DETERMINING THE COST-EFFECTIVENESS OF
UTILITY LATE PAYMENT CHARGES

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Utilities often seek to impose a late payment charge on those households who do not pay by a designated due date.\(^1\) The imposition of such a charge is generally designed to serve either of two purposes: (1) to compensate the utility for expenses incurred as a result of the late payment; or (2) to provide an incentive for households to make timely payments.\(^2\) Unfortunately, not only do utility late payment charges often bear little relation to these two stated purposes, but, in overcharging in cases of delinquent payments, utilities often create other adverse impacts.

The purpose of this memo is to examine the elements which go into a determination of whether a late payment charge is justified. The memo is divided into three parts. **Part I** defines the differing types of late payers. **Part II** looks at the late payment charge designed to compensate the utility for the expenses associated with delinquencies. **Part III** examines the rationality of a late payment charge designed to serve as an inducement for prompt payment. Before looking at the specific late payment charges, however, it is necessary to delineate the type of customers which are likely to be involved.

I. DEFINING THE LATE PAYER: WHY PEOPLE DON'T PAY ON TIME.

To prevent discrimination in the collection of late payment charges,\(^3\) a utility must recognize the differences which exist between habitual nonpayers.\(^4\) Nonpayers can be categorized into three primary groups. Households who do not pay because they cannot pay represent the first group. These households are typified by extremely low-incomes and high bills as a percentage of their income.\(^5\) These households simply have insufficient funds to pay their bills. The 1989 NCLC study *The Forgotten Crisis*, for example, found that in 10 of the 16 states which collect and report income on LIHEAP recipients, after paying their winter home

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\(^1\) The name given to these charges does not change their nature. They may be called late payment charges, forfeited discounts, a "net" bill versus a "gross" bill, a penalty and the like. Moreover, there is no conceptual difference between the promise of a lower bill for prompt payment and the threat of a higher bill for late payment.

\(^2\) But see, section II.C, page 8, infra.


\(^5\) One study in Philadelphia found that while customers below 150 percent of poverty, who heat with natural gas, spent 13.6 percent of their income on their gas bill, customers at or above 150 percent of poverty, who heat with natural gas, spent 3.1 percent. Direct Testimony and Exhibits of Eunice Grier, *In Re. Philadelphia Gas Works*, presented on behalf of the Public Advocate (June 1989). According to the Energy Information Administration of the U.S. Department of Energy, nationwide, while all households heating with natural gas spent on average six (6) percent of their income on their gas bills, households with income less than $5,000 spent 25 percent and households with income of $5,000 - $10,000 spent 13 percent. Similarly, DOE reported, households at or below 100 percent of poverty, who heat with natural gas, spent 19 percent of their income on their gas bill, while households at or below 125 percent of poverty spent 16 percent. U.S. Department of Energy, Energy Information Administration, *Residential Energy Consumption Survey: Consumers and Expenditures, April 1984 through March 1985*, Part I: National Date (1987).
heating bills, these recipients had less than $75 per week left for all other household expenses, including housing, food, transportation, medical care, clothing and telephone service.\textsuperscript{66} To put this figure in perspective, national figures indicate that, on average, low-income households spend $67 per week on food alone, $60 per week on housing alone (excluding energy) and $39 per week on transportation.\textsuperscript{77}

Households who experience an ongoing mismatch between their utility cycle billing date and their receipt of public assistance comprise a second group of habitual late payers. A household in this group might, for example, receive a utility bill due on the 15th of each month but not receive its Social Security check until the 20th. In such instances, while all monthly payments are likely made, they are routinely made after the due date. The potential for this class to be sizeable is great. Households who depend on public benefit programs such as SSI, AFDC, Social Security and the like not only have no control over the date on which they receive their income. Moreover, they do not have sufficient funds on a month-to-month basis to be able to set aside some amount for a contingent future liability such as a utility bill in the next month. These households live check-to-check.

Households who use late payment as a money management technique comprise the third and final group of chronic late payers. In these cases, so long as the return on the funds not paid to the utility exceeds any resulting late payment charge, the customer will financially benefit from delaying payment as long as possible. These households are not likely to be low-income households. Households making this type of sophisticated financial calculation are not likely to include those households lacking in education.\textsuperscript{88}

Each of these different classes creates different issues for assessing the efficacy and reasonableness of a late payment charge. Accordingly, the implications of each will be assessed throughout the discussion below.

