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Addressing the Affordability of Regulatory Prices

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TABLE OF CONTENTS

| | Page No. |
|--|-----------|
| 1. BACKGROUND..... | 2 |
| 1.1 Purpose of Document..... | 2 |
| 1.2 Responding to this Document..... | 2 |
| 2. LEGAL REQUIREMENTS AND AFFORDABILITY..... | 3 |
| 3. DEFINING ELECTRICITY AFFRODABILITY | 5 |
| 4. ADDRESSING AFFORDABILITY CONCERNS..... | 6 |
| 4.1 Classification of Affordability Instruments..... | 6 |
| 4.2 Types of Affordability Instruments..... | 7 |
| 4.2.1 <i>Supply-side Measures</i> | 8 |
| 4.2.2 <i>Demand-side Measures</i> | 8 |
| 4.3 Criteria for Evaluating Affordability Instruments..... | 11 |
| 5. RIC’S MITIGATION STRATEGIES..... | 12 |
| 5.1 Other Strategies..... | 13 |
| 6. SUITABILITY OF AFFORDABILITY INSTRUMENTS..... | 16 |
| 7. CONCLUSION..... | 17 |

List of Table

| | |
|---|---|
| Table – Affordability Instruments | 7 |
|---|---|

1. BACKGROUND

The Regulated Industries Commission (RIC) is the economic regulator for the electricity sector in Trinidad and Tobago. In fulfilling this role, one of RIC's core functions is to review the principles and methodologies for determining rates and charges for services under its jurisdiction every five (5) years. In setting price controls, there are a range of matters that the RIC is required to have regard to, including the ability of consumers to pay rates and the funding and ability of the service provider to perform its functions. Therefore, the challenge for the RIC is to take into account the social impact of prices while ensuring that the efficient service provider can carry out and finance its operations. The RIC therefore contributes to the promotion of social equity by putting such mechanisms in place to manage affordability issues, as: a lifeline block in the tariff structure for consumption-related tariff and explicit, targeted subsidies to low income and vulnerable groups in society.

1.1 Purpose of the Document

This paper outlines the RIC's approach to reducing the impact of increased electricity prices on low income and vulnerable groups in Trinidad and Tobago during the first control period. Strategies to make electricity affordable and soften the impact of increased electricity prices on low income and vulnerable groups for the second price control review are also proposed.

1.2 Responding to this Document

All persons wishing to comment on this document are invited to submit their comments. Responses should be sent by post, fax or e-mail to:

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All responses will normally be published on the RIC's website unless there are good reasons why they must remain confidential. Any requests for confidentiality must be indicated. A copy of this document is available from the RIC's website at www.ric.org.tt.

2. LEGAL REQUIREMENTS AND AFFORDABILITY

One of the Regulated Industries Commission's (RIC) core functions is to set price limits every five years. In setting price limits, there is a range of matters that the RIC must have regard to, in particular:

- To ensure, as far as is reasonably practicable, that the service provided by a service provider operating under prudent and efficient management will be on terms that will allow the service provider to earn sufficient return to finance necessary investment;
- To ensure maximum efficiency in the use and allocation of resources and to ensure as far as reasonably practicable, that services are reliable and provided at the lowest possible cost;
- The ability of consumers to pay rates;
- To ensure fair treatment of consumers and of service providers similarly placed; and
- The public interest.

Although the Act does not provide any specific guidance as to which factors should prevail if the matters/issues compete, the RIC will ensure that its final decision strikes the right balance.

Given the above factors, the RIC sets price limits to meet the service provider's total revenue requirement, while setting tariffs for customers in a way that reflects the lowest possible cost of providing service to them. However, the established tariffs are likely to have a disproportionate impact on different customers' ability to pay, thereby giving rise to the issue of the affordability of the service. The affordability of the service is also influenced by:

- the availability of rebates/concessions;
- the availability of payment options;
- assistance offered for payment difficulties in the form of payment plans; and
- restrictions for non-payment.

The affordability and equity of regulatory prices is of particular concern to the RIC as its Act requires the RIC to take into account the social impact of prices. The affordability of electricity may affect some or all customers and may be the result of the absolute price of the service or the rate of increase of the price of the service.

