

# Economic Development Rates: Public Service or Piracy?

By John Wolfram

Economic Development Rates (“EDRs”), which provide electric rate incentives to large commercial and industrial customers to promote business attraction, expansion and retention, are experiencing a bit of a renaissance in North America. But do these rate structures provide a public service or constitute institutionalized piracy?

According to recent reports, economic development and site selection consultants believe the U.S. economy is already on a continuous growth track, which is reflected in the new facility and expansion plans of their clients.<sup>1</sup> Many utilities believe that if they adopt a creative economic development strategy, they can accelerate the success of such growth through regional attraction, retention, and expansion efforts. Such growth results in direct, indirect, and induced economic benefits for the region. Utilities have long relied upon EDRs as essential components of a comprehensive economic development strategy.

A general set of principles for the evaluation of EDRs has emerged from the broad body of regulatory deliberation spanning several decades. EDR tariff offerings may also be generally referred to as “discount rates” or “incentive rates.” Properly designed and administered, discount rates can lead customers to make business decisions that are both financially attractive and economically efficient, providing advantages to the affected customer and other customers on the system.

## EDRs Defined

Generally, EDRs act as a vehicle for the utility to provide an economic incentive to large commercial or industrial customers to locate or maintain a facility within the utility’s service territory. The incentive is ordinarily provided in the form of a discount from the utility’s standard tariff rates, terms or conditions.

Specifically, EDRs are rate structures aimed at persuading a customer to take or continue taking service from the utility when the customer is prepared to locate elsewhere or relocate for economic reasons. This applies both to customers considering relocation to another utility service territory and to those contemplating plant closure; the politics around each differ but the economics are largely the same. A rate discount lowers the operating costs of the business, which in theory should improve the customer’s bottom line and thus help the utility to retain the load.

In the current economic climate, many utilities are focusing their attention on load retention and expansion more than attraction, in part because new projects are few and far between, but more so because almost all utilities have major commercial/industrial customers that provide a sizable revenue stream -- one that warrants additional protection in uncertain times.

## Regulatory Criteria for EDRs

When a utility is considering an incentive rate offering, several factors warrant consideration. The following inquiries address the key regulatory criteria that are pertinent to an efficient and effective rate design:

- Is the discount rate *necessary*?
- Is the discount rate *sufficient*?
- Does the discount rate *exceed the marginal cost* of providing service?
- Does the discount rate *benefit all ratepayers*?

*The discount must be necessary to secure the load.* The question is, absent a discount, will the customer locate somewhere else or otherwise leave the system? In order to verify that this requirement is met for existing customers, many utilities and/or regulators require a sworn affidavit from the customer confirming that absent the rate discount, the customer load would leave the system. Alternatively, further evidence that demonstrates the need for a rate discount may also be considered, including documented customer communications with neighboring utilities, financial and accounting reports of the customer demonstrating financial distress, requests for proposals, or forecasts showing the extent of the customer’s financial risk on a prospective basis. It is also important to note that compliance with this criterion must be demonstrated by the customer, not by the utility; only the customer is properly positioned to

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See footnotes at end of text.

provide adequate evidence that a potential discount is necessary for the customer to remain on the system.

*The discount must be sufficient to secure the load.* The rate discount must be set so that the rate benefit to the customer is enough to offset any economic incentive for the customer to close its operations or to be served by another utility. A corollary to this requirement is that the discount be minimized; in other words, the discount must not be any larger than required to achieve the objective. Any discount beyond the minimum necessary to secure the load is a superfluous subsidy. Thus the discount must be sufficient -- but not *more* than sufficient. This can be a difficult criterion to meet because it is not formulaic and requires a subjective assessment. Regulators have recognized a balance between the need to offer a discount to retain the load and not offering a discount that is larger than necessary to prevent the loss of a major utility customer and regional employer.

*The discounted rate must exceed the marginal cost of providing service.* This is so because it is not efficient to charge less than marginal cost for marginal usage. Thus the utility that implements an incentive rate should incur lost revenues (i.e., the difference in revenues between the standard rate and the discounted rate) but should not incur negative margins by serving the load in question. This is an essential element of an efficient rate design.

*The discounted rate must benefit all ratepayers.* In many jurisdictions, there is a requirement that the discounted rate must benefit all ratepayers. There is no industry-wide consensus around this criterion. Some regulators require only that other rate classes are *made no worse off* by the offering of an incentive rate. Often, the requirement for “benefits” is interpreted to mean that the discounted rate should provide some contribution toward the utility’s fixed costs -- an amount less than the contribution to fixed costs that is embedded in the standard tariff, but greater than zero. In this way, the other ratepayers benefit because this recovery of some utility fixed costs would not occur if the load were not served by the utility. Thus the discounted rate benefits other ratepayers by reducing the contributions required from them over time to cover the utility’s fixed costs.

