REGULATED INDUSTRIES COMMISSION

P0 Adjustment – Passing Cost Savings to Customers

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The purpose of this document is to discuss the usefulness of a P0 adjustment, among other approaches, as an incentive mechanism in a state-owned and operated sector.

Consultative Document

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1. Introduction

As part of its second price control review for the electricity distribution and transmission sector, the Regulated Industries Commission (RIC) plans to release a series of papers detailing key aspects of the regulatory framework. One of these aspects is whether or not options for sharing the benefits of out-performance remain a useful incentive for encouraging the service provider to make savings above those envisaged in the price formula.

The RIC Act, Chapter 54:73, sections 6 and 67 as well as Part 5, provides that the type of regulation utilized by the RIC be some form of incentive regulation. Specifically, the Act mandates the RIC:

- to establish the principles and methodologies for determining rates; and
- to determine the rates and charges for services every five years.

In the performance of these functions the RIC is required to have regard to:

- furthering the interest of consumers, including the ability to pay rates; and
- promoting economy and efficiency.

As part of its pricing methodology for the first price control review (2006-2011), the RIC had discussed a number of options for sharing the benefits of out-performance with customers. The RIC decided to employ a Po (an initial price adjustment from one price control period to the next) as well as an X-factor during the price control period, where gains were to be passed on to customers over a period of years (a glide path). Po refers to the level of cost reduction that regulated entities are required to pass on to customers at the beginning of new price controls. The Po is intended to reflect the change in allowances under the new price control as compared with the allowances that were available under the existing control.

The RIC also indicated that it would continue to utilize a Po factor/adjustment to share out-performance in the future because it was of the view that consumers should share as quickly as possible from gains in excess of those embodied in the X-factor. However, it reserved the right to utilize a combination of Po Adjustment and a phased adjustment if it felt it was necessary to limit the rate of change in prices for customers, or to consider the cash flow impact on the service provider. **Very importantly, it was felt that a hybrid approach also ensured that the service provider had the maximum incentive to cut costs throughout the regulatory period while at the same time ensuring that customers also benefitted**.

Purpose of Document

This purpose of this document is to discuss the usefulness of a Po adjustment, among other approaches, as an incentive mechanism in a state-owned and operated sector.

Responding to this Document

All persons wishing to comment on this document are invited to submit their comments by 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. Utilizing a Po Adjustment

The RIC's regulatory duty entails setting price controls that allow the service provider to finance efficient capital investments (Capex), cover efficient operating expenditure (Opex) and earn an appropriate return on investment whilst delivering specified outputs, inclusive of quality of service standards. Using the building block approach, the RIC assessed the service provider's future efficient Opex, Capex and return on assets (cost of capital) and depreciation in order to calculate an allowed revenue stream over the regulatory control period (i.e. five (5) years).

Opex was assessed by reference to a range of different sources of evidence including:

- the historical performance of the service provider;
- the service provider's own Opex projections;
- different types of benchmarking exercises; and
- evidence of what efficiencies were achieved elsewhere.

Similarly, Capex was also assessed by reference to a range of different sources, including whether:

- the proposed Capex trends were related to trends in historical Capex;
- there was evidence of, and consistency with, well developed asset management planning and processes that demonstrated that the forecasts took account of a planning horizon which extended beyond a five year control period;
- the Capex associated with new functions and obligations was clearly identified; and
- the proposed Capex was deliverable over the five year period.

The market cost of borrowing to finance Capex was included in the cost of capital.

Under the RPI-X form of regulation, the service provider retains the benefits of out- performance (or suffers the consequences of under-performance) against the allowances set for the five years. Apart from this, the RIC had included the efficiency carryover mechanism for Capex, which meant an efficiency gain (loss) in Capex is to be calculated as the WACC multiplied by the reduction (increase) in Capex against the Capex forecast.

Regulators have long acknowledged that a service provider will, at the time of a new price review, want to know what proportion of the additional gains, produced by its extra exertions, that it will be allowed to retain at the end of each review period and for how long. The issue of benefit sharing thus arises.