The way the RIC treats with issues concerning the affordability of prices will depend on specific characteristics of the particular affordability issue. For a particular class of customers, for example pensioners and those who receive fixed incomes, electricity prices may be too high relative to their income levels. As electricity is an essential service and access to it is necessary for a basic standard of living and the general welfare of society, its affordability for these customers is of major concern to the RIC. Transitional affordability issues may arise when prices increase quite suddenly, for example, after a long period of time. Prior to the electricity rate increases established/determined in June 2006, customers had not experienced an increase since 1992. Consequently, customers may not have planned for these increases and may have faced difficulties paying their electricity bills. Finally, an increase in prices may place an unfair burden on current customers due to infrequent, large capital investments. This increased capital expenditure is likely to give rise to equity issues between present and future customers, i.e.

intergenerational equity issues, as an excessive burden will be put on current customers to fund this “lumpy” investment from which future customers will also benefit.

3. DEFINING ELECTRICITY AFFORDABILITY

There are a number of methods that are used to assess electricity affordability. It is widely recognised that certain individuals are particularly vulnerable to energy poverty and affordability issues. For example, pensioners and disabled individuals are doubly affected, because in addition to being more likely to be at home for longer hours and hence likely to having higher energy costs, they are also likely to be more vulnerable due to their fixed income levels.

The most frequently used method for defining affordability is the *Average Employment Income method*, where affordability is measured relative to the average monthly income. This is the approach used by the RIC in its First Determination of electricity rates and charges. A threshold of monthly electricity expenditure accounting for more than 5% of monthly income was used. This has the advantage in that monthly income is both easily measurable and comparable between countries. However, difficulties arise if households have no salary earners or multiple salary earners. Furthermore, the measure may exclude income from the informal sector.

The use of *Consumption Deciles/Expenditure* is sometimes preferred to income as an indicator of electricity affordability. Here one uses a threshold where electricity consumption accounts for more than a certain percentage, say 10 per cent or greater, of total expenditure. Using consumption captures the application of funds from all sources of income (salary, pensions, benefits, rental income, informal economy earnings, self-employment, agricultural income etc). This measure also captures the effect of smoothing consumption over time, for example, using savings during times of temporary income shortfalls.

One can also calculate the affordability of electricity to those in poverty, as measured by the *National Poverty Line*. To facilitate cross-country comparisons of electricity consumption by

those in poverty, one can choose to use the absolute poverty lines¹. As national poverty lines are often country specific, this makes cross-country comparisons of poverty difficult.

4. ADDRESSING AFFORDABILITY CONCERNS

In determining what is the best method for addressing affordability concerns, one needs to know the specific characteristics of the particular affordability issue. In practice, the decisions of the regulator are not the only, or necessarily the best, means of managing the social impacts of increased electricity prices. Government policies such as rebates or direct financial assistance, continue to be the best way to address issues related to customers' ability to pay.

4.1 Classification of Affordability Instruments

Affordability instruments are generally classified² based on certain characteristics. Firstly, the instruments can be considered either supply side or demand side. **Supply-side** instruments are directly given to service providers, thereby reducing the prices to all customers. On the other hand, **demand side** instruments are directed towards customers or subsets of customers, thereby reducing the prices paid by customers without reducing the service provider's cost. Secondly, some affordability instruments fall within the purview of the regulator, while others are delivered via a government's income support and social security benefits system or even through direct payment to the service provider. Thirdly, affordability instruments can either be funded by cross-subsidies or by taxpayers through government payments. Fourthly, an instrument can either be general or specific in its focus. General instruments reduce prices to all or most customers, while specific instruments reduce prices for particular customers. Finally, affordability instruments may be either on-going or transitional, where assistance is for a limited time.

¹ These are US\$1 per person per day expenditure at purchasing power parity (extreme poverty) or US\$2 per person per day expenditure at purchasing power parity (poverty) as used by the World Bank.

² The classification is based on the paper "Affordability and subsidies in public urban transport", Policy Research Working Paper Series 4440, World Bank, 2007.

4.2 Types of Affordability Instruments

There are a number of instruments available to address affordability concerns. The choice and implementation of the instrument will depend on the criteria outlined in Section 4 above. The **Table** below presents the various instruments available to mitigate the impact of increased prices. It shows the instruments available for use by both the regulator and the government. Typically, effective measures to mitigate energy poverty and increase affordability require a combination of significant financial resources with a good understanding of the end consumer. This would include high-quality data on electricity consumption, income levels and the condition of housing stock, together with the technical expertise to carry out electricity poverty mitigation measures.

