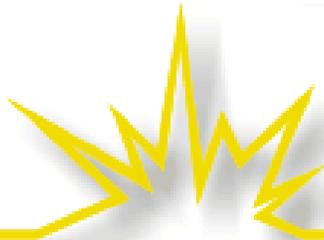


# Principles of Rate Design

Frederick Weston  
October 1999

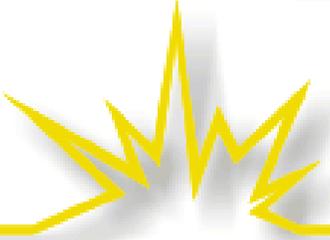


*The Regulatory Assistance Project*

50 State Street, Suite 3  
Montpelier, Vermont USA 05602  
Tel: 802.223.8199  
Fax: 802.223.8172

Website:  
<http://www.raonline.org>

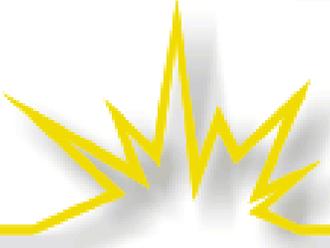
177 Water Street  
Gardiner, ME 04345-2149  
Phone (207) 582-1135  
Fax (207) 582-1176



# Rate Design

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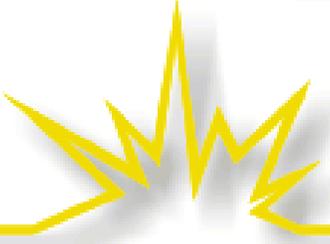
- The *structure* prices
  - That is, the form and periodicity of prices for a firm's goods and services
    - Usage-Based
    - fixed, recurring charges
    - Installation, Hook-up and Exist Fees



# Objectives of Rate Design

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- Revenue-Related Objectives:
  - Rates should yield the total revenue requirement
  - Rates should provide stable and predictable revenues
  - The rates themselves should be stable and predictable

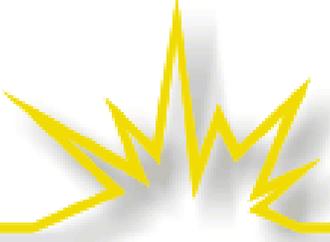


# Objectives of Rate Design

## *(continued)*

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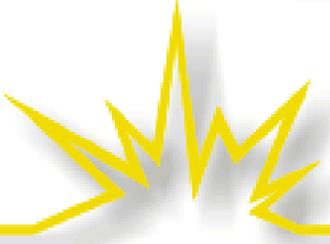
- Cost-Related Objectives
  - Rates should be set so as to promote economically-efficient consumption (static efficiency)
  - Rates should reflect the present and future private and social costs (and benefits) of providing service
  - Costs should be apportioned fairly among customers and customer classes



# Objectives of Rate Design (*continued*)

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- Cost-Related Objectives (cont.)
  - Undue Discrimination should be avoided
  - Rates should promote innovation in supply and demand (dynamic efficiency)
- Practical Considerations:
  - A rate design should be, to the extent possible, simple, understandable, acceptable to the public, and easily administered

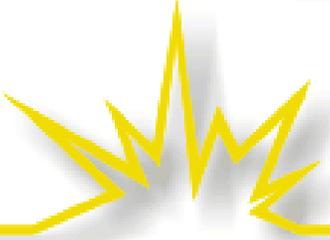


# Objectives of Rate Design

## *(continued)*

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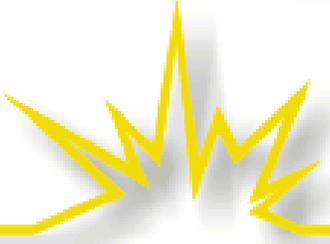
- The objectives of rate design are, in effect, the objectives of regulation
- The objectives of rate design are, sometimes, in conflict with each other



# Revenue-Related Issues

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- Rates set should be set so as to give a regulated firm a reasonable opportunity to
  - recover prudently incurred expenses, including investment, and
  - to earn a fair rate of return on the remaining costs (the undepreciated portion) of its prudent investment

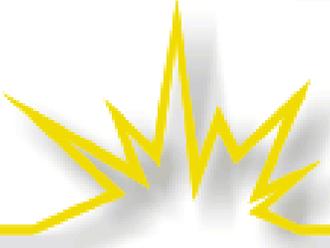


# Revenue-Related Issues

## *(continued)*

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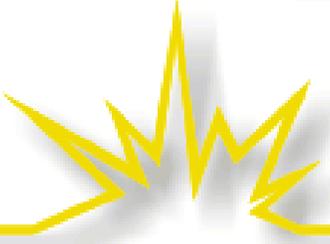
- Rates set in this way enable a company to cover its debt service obligation, pay dividends to shareholders, and attract new capital investment



# Cost-Related Issues

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- Will rates set at average cost per unit be economically efficient?
  - Average cost vs. marginal cost
    - Long run vs. short run\
- Private financial vs. total social cost
  - Cost of environmental damage from electricity production and delivery
- Who pays what costs?
  - The principle of cost causation



# Cost-Related Issues

## *(continued)*

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- Pricing below cost and undue discrimination
  - Below average or marginal cost?
- Dynamic efficiency and the proper incentives for new investment
  - Long-run marginal costs