Principles of Rate Design

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Rate Design

- 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

- 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*)

- 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)*

- 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)*

- 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

- 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*)

- 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

- 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*)

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