

# Use Great Caution in Design of Residential Demand Charges

*Jim Lazar*

For decades, electricity prices for larger commercial and industrial customers have included demand charges, which recover a portion of the revenue requirement based on the customer's highest usage during the month. Data being collected through smart meters allows utilities to consider expanding the use of demand charges to residential consumers.

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Great caution should be applied when considering the use of demand charges, particularly for smaller commercial and residential users. Severe cost shifting may occur. Time-varying energy charges result in more equitable cost allocation, reduce bill volatility, and improve customer understanding. The caution applied should address the following key issues in most demand-charge rate designs:

- *Diversity*: Different customers use capacity at different times of the day, and these customers should share the cost of this capacity.
- *Impact on Low-Use Customers*: Most demand-charge rate designs have the effect of increasing bills to low-use customers,

including the vast majority of low-income customers.

- *Multifamily Dwellings*: The utility never serves individual customer demands in apartment buildings, only the combined demand of many customers at the transformer bank.
- *Time Variation*: If demand charges are not focused on the key peak hours of system usage, they send the wrong price signal to customers.

In the recent Regulatory Assistance Project (RAP) publication *Smart Rate Design for a Smart Future*,<sup>1</sup> we looked at many attributes of rate design for residential and small commercial consumers. We identified three key principles for rate design:

- A customer should be able to connect to the grid for no more than the cost of connecting to the grid.
- Customers should pay for power supply and grid services based on how much these customers use and when they use it.
- Customers supplying power to the grid should receive full and fair compensation—no more and no less.

Applying these principles results in an illustrative rate design that constructively applies costing principles in a manner that consumers can understand and respond to. **Exhibit 1** shows the illustrative rate design, including a customer charge for customer-specific billing costs and a demand charge for customer-specific transformer capacity costs. The exhibit also includes a time-varying energy price to recover distribution

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**Exhibit 1. Illustrative Rate Design**

| Illustrative Residential Rate Design |   |                   |
|--------------------------------------|---|-------------------|
| Rate Element                         | Based On the Cost Of                                | Illustrative Rate |
| Customer Charge                      | Service Drop, Billing, and Collection Only          | \$4.00/month      |
| Transformer Charge                   | Final Line Transformer                              | \$1/kVA/month     |
| Off-Peak Energy                      | Baseload Resources + Transmission and Distribution  | \$0.07/kWh        |
| Mid-Peak Energy                      | Baseload + Intermediate Resources + T&D             | \$0.09/kWh        |
| On-Peak Energy                       | Baseload, Intermediate, and Peaking Resources + T&D | \$0.14/kWh        |
| Critical Peak Energy (or PTR)        | Demand Response Resources                           | \$0.74/kWh        |

Source: Lazar, J., & Gonzalez, W. (2015). *Smart rate design for a smart future*. Montpelier, VT: Regulatory Assistance Project. Retrieved from <http://raponline.org/document/download/id/7680>.

system capacity costs and power supply costs designed to align prices with long-run marginal costs.

Customers can and will respond to rate design. We need to make sure that their actions actually serve to maximize their value and minimize long-run electric system costs. The illustrative rate is clearly directed toward these ends.

**DEMAND CHARGES HAVE ALWAYS BEEN ONLY AN APPROXIMATION**

Demand charges are imposed based on a customer’s demand for electricity, typically measured by the highest one-hour (or 15-minute) usage during a month. Demand charges are sometimes coupled with a “ratchet” provision

that charges the customer on the basis of the highest measured demand over the previous 12-month period or other multi-billing-period span of time.

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**Exhibit 2** is a typical medium commercial rate design. It includes a demand component.

Utilities often justified demand charges on the basis of two arguments. First, they were

**Exhibit 2. Illustrative Demand Charge Rate**

**Basic Tariff For Large Commercial Customer**

| Rate Element              | Price   |
|---------------------------|---------|
| Customer Charge \$/month  | \$20.00 |
| Demand Charge \$/kW/month | \$10.00 |
| Energy Charge \$/kWh      | \$0.08  |

**Key Terms for Demand Charges**

**CP:** coincident peak demand: the customer’s usage at the time of the system peak demand.

**NCP:** non-coincident peak demand: the customer’s highest usage during the month, whenever it occurs.

**Diversity:** the difference between the sum of customer NCP and the system CP demands.

asserted as a “fairness” rate that assured that all customers paid some share of the utilities’ system capacity costs. Second, especially when coupled with ratchets, they had the effect of stabilizing revenues.

Residential consumers have much more diversity in their usage, with individual customer maximum demands seldom coinciding with the system peak.

