FTC Comments on JPS 2014-2019 Rate Case Submission

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Background

This opinion is being provided as FTC's contribution to the Office of Utilities Regulation's (OUR's) stakeholder group consultation exercise, as per letter dated March 26, 2014 from Mr. Gordon Brown, Public Affairs Coordinator of OUR to Mr. David Miller, Executive Director of the Fair Trading Commission (FTC). These comments are offered with reference to a document entitled "JPS 2014-2019 Rate Case Submission: Summary Report" issued by the OUR on April 11, 2014. In reviewing the document, our comments are limited to identifying proposals which are likely to influence the incentives for the JPS to operate efficiently, given the regulatory environment in which it operates.

- Proposed Revenue Cap

JPS proposes to replace the current Price Cap regime with a Revenue Cap regime.

1. **A pure revenue cap regime is likely to lessen the incentives for JPS to establish an efficient tariff structure, relative to the incentives to do so under a pure price cap regime.**

Justification:

A revenue cap provides adequate incentives for a profit-maximizing utility company such as the JPS to reduce the total cost of production, since total revenue is guaranteed. A utility company operating under revenue cap, rather than a price cap, can reduce production levels without reducing revenue flows. The company will choose to reduce production costs by (i) satisfying the current demand using more cost-effective production techniques while maintaining the same level of production; and/or (ii) reducing the quantity of electricity demanded below current levels, hence reducing the output volume required to produce to satisfy demand.

Under a revenue cap, the utility company would suppress demand for electricity by simply setting a tariff structure that deviates from efficient levels. In contrast, it would be considerably more costly for the company to improve the productive efficiency of its plants as this would require replacing its stock of inefficient generating machinery (turbines). Accordingly, it is likely that a revenue cap regime provides the

JPS with adequate incentives to set a tariff structure designed to reduce the volume of electricity demanded by its customers. The proposed rate changes are consistent with the view that the tariff structure deviates from efficient pricing principles (for more details on this issue see our comments on proposed rate changes).[1]

- Proposed Rate Changes

The JPS proposes to (i) increase its residential tariff (Rate 10) by 21% on average; (ii) increase its general service tariff (Rate 20) by 15% on average; and (iii) reduce its commercial and industrial tariff (Rate 40 and Rate 50) by 1.5% on average.

2. **The proposed rate change is likely to deviate from accepted rules of efficient pricing, relative to existing structure.**

Justification

It is recognized in regulatory economics that an efficient pricing structure of a monopolist would charge a higher price mark-up for customers whose demand are less sensitive to price changes ('less elastic demand') and charge a lower price mark-up on customers whose demand are more sensitive to price changes ('more elastic demand').[2] The proposed rate changes will increase the price of electricity paid by residential customers, relative to the price paid by commercial and industrial customers. The FTC is unaware of any attempts to measure the elasticity of demand for the different class of customers. We note, however, that studies conducted in other jurisdictions conclude that in the short run, residential customers exert a more elastic demand for electricity compared to commercial customers.[3] If these measures hold true for Jamaica, then under the proposed rate structure JPS would charge a higher mark-up to consumers with the more elastic demand and relatively lower mark-up to consumers with less elastic demand; in violation of an accepted rule for efficiently pricing on the part of a monopolist.

- Proposed Wholesale Tariff

The JPS proposes to introduce a wholesale rate designed to encourage its largest customers to remain entirely on the grid.

3. **The proposal to encourage large customers to remain on the grid is internally inconsistent with the JPS proposal to replace the price cap regime with a revenue cap regime.**

Justification:

[1] For a more detailed discussion on efficient pricing in a monopoly market, see Frontier Economics, 2009. Theory of Efficient Pricing of Electricity Transmission Services: A report prepared for the New Zealand Electricity Commission. Available at www.ea.gov (last accessed: April 29, 2014)

[2] This is referred to as Ramsey rule for efficient pricing (in natural monopoly markets).

[3] See Bernstein, M.A. and J. Griffin, 2006. Regional Differences in Price Elasticity of Demand. Available at http://www.nrel.gov/docs/fy06osti/39512.pdf (last accessed April 29, 2014).

For reasons explained above, a revenue cap provides adequate incentives for any utility company to discourage demand as a reduction in demand will increase profits by reducing production costs without any reduction in revenue.

- Three year Rate Review Request

The JPS proposes that the rate review period be reduced from five years to three years.

4. **The FTC does not support the proposal to reduce the review period to three years as it would likely frustrate the ability of the regulator (OUR) to monitor and evaluate the behavior of the utility company.**

Justification:
One of the inherent problems overseeing any regulated industry is the information asymmetry problem which exists between the regulator and the regulated entity. Typically, the regulated entity has superior information about, say, the costs of providing the service. Reducing this asymmetry is one of the crucial reasons for establishing a review period since it allows the regulator to acquire critical information while key variables, such as price, are stabilized. Reducing the review period is likely to reduce the quality of the information that the regulator has at its disposal when reviewing the rates, hence exacerbating the information asymmetries. In practice, the rate review period is typically between 4 and 6 years and we know of no compelling reason for the JPS review period to be established outside of this range.[4]

- Proposed Non-fuel Rate Schedule
  Comments reserved

- Proposed Tariff Design
  Comments reserved

- Proposed FX Adjustment Factor
  Comments reserved

- Foreign Exchange Losses
  Comments reserved

- Interest on Accounts Receivables for Commercial Customers
  Comments reserved

- Community Renewal Programme
  Comments reserved

[4] See page 3 of Jamison, Mark A. Regulation: Price Cap and Revenue Cap. Available for download at http://warrington.ufl.edu/centers/purc/purcdocs/papers/0527_jamison_regulation_price_cap.pdf (last accessed: April 28, 2014)

- Prepaid Metering
  Comments reserved

- Proposed System Losses & Heat Rate Targets
  Comments reserved

- Quality of Service Standards
  Comments reserved