II. THE LATE PAYMENT CHARGE AS COMPENSATION FOR EXPENSES.

The primary purpose of a utility late payment charge is to compensate the utility for expenses associated with delinquent payments. A customer's delinquent payment of her utility bill can result in two types of expenses to the company. The utility may first experience out-of-pocket expenses. A second expense involves the carrying charge associated with delinquent payments. A utility is entitled to compensation for each.

A. COMPENSATION FOR OUT-OF-POCKET EXPENSES.

Late payments by utility customers can create out-of-pocket expenses for the utility. These

\textsuperscript{66} National Consumer Law Center, \textit{Energy and the Poor: The Forgotten Crisis} (May 1989).

\textsuperscript{77} Id.

\textsuperscript{88} Compare, National Assessment of Educational Achievement, \textit{Mathematics Report No. 04-MA-02} (1975).
expenses might include, for example, the postage associated with delivering reminder notices or shutoff notices, the costs of telephone calls to make "personal contact" prior to a shutoff, and the cost of fuel used in making a premise visit to disconnect service. In seeking compensation for out-of-pocket expenses, it is as important to determine how to collect these expenses as it is to determine when to collect them.

1. The Level of the Late Payment Charge.

A late payment charge designed to compensate a utility for out-of-pocket collection expenses should be based on the decremental cost of collection to the utility. In this fashion, the utility will be compensated for those costs, but only for those costs, that are incurred as a result of the late payment. A decremental cost is the cost that the utility would save should one late payment instead be made in a timely fashion.

Historically, most late payment charges have been based on a fully-embedded cost analysis. This type of analysis posits that if, for example, a utility staffmember spends 1/4 hour on a delinquent account, and the utility staff salary is $4 per hour, the delinquent account has "cost" the utility $1. The embedded cost analysis, in other words, assigns an expense to the collection function and per se ascribes the cause of that expense to the collection activity.

A decremental cost analysis approaches the issue in a somewhat different manner. The decremental analysis first calculates total utility costs with the late payment. The analysis next calculates total utility costs without the late payment. Only the difference is then assigned to the late payment charge. In this case, if the utility uses existing staff for collection, a not uncommon occurrence, the late payment imposes no decremental cost on the utility.\(^9\) Paying the staff salary in this instance is not caused by the need to engage in collection activity. As a result, the late payment charge should include only the truly decremental expenses: items such as postage, envelopes and the like.\(^10\)

Even within a decremental cost analysis, limits need be placed on the level of late payment fees. Most importantly, given the fixed dollar nature of out-of-pocket expenses, late payment charges tied to a percentage of the bill are inappropriate. A collection expense does not vary as a function of the size of the customer's arrears. A disconnect notice, for example, would cost $0.32 whether the arrears underlying the disconnection are $50 or $500. So, too, do other out-of-pocket expenses -- for example, the cost of sending a person to disconnect service -- not vary as function of the size of the bills. Accordingly, late payment charges that are based on a percentage of the outstanding bill (e.g., 1.5% of the monthly arrears) cannot be justified on the basis of providing compensation for out-of-pocket

\(^9\) If, in contrast, the utility contracts its collection activity to an external agency, there may well be a decremental cost.

\(^10\) In no instance, should the late payment charge include allocated overhead, such as management salary or building and grounds. The late payment does not in any fashion "cause" those expenses.
expenses.\footnote{11} For very small arrears, such a charge is probably inadequate to cover such expenses; for very large arrears, such a charge is likely to be overly compensatory.

2. Inappropriate Situations for Levying Late Payment Fees.

An analysis of late payment fees does not turn solely on what the level of the charge should be. Circumstances exist when late payment fees are inappropriate, regardless of their size. These times generally involve when the late payment fee is designed to compensate for out-of-pocket expenses that have not arisen.

a. Beginning the collection process: Given the fact that late payment charges are intended only to compensate for out-of-pocket expenses, the imposition of such a charge must be triggered by some event that also triggers the incurrence of the expenses. This principle is often violated by utilities which prematurely levy late payment charges. In these circumstances, the utility might set a past due date of the 15th of the month, with a late payment charge levied for all payments made after that date. If, however, no utility collection activity occurs until a bill is 10-days overdue (i.e., the 25th), households making payments during that 10-day interim are paying compensation for collection expenses that were never incurred.

