Chapter Ten

Retroactive Ratemaking: The Prohibition and the Exceptions
The Commission may not disinter the past merely because experience has belied projections, whether the advantage went to customers or the utility; bygones are bygones.¹

10.A. Three bases
In cost-based ratemaking, a commission sets rates for a future period (called the “rate year”). There are two major steps: (1) computing the utility’s “annual revenue requirement” based on projections of reasonable costs, and (2) dividing that revenue requirement by the predicted volume of sales.² The revenue requirement includes an authorized return on equity. The utility’s actual return on equity, when the rate year closes, will match its authorized return only if actual costs and sales exactly match the projections (or if positive and negative deviations balance out perfectly). In reality, that matching never occurs. As a result, the utility’s actual return on equity typically varies from the authorized return. May the regulator “correct” this outcome, refunding to customers any excess or making them pay extra to cover any shortfall?

The general answer is no. “It is a fundamental rule that utility rates are exclusively prospective in nature.”³ The rule stems from ratemaking’s legislative character: legislative activity is prospective,⁴ and the legislature has delegated its ratemaking authority to the regulator. To “correct” a pre-existing rate based on end-of-year results, the commission would have to order a change to previously approved rates, then apply that change to a past period. That is the definition of retroactive ratemaking.⁵

The rule against retroactivity has roots in statutes, the Constitution and policy. These roots are discussed next.

10.A.1. Statutory basis
The statutory basis is, naturally, statutory language. Section 5(a) of the Natural Gas Act is typical. It requires the commission to “determine the just and reasonable rate to be thereafter

¹. Associated Gas Distrib. v. FERC, 898 F.2d 809, 810 (D.C. Cir. 1990) (Williams, J., concurring in denial of rehearing and rehearing en banc).
². Rate-setting is of course more complicated than this single sentence suggests. See Chapter 6 and its references for details.
observed and in force” (emphasis added), the term “thereafter” signaling prospectivity only. Note that this prospectivity enforces the filed rate doctrine, itself a statutory principle. As explained in Chapter 9.A, once a commission has accepted a rate for filing (assuming that the acceptance is lawful), the accepted rate is the lawful rate—and the only lawful rate. That it produces an actual return different from the authorized return does not make the lawful rate an unlawful rate. To “correct” this difference by granting customer refunds or forcing customer paybacks would be to disregard a previously approved rate, just as FERC did in Associated Gas Distributor, when it violated the filed rate doctrine by approving a “purchase deficiency” surcharge. If the actual return varies from the authorized return, the regulator can change the rates, but only prospectively.

10.A.2. Constitutional basis
The constitutional basis of the rule against retroactivity is the Fifth Amendment’s Takings Clause. Recall that the Clause’s “just compensation” command requires regulators to honor “distinct, investment-backed expectations.” On approving a lawful rate, a commission creates a distinct expectation, relied on by investors, that the utility can collect that rate until it is changed prospectively. Refunds of overearnings would undermine those legitimate expectations. Conversely, denying a utility an opportunity to collect past shortfalls does not violate the Takings Clause, because the utility had no legitimate expectation of retroactive recovery. It understood its revenue requirement to include an authorized return, not a guaranteed return.

10.A.3. Policy basis
The rule “ensures the predictability and stability of utility rates and generally prevents utility companies from recovering losses that stem from ‘past company mismanagement or improper forecasting.’” Its “equity lies in its steady application regardless of what party is seeking to reexamine the past.”

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7. Mountain Water Co. v. Mont. Dep’t of Pub. Serv., 835 P.2d 4, 5 (Mont. 1992) (holding that the Montana Commission’s refusal to allow utility to collect past shortfalls was not a denial of just compensation).