customers to avoid plant closure or relocation. (Often, the phrase “Economic Development Rate” is used to collectively refer to discount rates for business attraction, retention, and/or expansion.) These rates can allow a utility to compete more effectively in a business’ site selection process. The EDRs, when deployed as a part of a comprehensive utility economic development strategy, can serve as an effective tool to support the goals of the utility, the customer, and the community at large.

Like many issues for regulated utilities, EDRs are not without their problems. The key question for state regulators is a simple one: if a utility gives a rate discount to a big customer, who pays for it? Do the other utility customers have to pay more, or do the utility shareholders bear those costs? Fortunately, there is a body of regulatory findings that address this point. There are existing laws, regulations, policy statements, and case precedent in many states, along with approved economic development tariffs, upon which utility personnel and state regulators can rely to answer questions about EDRs and how they should function.

#### **Why Offer EDRs?**

Utilities offer EDRs to compete in the business site selection process. This is as simple as it sounds. But why do incentive rate offerings really matter?

Incentive rate offerings are important for two reasons. The first reason is the actual economic advantage that the customer may receive if they ultimately take service from the utility. Incentive rates allow the business to pay less for its energy usage than it otherwise would under the standard tariff offering. If designed and implemented properly, incentive rates also allow the utility to recover its marginal cost of service and perhaps a portion of its fixed costs. This

provides benefits to the new customer, to the utility, and to the other utility customers who would otherwise have to contribute more to cover the utility's fixed costs.

The second but perhaps more important reason is that the mere offering of an incentive rate tariff can favorably impact the vetting of possible locations in the site selection process. The business looking to expand (or their consultant) will start the site search with a large number of potential locations. They will reduce that field by using a checklist of desirable items, one of which is the availability of an incentive rate from the utility. (Other items include power quality measures, outage rates, customer satisfaction ratings, and fuel mix of generating resources.) A given location may last longer in the site selection contest if more items can be checked on the consultants' list. Every item counts, especially in the early stages. Ordinarily the utility incentive rate offering does not ultimately make or break the deal (although it can for certain energy-intensive industries like steel mills), but having an offering in place will keep a utility in the contest until other, more influential factors drive a final decision. Having a well-designed incentive rate offering in place provides this advantage without introducing any disadvantages to the utility.

For many business firms engaged in the site selection process, the initial costs of establishing a new facility are a higher priority for site selection than the on-going operating costs of the facility. Up-front capital cost savings -- including any concessions on costs for high voltage interconnections, redundant feeds, or enhancements for power quality and system protection -- can be especially persuasive. Both EDRs and LRRs ultimately reduce costs for the business, which provides the motivation to take service from the utility.

Many utilities offer an EDR as a Rider to its standard large commercial or industrial tariff. The EDR may provide discounts to the demand charge, the energy rate, the fixed monthly customer charge, or the total customer bill. EDRs may also provide potential new customers with discounts to other standard tariff terms and conditions, including any line extension policies or standby service offerings.

### **Rate Treatment for EDRs**

The central ratemaking issue for EDRs is whether the shareholders or the other ratepayers pay for the discount. In other words, during a rate proceeding, should the utility recover from other customers the difference in revenues between the discount rate and the standard tariff rate? Alternatively, will the regulator require the utility shareholders to absorb the "lost revenues" associated with the rate discount, by requiring that the utility impute revenues associated with the discount in the determination of the revenue requirement?

The answer varies by jurisdiction. Regulators in certain states have required shareholders to absorb the discount from standard tariff rates. Other regulators have authorized a sharing of lost revenues between the utility customers and shareholders. Typically, the argument for sharing says that because serving the customer load offers economic advantages both to utility customers (via a contribution to the utility's fixed costs) and to utility shareholders (via a contribution to utility earnings), the revenue loss stemming from the discount should also be shared. Simply put, if the utility customers are better off with the load than without it, then the shareholders are

similarly better off with the load than without it, and thus should share in the lost revenue burden. In this case, the utility must impute the discount in test period revenues in a rate case when establishing the revenue requirement -- effectively setting rates for other customers as if the incentive rate customer had paid a "full fare" and letting shareholders absorb the difference.

Regulators in other jurisdictions, however, allow utilities to allocate the lost revenues to other rate classes for ratemaking purposes. The basis for doing so is the regulatory compact, which essentially grants utilities the right to earn a reasonable rate of return on investment in return for providing energy services with its service territory. Regulated utilities are entitled to a reasonable opportunity to recover their prudently-incurred costs. This principle was established in the landmark U.S. Supreme Court case, *Federal Power Commission et al v. Hope Natural Gas Co. ("Hope")*, 320 U.S. 591, 603 (1944). Regulated utilities are also entitled to earn a fair and reasonable rate of return on their capital investments. This principle was established in another landmark U.S. Supreme Court case, *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia ("Bluefield")*, 262 U.S. 679 (1923). Hope and Bluefield are cited almost universally by regulated utilities in the U.S. as a basis for setting rates that are fair, just and reasonable. At bottom, the question of whether a utility benefits from serving a particular load does not diminish the right of the utility to recover its prudently-incurred costs from customers and to earn a fair rate of return on its investment.