This last realization --that payments must be overdue by some time before the utility begins its collection process and thus before the utility begins to incur expenses --is particularly important to ensure that households who pay late, but who do not have collection activities directed against them, are not discriminated against. Discrimination would exist if a customer is charged for a cost she did not cause the utility to incur.\footnote{12} Discrimination would exist if a late payment fee is imposed on the day after the due date, failing to recognize that collection activity is not initiated until some later date.

b. Suspending the collection process: Late payment charges are often inappropriate for low-income customers because of the special credit and collection protections established by state Public Utility Commission (PUC) regulations. Under many PUC rules, utilities are prohibited from seeking to collect a bill through the disconnect process in a variety of circumstances.\footnote{13}

\begin{itemize}
  \item Most states now have special winter protections. Whether it be a strict "winter moratorium" or protections tied specifically to cold temperatures,\footnote{14} the utility is prohibited from disconnecting service
\end{itemize}

\footnote{11}{A percentage charge, however, may have another basis, such as compensating the utility for the carrying costs associated with late payment. To identify the purpose of the late payment charge with precision is thus important.}

\footnote{12}{See, notes \textit{Error! Bookmark not defined.} - \textit{Error! Bookmark not defined.}, supra, and accompanying text.}

\footnote{13}{In many instances, the protections are not simply for the poor.}

\footnote{14}{Some PUC rules, for example, prohibit the disconnection of service when the temperature falls below 32 degrees.}
during designated times. Under a strict moratorium, the prohibition lasts through the designated cold weather months (often November through March).

- Many states prescribe a minimum arrears, under which the utility may not disconnect service. In Vermont, for example, a utility may not disconnect for arrears less than $50. Moreover, even absent regulatory directive, some utilities have adopted similar limits as a matter of internal policy.\textsuperscript{15}

- Many states require utilities to suspend collection activities when a household presents a "medical certificate" indicating that the disconnection of service would present a particular health problem. Frequently, these health problems are tied simply to the presence of the very old or the very young in a household.

In these instances of special protections against collection activity, it would be inappropriate to collect a late charge. Given the fact that a late charge is designed to compensate the utility for out-of-pocket collection expenses, and given the fact that the PUC regulations result in the suspension of collection activities, to charge a late fee would be to compensate the utility for expenses never incurred.

At the least, in states where utilities operate under a winter moratorium or other similar winter protections, late charges should be suspended or reduced on a seasonal basis. Moreover, late charges should be suspended for any arrears made subject to a payment plan. Finally, late charges should only apply to arrears greater than a minimum amount. That amount should be set equal to the level at which the utility begins to collect through the disconnect process.\textsuperscript{16}

c. \textbf{Imprudence of the collection process:} The collection of a late payment charge designed to compensate the utility for out-of-pocket collection expenses should be limited, as well, by the prudence of the utility in incurring the expenses. If the utility's collection expense is imprudent, the company should not be permitted to pass on that expense through late charges. A collection expense might fail the test of prudence if it is known to be unnecessary, excessive or counterproductive.

A collection cost is unnecessary if the utility has a reasonable belief that the arrears will be paid even without the collection activities. This situation would arise, for example, if the delinquent payer is routinely late because of a mismatch between the date of receiving the bill and the date of receiving some type of public assistance. In these circumstances, the

\textsuperscript{15} For example, Union Heat, Light and Power Company (UHLP), in Kentucky, will not disconnect service for less than $50.

\textsuperscript{16} In circumstances where this amount is not set by state regulation, this amount may vary from utility to utility.
late payment is due to a recurring, but nonetheless temporary, lack of cash flow. If the utility has a history of receiving prompt customer payment when household funds do indeed become available, to initiate the collection process each month serves no function. If a customer can demonstrate that habitual late payment is due to this timing mismatch between receipt of a bill and receipt of public assistance, the utility should not be permitted to impose a late charge to gain compensation for incurring unnecessary collection expenses.

