REGULATED INDUSTRIES COMMISSION

IMPROVING PERFORMANCE - EFFICIENCY INCENTIVES FOR A PUBLIC SECTOR MONOPOLY

July 2018

Summary Document

BACKGROUND

The RIC Act supports an incentive-based approach to economic regulation. Incentive regulation incorporates two broad sets of incentives. The first is focused primarily on reducing costs or process innovation and the second focuses on service quality or product innovation.

RIC'S APPROACH TO INCENTIVES

The RIC adopted an incentive-based approach to regulation that involved a number of mechanisms which encompassed both financial incentives and non-financial. These incentive mechanisms are illustrated below.

FINANCIAL INCENTIVES

Setting a Long Price –Path

The RIC established a price path for a period of five years on the basis of forecasts of key components of the revenue requirement. This allows the service provider to retain any benefits that arise from out-performing the forecasts and equally requires the service provider to bear any losses from under performance.

Building-Block Mechanism

In determining price limits, the RIC used a building-block approach. Forecasts of utility-specific, efficient costs are used to make an assessment of forward looking revenue requirements. In this way the regulator only allows what it determines to be efficient costs to pass through into rates.

Rate of Change

The rate of change is the year-to-year change in operating and maintenance costs (Opex) for factors, such as productivity improvements in labour and other costs. This rate may be established by examining the productivity achievement in Opex for a number of years and estimating expected reductions in future cost.

Efficiency Carryover Mechanism

To supplement the above three mechanisms, the RIC also utilized an efficiency carryover mechanism to encourage efficiencies within the regulatory period.

Guaranteed Payments

The RIC has a Guaranteed Standards Scheme for Trinidad and Tobago Electricity Commission (T&TEC). Under this Scheme T&TEC is required to make guaranteed payments to customers who receive service below a certain benchmark.

NON-FINANCIAL INCENTIVES

Comparative Performance Reporting

Under this approach the service provider is required to report its performance against a specified set of measures. It is a relatively straight forward approach and arguably a pre-requisite for other forms of incentives.

REGULATING STATE OWNED AND OPERATED UTILITIES

The reasons for the poor performance of state-owned enterprises (SOEs), including public utilities infrastructure providers, are rooted in the failure of the political directorate to maintain an arms-length relationship with these enterprises (Irwin and Yamamoto 2004, Foster 2005, Nellis 2006). Making service delivery and regulation more independent, strengthens a utility's accountability and performance. The following principles of good governance can be applied to the utility sector where the Government is the major shareholder:

- The Shareholder appoints the board and agrees to the terms on which the Directors and senior managers are appointed.
- The shareholder agrees to the Company's strategic plan with the Board.
- The Board is accountable to the shareholder for delivering the agreed plan.
- The shareholder gives the Board the operational freedom to take the necessary action needed to deliver the goals and objectives of the Strategic Plan.
- The shareholder monitors the Company's performance to satisfy itself that the strategic plan is on track.
- The strategic plan is to be a business plan setting out how management intends to deliver objectives and metrics that would be designed to deliver on and out-perform the regulatory determination.

A challenge for many regulators, especially those of state-owned and operated utilities, is to establish the appropriate mix of incentives and mechanisms to improve the utility's performance while encouraging efficient operations. In an attempt to find the best combination of incentives to improve performance, the regulator may apply the following mechanisms:

Establishment of Specific Targets - the establishment of specific targets in areas where improved performance is deemed to be critical.

Governance Initiatives - a key cornerstone for improving the performance of state-owned and run entities is strengthening the governance framework within which the entity operates. There are two key initiatives in this regard: The establishment of a hard budget constraint and Performance–related pay (PRP).

The "Trigger" Mechanism - this is the inclusion of certain "triggers" or price cap conditions within its price cap formula. Such an approach can be easily adapted for the delivery of critical projects or tied to the lack of attainment of key deliverables.

Responding to this Document

All persons wishing to comment on this document are invited to submit their comments by August 23, 2018. 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.

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