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The electric utilities in New York, Michigan, and Pennsylvania rely almost entirely on coal and oil to fuel their generators. Fuel supplies are obtained from a variety of sources at varying prices, but the majority of the utilities contract with more tha one supplier because they believe that multiple supply sources are necessary to ensure supply reliability. There appears to be an increased interest by State utility commissions in more closely monitoring utility fuel costs. Although utility officials cite the need for reliable supplies and high quality of product as reasons why they prefer to negotiate fuel procurements, the effects of negotiated procurements compared with sealed-bid competitive purchases could not be determined. Utility rate structures have traditionally favored large industrial consumers, with commercial and residential customers paying higher rates. Since most small businesses fall into the commercial rate category, the burden of increased rates falls heavily on them. Studies of business relocations show that electric costs do not appear to be a major factor in the initial decision to relocate. However, once the decision has been made, electric rates and the availability of utility service can play a role in selecting a new site. (RRS)

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STATEMENT OF
J. DEXTER PEACH, DEPUTY DIRECTOR
ENERGY AND MINERALS DIVISION
BEFORE THE
SUBCOMMITTEES ON MINORITY ENTERPRISES
AND GENERAL OVERSIGHT; AND ENERGY,
ENVIRONMENT, SAFETY, AND RESEARCH
OF THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman:

We appreciate your invitation to discuss some of the issues related to our review of energy costs and their potential impact on small business relocations in the States of New York, Michigan, and Pennsylvania. You asked that we address issues related to electric utility fuel procurement practices and the structure of electric rates and determine how they could affect energy costs.

FUEL PROCUREMENT PRACTICES

The electric utilities in the three states covered by our review relied almost entirely on coal and oil to fuel their generators. Fuel supplies were obtained from a variety of sources at varying prices. None of the three State Public Utility Commissions require that utilities use advertised solicitations with sealed bids for fuel purchases, although a few utilities do use this procurement method. Most of the utilities buy their fuel under negotiated contracts. Under this method, the utilities solicit bid responses from a number of selected suppliers. After the bids are received, they are evaluated for price, quality of product, vendor reliability, and transportation costs. Further price negotiations may follow with one or more of the bidders before a final decision is made.

The majority of the utilities contract with more than one supplier because they believe that multiple supply sources are necessary to ensure supply reliability. Long-term contract supplies may also be supplemented with short-term spot purchases when they can be made at favorable prices.

There appears to be an increased interest by State utility commissions in more closely monitoring utility fuel cost. In the past, such costs have been considered only when a utility submitted a rate increase filing with the State Commission. While this is still the practice with the Michigan and New York Commissions, a Michigan Commission staff study of utilities' procurement practices found that improved audits and additional management incentives were needed to keep fuel costs down.

The Pennsylvania Commission issued regulations in March 1977 concerning fuel procurements. The regulations are designed to prevent utilities from passing excessive fuel costs on to consumers. The three utilities covered in our review were either recently audited by the Commission or are currently undergoing a procurement review. Final reports on these audits have yet to be issued.

The Commission audits uncovered some excessive costs for coal that the Pennsylvania Power and Light Company was passing on to its consumers. These excessive costs were for coal from "captive" mines which were affiliated with the utility. This type of affiliation is not uncommon in the utility industry and has been encouraged by the Pennsylvania Commission for its jurisdictional utilities. In 1976 Pennsylvania Power and Light purchased about 43 percent of its coal supply from five affiliated mining companies. Because of high unit development and operating costs and low production, coal from one of the mines had a cost of almost $60 per ton which was included in the utility's fuel charges to consumers. This compares to $22 per ton for coal purchased from nonaffiliated companies. Following the audit disclosure, the state commission and the utility reached an agreement whereby the utility would absorb part of the excess development and operating costs. This arrangement still resulted in captive coal costs averaging $8 per ton higher than coal purchased from nonaffiliated sources.

We could not accurately assess the effects of negotiated fuel procurements compared to sealed-bid competitive purchases because most procurements are negotiated. Utility officials cited the need for reliable supplies and high quality of product as reasons why the negotiated method is preferred. It is possible, however, for utilities to include delivery and quality specifications in competitive bid solicitations.

UTILITY RATES AND THEIR EFFECT ON CONSUMERS

Utility rate structures have traditionally favored large industrial consumers of electricity with commercial and residential customers paying higher rates. Since most small businesses fall into the commercial rate category, the burden of increased rates falls heavily on them.

Utility companies justify the higher rates to small businesses by claiming that it costs more to service this class of customer. Most business establishments do not use enough electricity to take advantage of declining block rates--rates which decline per unit of electricity as usage increases. However, they are large enough to warrant the utility assessing a fixed-cost demand charge for reserving part of its generating capacity to meet the peak needs of the user. This fixed monthly demand charge is in addition to the charge for each kilowatt hour of electricity used. Because business establishments usually are unable to spread this fixed cost over a large number of kilowatt hours in comparison to industrial firms, their per unit cost of electricity is even higher in comparison.

Utility companies claim that their rate structures are based on the cost of providing service to the various classes of customers served. State commissions usually approve the rates based on this cost of service concept, plus an allowed rate of return on the utilities investment. New York and Pennsylvania commissions permit utilities to charge all customers the same rate of return. The Michigan commission, however, allows utilitities to assess a higher rate of return on their commercial customers. This further increases the electric costs for many small businesses in Michigan.

In order to reduce the cost of generating power, changes in current rate structures are being made or are being considered by utilities and state commissions. One of the most common provisions is to vary the unit cost of electricity according to the time of day it is used. The highest cost is charged for power used during daytime peaks. This method is intended to better balance the generating requirements of the utility by increasing nighttime usage, and thus make greater use of base-load generators which have the lowest operating costs. Since most small businesses operate during normal daytime business hours when rates would generally be the highest, many establishments will either have to change their hours or methods of operation or face higher electric charges.

Electric rates vary widely from one region of the country to another with the highest rates in the northeastern states. Consolidated Edison of New York has the highest rates. the country. Philadelphia Electric ranks third in a field of 50 utility companies from across the country. Industrial rates at both Consolidated Edison and the Long Island Lighting Company were consistently above cost averages for other utility companies when compared at both the regional and national levels.

<u>THE IMPACT OF ENERGY COSTS ON SMALL BUSINESS RELOCATIONS</u>

Although it is well known that there has been considerable movement of business establishments from the large urban areas, complete data showing the extent and cause of these movements was not always available. While much attention has focused on business relocations from the north to the sunbelt area, we were told by utility companies and economic development officials that movements within metropolitan areas are a far more frequent occurrence. Regardless of where the move was made, studies made of business relocations and the contacts we made during our review show that electric costs do not appear to be a major factor in the initial decision to relocate.

Electric costs are obviously more significant to energy-intensive businesses, but even here other factors may take precedence in decisions to move. An electroplating company in New York City remains there because of its market, although it pays very high electric rates. An industry representative said that the high relocation costs would probably prevent most firms from moving. In contrast, a representative of the plastic molders industry said movements to the suburbs are encouraged because of the lower electric costs there.

In general, we found that factors such as better land sites, high taxes, deteriorating neighborhoods, security problems, and labor costs assume primary importance in making the initial decision to move. However, once the decision has been made electric rates and availability of utility service can play a role in selecting a new site.

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That concludes my prepared statement, Mr. Chairman. We will be happy to answer any questions you may have.