Table - Affordability Instruments

| | GOVERNMENT DELIVERED | REGULATOR DELIVERED |
|--------------------|--|--|
| SUPPLY SIDE | <ul style="list-style-type: none"> • Operating Subsidies • Capital Subsidies • Tax Rebates | <ul style="list-style-type: none"> • Deferring Cost Recovery • Lowering Rate of Return on Capital • Lowering Initial Regulatory Asset Base (RAB) • Applying Negative Depreciation • Allowing Longer Asset Lives |
| DEMAND SIDE | <ul style="list-style-type: none"> • Income Support Payments • Customer Rebates • Grants • Vouchers • Pricing Concessions - Connection and Consumption Subsidies • Payment Assistance Programmes • Energy Efficiency Programmes • Information Services | <ul style="list-style-type: none"> • Glide Path Pricing • Use of Side Constraints • Variable Tariffs • Volume Differentiated Tariffs |

4.2.1 Supply-side Measures

Supply-side measures are normally general in nature as they cannot discriminate between different types of customers. Government-delivered supply-side measures such as operating subsidies, capital subsidies, etc., reduce the service provider's cost, thereby reducing the tariffs to all customers. Government-provided supply-side subsidies perform poorly from the aspect of affordability and can lead to reduced incentives to pursue efficiency improvements on the part of the service provider and to over-consumption and wastage on the part of the customers. Similarly, regulator-delivered supply-side measures generally have the same problems with potential leakage as government-delivered measures, and potentially deliver benefits to non-deserving customers. However, they are more appropriate to managing situations where affordability is of general concern. Administrative costs are also likely to be lower for regulator-delivered supply-side measures.

4.2.2 Demand-side Measures

Overall, demand-side measures facilitate customer choice and can be price-based (e.g. variable tariff structures, targeted price concessions), or non-price based, such as information services, grants to purchase energy-efficient appliances, etc. Additionally, they can be "paid" to customers either directly or through the service provider. Government-delivered demand-side measures (e.g. income support systems, access subsidies) are transparent, do not distort prices and directly benefit those in need. Being taxpayer funded, the funding burden is spread across the entire taxpayer base. Non price-based measures such as "information services" can assist customers in managing their demand or using services in a manner that lowers their bills.

Regulators use demand-side measures to address affordability problems. Glide-path pricing (i.e. phasing-in tariff increases) is used to address rapid price increases, whereby tariffs reach full cost recovery levels over a number of years rather than during the first year of a determination. Regulators invariably use "variable tariff" structures to address affordability concerns and/or to manage demand. Variable tariff structures aim to help the disadvantaged and vulnerable groups meet their basic needs by offering a discounted

usage charge for lower levels of consumption. The two main methods used to target quantity levels are:

- inclining block tariffs, where tariffs increase for each successive consumption block, the first block (known as lifeline block) being set to meet basic energy needs; and
- volume-differentiated tariffs, where a higher flat-rate tariff applies to all consumption, once a threshold volume has been exceeded.

Inclining block tariffs are likely to be less well targeted to affordability than volume-differentiated tariffs, as all customers, irrespective of their total consumption, receive a quantity discount. Quantity-targeted tariffs can be less effective at improving affordability for lower income customers if there is no strong correlation between consumption and low income household usage. It is quite possible that, in some cases, disadvantaged groups may not be in a position to change their usage patterns.

In its first determination of electricity rates and charges, the RIC employed the use of a lifeline block in the residential consumption-related tariff structure so as to allow for the consumption of the established level of ‘lifeline’ electricity by all households and to discourage inefficient use of electricity.

Lower connection and/or fixed charges, while not a targeted measure, tend to be pro-poor as they reduce barriers to poor people using small amounts of energy within their affordability range. “*No disconnection policies*” or more lenient disconnection procedures for poor households may also be implemented to facilitate an adequate level of electricity consumption. However, they provide no incentive to improve collection rates from non-paying customers, provide poor coverage of the poor and do not effectively target them.

