

**Regulating Public Utility Performance:**  
The Law of Market Structure, Pricing and Jurisdiction

## **Chapter Eight**

# **Discrimination: When Is Favoritism “Undue”?**

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*Self-interest of the carrier may not override the requirement of equality in rates.*<sup>1</sup>

Chapters 6 and 7 addressed the statutory requirement of justness and reasonableness, as applied to cost-based rates and market-based rates, respectively. Justness and reasonableness is necessary for lawfulness, but it is not sufficient. Regulatory statutes typically add that rates may not grant an undue preference:

Every gas corporation, every electric corporation and every municipality shall furnish and provide such service, instrumentalities and facilities as shall be safe and adequate and in all respects just and reasonable. . . . No gas corporation, electric corporation or municipality shall make or grant any undue or unreasonable preference or advantage to any person.<sup>2</sup>

In the pricing context, discrimination can be lawful or unlawful, depending on whether it is “due” or “undue.” This chapter illustrates the distinction with examples. Undue discrimination includes rate differences not justified by cost differences and rate differences with anti-competitive effect. Due discrimination includes rate differences based on customer profiles and load characteristics, rate differences arising from settlement strategies and contract histories, price discounting to retain customers, and rate differences arising from product differences. It then turns to a modern problem of discrimination: cost allocation on multi-utility systems.

## 8.A. Undue discrimination

### 8.A.1. Rate differences not justified by cost differences

The prohibition against undue discrimination distills to this golden rule: Treat similar customers similarly; dissimilar customers dissimilarly. Customers who cause similar costs should face similar cost-based rates.<sup>3</sup> Cost-causation underlies the common method for

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1. *United States v. Ill. Cent. R.R.*, 263 U.S. 515 (1924).

2. N.Y. PUB. SERV. § 65. *See also* D.C. CODE § 34-1101 (“The charge made by any public utility for a facility or service furnished, rendered, or to be furnished or rendered, shall be reasonable, just, and non-discriminatory.”); KAN. STAT. ANN. § 66-101b (“Every unjust or unreasonably discriminatory or unduly preferential rule, regulation, classification, rate, charge or exaction is prohibited and is unlawful and void.”). *See also* Section 205(b) of the Federal Power Act (FPA), 16 U.S.C. § 824d(b):

No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

3. *See* *Portland General Exchange, Inc.*, 51 FERC ¶ 61,108, at p. 61,245 n.62 (1990) (“[D]ifferences in rates must be based upon factual differences, for instance, in a utility’s cost of service . . .”).

allocating the cost of capacity: Each customer group bears that share of the utility's total capacity cost equal to the group's proportional contribution to the peak demand, since peak demand is what drives the need for the capacity. To over-allocate cost to a group, relative to its contribution to peak demand, is unduly discriminatory.

Undue discrimination cannot be justified by self-interest. Illinois Central Railroad charged more to haul lumber from areas it served exclusively, compared to areas also served by competitors; yet the distance to destination lumber markets for the discounted areas was longer. Same freight, same destination market, same main route, different rates. The railroad defended the difference by arguing its business purpose: the lower rates would increase its traffic. The Interstate Commerce Commission found the discrimination undue, and the Supreme Court agreed: "Self-interest of the carrier may not override the requirement of equality in rates. . . . [T]he interests of the individual carrier must yield in many respects to the public need." That each rate itself was just and reasonable did not make the discrimination "due": "Both rates may lie within the zone of reasonableness and yet result in undue prejudice."<sup>4</sup>

*Cost-based vs. market-based prices:* Claims of undue discrimination usually arise where the seller is an incumbent utility with market power, charging cost-based prices. What if the regulator has authorized the seller to charge market-based rates—to price at will—because it lacks market power?<sup>5</sup> A seller lacks market power because its customers have alternatives. If customers have alternatives, a seller attempting undue price discrimination should fail because the customers will choose an alternative. What if the market-based seller is price-discriminating and succeeding (i.e., not losing sales)? There would be two possible reasons: (a) the seller lacks market power, so is pricing differentially based on cost differences or product differences (and therefore practicing due discrimination; see Chapter 8.B below); or (b) the seller has gained market power, and therefore should have its market rate authorization revoked.

Because market-pricing sellers are supposed to lack market power, FERC has authorized them to grant discounts. These sellers have no duty to post their discounts publicly or offer them to all similarly-situated buyers. FERC relies on the sellers' quarterly reporting requirements (discussed in Chapter 7.C.2 above) to monitor the discounts for evidence of market power, and invites potential victims of discrimination to file complaints.<sup>6</sup> Under this case-by-case regime, FERC has found undue discrimination arising from selective discounting, as illustrated by the *Portland General Exchange* case discussed next.

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4. United States v. Ill. Cent. R.R., 263 U.S. 515, 524 (1924).

5. Cost-based prices and market-based prices were discussed in Chapters 6 and 7.

6. Market-Based Rates for Wholesale Sales of Electric Energy, Capacity & Ancillary Services by Public Utilities, 119 FERC ¶ 61,295, at pp. 718–19 (2007) (“[A]llegations of undue discrimination arising from selective discounting are best addressed on a case-by-case basis.”).