A utility's collection expense is excessive in those instances where the utility spends more on the process of collection than the outstanding arrears. Unfortunately, this happens in many cases. For example, a 1989 study found that for Vermont's four largest utilities, the expense of disconnection exceeded the level of outstanding arrears subject to collection in 40 to 60 percent of the cases of disconnection. A utility is not entitled to charge its customers for excessive or unreasonable expenses. This dictate should hold true for late payment fees as well as for other rates and charges.

A utility's collection expense is counterproductive when it is further from full payment after the collection process than before it. Particularly in situations involving low-income households, this will often be the case. In these situations, even when the collection process obtains some payment toward the arrears, and assuming that the full cost of collection can be charged to the delinquent payer through a late fee, if the nonpayer is incapable of paying her bill in full, the utility ends up worse off having undertaken the collection efforts than having not. Why this happens is set forth in Illustration A.

As discussed in detail above, one distinguishing factor of a low-income household is the fact of the limited corpus available to pay month-to-month utility bills. In the Illustration, the hypothetical low-income household has an arrears at the time of disconnection of $75; the late payment fee is $20. After the process of disconnection, therefore, the total bill owed by the customer is $95 ($75 arrears plus $20 late fee). The household is assumed to be capable of making only a partial payment. In the Illustration, the hypothetical customer makes a payment of $55, leaving a total arrears of $40 after the utility's collection efforts.

ILLUSTRATION A
THE IMPACT OF LATE PAYMENT CHARGES FOR LOW-INCOME PAYMENTS

\[17\] Vermont Gas=42.4%; Central Vermont Public Service=47.2%; Green Mountain Power=58.5%; and Citizens Utilities=44.3%.

\[18\] See, note Error! Bookmark not defined., supra, and accompanying text.
Customer arrears at time of disconnect: $ 75
Late payment charge: $ 20
Customer bill in total after disconnect: $ 95
Customer payment: $ 55
Customer arrears after payment: $ 40

As can be seen, directing collection efforts at this household, and charging a late fee to get paid for such efforts, does not serve the best interests of all customers. In this Illustration, everyone loses. The customer is worse off. She started by owing $75 and now owes $40, despite having exhausted her ability to make payments to the utility. The utility, too, is worse off. It started with the customer $75 in debt and willing and able to make a $55 payment that would have left a $20 arrears. Instead it has a customer $40 in arrears (with no further ability to make payments).

The conclusion that imposing a late fee can be a losing proposition does not depend for its efficacy on an assumption of nonpayment or partial payment. Even in those instances where the customer makes full payment of the outstanding arrears, the utility cannot be found ipso facto to have benefitted from the late payment charge. So long as the late paying household has a limited corpus, if some part of the household's ability-to-pay is diverted to paying late payment charges, there is that much less left to pay current bills.

The impact of charging a late fee was studied in some detail for Columbia Gas Company of Pennsylvania. The conclusion was that:

the imposition of late payment charges would only serve to push households further into debt, thus diverting scarce household resources away from current payments to these extrinsic payments. Accordingly, it would not redound to the benefit of all remaining households. One cannot simply add new charges on to a household that has an inability to pay current bills with the expectation that these new charges will be paid in full.

The Columbia Gas study looked at a sample of 3,907 households who had entered into the Company's Budget Plus payment plan. Under a Budget Plus plan, the household declares its available monthly income. Columbia Gas then divides the outstanding arrears by the available income. The resulting figure is the length of the payment plan in months. Thus, if

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a household has an available monthly income of $30 and an arrears of $600, the Budget Plus plan would call for the household to retire its arrears over a 20-month payment plan ($600 divided by $30 per month equals 20 months). In addition, the household must pay its current bill (as spread equally over a 12 month "budget plan"). There is a minimum five dollar ($5) payment toward arrears (i.e., the "Plus" payment), even if the household has a "negative ability to pay," i.e., its monthly expenses exceed its monthly income.

To study the impact of a proposed late fee, the Budget Plus monthly payment was assumed to accurately reflect the limit of the participating customer's ability to pay. The late payment charge was set at the Columbia Gas weighted cost of capital (12 percent).\(^\text{20}\) For the 3,907 customers in the Columbia Gas sample, this late payment charge would have added up to more than $200 per year to the cost of the arrears subject to the payment plan.

