

Price Level Regulation

The Body of Knowledge on Infrastructure Regulation is divided into seven main sections. Chapter IV is dedicated to issues dealing with **Price Level Regulation**.



Regulators use incentive regulation primarily to regulate the overall price level of the operator.

Financial analysis assists the regulator in gathering information on the operator and the market by providing the regulator with information on how various price levels affect the operator's ability to obtain capital for investment.

How This Section Is Structured

4. Price Level Regulation
Narrative
Introduction
Basic Forms of Regulation
Incentive Features and Other Properties
Features of Price Cap and Revenue Cap Regulation
Earnings Sharing
Issues in Regulating the Price Level
Properties of Benchmarking and Yardstick Analyses
Conducting a Price Review
Concluding Observations
References
Self-Testing

The BoKIR first examines the Basic Forms of Regulation by describing the four main primary approaches to regulating the overall price level. These are: rate of return (or cost of service) regulation, price cap regulation, revenue cap regulation, and benchmarking (or yardstick) regulation, all of which are described in this section.

It then goes over Incentive Features and Other Properties. The opportunity to keep additional profits is the incentive feature employed in the basic forms of regulation. The difficult challenges for the regulator are to know how much additional profit is needed to induce the operator to improve performance and to know whether the additional efficiency gained is worth the additional profits allowed. Approaches for doing this are discussed here.

Then, the Features of Price Cap and Revenue Cap Regulation (and the underlying theory behind these) are discussed. Price cap regulation adjusts the operator's prices according to the price cap index that reflects the overall rate of inflation in the economy, the ability of the operator to gain efficiencies relative to the average firm in the economy, and the inflation in the operator's input prices relative to the average firm in the economy. Revenue cap regulation attempts to do the same thing, but for revenue rather than prices.

The next section describes Earnings Sharing. With earnings sharing, the regulator allows the operator to keep some portion of the earnings it receives from the market and requires the operator to give the rest to customers, perhaps through price reductions, refunds, or increased investment. An example of how a typical Earnings Sharing mechanism might work is given.

Then, Issues in Regulating the Price Level are examined. The two main issues faced by regulators pertain to the treatment of extraordinary events that impact earnings and the treatment of controllable and non-controllable costs.

The BoKIR then goes over Properties of Benchmarking and Yardstick analyses. Benchmarking quantifies the relative historical performance of organizations or divisions, controlling for external conditions. This section goes over metrics that can be used for benchmarking

Finally, the BoKIR addresses how to Conduct a Price Review. The steps for conducting a price review, deciding what to regulate, evaluating the existing price control scheme, choosing how prices will be controlled going forward, and implementing the new control are described.

Overall Conclusions

4. Price Level Regulation
Narrative
Introduction
▶ Basic Forms of Regulation
Incentive Features and Other Properties
Features of Price Cap and Revenue Cap Regulation
Earnings Sharing
Issues in Regulating the Price Level
Properties of Benchmarking and Yardstick Analyses
Conducting a Price Review
Concluding Observations
References
Self-Testing

The appropriate combination of rate of return tools, price or revenue caps, benchmarking, and length of time between price reviews depends on a country's goals, institutional strength, level of competition, and economic stability to name a few.

Of the general approaches to regulating overall price levels, rate of return regulation generally provides flexibility in addressing changes in costs and earnings. Price and revenue cap regulation provide the greatest pricing flexibility for the operator. Furthermore, rate of return regulation provides the greatest predictability of earnings, if the regulatory environment is considered to be predictable. Price and revenue regulation provide the greatest predictability for overall price levels.

Self-Testing
References
Concluding Observations
Review
Conducting a Price
Properties of Benchmarking and
Yardstick Analyses
Earnings Sharing
Features of Price Cap and Revenue Cap Regulation
Incentive Features and Other Properties
▶ Basic Forms of Regulation
Introduction

References

The principal resource featured in the BoKIR is the list of (and access to) references that is provided under each section. The literature includes decisions and publications by regulatory agencies and other governmental bodies; policy advisories by think tanks, consultants, donor agencies, etc.; and research by academics, consultants, and other experts.

In the Price Level Regulation section, references are organized under the following categories:

- Principles
 - Case Studies
 - Alternative forms of regulation
 - Differences between alternative forms of price regulation
 - Use of extraordinary price adjustments and other techniques
 - Treatment of different categories of costs (controllable vs. non-controllable) in price controls
 - Trade-offs between flexibility and predictability of regulatory arrangements
 - Main steps in conducting a price review
 - Establishing the duration of the price control
- Price Regulation
 - Case Studies
 - Choice of price escalation indices
 - Basics of financial modeling for price regulation
 - Principles for determining the X-factor, including total factor productivity approach and earnings forecasting approach
- Revenue Caps
- Principles for using Efficiency Measures for Benchmarking
- Earnings and Revenue Sharing Techniques

Further divided into:

- Core References
- Sectoral References
- Other References

Further divided into:

- Case Studies
- References

4. Price Level Regulation
Narrative
Introduction
▶ Basic Forms of Regulation
Incentive Features and Other Properties
Features of Price Cap and Revenue Cap Regulation
Earnings Sharing
Issues in Regulating the Price Level
Properties of Benchmarking and Yardstick Analyses
Conducting a Price Review
Concluding Observations
References
Self-Testing

Self-Testing
References
Concluding Observations
Review
Conducting a Price

Other Resources

Self Testing: Test your command of the BoKIR content for each section. Answers are provided with an explanation and with references for further study.

4. Price Level Regulation

Narrative

Introduction

▶ Basic Forms of Regulation

Incentive Features and Other Properties

Features of Price Cap and Revenue Cap Regulation

Earnings Sharing

Issues in Regulating the Price Level

Properties of Benchmarking and Yardstick Analyses

Conducting a Price Review

Concluding Observations

References

Self-Testing

self-testing

references

concluding observations

review

conducting a price

Which of the following is **false**?

- Rate of return regulation is based on the operating costs of a model firm that has optimized its capacity and minimized its operating cost.
- Price cap regulation is based on an index that reflects the overall rate of inflation and the ability of the operator to gain efficiencies.
- Under benchmarking, the operator's performance is compared to other operators' performance.
- Often, regulators use a combination of price regulation plans, which is called using a hybrid approach.

Glossary: Keywords throughout the text are hyperlinked to a glossary for complete definitions (also available in other languages).

Incentive Regulation: Regulation that encourages certain types of corporate behavior. Some incentives can be perverse—discouraging cost containment. See [incentive-based regulation](#) and [performance based ratemaking](#).