Continuing this argument, the only instance in which the utility shareholders would legitimately face exposure to lost revenues due to the implementation of a sound incentive rate is between rate cases. If an incentive rate is placed into effect between rate cases, the utility would be responsible for lost margins until the reduced revenues could be incorporated into base rates in the next rate case. This is no different from what would happen if a large customer were to close or curtail its operations; in that case, the fixed costs that were formerly recovered from the departing customer could then be considered for recovery from the remaining customers in the utility's next general rate case proceeding. This is consistent with standard ratemaking principles.

## **Typical Features of EDRs**

Economic Development Rates approved by regulators across the U.S. share several common features. A common set of principles also exists among utilities, consumer advocates, customer stakeholder groups, and state regulators. Many of the items in the list that follows are included in the EDR tariffs, or are otherwise addressed by the regulatory entity in its decisions regarding filed EDRs.

### EDR Tariff Provisions

- 1) The EDR should not harm other customers; customers not on the EDR should be no worse off than they would be if the utility did not offer an EDR. This is referred to as the "No Worse Off" principle. (In many jurisdictions, there is a requirement that the discounted rate must benefit all ratepayers. This goes a little bit further than the No Worse Off principle. There is no industry-wide consensus around this subtle point.)

- 2) The EDR should only apply to customers who demonstrate by sworn affidavit that if not for the rate discount, the customer would be unable to establish, expand, or maintain operations in the utility service territory. This is called the “But For” principle. The burden of demonstrating this point is on the customer, not the utility.
- 3) The EDR should not be used to promote intra-state relocations; it should only be used to attract customers who would otherwise locate out-of-state.
- 4) The EDR should only apply to customers who qualify for and receive a certain amount of local, state, or federal financial assistance for economic development or economic stimulus specific to the expansion/retention load. These requirements offer an independent verification that the customer will be providing an economic improvement to the local community of lasting value. They also shield the utility against claims of discrimination by placing the responsibility for deciding which businesses merit a discounted rate on the economic development officials and not on the utility.
- 5) The EDR should only provide a rate discount for a limited period of time. Typically, the EDR provides a demand rate discount that shrinks over time and is phased out by the end of a set period (e.g. a demand charge discount of 50% that declines by 10% each year so that after five years there is no discount).
- 6) The total amount of EDR discounts available annually from a utility should be capped. This limits the exposure of either the other ratepayers or the shareholders, or both, depending upon on the ratemaking treatment of the discount in that particular jurisdiction.
- 7) The EDR should only apply if a set minimum level of job creation is achieved.
- 8) The EDR should only apply if a set minimum level of new electric demand is achieved.

#### Utility Requirements

- 9) The utility should be required to demonstrate that rate classes that are not party to the transaction should be no worse off than if the transaction had not occurred; in other words the utility must provide some evidence that the “No Worse Off” criteria is met.
- 10) The utility should be required to ensure that the incremental revenues derived from the EDR are not less than its marginal energy costs. Also, the utility may be required to demonstrate that the transaction makes some contribution to fixed costs. Thus the utility that implements an incentive rate will incur lost revenues (i.e. the difference in revenues between the standard rate and the discount rate) but will not incur negative margins by serving the load in question. This is an essential element of an efficient rate design for EDRs.
- 11) The utility should be required to demonstrate the system-wide benefits of the EDR.

- 12) The utility should be required to demonstrate that it has adequate capacity to meet anticipated load growth each year in which the EDR is in effect.
- 13) The utility should be required to ensure that the customer-specific fixed costs associated with the EDR customer, if any, should be recovered either up front or as a part of the minimum bill over the life of the contract with the customer.
- 14) The utility should be required to document and report any increase in employment and capital investment resulting from the EDR on an annual basis.
- 15) The utility offering an EDR should be required to file a tariff stating the terms and conditions of its offering, and should be required to enter into a special contract with each customer. The contract must specify the minimum bill, the estimated annual load, the length of contracting period, and any other unique terms or conditions.

## **Conclusion**

During economic downturns, electric and gas utilities turn to Economic Development Rates as a ratemaking tool to help the utility compete in the site selection contest for attracting, maintaining, and expanding customer load. The EDRs help the utility to attract and retain major customers by providing those customers with a discount from the standard tariff rates.

Typically utilities implement EDR offerings that include some or all of the common features listed herein. Chief among these features are the “No Worse Off” principle for other customers, and the “But For” principle for the customer seeking the benefit of the EDR discount. Other features are designed to ensure that the utility avoids discrimination, limits the duration of the discounts, and generally demonstrates the benefits of the EDR offering. Also, the utility should ensure that the incremental revenues derived from the EDR are not less than the utility's marginal energy costs. This is a critical element of a sound rate design to ensure that the utility will not incur negative margins by serving load under an EDR.

Utility regulators typically support EDRs comprised of these common features. Offering EDR discounts between rate cases can expose utility shareholders to lost revenues, but many utility regulators will allow the utility to recover the discounts from other customers in the next rate case if the incentive rate offering meets most of the aforementioned criteria.

Utilities are revisiting EDRs now for a reason. Properly designed and administered EDRs can boost utility revenues, bolster public relations, promote job creation, and enhance the welfare of the community at large. Utilities should thoroughly investigate and pursue the implementation of EDRs, as an element of a comprehensive economic development strategy, in order to advance these goals – especially in times when vigorous economic development is most urgently needed.

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