



# A study of the negotiated-settlement practice in regulation: Some evidence from Florida

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## ABSTRACT

Negotiated settlements have become a frequently used alternative to contested proceedings when setting prices charged by public utilities under the US rate-of-return regulatory model. The behavior of the representatives of consumer advocates and the firms during settlement negotiations determine customer prices. This paper examines this behavior by using data from the Florida Public Service Commission to estimate the payoff functions of both parties. The estimation suggests that the advocate and the firm weight the present rate change more than the consumer's future average price and the firm's future operating revenue in their settlement decisions. It also indicates that the time saved by settlements is not a primary reason for their popularity.

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## 1. Introduction

Traditionally, the prices that consumers in the US and Canada pay for essential services such as electricity have been determined under rate-of-return (ROR) regulation, including formal contested proceedings. Under ROR regulation, the public utility commission considers testimony by interested parties, including the regulated utility and consumer representatives. The commission then sets prices to generate revenue for the utility sufficient to cover its prudently incurred costs and provide a fair rate of return on its rate base.<sup>1</sup>

**Abbreviations:** FERC, Federal Energy Regulatory Commission; FPSC, Florida Public Service Commission; MMFR, modified minimum filing requirements; NEB, National Energy Board; ACCC, Australian Competition and Consumer Commission; OPC, Office of the Public Counsel; ROE, return on equity; ROR, rate of return; TECO, Tampa Electric Company.

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<sup>1</sup> The rate base is the book value of the firm's capital investment less depreciation.

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Alternative dispute resolution such as negotiated settlement (including stipulation) has become a popular approach within ROR regulation over the past 25 years. Under the negotiated settlement process, the firm, the consumer representative, and other involved parties negotiate terms with regard to consumer rates and other items outside of formal regulatory hearings. Other items might include depreciation and amortization practices, funding of reserve accounts, and revenue-sharing plans as well as future actions of the parties. The parties submit the settlement to the regulator for approval. If the settlement is approved, no formal hearing takes place and terms of the agreement are upheld. Littlechild (2009a) reports that the Florida Public Service Commission (FPSC),<sup>2</sup> the regulatory commission whose rate cases we analyze in this paper, “almost invariably adopted” (Littlechild, 2009a, p. 103) all settlements put to it. Between the years 1976–2002, only one settlement was overturned. This settlement was approved in 1989 after one item that the FPSC opposed was removed from the agreement.

<sup>2</sup> The FPSC is the regulatory commission in Florida that regulates telephone, electric, natural gas, water and wastewater companies.

In spite of its prevalence in practice, negotiated settlement has not received much careful study.<sup>3</sup> Earlier studies include [Burns \(1988\)](#) that discusses negotiated settlements at state and federal utility commissions. [Burns \(1988\)](#) views the negotiated settlement as a “procedural streamlining technique” which is a procedure to expedite the decision-making process but not to necessarily substantively change the decision by the regulator that would have resulted if the case had not been settled by the parties. Negotiated settlements have been seen as a less costly and less time-consuming way to reach the same outcomes that traditional proceedings provide. Recent research, however, argues that this is not the main reason for settlements. [Wang \(2004\)](#) and [Littlechild \(2012\)](#) studied settled rate cases of major interstate gas pipeline at the Federal Energy Regulatory Commission (FERC). [Littlechild \(2009a, 2009b\)](#) examined negotiated settlements for rate cases of telecommunications, electric and gas companies at the FPSC. [Doucet and Littlechild \(2009\)](#) document the development of the negotiated-settlement practice in toll cases of large pipeline companies before the Canadian National Energy Board (NEB). [Bordignon and Littlechild \(2012\)](#) examined a negotiated access undertaking approved by the Australian Competition and Consumer Commission (ACCC). These studies find that reduction of costs and saving time, one of the purported reasons for choosing settlements over traditional proceedings,<sup>4</sup> are not the driving motivation behind these types of agreements. The consensus of these papers is that the parties can reach “more innovative and creative solutions” ([Littlechild, 2009b](#), p. 276) with settlement than the regulator can secure by other means. That is, the settlement process offers outcomes beneficial to all parties that are not available under traditional proceedings. The authors suggest these outcomes arise because: (i) the regulator cannot legally prescribe such solutions or is unwilling to do so because these outcomes may represent departures from the regulatory policy; or (ii) the parties can fashion better agreements than can any regulatory ruling because the parties know their own preferences better than the regulator.