The RIC believes that T&TEC’s disconnection policy should be reviewed so as to fully take account of the needs of poorer customers. The Low Income Assistance Programme,

for customers who have been identified as being in need and whose usage falls below 400 kWh bi-monthly, provides for arrears forgiveness; waiving of interest payments on outstanding accounts; protection from service termination (some forms of non-payment are not to be tolerated i.e. illegal tampering of meters); and extended payment arrangements i.e. the option of arranging alternative payment schedules and deferring payments. T&TEC may also consider offering levelised payment plans, (i.e. spreading high consumption charges over the entire year) or where feasible, pre-payment meters as an alternative to disconnection.

There are other measures on the demand-side including methods to promote the use of energy efficient materials and equipment in households (e.g. solar water heaters, compact fluorescent light bulbs etc). Included in these are grants that are given to households who install energy efficient lighting and appliances so as to encourage a reduction in electricity demand. These instruments have received increasing attention in recent years due to a growing understanding of the environmental impacts of energy use, in particular the climate change impact of greenhouse gas emissions from fossil fuels. Reducing the electricity demand of poor households through improving the energy efficiency of housing and appliances offers a potential long-term solution that can also reduce the amount of subsidies paid to low income households.

Energy efficiency measures have been shown to reduce energy bills by 20-40 per cent - an effect equal to or greater than that achieved by subsidies, and at lower costs too (World Bank 2003). Furthermore, such measures are mostly required on a one-off basis (depending on the lifetime of a particular measure, although most measures apart from weatherization, are expected to last more than 10 years). The impact of such measures can be immediate in terms of eliminating, for example, supplemental electricity use.

An approach that has worked well in the UK and several other countries has been to place an obligation for eliminating energy poverty on energy companies, in proportion to their customer base. This makes sense because these companies, far more than the government, have a direct interface with all consumers of commercial energy resources,

and furthermore, they have the technical expertise to be able to help households with practical measures in their own homes. However, such a strategy is feasible only if the energy companies are commercially viable to begin with and have the finances, capabilities and incentives to address energy poverty.

4.3 Criteria for Evaluating Affordability Instruments

Different instruments will perform differently depending on the nature of the affordability problem being addressed. Therefore, it is important that proper criteria be employed for evaluating affordability instruments. Some of the criteria for evaluating affordability instruments include:

- the extent to which those in need are being reached, that is, the **coverage of the benefit**. It is important to ensure that the benefit is indeed reaching the poor and vulnerable in society and that a large proportion of those in need benefit from the subsidy. The benefits must relieve the affordability problem.
- the share of the benefit that goes to the poor, that is, the **targeting** efficiency of the benefit. A targeting variable is often used to identify households that are eligible to benefit from a particular subsidy. It is important that these variables are well chosen to ensure that funds are not misdirected to households who meet the criteria but are not genuinely in need of the subsidy. This will ensure that there is relief from the affordability problem by those in need.
- the **extent of price distortions and other unintended side effects** of the benefit. The use of subsidy mechanisms can lead to changes in the relationship between cost and prices and distortions in demand. It is important to monitor these and if necessary find ways to remove these distortions so that there is minimal impact on economic efficiency, such as encouraging under or over-consumption, compromising the service provider's financial viability, etc.

- the **administrative costs and simplicity**. High administrative costs are often associated with schemes that have high targeting efficiencies. Although screening customers to determine eligibility is important, it is also equally important that there be a balance between the targeting efficiency and administrative costs of the benefit. The costs imposed by the administration of the benefit should not place an excessive burden on those funding it. The instrument should also be relatively simple so as to minimize these administrative costs.
- the **excessive burden** on those funding the instrument. It is important that there should not be an excessive burden on those funding the instrument.

5. RIC'S MITIGATION STRATEGIES

In its first control period, the RIC established the various tariff categories and the corresponding tariffs for the various consumer categories. The increases implemented varied across consumer categories with the lowest increase for lower income groups. With respect to low income and vulnerable groups, the RIC's three main strategies for reducing the impact of increased prices in the first year of the first control period were:

- (a) **A Discount Plan/Tariff Mechanism:** The RIC utilized an inclining block tariff structure that incorporated a life-line tariff which allowed the households to pay at a lower rate for a certain monthly consumption level, and the discount varied with customer's usage, for example:
- customers using up to 400 kWh bi-monthly enjoyed a **discount of 44.9%**;
 - customers using 401 – 1,000 kWh enjoyed a **discount of 29.7%**; and
 - customers using over 1,000 kWh enjoyed a **discount of 19.1%**.

