Topic 6. Rate of Return Regulation

What Is Rate of Return Regulation?

Rate of return regulation is a form of price setting regulation where governments determine the fair price which is allowed to be charged by a monopoly. It is meant to protect customers from being charged higher prices due to the monopoly's power while still allowing the monopoly to cover its costs and earn a fair return for its owners.

Advantages and Disadvantages of Rate of Return Regulation

Customers benefit from prices that are reasonable, given the monopolist's operating costs. It offers long-term rate sustainability, as it provides some resistance for rates against the popularity of a company among investors and against changes that might take place within that company. It provides stability in monopolized industries, while preventing monopolies from making large profits with price manipulations. Investors, while they will not make huge dividends, will benefit from substantial and consistent returns. Customers do not feel as if they are being overcharged for essential services, and the monopoly in question benefits from a stable public image as a result.

Is rate of return regulation an incentive regulation?

Rate of return regulation is often criticized because it provides little incentive to reduce costs and increase efficiency. A monopolist who is regulated in this manner does not earn more if costs are reduced. Thus, customers may still be charged higher prices than they would be under free competition.

Public utility regulation arose naturally in the nineteenth century for gas, water, rail, telegraph, and later, electricity and telephony because these utilities require a fixed network to deliver their services. These networks need access to rights of way which requires community or government approval, while the network is a natural monopoly that precludes efficient competition and confers potentially exploitative power on the owner that will inevitably lead to political demands for restraint. The durable, costly and irrecoverable nature of the network raises the fear that curbs on prices will prevent the investor recovering a fair return on his investment. Regulation evolved to balance the interests of investors and consumer/voters. Where a satisfactory balance could be achieved, utilities could remain under regulated private ownership. If private investors lacked confidence that they would be allowed to earn an acceptable return, or if the polity believed that it could secure a more satisfactory distribution of the benefits of the public utility, the outcome was public ownership.