When a regulated firm is able to make efficiency savings above those reasonably expected as provided in the X-factor, these gains can arise from two primary sources[1]:

- those arising from management's initiatives; and
- those due to exogenous factors such as demand growth, changes in interest rates or windfalls.

These sets of gains are normally associated with the out-performance of the X-factor and the regulator needs to consider:

- the extent to which out-performance of the X-factor should be shared with customers or retained by the firm;
- the period over which it should be shared with customers; and
- the profile of the sharing arrangements.

There are **two broad options** that may be utilized to share the benefits of the out-performance of the X-factor with customers:

[1] Gains can also arise by reductions in service standards, by delaying or avoiding necessary expenditure or gross errors in estimates of capital and operating costs at the time of the review.

- **One-off reductions** (P_0 Adjustment) – Here 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, and a new X-factor is set for the new price control period. Under this approach, the service provider has little incentive to invest in efficiency enhancements towards the end of the regulatory period; and

- **Phased option** – Here gains are passed to customers over a period of years to provide stronger incentives. This approach is generally referred to as **glide path mechanism**. Another variation under this option is what is referred to as **'gains maintenance'**. Gains maintenance (rolling or fixed carryover) allows the service provider to retain the **full gains** for each year for a pre-specified period unconnected to any review period whereupon gains can be passed to customers in a one-off or phased price reduction. However, a rolling or fixed carryover usually does not extend past one subsequent regulatory period.

In practice, the options are often combined. For example, a glide path could incorporate a one-off reduction at the start of the period or it could return the benefit over a longer period (e.g. ten years) or over a shorter period.

At the time of its first price review for T&TEC, the RIC's final decision was to utilize P_o Adjustment to share the out performance of the X-factor for the first price control period. However, the RIC reserved the right to utilize a combination of P_o Adjustment and gradual adjustment if it considered it necessary to limit the rate of change in prices to consumers or the cash flow impact on the service provider.

Implicit in the provision of both a Po adjustment and/or a gradual adjustment mechanism is the assumption that a firm will try to "outperform" predetermined benchmarks, that is, X-factors embodied in the price cap/revenue cap regime, because it will retain part or all the benefit (profit) from doing so (at least for the duration of the price control period). It is argued that by doing this, the firm has a financial incentive to devote effort to decreasing its costs.

Alternatively, because the firm is not guaranteed a fixed rate of return it is also motivated to improve its performance to ensure that it does not sustain losses. In this way incentive regulation mimics the behaviour of the competitive market.

It is generally accepted that the incentives to make such savings are strongest in firms which are privately owned and operated, that is, conventionally financed through a mixture of debt and equity. Utilities that are state-owned and controlled sometimes have very different objectives and it may be necessary to provide additional incentives or employ different mechanisms to ensure improved efficiency on the part of those utilities. In fact, the RIC is concerned that instead of attempting to out-perform the X-factor which has been set in the current revenue controls the service provider views it instead as a budgetary constraint.

As indicated above, the RIC's approach was to set ex-ante efficiency targets and upfront reduction of costs so that customers are guaranteed that only efficient costs are included in the revenue requirements. On balance, the RIC considers that there is merit in setting efficiency targets to achieve the best possible outcome. Such a mechanism would include pricing that recovers the efficient cost of providing services. Furthermore, in order to provide incentives as well as to maintain a robust and credible organization, there has to be a linkage between the service provider's own costs and revenues. Without some form of link between a service provider's costs and revenues, prices would not be able to track costs (they could either be too high or too low). Finally, if service providers are permitted to retain the benefits of out-performance, significant weight will usually be given to the most recent actual (or revealed) performance of the service provider.

The RIC is therefore seeking views on whether or not a Po adjustment should be utilized in its second price control review for T&TEC or alternatively whether it should continue to ensure that only the efficient costs are passed "up-front" in rates to customers.