# PART TWO

## Pricing

## How Much Can Sellers Charge—and Who Decides?

Setting prices for utility services is time-consuming and contentious. The applicable law boils down to three simple-sounding phrases. The first two appear in nearly every regulatory statute: Rates must be "just and reasonable," and they must not grant any "undue preference or advantage." The third phrase appears in the U.S. Constitution's Fifth Amendment: once a utility has spent money to perform an obligatory public service, it is entitled to "just compensation."

Empowered and constrained by these phrases, and the hundreds of court opinions interpreting them, regulatory rate-setters have used two major approaches:

- *Cost-based rates and their variants*: The regulator sets or caps the price based on some measure of cost. The permissible cost bases range from "embedded cost" of sunk investments to long-run incremental cost of future technologies. Rates in this cost-based category include variants of "performance-based rates" like "price caps" and "alternative forms of regulation"—concepts that use cost as a starting point but give the seller some degree of pricing discretion.
- *Market-based rates*: The regulator authorizes the seller to set its own prices, subject to regulatory oversight. That oversight has two components: an advance finding that the seller has no "market power," and subsequent monitoring to prevent the seller from gaining and exploiting market power.

Cost-based and market-based ratemaking have a common purpose: to induce all sellers to perform cost-effectively. Each method draws from the other. When setting cost-based rates, regulators look to market prices for benchmark comparisons. When monitoring market-based rates, regulators compare them to generic costs to see if sellers are pricing above reasonable costs—evidence of possible market power. And in markets where sellers might gain market power due to shortages or other factors, regulators might allow market prices but cap them at ceilings that bear some relationship to costs.

There is of course a third approach to price-setting—no regulation: Repeal the regulatory role entirely, leaving consumer protection to market forces and antitrust enforcement. All three approaches co-exist, for one or more types of transactions, in each of the electric, gas and telecommunications industries.

Chapters 6 and 7 describe the many legal features of cost-based ratemaking and market-based ratemaking, respectively. We then turn to four subjects that apply, to a lesser or greater degree, to both cost-based ratemaking and market-based ratemaking:

- The *prohibition against undue discrimination* requires that similar customers be treated similarly, but also allows due discrimination—treating dissimilar customers dissimilarly. (Chapter 8)
- Under the *filed rate doctrine*, a utility may charge only the rate officially filed with and accepted by the regulator. Simple in principle, the doctrine's applications are complex. It constrains not only the utility but also federal and state courts, and the rate-setting commission itself. It bars these bodies from approving any form of compensation, whether in the form of contract damages, tort damages, rate refunds or rate surcharges, that varies from the filed rate. (Chapter 9)
- The *prohibition against retroactive ratemaking* prohibits regulators from allowing refunds or surcharges when past rates do not produce their intended results. (Chapter 10)
- The *Mobile-Sierra doctrine*, an interpretation of federal regulatory statutes, limits the regulator's authority to relieve a contracting party of its contract obligations. (Chapter 11)