But demand charges are a shortcut, measuring each customer’s individual highest usage during a month, regardless of whether the usage was coincident with the system peak. The customer’s individual peak was used as a proxy for that customer’s contribution to system capacity costs. Demand charges were implemented in this way even though customers’ individual demands did not coincide with the peak system demand, or more accurately, with the coincident peak for the individual components of the system involved, each of which may have peaks different from the system peak. This was always a “second-best” approach. It is roughly accurate for large

commercial customers, because their highest usage *usually* (but not always) coincided with the system peak.

Residential consumers have much more diversity in their usage, with individual customer maximum demands seldom coinciding with the system peak. The rough accuracy that exists for using non-coincident peak (NCP) demand charges for large commercial customers is woefully inaccurate for residential consumers. But coincident-peak (CP) demand charges have other shortcomings, leaving some customers with more than their share of costs and others with none at all, as shown in **Exhibit 3**.

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**Exhibit 3. Garfield and Lovejoy Criteria and Alternative Rate Forms**

| Garfield and Lovejoy Criteria   | CP Demand Charge | NCP Demand Charge | TOU Energy Charge |
|---|------------------|-------------------|-------------------|
| All customers should contribute to the recovery of capacity costs.  | N                | Y                 | Y                 |
| The longer the period of time that customers pre-empt the use of capacity, the more they should pay for the use of that capacity. | N                | N                 | Y                 |
| Any service making exclusive use of capacity should be assigned 100% of the relevant cost.  | Y                | N                 | Y                 |
| The allocation of capacity costs should change gradually with changes in the pattern of usage.                                    | N                | N                 | Y                 |
| Allocation of costs to one class should not be affected by how remaining costs are allocated to other classes.                    | N                | N                 | Y                 |
| More demand costs should be allocated to usage on-peak than off-peak.   | Y                | N                 | Y                 |
| Interruptible service should be allocated less capacity costs, but still contribute something.                                    | Y                | N                 | Y                 |

of usage. This more precise usage data makes demand charges a largely antiquated approach for all customer classes—and particularly inappropriate for residential consumers.

### **DIVERSE USER PATTERNS VARY GREATLY**

Residential customers use system capacity at different times of the day and year. Some people are early-risers, and others stay up late at night. Some shower in the morning, and some in the evening. Some have electric heat, and others have air conditioning.

This variability results in great diversity in usage. It is important to anticipate and recognize this diversity in choosing the method for recovery of system capacity costs. Demand charges are not very useful for this purpose.

A half-century ago, Garfield and Lovejoy discussed how system capacity costs should be reflected in rates.<sup>2</sup> Their observations, summarized in Exhibit 3, are as relevant today as when they were published. We compare the performance of three rate-design approaches to these criteria.

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Following this guidance, capacity costs need to be recovered in every hour, with a concentration of these charges in system peak hours. The illustrative rate design in Exhibit 1 does this effectively. The typical commercial rate design in Exhibit 2, loading system capacity costs to an NCP demand charge, does not, because it recognizes only one hour of customer-specific demand.

Churches and stadiums illustrate this problem with demand charges. Churches have peak demands on days of worship—most often Wednesday nights and Sunday mornings, and stadium lights are used only a few hours per month, in the evening hours in the fall and winter. None of this usage is during typical peak periods.

Applying demand charges to recover system capacity costs based on non-coincident peak demand to churches and stadiums has long been recognized as inappropriate. Such charges have the effect of imposing system capacity costs on customers whose usage patterns contribute little, if anything, to the capacity design criteria of an electric utility system at the same rate as customers using that capacity during peak periods. The same problem applies for residential consumers.

On a typical distribution system, multiple residential consumers share a line transformer, and hundreds or thousands share a distribution feeder. The individual non-coincident demands of individual customers are not a basis for the sizing of the distribution feeder; only the combined demands influence this cost. Even at the transformer level, some level of diversity is assumed in determining whether to install a 25-kilovolt-amp or 50-kilovolt-amp transformer to serve a localized group of perhaps a dozen customers.

Demand charges applied on NCP ignore this diversity, charging a customer using power for one off-peak hour per month the same as another customer using power continuously for every hour of the month.

