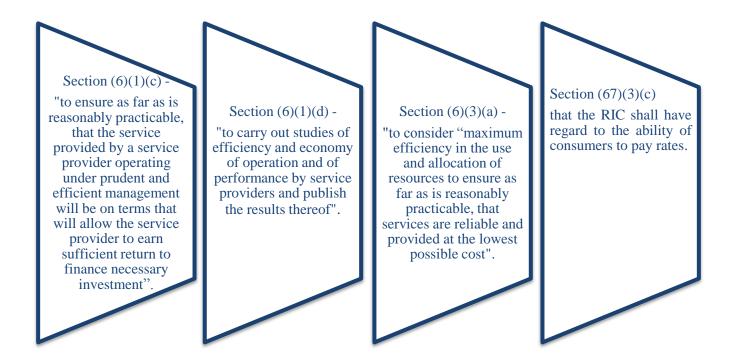


Why Assess Capital Expenditures for Price Reviews?

RIC's rate review process is guided by the RIC Act. Overall the process is designed to improve accountability and transparency and ensure that proposed rates are based on reasonable cost assumptions. To meet these objectives and others articulated in the RIC Act, the interrogation/assessment of proposed (forecast) capital expenditures (Capex) of the utility is a critical activity in the rate review process. The specific sections of the RIC Act which suggest the need for capital expenditure (Capex) assessment and/or guide the RIC's overall approach to the capital expenditure assessment are as follows:



Working within this legal framework, the RIC has established its approach to assessing expenditure, and the overall revenue requirement for service providers.

RIC's Approach to Capex Assessment

The RIC engages in the careful and thorough assessment of the service provider's proposed capital programme, to ensure that the approved Capex is prudent and that the programme consists of projects that are necessary to deliver a satisfactory and adequate level of service, which is provided at the most efficient cost. The assessment can essentially result in the regulator's acceptance, adjustment or even disallowance of the service provider's proposals for capital expenditure. Broadly the assessment involves evaluating whether past and forecast future capex represent the best way of meeting customer needs for electricity services:

Part 1

Review of the actual or out-turn Capex of the previous control period (ex-post¹ assessment) to assess whether in the circumstances existing at the time, T&TEC's past decisions regarding capex investments were prudent and efficient and consistent with RIC

Part 2

Review of the forecast Capex for the subsequent (future) regulatory control period to establish the efficient and necessary level of Capex that will be required for the provision of services.

The assessment involves the testing of efficiency, prudency and used and usefulness of past and forecast Capex. These tests are defined as follows:

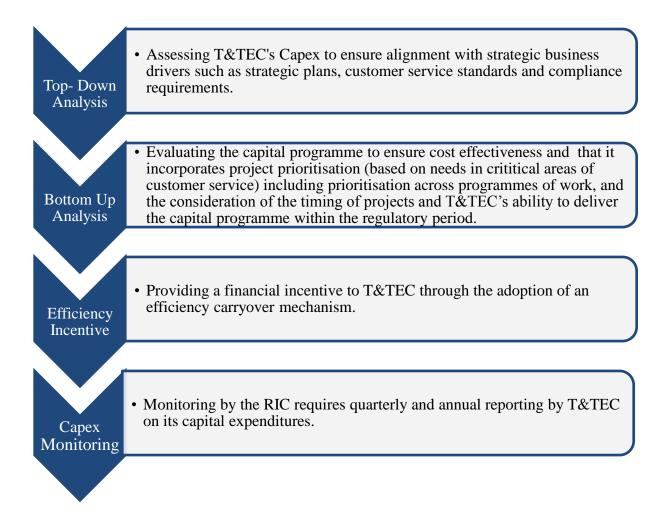
- i. Efficiency Tests which determine whether the proposed Capex was representative of the best way to meet customers' needs for services.
- ii. **Prudency Tests** which seek to establish whether or not the decision to invest is prudent, given the particular and specific circumstances at the time.

¹ Examination of results and events after they have occurred

iii. **"Used and Useful" Tests** – which essentially examine whether or not the particular assets/equipment/plant are utilised in and contribute to, the provision of the particular service.

The RIC primarily employs a combined top-down² and bottom-up³ approach for the assessment of Capex. It is critical that comprehensive information is provided by T&TEC to support the assessment under these approaches.

Some of the activities undertaken by the RIC in its determination of Capex which meet the requirements of prudency, efficiency and "used and useful" are as follows:



² Top down analysis – high level review of strategic plan and methodology used to determine capex forecasts

³ Bottom-up analysis – detailed examination and reassessment of particular investment projects plans.

Further Considerations and Measures in the Treatment of Capex

The RIC's review of T&TEC's out-turn Capex for the first regulatory period (2006 -2011) highlighted the need for further measures to treat with undesirable outcomes such as cost overruns, project delays and poor project execution. Further, challenges have arisen as a result of the governance arrangements for T&TEC due to state ownership. To address specific issues arising out of these circumstances, the following considerations and recommended measures are proposed.

The engagement of the Minister and Board of T&TEC to seek assurance that tariff revenues would not be used for non-approved state driven projects.

The engagement of Government to implement a Management Incentive Plan which provides appropriate incentives for senior management to scrutinise and question cost forecasts and project implementation plan e.g. (bonuses for improved capex performance, performance related pay, etc.).

The adjustment of the Regulatory Assest Base to address under and over spends of approved Capex.

The strengthening of exisiting Capex Reporting Framework to require more frequent reporting by T&TEC to the RIC as well as public disclosure (via media) of non- complaince by T&TEC.

The review of existing Capex Incentive Mechanism and consideration of other measures such as capex triggers.

The provision of an allowance for contingency to provide a buffer against overruns relative to the overall capex forecast.

The engagement of T&TEC for the development and submission of detailed asset management plans, alongside longer term capital investment plans, to assess how T&TEC's proposed Capex relates to, and corresponds with same.

Overall the RIC considers its approach to Capex assessment to be sufficiently robust and in keeping with established regulatory practice. The RIC believes the provision of incentives, the monitoring of Capex throughout the regulatory control period and the engagement of the Government and the Board of T&TEC on several matters will allow for continuous improvement in T&TEC's delivery of the approved Capex programme.

The RIC invites comments and views on all the ideas presented in this paper

Responding to the Document

All persons wishing to comment on the main document are invited to submit their comments 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**.