This paper investigates the circumstances under which consumer advocates and company representatives will settle a rate case. In the US, consumer advocacy emerged in the 1970s at a time when utility rates were increasing. The purpose was to give more representation to consumers in the formulation of regulatory policies and decisions. It is the duty of the consumer advocate to represent the interests of utility consumers (typically but not exclusively residential consumers) in rate cases. One of the objectives this responsibility involves is trying to secure the lowest rates that customers must pay for utility services. Similarly, the firm's representatives will try to obtain opportunities to enhance profits (or returns) for shareholders. An additional motivation of all parties is the appearance of good job performance. According to [Littlechild \(2009a, p.104\)](#), the consumer advocate and firm “are likely to be interested not only in furthering the interests of their principals (consumers and shareholders), but also being seen to do so.” The immediate reported rate change typically is the most clearly understood characteristic of a regulatory decision or negotiated settlement. Consequently, a rate reduction can serve as an observable signal for good job performance by the consumer advocate. The advocate might negotiate more immediate rate decreases in settlements than is possible under a traditional proceeding in

exchange for other benefits to the utility. Mr. Jack Shreve, the longest-serving head of Florida's primary consumer advocacy agency, Office of Public Counsel, went on to be appointed by the Governor as Special Counsel for Consumer Affairs to the Florida Attorney General in 2003. A press release from the Florida Attorney General's Office announcing Mr. Shreve's appointment identified his negotiated settlements with Progress Energy Florida, Florida Power and Light, and BellSouth that secured large rate reductions for consumers as his primary accomplishments as Public Counsel.<sup>5</sup> The firm can similarly claim a rate increase reached by settlement as beneficial to shareholders in terms of profit potential.

Settlements and stipulations between the parties can also benefit the firm in other ways.<sup>6</sup> One common stipulation that [Wang \(2004\)](#) and [Littlechild \(2009b\)](#) discuss is the agreement by advocates and customers to not seek to initiate a rate or earnings investigation for an extended time period. This can be advantageous to firms because it allows them to retain any earnings in excess of those authorized during the specific period. The regulator cannot bar parties from filing a petition or complaint. [Littlechild \(2009b\)](#) discusses two stipulated items common at the FPSC that benefit the firm and represent departures from usual commission policy. One item grants a more flexible depreciation and amortization policy than the commission would otherwise allow. Flexibility with regard to depreciation enables the firm to adjust expenses relative to revenues and earnings.<sup>7</sup> The second stipulation concerns incentive regulation, which allows firms to earn returns above the cost of capital. [Littlechild \(2009b\)](#) reports that for some settlements, the FPSC staff estimated that the firm incentive regulation would result in higher earnings than traditional regulation.

Florida's Office of the Public Counsel (OPC) represents all utility consumers in the state (residential, commercial, and industrial) and is accountable only to the people of Florida through the Florida legislature.<sup>8</sup> Following [Littlechild \(2009a\)](#), FPSC rate cases can be classified into three types. The first two types were earnings-review cases and company-request cases. An earnings-review case is initiated by the regulator, sometimes at the request of the consumer advocate, in the belief that the firm has earned above its authorized level such that a rate reduction might be in order. A company-request case is initiated by the utility when it believes a rate increase is necessary. All other types (such as periodic reviews of returns on equity (ROE), Modified Minimum Filing Requirements (MMFRs), and tax savings affecting the utility's allowed revenues) were grouped together in a third category. This last type involves small rate changes, typically a reduction. The behavior of the Public Counsel and public utility representatives during settlement negotiations for these three types of cases (subject to regulatory approval) determines the

<sup>5</sup> An excerpt from this news release from the Florida Office of the Attorney General on September 24, 2003 states: “Among Shreve's many accomplishments is an agreement in 2002 with Florida Power, now Progress Energy Florida, that cut electric rates by \$125 million per year. In 2003, he worked with the Attorney General's Office to enforce a refund that could total up to \$60 million, which was part of the 2002 agreement. He brokered an agreement with Florida Power and Light that is presently providing rate cuts of more than \$600 million per year. He negotiated a 1994 agreement with Southern Bell, now BellSouth, that reduced consumers' rates by \$300 million per year.”

<sup>6</sup> For a detailed discussion of these firm benefits and other issues discussed here, see [Chakravorty \(2012\)](#).

<sup>7</sup> [Littlechild \(2009b, footnote 33 p.283\)](#) reports that the FPSC staff voiced a concern that the “the design of depreciation rates, and the resultant rate base, will no longer reflect the matching principle [matching capital recovery with consumption over an asset's service life], but rather, the degree of variability in the company's revenue.”

<sup>8</sup> The Public Counsel in Florida is appointed and re-appointed every year by the Joint Committee of Public Counsel Oversight, a state Congress committee.

<sup>3</sup> See [Doucet and Littlechild \(2006\)](#) for a survey of economic and legal literature on negotiated settlements.

<sup>4</sup> These are given as the main motivations in the law and economics literature that make a defendant and plaintiff come to a settlement before a trial ([Cooter and Rubinfeld, 1989](#)).

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