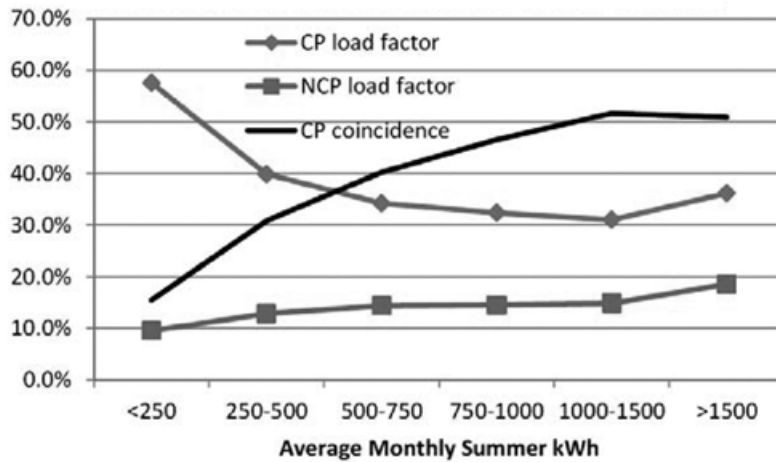
Demand charges applied on NCP ignore this diversity, charging a customer using power for one off-peak hour per month the same as another customer using power continuously for every hour of the month. Some customers (think of a doughnut shop and nightclub) use capacity only in the morning or evening, and can share capacity, while others (think of a 24-hour mini-mart) use capacity continuously and preempt this capacity from use by others. Modern rate design needs to distinguish between different characteristics in the usage of capacity and ensure all customers make an appropriate contribution to system capacity costs.

Time-varying rates do this very well, while simple CP and NCP demand charges do not.

### **IMPACT ON LOW-USE CUSTOMERS**

Individual residences have very low individual customer load factors but quite average collective usage patterns.

**Exhibit 4. Load Factors**



Source: Marcus, B. (2015, June). Presentation at Western Conference of Public Service Commissioners, Phoenix, AZ.

**Exhibit 4** shows data from Southern California Edison Company. As is evident, while the individual customer load factors of small-use residential customers are only about 10 percent, their group coincident peak load factor is more like 60 percent, quite close to an overall system load factor. A demand charge based on NCP demand greatly overcharges these customers. Meanwhile, the high-use residential customers, who have more peak-oriented loads, would be undercharged with a simple NCP demand charge based on overall residential usage.

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Rate analysts have examined the impact of demand-charge rate designs on residential customers. The evidence is that the effect is to shift costs to smaller-use customers, with about 70 percent of small-use residential customers experiencing bill increases, and about 70 percent of large-use residential customers experiencing bill decreases, even before any shifting of load.<sup>3</sup>

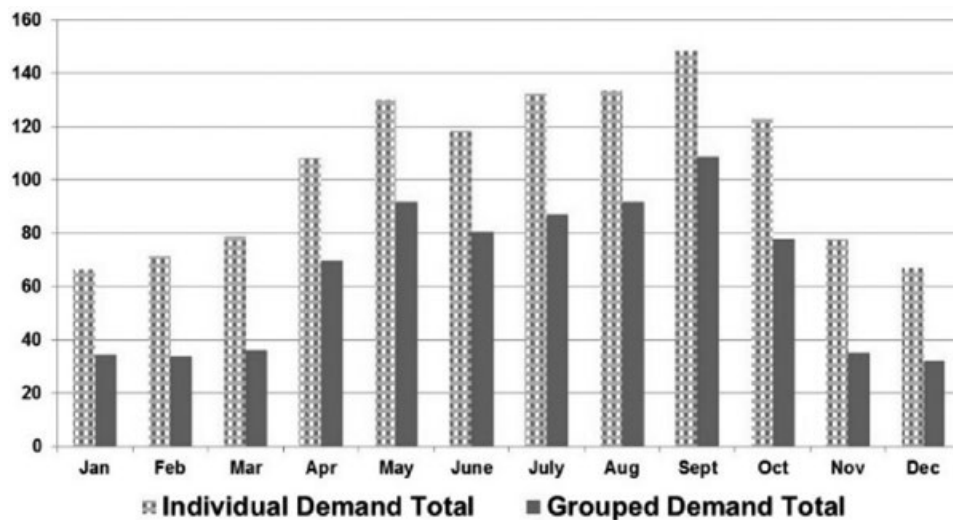
#### APARTMENT DIVERSITY

About 30 percent of American households live in some sort of multifamily dwelling. Apartments generally have the lowest cost of service of any residential customer group, because the utility provides service to many customers at a single point of delivery through a transformer bank sized to their combined loads. Because the sum of individual customer NCP demand greatly exceeds the combined group demand the utility serves, and by a greater margin than for other customer subclasses, NCP demand charges shift costs inappropriately to these multifamily customers.

