REGULATED INDUSTRIES COMMISSION

Embedding Financial Viability and Sustainability

February 2018

The purpose of this paper is to review the RIC's approach utilized for the first price control period to assessing financeability and to determine whether it remains valid and how the RIC will respond to potential financeability issues in the future.

Summary Document

Background

In order to carry out its functions efficiently, utilities need to be financially viable. One of the primary duties of the Regulated Industries Commission (RIC) is to ensure that the service providers under its purview are financially viable. One of the ways the RIC performs its duties is to review and set price limits.

Legislative Obligations

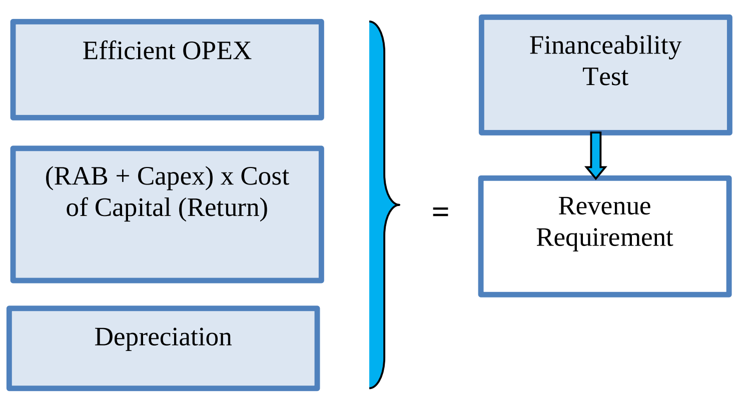
The RIC is required under its Act to set price controls every five years. The Act places an obligation on the RIC to ensure that service providers are capable of financing their operations as specified by Section 6(1) of the Act, which states that:

"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 the necessary investment".

Approach to Ensuring Financial Viability – The Building Blocks Method

In its first regulatory control period 2006-2011, the RIC utilised the building block methodology to establish the revenue requirement for T&TEC. The methodology is shown in Figure 1. The total allowed revenue requirement includes all efficient operating and maintenance (Opex) costs, plus allowances for "return on" (cost of capital) and "return of" (depreciation) T&TEC's regulatory asset base. The RIC will continue to utilise this method as the success of the method allowed T&TEC to remain financially viable up until the end of 2012.

Figure 1 - Overview of the Revenue Requirement Calculation



Issues and Assessment

Building-block Approach - As long as the cost of capital and other variables/factors are estimated correctly, the building-block method should ensure long-term financial viability of the service provider with the use of benchmarking or comparative efficiency assessments.

Notional or Actual Gearing Ratio - the gearing ratio feeds into the buidling -block model and and the financebility assessment. Some regulators used notional gearing while others use actual gearing ratio of the service provider. There are advantages and disadvantages to either approach. The RIC utilised notional gearing for the last price review and intends to continue with this approach.

Cost of Debt and Capital - In the first determination, the RIC discussed approaches to calculating the cost of capital, including whether to use the true WACC (i.e. as a Government-owned entity) or to use a private sector surrogate.The RIC considered that a combination of a forward-looking cost of capital, and an allowance for embedded fixed rate debt, provided a more reasonable approach than the traditional WACC approach.

Anticipatory Investment - a significant amount of investment in renewable generation will be required based on government targets and much of this may occur at locations currently not equipped for the transmission of such energy . How investments made on an anticipatory basis should be regulated is an issue, as there is the risk that the provision made for anticipatory investment may not be fully utilized.

Assessing Financiability - the RIC uses five main regulatory financial ratios as part of the financeability test which focus on the service provider's ability to pay interest and its level of gearing.

Restoring Financeability - using the nominal cost of capital should compensate service providers upfront for the effects of inflation .

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 February 28, 2018, by post, fax or e-mail to:

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