What is Regulation?

Definition

- “The imposition by a government of controls over the decisions of ..firms..in order to prevent..exploiting of market power to extract pure economic profits.
- ..an alternative to nationalization”
- ..a reason ..to encourage competition.”

- Source: A Concise Dictionary of Business, Oxford University Press

What is Regulation

- Companies providing necessary public service differ from other companies in the market and are likely to be monopolies.

- Since these monopolies are primarily privately owned, there is a need for a mechanism that allows them to remain viable by collecting revenues comparable to the market without making excessive profits while providing the public goods and service.

- A public authority gives these monopoly companies the opportunity to collect revenues through rates and tariffs to remain viable. This is regulation.

Regulation is a substitute for competition

The objectives of electric and gas utility regulation are to:

- Attract capital sufficient to build and adequate maintain service,
- Insure service at reasonable prices to consumers.

PAPUC decisions affect:

(a) the lives of -

- 5.7 million electricity customers
- 2.8 million natural gas customers
- 8.3 million telephone customers

(b) the operations of -

- Major electric, natural gas, telephone, and transportation companies in the state

Comparison: US vs. EU

- The USA does not have an explicit goal of creation of a “single” national electric market.

- The EU was created to develop a single market from the internal markets of the member states.

Why Is Regulation Necessary

- Excessive profits--Without regulation, a monopoly company may collect excessive profits.

- Reliable service--Since the monopoly company is given a franchise to provide public service in a certain area, it is the responsibility of the government to ensure that the citizens being served receive safe and reliable service at reasonable rates.

Why Is Regulation Necessary, cont'd.

- Regulator--The government creates an administrative agency (regulatory authority) that regulates such monopoly companies.

- Balancing--While setting rates, the regulatory authority has to balance the need for the viable operation of the monopoly company as well as the ability for its consumers to pay reasonable rates.

Different Approaches to Regulation

- Traditional Rate Regulation
- Performance-Based Rates
- Negotiated Contract Rates
- Rate Caps (or “Frozen” Rates)

Traditional Rate Regulation

- The regulatory agency permits a regulated company to set rates that will cover the company's:
  a) Operating costs; and,
  b) An <u>opportunity</u> (not guarantee) to earn a reasonable rate of return.

- Rates must be non-discriminatory among customers in the same class of service but could be different between different classes of service.

Performance-Based Rates (PBR)

- PBR is an alternative rate mechanism which allows a company to be awarded (or penalized) revenues based on its performance.
- The criteria for PBR is mutually agreed upon by the commission and the company.
- PBR is used if the commission wants the company to make certain performance improvements based on complaints that may receive from consumers.

Negotiated Contract Rates (NCR)

- NCR is another alternative rate mechanism that is used to allow very limited customers of a company to have individualized rates.
- For example, if a large manufacturing customer that employs thousands of employees wants to locate to a certain area, then a NCR may be used as an incentive to encourage that customer's relocation.
- NCR are a tool to encourage economic development in a state and has to be used under selective criteria.

Rate Caps (or “Frozen” Rates)

- Rate Caps have been used frequently in the U.S. by most states during the restructuring of their electric utility industry in the 1990s.
- Rationale-- generation is deregulated allowing the company to sell energy in the market.
- However, to ensure that consumers (especially domestic/residential and small business) are not harmed by the fluctuations of the energy market, legislation or settlement agreements enable the commission to set Rate Caps for a limited period of years to allow these consumers transition into market-based rates for electricity supply.

Calculation of Rate Level

RR = (ROR X RB) + E

- Revenue Requirement =Rate of Return x Rate Base Plus Expenses

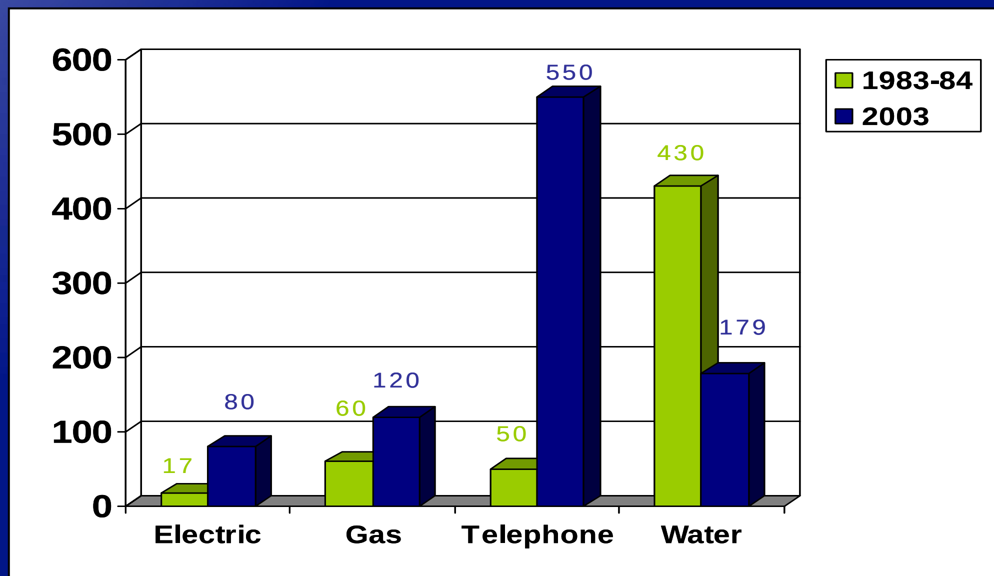
Changing Role of Regulation

1983-84

- **17** electric utilities
- About **60** gas companies
- About **50** telephone companies
- About **430** water companies

2003

- About **80** electric companies
- **120** gas companies
- About **550** phone companies
- About **179** water companies



Commission Impartiality

- Functions-- functions: legislative, judicial, and executive.
- Ethics--Commissioners and their staff are subject to statutory code of ethics with no financial interests in companies under the commission's jurisdiction.
- Ex Parte--Commissioners and their staff do not discuss issues of a case under that commission's review with any party in that case.

Commission Impartiality, cont'd.

- Terms--Staggered terms of commissioners result in independence from political and other pressures.

- Post employment--In many states, commissioners whose terms end cannot represent a company before that commission for a certain period of time.

Commission Impartiality, cont'd.

- Deliberations-- mostly held in public to maintain a sense of transparency in the proceedings.
- Record evidence--Commissioners, in their judicial roles, base their decisions on a case on issues that are only included in the record of that case.
- Appeals--decision can be appealed to a higher court in that state.