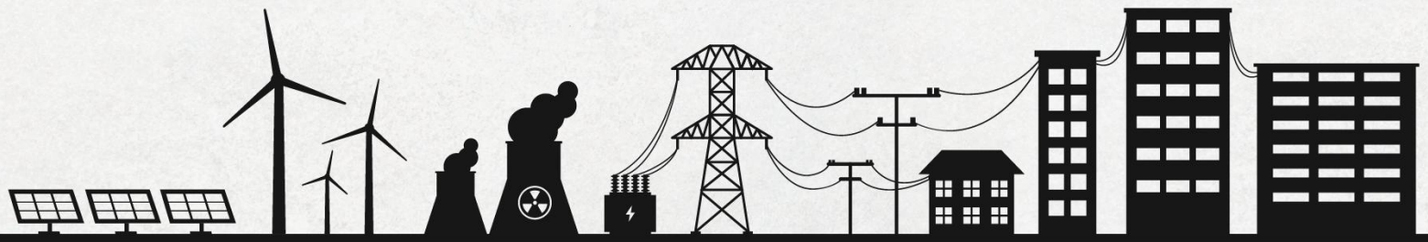
Understanding Electricity Rates

Electricity rates (prices) are not set like the prices for most other goods and services. Electricity rates are set by state or local utility regulators based on utility costs (the *revenue requirement*) and sales, as discussed below.

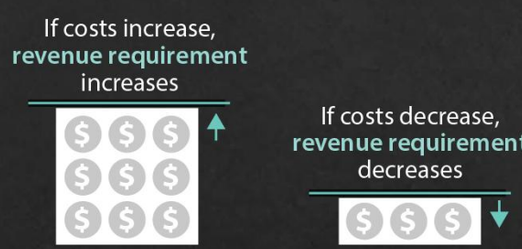


What is the revenue requirement?

The revenue requirement is determined by the utility regulator and mainly reflects the costs to build, operate, and maintain equipment for generating electricity (e.g., power plants, fuels) and delivering electricity (e.g., power lines, transformers).

Additionally, the revenue requirement might include costs for implementing state energy policies, taxes paid by the utility, and a reasonable return on the utility's capital investment (i.e., profit), as determined by the utility regulator.

Revenue requirements change over time. For example, if a utility needs to replace or expand its grid, the revenue requirement goes up. If fuel costs go down, the revenue requirement goes down.



Costs to build infrastructure (including return on investment)
+
Costs to operate and maintain infrastructure
+
Taxes
+
Costs to implement policies
+
Other costs (as determined by utility regulator)

Revenue Requirement

How are most rates set?

The utility regulator projects the utility's sales for the next few years and sets a **rate** equal to the **revenue requirement** divided by estimated **sales**. If sales are different than expected, the regulator might direct the utility to change the rate (up or down) so that the utility's actual revenue closely matches its revenue requirement.

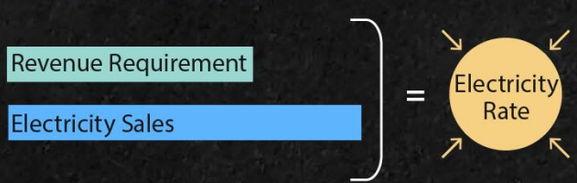
$$\frac{\text{Revenue Requirement}}{\text{Sales}} = \text{Rate}$$

Not all of a utility's customers pay the same electricity rate. Rates for different types of customers (*customer classes*) reflect their differing contributions to the utility's revenue requirement. Generally, large customers that may be densely located (e.g., industrial customers) pay a lower rate than small customers that may be less densely located (e.g., residential customers). Utility regulators typically follow several common principles in setting rates, including fairly allocating customers' contributions to the revenue requirement, avoiding overly complex administrative procedures, and keeping rates relatively stable and simple to understand.

Utility regulators may use variations on the process described above to incentivize certain customer behaviors or utility performance.

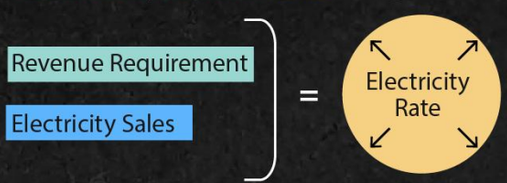


When **sales** are high relative to the **revenue requirement**, **rates** are low.





When **sales** are low relative to the **revenue requirement**, **rates** are high.



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