The study concluded, however, that it was not the dollar amount that was so important. Rather, the impact of the late payment charge was the strain that the added late payment charge would add to the Budget Plus plan. A late payment charge for Columbia Gas would have added the equivalent of up to more than 20 additional payments per year to the Budget Plus plan.\(^\text{21}\) Those equivalent additional payments would be above and beyond the level of payment which had already been determined to be the limit of the participating customer's ability to pay. According to the study:

\[
\text{The fallacy in any belief that a late payment charge will accomplish any constructive task is seen with a sub-sample of the 3,907 Budget Plus plans studied. A late payment charge would add a monthly cost of $5 or more to 751 households who are charged the minimum $5 "Plus" amount because they already have an acknowledged negative ability to pay. (emphasis added). A utility should not be permitted to engage in a collection process that was counterproductive. A process is counterproductive if it leaves the company farther from collecting the outstanding arrears after the collection process than before it. In sum, a utility should not be permitted to collect a late charge if the underlying process of collection was unnecessary, imprudent or counter-productive. If the collection process is such that it performs no function, or actually results in leaving the utility worse off than had it not been performed, the expenses associated with the process should not be charged to ratepayers in any fashion, including through late payment charges.}
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3. The Disconnection of Service as a Deterrent.

\(^\text{20}\) This proposal was also opposed on the grounds that a percentage of the bill bears no reasonable relationship to the out-of-pocket expenses associated with late payment. See, page 3, supra.

\(^\text{21}\) Thus, if a household was required under Budget Plus to make twelve monthly payments of $10, to add a late payment charge would instead require that household to make the equivalent of 32 monthly payments of $10 each year, or almost three times the amount determined to be affordable.
Even in those instances where a utility incurs expenses in the disconnection process, when the disconnection of service has a purpose beyond the mere collection of the outstanding arrears from an individual household, the cost of the disconnection should not be borne entirely by the household having arrears. Under cost-of-service ratemaking principles, a utility should charge the cost of an expense to those customers causing the expense. If the cause cannot be isolated to the particular household having the arrears, therefore, the cost of disconnection should not be charged solely to that household.

Some utilities engage in the disconnection of service to serve as a deterrent to other ratepayers as much as to serve as a means to collect the particular arrears in question. If customers in general recognize that nonpayment will place their continuing service in jeopardy, utilities reason, they will engage in prompt payment practices. Under these circumstances, the "cause" of the utility disconnection is not the arrears of the particular household subject to collection but rather the desire of the utility to create a deterrent for all other households.

Where deterrence of nonpayment is a purpose of the disconnection of service to individual households, the cost of the disconnection should not be included in a late fee charged to the household, but rather should be included as a general administrative expense in base rates charged to all customers. The "cause" of the disconnection must be measured by the purpose which it serves. If the purpose goes beyond the mere collection of the arrears, the customers causing the need for the utility to pursue that greater purpose must bear the cost of the collection activity.

B. COMPENSATION FOR CARRYING COSTS.

Some utilities justify late payment charges as a means to gain compensation for the carrying costs of late payments rather than simply for the out-of-pocket expenses.\textsuperscript{22} Carrying charges associated with late payment will show up in a utility's working capital requirement. If, in other words, the utility immediately needs the revenue that has been billed but not collected, it will need to borrow short-term debt to acquire that revenue. The carrying cost of that debt will appear as a cost-of-capital requirement for the company. Three issues exist with gaining compensation for this working capital expense. First, the utility should not gain double compensation for the expense. Second, the utility should not gain compensation for a non-existent carrying charge expense. Finally, the utility should not gain over-compensation for the carrying charge expense. Each of these issues is examined below.

\textsuperscript{22} Those utilities who charge a late fee to gain compensation for the carrying costs associated with late payment should also be required to pay interest on prepayments by customers for avoided working capital expense. Prepayments might arise, for example, by receiving LIHEAP benefits that will apply to future bills, by prepayment of winter bills through level billing plans (or "budget" billing plans) and the like. If customers must pay for being late, equity would call for them being paid when they are early.

