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
The objectives of rate design are, in effect, the objectives of regulation.

The objectives of rate design are, sometimes, in conflict with each other.
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
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