The RIC also applied a fixed dollar discount on the residential customer charge and a fuel cost subsidy.

(b) A Low Income Assistance Programme: T&TEC was required to establish a special fund of \$5 million annually to cater for the special needs of those who may still experience difficulty in paying their bills. This fund was available for customers who would have been identified by the Ministry of Social Development as being in need and whose usage fell below 400 kWh bi-monthly. T&TEC was also required to maintain a register of customers in need and the fund was to be used for:

- customer bill assistance (that is, a maximum of 7% and 5% of customer's bill for customers using less than 100 kWh and between 101 to 400 kWh respectively);
- appliance repair assistance; and
- arrears forgiveness.

Other measures under the low income assistance programme included:

- waiving of interest payments on outstanding accounts;
- protection from service termination (some forms of non-payment were not to be tolerated i.e. illegal tampering of meters); and
- extended payment arrangements i.e. the option of arranging alternative payment schedules and deferring payments.

(c) An Energy Efficiency Programme: This demand side programme was centered on education of consumers to encourage the reduction and management of energy consumption so as to control bills by wise usage.

5.1 Other Strategies

The RIC also utilized a number of other mechanisms in the first control period to reduce the impact of increased prices. The RIC introduced a mechanism to provide T&TEC with a continuous incentive to achieve efficiency gains. This **efficiency carryover mechanism** allows the service provider to keep any efficiencies for a specified period of time, regardless of when

those efficiencies are generated. Specifically, the RIC implemented a rolling carryover mechanism, where efficiency gains (losses) are carried over for a specified number of years following the year in which they occurred. The RIC used an arrangement whereby the efficiency gains from under spending on capital or operating expenditure should be retained for five years from the year in which the gains were made, regardless of which year in the regulatory period the gains were made. This would provide an equal incentive to T&TEC to make gains in each year of the control period.

Under this efficiency carryover mechanism, the benefits are shared between customers and the service provider over different periods of time. Service providers derive benefits over the specified period set by the regulator. Customers, on the other hand, derive benefits in the form of lower prices. The RIC utilized a P₀ Adjustment to share out-performance, where gains in excess of those stipulated by the X-factor in the current period are passed directly on to customers in the development of new price controls. This allows customers to benefit as quickly as possible from gains in excess of those embodied in the X-factor through a one-off reduction in prices. However, a hybrid approach, that is, a combination of P₀ Adjustment and the glide path/phased option³, may be necessary to ensure that the service provider has the maximum incentives to cut costs throughout the regulatory period while at the same time ensuring that customers also benefit from excessive gains in the quickest period possible. The RIC utilized a mechanism for sharing profits with customers if profits exceeded 10% of the total revenue forecasts.

In considering the impact of its price control decisions on consumers, the RIC decided to incorporate a rebalancing control (**side constraint**) as part of the first regulatory price control. Here the regulator sets limits to the extent of annual price increases to customers. In the absence of side constraints, individual customers could face significant price movements from year to year. The RIC set the size of the side constraint⁴ on the expectation that it would broadly allow the achievement of cost reflective pricing by the end of the first regulatory control period.

³ Under the **Glide Path Pricing** approach gains are passed to customers over a period of years rather than a one-off reduction in prices. A variation of this approach is 'gains maintenance'.

⁴ The overall side constraint was set at $(RPI + X) = 7.4\%$.

Given the capital-intensive nature of transmission and distribution networks, capital related costs, return on capital and return of capital (depreciation), can form the largest component of the revenue requirement and therefore have a large impact on prices. The recovery of the annual costs of financing investments in long-term assets is achieved through both a return of capital (depreciation), to allow for the recovery of invested capital, and a return on the regulatory asset base, which enables the recovery of the costs related to the providers of equity and debt.

In determining prices, the regulator includes a rate of return on the assets of the service provider in the allowed revenue. Shareholders and creditors require a return on the capital which they invest. The cost of capital is the cost to the service provider of meeting the required return. The cost of capital (allowed return) when applied to the asset base of the service provider enables it to meet its cost of debt financing and provide a return on investment. The service provider is thus able to recover the costs of financing both past and future capital expenditure over the life of the assets. The regulator has a duty to set an appropriate rate of return that allows an efficient utility to properly finance its operations. The regulator must also seek a balance between current and future customers by ensuring that the allowed rate of return is only just high enough to cover the costs of the benefits provided to current customers.