\textsuperscript{23} In this instance, consistent with the principle of not tracing particular sources of capital to a particular project, the carrying charge should be set equal to the utility's weighted cost of capital.
1. Preventing Double Compensation.

Even when a utility is conceptually justified in charging a late fee to cover the carrying costs associated with delinquent payments, regulators should ensure that the company is not double-compensated for those costs. Double compensation would occur if the utility were to collect the carrying costs first through its working capital adjustment and then again through a late payment charge.

A utility's working capital requirement takes into consideration the elapsed time between when a utility incurs an expense in providing service and the time that the utility is able to recover that expense through receipt of billed revenue.\(^{24}\) Examples of expenses which contribute to working capital requirements include payments for fuel, insurance and the like.

The key element in calculating a working capital adjustment involves the lag days between the date of the expense and the date of payment. Thus if a utility buys fuel to use on January 1st (paying for the fuel at the time of purchase), renders a bill to the customer on January 20th, and receives payment on the due date of February 1st, there is a 31 day “lag.” If the customer is ten days late --not making her payment until February 10th-- there is a 41 day lag.

As can be seen, to the extent that the utility includes the lag days associated with late payment in its calculation of working capital, it has received compensation for the carrying costs associated with arrears. If the utility includes the lag days associated with delinquent payments in its working capital, therefore, it is not justified in again collecting carrying charges associated with those lag days through a late payment fee.

2. Identifying Non-existent Carrying Charge Expenses.

Just as a utility is not justified in collecting double compensation for carrying charges, neither is it justified in collecting for non-existent carrying charges. A utility's working capital requirement must be examined to determine whether the utility incurs an expense associated with carrying late payments. In the event that the utility does not have a working capital requirement --a not uncommon occurrence for natural gas utilities-- the utility has sufficient internal funds to avoid the need to obtain additional capital to meet short-term requirements.

In addition to looking at natural gas companies in particular, utilities that are "cash rich" should be carefully examined to determine whether they have ongoing working capital

\(^{24}\) The lag days, of course, must be set-off by expenses that involve lead days. These expenses are collected before they must be paid. Property and sales taxes involve typical expenses creating lead days.
requirements that are exacerbated by late payments. Given today's relative freedom from making large capital investments, many utilities have substantial sums of cash on hand. If working capital is financed through internally generated funds rather than through an explicit addition to rate base, there is no cause for a late payment fee to compensate the utility for "carrying costs."

3. Identifying Expenses Not Associated with Carrying Charges.

Where a utility experiences a carrying charge expense, and seeks to recover that expense through a late payment charge, care must be taken in determining the level of the charge. The purpose of the late payment charge is to compensate the utility for the carrying cost expense, but only for the carrying cost expense, of carrying the bill for some time past its "due date." No other cost component is appropriate for inclusion in a late payment charge in this sense.

Given the limited function of a late payment charge --to compensate the utility for the carrying costs of delinquent payments-- it is important to recognize that a late payment fee is not the equivalent of interest charged in consumer credit transactions. As a result, to borrow interest rates from the consumer credit industry will inappropriately result in late payment charges that include cost components other than the carrying costs of the debt.

This inquiry into the cost components of various interest rates is nearly identical to judicial inquiries into what interest rates can appropriately serve as the discount factor in Chapter 11 "cramdown" cases. One uniting principle found by the courts in those cases is that while there has been a cornucopia of approaches suggested on how to determine the appropriate discount rate, and while the argument over which interest rate is "best" has become quite involved, the workload of the interest rate is nevertheless still limited simply to compensating the lender for not receiving the liquidation value of his collateral at the time of the plan, while instead getting a stream of payments stretching into the future.

As a result of this limitation of purpose, the bankruptcy courts have held that several of the factors inherent in the old contract are inappropriate in setting the discount rate. The

\[125\] Indeed, industry analysts have found that it is this mounting cash reserve that has prompted many utilities to seek to diversify.


\[128\] The discount rate is that factor that "when utilized to determine deferred payments, places a party in 'as good a position' as if it had received its claim now, rather than later." In Re. Fi-Hi Pizza, 40 Bankr. 258, 262 (Bankr. Mass. 1984).
Tennessee court noted, for example, that it "is not aiming to produce a lender's profit but only to protect the creditor from loss caused by its being paid over a period of time." So, too, did the Texas court find that "* * *contract interest rates are determined by many factors other than simply the time value of money, including" * * "overhead costs." The Kansas court found that the contract rate would inappropriately include depreciation and collection costs.

