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Price-cap versus rate-of-return regulation

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Abstract

Rate-of-return regulation has been criticized for providing inappropriate incentives to regulated firms and for being costly to administer. An alternative is price-cap regulation, by which ceilings (“caps”), based on indices of price and technological change are imposed, below which the regulated firm has full pricing freedom. The differences and similarities of the two are reviewed herein in the light of recent literature. In practice, price-cap is not distinct from rate-of-return regulation. Especially for the multiproduct firm, information requirements—the ultimate source of problems with rate-of-return regulation—are comparables. Price-cap regulation fails to address the real regulatory issue of whether an industry is, in whole or in part, a natural monopoly.

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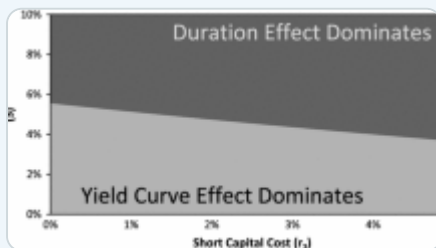
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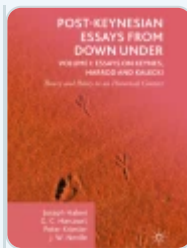
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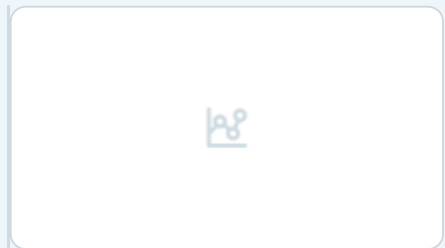
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Author information

Authors and Affiliations

Department of Applied Economics, Université Laval, G1K 7P4, Québec, Canada

Catherine Liston

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