In the first determination, the RIC sought to provide a return that was sufficient for T&TEC to fund its activities in a sustainable way. It was found that T&TEC carried high-cost embedded debt (11.87%) as compared to existing market rates of 6.35% to 6.5% for government guaranteed debt. In fact, a major part of its debt was negotiated at an effective rate of 13.65% to finance operating deficit. The RIC considered that such imprudent interest costs should not be passed to consumers in the form of higher prices and thus **lowered the rate of return** on capital that it allowed for T&TEC in the first determination. Given all the circumstances, the RIC used a cost of capital of 8.0%, applied to the Regulatory Asset Base (RAB), to determine the return on assets T&TEC could reasonably earn over the first regulatory control period. The RIC further recommended that T&TEC should initiate debt restructuring immediately with a view to negotiating lower interest rates and did not allow a return on equity to the shareholder (government).

To estimate both the return on capital and return of capital (depreciation), the regulator must first establish an opening value of the Regulatory Asset Base (RAB), that is, the investment base upon which a service provider is allowed to earn a fair return. This value directly impacts on the tariffs consumers pay. Any under-valuation or over-valuation can lead to losses or undue surpluses for the service provider. The RIC used a value based on historical cost valuation for the determination of the initial/opening RAB for the first regulatory control period. Subsequent to this, assets would be revalued by using a “roll-forward” methodology, whereby the RAB is updated by adjusting for efficient new capital expenditure, depreciation, asset disposals and inflation. The RIC ensured that those fixed assets that were included in the RAB were long-term in nature and “used and useful”⁵ and that only prudent capital expenditure was included, thus in effect **lowering the Regulatory Asset Base** and the prices that customers pay.

6. SUITABILITY OF AFFORDABILITY INSTRUMENTS

In addressing affordability issues one must first determine the nature and extent of the affordability issue and only then appropriate measures to address the issue can be determined in a way that maximizes benefits. As far as possible, across-the-board subsidies should be avoided. Such non means-tested or categorical subsidies often do not reach the poor, poorly target the poor, produce price distortions by reducing the apparent cost of service, and are often difficult to administer and are non-transparent.

As a general rule, the following approach would achieve better results:

- where affordability issues arise as a result of rapid changes in tariffs to all or most customers, the regulator is best placed to achieve the objectives by determining an appropriate price path through applying a cap on the size of annual increases in tariffs, that is, by imposing side constraints;
- where future customers are likely to be the significant beneficiaries, adjustment of pricing parameters such as depreciation should be considered;

⁵ “Used and useful” means that the assets should be in a condition that makes it possible to satisfy demand in the short-term.

- where there is a shortfall between the regulator’s determined tariff and the cost-reflective tariff, an explicit government-funded payment would be a preferred instrument;
- where the issue is one of public good such as universal service obligation/access charges, an explicit government-funded subsidy should be the favoured method of addressing the issue; and
- finally, the affordability issues affecting vulnerable or disadvantaged groups should best be addressed by a direct, targeted subsidy (i.e. income support payments or benefits, rebates, concessions, etc.) directly to those in need.

7. CONCLUSION

As the RIC looks towards the second Price Determination for T&TEC it has to, as a responsible regulator, examine the effects of its measures and determine what affordability instruments are best suited for the purpose at hand. The RIC has proposed a number of measures that it expects will more adequately address affordability issues, bearing in mind its duty to balance impacts on affordability, economic efficiency and the service provider’s financial viability. The RIC’s capacity to respond to specific affordability issues facing low income groups is limited. As a regulator, the RIC can pursue general affordability by establishing tariffs at levels no greater than necessary for the recovery of efficient costs and a reasonable rate of return. Effective monitoring and reporting are also essential in enabling the RIC to track progress on social issues and identify possible additional areas for future action. The RIC will continue to monitor and report on the service provider’s performance against its social obligations relating to debt, disconnection, energy efficiency advice, etc., by publishing quarterly/annual reports. Having input from customers, particularly the vulnerable, is key to being able to properly take their interests into account, in the RIC’s decision-making.

The RIC invites comments on the issues discussed in this document.