So, too, do interest rates "borrowed" from other industries include cost elements inappropriate for a utility late payment charge. While, for example, those interest rates are designed to generate a profit, the utility's rate of return is already included in the bill subject to collection. While an interest rate will include a component for uncollectibles, a utility's uncollectibles are already included in the bill subject to collection. While an interest rate will include a component for overhead, a utility's overhead is already included in the bill subject to collection. In short, just as the courts are willing to address the appropriate discount rate to be applied in Chapter 11 bankruptcy proceedings to determine whether those rates include only the components permitted by statute, so, too, should regulators be willing to address the appropriate late payment charge to ensure that only the carrying costs associated with the delinquent payment are included.

In the case that late payment charges do substantially overstate the costs associated with delinquencies, they are subject to challenge based on contract principles as well as on regulatory principles. Under regulatory principles, excessive late payment charges violate the standard that rates and charges be "cost-based." Under contract principles, an excessive late payment charge may be challenged as an unlawful "penalty." For example, a bank's "bounced check" fee that far exceeded the cost of processing the returned check was held to be unlawful on this theory. Likewise, if the utility late payment charge bears no relation to the reasonably estimated expense to the utility arising from the delinquent payment, the charge will likely be held to be an unenforceable penalty clause. The fact that a "fixed penalty" might operate "in terrorem and (be) much more likely to induce the promised performance" does not save it from challenge.

\[\text{Fi-Hi Pizza, 40 Bankr. at 269 - 70.}\]
\[\text{In Re. Johnson, 8 Bankr. 503, 505 (Bankr. Texas 1981).}\]
\[\text{Fisher, 29 Bankr. at 544, 545 - 46.}\]
\[\text{See, e.g., Fisher, 29 Bankr. at 545.}\]
\[\text{(bounced check fee of$6 when actual cost$1 unlawful).}\]
\[\text{See, National Consumer Law Center, Sales of Goods and Services, at §39.11 (2d ed. 1989).}\]
\[\text{5 Corbin on Contracts §1054 (1951).}\]
III. THE LATE PAYMENT CHARGE AS AN INDUCEMENT FOR PROMPT PAYMENTS.

Utility late payment charges are sometimes justified not as a means to gain compensation for expenses, but rather as a means to induce prompt payments on the part of customers.\footnote{36} If this rationale is proffered, it is a legitimate inquiry as to whether the level of the late payment charge bears any relation to an acceleration in payment dates. Moreover, it is a legitimate inquiry as to whether a late payment charge designed to induce prompt payment is rational in those instances where nonpayment occurs in households who are unable to pay either because of chronic poverty or because of a mismatch between their receipt of utility bills and public benefits checks.

A. Relationship to Inducement.

If a utility late payment charge is designed to create an inducement to pay, it should be capped at a level equal to the interest rate imposed by the Internal Revenue Service for delinquent taxes.\footnote{38} This IRS rate is one of the few readily ascertainable rates that exist whose purpose is to serve this "inducement" function. As the courts have noted in calculating this IRS interest rate:

\begin{quote}
the (tax collector) has determined that its rate of interest must be high enough to deter tax evasion, restrict creative tax avoidance and compel timely payments.
\footnote{39}
\end{quote}

The tax rate should serve as a cap because of the added collection advantage enjoyed by public utilities. Low-income customers, for example, often indicate that the fear of evictions and utility service terminations often unto themselves make the payment of rent and utility bills top priorities when allocating scarce household resources. The relevant inquiry is, therefore, into what additional inducement is created that does not already exist through these collection mechanisms.

B. IMPACT ON LOW-INCOME HOUSEHOLDS WHO CANNOT PAY.

The rationale of imposing a late payment charge at all as an inducement for low-income.