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Low-income consumers are more likely to reside in apartments, and nationally, low-income household usage is about 70 percent of average household usage.<sup>4</sup> Therefore, imposing NCP demand charges on residential consumers, without separate treatment of apartments, would have a serious adverse impact on these customers, many of whom are

**Exhibit 5.** Individual and Group Peaks for a 26-Unit Apartment Building



Source: Author, from data supplied by Los Angeles-area municipal utility.

low-income households and often strain to pay their electric bills.

**Exhibit 5** shows the sum of individual customer monthly non-coincident peaks for a 26-unit apartment complex in the Los Angeles area, and the monthly group peaks of these customers actually seen by the utility at the transformer bank serving the complex. The exhibit shows that billing customers on the basis of non-coincident peak demand would dramatically overstate the group responsibility for system capacity costs.

### TIME-VARYING COST RECOVERY

As expressed by Garfield and Lovejoy, the optimal way to recover system capacity costs is through a time-varying rate design. This can be as simple as a higher charge for usage during on-peak hours than off-peak hours, or it can be a fully dynamic hourly time-varying energy rate. What is clear is that a single demand charge, applied to a single one-hour NCP or CP measure of demand, is unfair to those customers whose usage patterns allow the shared use of system capacity.

Some utilities have implemented time-varying demand charges. California investor-

owned utilities impose NCP demand charges for distribution costs, and CP demand charges for generation and transmission capacity on larger commercial consumers. More recently, some utilities have imposed demand charges on smaller customers based on summer on-peak-hour demands only. All of these reflect gradual movement toward equitable recovery of system capacity costs, but full time-of-use (TOU) energy pricing is more effective, more cost-based, more equitable, and more understandable.

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Today, with interval data from smart meters, we can easily collect data on the actual usage during each hour of the month. Usage during peak periods can be assigned the costs of peaking power supply resources and seldom-used distribution system capacity costs installed for peak hours. Usage during other hours can be assigned the cost of baseload resources and the basic distribution infrastructure needed to deliver that power.

The pricing can be as granular as the analyst chooses and the regulator approves—but a key element of rate design is simplicity. For that reason, most analysts shy away from rate design with more than three time periods and a few rate elements.

The illustrative rate design in Exhibit 1 shows a three-period TOU plus critical peak price for both power supply and distribution capacity cost recovery, a customer charge for billing costs, and a demand charge to recover the cost of the final line transformer. It may be as complex a rate design as most residential consumers will reliably understand.

### TRANSITIONING TO A TOU RATE DESIGN

Many customer groups are apprehensive about time-varying utility rates, because some consumers will receive higher bills and may not be able easily to change their usage patterns. This same concern would apply to implementation of a demand-charge rate design, but because that produces a less desirable result, we do not consider it a meaningful option. There are the following tools that can be used for a transition:

- *Shadow billing*: Provide consumers with *both* the current rate design and the proposed TOU rate design calculated on the bill prior to rollout.
- *Load control*: Prior to implementing a TOU rate, assist customers to install controls on their major appliances to ensure against inadvertent usage during on-peak periods.
- *Customer-selected TOU periods*: The Salt River Project in Arizona has had excellent success allowing customers to choose a three-hour “on-peak” period out of a four-hour system peak period.<sup>5</sup>

### COMMON ERRORS IN DEMAND-CHARGE DESIGN

Common errors include the following:

- *Upstream Distribution Costs*: Any capacity costs upstream of the point of customer connection can be accurately assigned to usage and recovered in time-varying prices.
- *Using NCP Demand*: NCP demand is not relevant to any system design or investment


criteria above the final line transformer, and only there if the transformer serves just a single customer.

- *Accounting for Diversity*: Diversity is greatest among small-use customers and needs to be fully accounted for.
- *Apartments*: Apartments have the lowest cost of service of any residential customer group, the highest diversity, and suffer the most when a single rate design is applied to all residential customers.

### GUIDANCE FOR COST-BASED DEMAND CHARGES

The following guidelines can be used:

- Limit any demand charges to customer-specific capacity.
- Fully recognize customer load diversity in rate design.
- Demand charges upstream of the customer connection, if any, should apply only to the customer’s contribution to system coincident peak demand.
- Compute any demand charges on a multi-hour basis to avoid bill volatility.

Modern metering and data systems make it possible to increase greatly the accuracy, and therefore the fairness, of cost allocation among a diverse customer base. Legacy concepts, such as demand charges, especially those based on NCP demand, prevent the implementation of these improvements and should be eliminated. Time-varying cost assignment is preferred, so that these new technologies can deliver their full value to customers and utilities alike. 

### NOTES

1. Lazar, J., & Gonzalez, W. (2015). *Smart rate design for a smart future*. Montpelier, VT: Regulatory Assistance Project. Retrieved from <http://raponline.org/document/download/id/7680>.
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