P_0 Adjustments – Passing Cost Savings to Customers

February 2018

This document discusses the usefulness of a P_0 adjustment (where gains in excess of those stipulated by the X factor are passed directly on to customers when new price controls are set), as an incentive mechanism in a state-owned and operated sector. Alternative approaches are also discussed.

Summary Document

Sharing the Benefits of Out-Performance/Cost Savings

When a regulated firm is able to make efficiency savings above those reasonably expected as provided in the X-factor[1], 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.
- The profile of the sharing arrangements.

Options for Sharing the Benefits of Out-Performance

Although they are often combined in practice, there are **two broad options** that may be utilized to share the benefits of the out-performance of the X-factor with customers:

P_0 Adjustment (One-off reduction)

- Gains in excess of those stipulated by the X-factor in the current period are passed directly on to customers when new price controls are set.

Glide Path Mechanism (Phased option)

Gains are passed to customers over several years to provide stronger incentives.

1 The X-factor is the real change in revenue or prices each year, and is often referred to as the general efficiency assumption.

RIC's Approach to Sharing the benefits of Out-Performance

As part of its pricing methodology for the first price control review (2006-2011) the RIC included a P_0 adjustment as well as a glide path mechanism. Implicit in the provision of both a P_0 adjustment and/or a gradual adjustment mechanism is the assumption that a firm will try to "outperform" X-factors embodied in the price control, 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.

The incentives to make such savings are strongest in firms which are privately owned and operated, and 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 these utilities. The RIC has observed, that instead of attempting to out-perform the X-factor which was set for the first control period, the service provider viewed it instead as a budgetary limit and there was no out-performance.

At the time of the first Price Review, the RIC's approach was to set ex-ante efficiency targets and to reduce costs upfront so that customers were guaranteed that only efficient costs were included in the revenue requirements. The RIC considers that this approach remains fit for purpose in the absence of evidence that the Service Provider actively sought to out-perform the X-factor included within the price limits.

The RIC welcomes views on the use of P_0 adjustment in its second price control review for T&TEC.

Responding to this 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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Deadline for submission of comments is March 16, 2018.

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.