\footnotetext{36}{See, e.g., MacMahon v. Independent Telephone Co., 109 P. 366, 367 (Wash. 1910); Re. Utah Power and Light Company, 19 P.U.R. (NS) 369, 372 (Utah PSC 1937).}


\footnotetext{38}{26 U.S.C. §6621 (1979).}

\footnotetext{39}{Fisher, 29 Bankr. at 545.}
households to make prompt payments on their utility bills can be called into question. This purpose is not served when the reason for nonpayment is a chronic shortfall between household resources and household expenses.

That low-income households do not have sufficient funds to pay all household bills can not be seriously questioned. One 1989 study in Philadelphia, for example, found that 100 percent of households living at or below 50 percent of the Federal Poverty Level in that city had negative monthly income left after paying essential home expenses, but before paying home heating bills; 75 percent of households at 50-99 percent of the Poverty Level had negative income (with another 10 percent having less than $24 per week left) before paying home energy bills.\footnote{Direct Testimony and Exhibits of Eunice Grier, \textit{Re. Philadelphia Gas Works}, presented on behalf of the Public Advocate (June 1989).}

The National Consumer Law Center has consistently made similar findings. A 1989 NCLC study in Utah,\footnote{National Consumer Law Center, \textit{Losing the Fight in Utah: Low-Income Households and Rising Energy Costs}, at 46 - 48 (January 1989).} for example, found the cost of a minimum standard of living to be $9,708 (in 1986 dollars). In contrast, the average income of a LIHEAP recipient in that state (for a family of three) was only $6,400. Similarly, a 1986 NCLC study in Pennsylvania\footnote{National Consumer Law Center, \textit{The Crisis Continues: Addressing the Energy Plight of Low-Income Pennsylvanians Through Percentage of Income Plans}, at I-4 - I-5 (November 1986).} found that a minimum standard of living was $8,445 in that state for a family of two. In contrast, a two person household living at 100 percent of the federal Poverty Level had $7,050 in annual income.

Using a late payment charge is effective when nonpayment occurs as a money management technique. Clearly, however, low-income households do not withhold payments toward their utility bills in order to gain a higher return by devoting their resources to alternative uses. Low-income households do not pay because they cannot afford to pay. Increasing their bill will thus provide no inducement to make prompter payments.

Indeed, some utilities have found that they receive more timely payments, and more frequent payments, by reducing bills to affordable levels rather than by increasing bills as a penalty for late payments. In Rhode Island, for example, the state’s Percentage of Income Payment Plan (PIPP), whereby utility bills were based on an affordable percentage of household income, resulted in an improvement in payment patterns for both the gas and the electric companies. At the end of the first program year, instead of having 55 percent of its pre-PIPP LIHEAP households three or more months behind on their unaffordable bills, Providence Gas had 95 percent of its PIPP households totally current or only one month behind. Similarly, instead of having 45 percent of its pre-PIPP LIHEAP households three or more months behind, Narragansett Electric had 95 percent of its PIPP households either
totally current or only one month behind.

Washington State experienced similar results. The Clark County Public Utility District found in a recent analysis of its Guarantee of Service Plan (GOSP) (which also based utility bills on an affordable percentage of income) that out of 1,966 GOSP participants, 86 customers were removed from the plan for default. 161 customers were two months past due. This equated to an overall success rate of 76 percent of GOSP customers who were **completely current** in their obligation. 87 percent were one payment or less in arrears. According to the Clark PUD, "when you consider that 67 percent of all those entering the plan had a delinquent balance, the results are impressive."

Seeking to create an incentive to make prompt payments by making unaffordable bills even higher is not only ineffective, but ultimately counterproductive. If nonpaying households do not pay because they cannot pay, it is no remedy to impose penalties which increase the bill even further.

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CONCLUSION

Late payment charges are often used to compensate a utility for delinquent payments. A utility may experience both out-of-pocket collection expenses and carrying charges when a bill is not paid by its due date. In assessing the reasonableness of late charges, a utility must distinguish between classes of late payers to ensure that compensation is provided only when expenses are truly incurred. When compensation is provided for out-of-pocket expenses, it should be calculated using a decremental cost analysis. When a late payment charge is not used as compensation for a utility's expenses, but rather as an inducement to make prompt payment, whether the level of the charge actually results in the acceleration of payments is necessary to determine. For low-income households in particular, increasing costs in response to nonpayment may retard rather than accelerate eventual payment of the arrears.