#### **Other Regulatory Considerations**

Incentive rates can benefit customers in a number of ways. Retention of a major customer through an incentive rate can keep a significant industry in the region, with direct, indirect, and induced economic effects that benefit the entire region. By retaining the load, the utility’s costs are higher, but the revenues from the retained customer more than cover the added costs. As a result, the utility earnings are higher than they would otherwise have been (although not as high as if the customer were on the system under full standard rates).

An important feature of an EDR tariff is whether the tariff sufficiently protects against free riders. A free rider is a customer who receives the benefit of a rate discount but for whom the discount is not necessary. A generally available incentive rate, by itself, does not sufficiently protect against free riders. However, an EDR built into a *special contract*, subject to approval by the regulator, is a standard approach for protecting against free riders. This allows for the individual consideration of each application of an incentive rate, and permits an individual customer demonstration of the requirements outlined above (i.e., that the discounted rate is necessary, is sufficient, exceeds marginal costs, and benefits all ratepayers).

Some utilities design discount rates such that the incentive declines over time and is phased out by the end of a set period (e.g., a discount of 50% that declines by 10% each year so that after five years there is no discount). This design is more common for attraction than it is for expansion and retention rate offerings.

Finally, when the utility regulator evaluates the overall appropriateness of a load retention rate, it is not merely proper but imperative for the regulator to consider the effects of the potential loss of a significant business in the community. The possible impacts of the decision regarding a load retention rate have a legitimate and serious relevance to the public interest, so the regulator should give due consideration not only to ratemaking practice and precedent but also to the specific circumstances of the case. Many factors warrant review, including whether the customer is a major employer in the area, whether the business creates related employment and business opportunities for supporting industries in the region, whether the loss of the business leaves a void that cannot otherwise be filled, whether the business supports the community at large in other beneficial ways, and any other circumstances or facts unique to the particular proposal before the regulator. As long as the regulator evaluates the discount rate first by applying the proper criteria outlined in the framework provided here, all of these other factors should be given the appropriate weight by the regulator in its deliberations on the matter at large.

### **Ratemaking Considerations**

The central ratemaking issue for approved load retention rates is whether 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, for an investor-owned utility, 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. Some regulators 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 in North America are entitled to a reasonable opportunity to recover their prudently-incurred costs,<sup>2</sup> and are also entitled to earn a fair and reasonable rate of return on their capital investments.<sup>3</sup> These are considered fundamental principles of utility regulation. 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 an 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 prudently-incurred fixed costs that were formerly recovered from the departing customer could then be recovered from the remaining customers in the utility’s next general rate case proceeding. This is consistent with standard ratemaking principles.

### **Conclusion**

Utilities turn to EDRs as a ratemaking tool to help the utility participate more effectively 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.

Utility regulators typically expect EDRs to be necessary, to be sufficient, to exceed marginal costs, and to benefit all utility customers. Offering such 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 the aforementioned four 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, without creating subsidization of large customers by other customer classes. Utilities will continue to thoroughly 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.

### **Footnotes**

<sup>1</sup> Area Development Magazine, 11th Annual Consultants Survey: Consultants’ Exhibit Confidence and Increasing Project Activity, Special Presentation (Q1 2015), at [www.areadevelopment.com](http://www.areadevelopment.com)

<sup>2</sup> Federal Power Commission et al v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

<sup>3</sup> Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

**For Further Reading**

\* James C. Bonbright, Albert Danielson, and David Kamerschen, *Principles of Public Utility Rates* (Arlington, VA: Public Utilities Reports, Inc., 1988)

\* Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (Cambridge, MA: MIT Press, 1988).

\* Jonathan A. Lesser and Leonardo R. Giacchino, *Fundamentals of Energy Regulation, 2<sup>nd</sup> Edition* (Arlington, VA: Public Utilities Reports, Inc., 2013).

\* Charles E. Phillips, *The Regulation of Public Utilities: Theory and Practice, 2<sup>nd</sup> Edition* (Arlington, VA: Public Utilities Reports, Inc., 1988).

\* Charles J. Cicchetti, et al, *The Marginal Cost and Pricing of Electricity: An Applied Approach* (Cambridge, MA: Ballinger Publishing Co., 1977).

\* Woolf, Tim and Michals, Julie, "Flexible Pricing and PBR: Making Rate Discounts Fair for Core Customers," *Public Utilities Fortnightly*, July 1996.



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