



THE IMPORTANCE OF TIMELY PRICE REVIEWS

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This document is one of a series of discussion papers exploring the factors that affect the timeliness of price reviews and the advantages of conducting such reviews when they are due.

**Consultative
Document**

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1. Background

The Regulated Industries Commission (RIC) Act No. 26 of 1998 established the RIC as the economic regulator of the electricity, water and wastewater sectors in Trinidad and Tobago. The RIC Act outlines the Commission's responsibilities as they relate to establishing the principles and methodologies by which rates are determined, establishing standards of service and monitoring the performance of service providers. Section 48 of the Act mandates that the principles and methodologies for designing rates are to be reviewed every five years; however, within recent time, this has not occurred in the case of the utilities under the purview of the RIC.

1.1 Purpose of this Document

This paper will discuss the factors that impact the timeliness with which price reviews occur in Trinidad and Tobago, the implications of these delays for various stakeholders and the merits of conducting price reviews when they are due.

1.2 Structure of this Document

This document is divided into several sections hereafter. Section 2 outlines the role of price reviews. Section 3 looks at the advantages of conducting timely price reviews and examples of the negative impacts when they are not conducted on a timely basis. Section 4 outlines local conditions and factors affecting the timeliness of price reviews and the way forward.

1.3 Responding to this Document

In keeping with the RIC's obligation to consult, stakeholders are invited to comment on this document. Responses should be sent by post, fax or e-mail to:

Executive Director
Regulated Industries Commission
Furness House – 1st & 3rd Floors
Cor. Wrightson Road and Independence Square, Port-of-Spain.

Postal Address: P.O. Box 1001, Port-of-Spain, Trinidad
Tel. : 1(868) 625-5384; 627-7820; 627-0821; 627-0503
Fax : 1(868) 624-2027
Email: ricconsultation@ric.org.tt

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.

The deadline for comments is March 30, 2018.

2. Introduction

As the economic regulator of the utility sector, the RIC is mandated to establish principles and methodologies for setting rates, establish and monitor service standards and conduct periodic reviews of rating regimes of the utility sectors under its purview. The RIC Act 1998, Section 48 mandates that the RIC review the principles for determining utility rates every five years or, where the licence issued to the service provider prescribes otherwise.

2.1 The Role of Price Reviews

In a utility sector that has a service provider operating under conditions of a natural monopoly, the establishment of utility rates for a specific time period is crucial to ensuring sustainability of the sector. For public utilities that are natural monopolies, the speed of adjustment to tariffs is critical as they operate in an environment where the price of the service is regulated¹ but the cost of their inputs is not.

Price reviews ensure that the service provider is able to earn revenues to cover the efficient costs of the daily operation and has sufficient funds to invest in new network infrastructure and replace aging assets. Price reviews also ensure that customers get appropriate price signals about the costs that the utility incurs to provide them with service, which should guide them towards efficient use and adopt conservative usage patterns.

A price review involves several broad stages. The first step involves establishing the service standards that the utility is expected to meet during the control period. The second step involves assessing each of the key components of revenue to ensure that T&TEC earns sufficient revenue to deliver reliable services to its customers. The final step involves determining tariffs to meet the revenue requirement and the mechanism for controlling changes in the tariffs over the regulatory period.

One important aspect of a price review is a requirement for the utility to submit a Business Plan for the relevant regulatory period. The business plan should outline the strategic path that the

¹ Regulated prices means that the price of the utility's service cannot be adjusted by the utility on its own accord to meet increasing cost of capital, labour, plant and equipment. Price changes must be approved by the regulator before they can be implemented.

utility would like to take over the price control period. This plan should include major projects that the utility intends to complete in order to bring improvements to the quality of service to customers. Also required to be submitted in this business plan is the recent history and current state of the utility sector as it pertains to: service quality, level of demand, the cost of service and other economic and social variables. These are all factors that the regulator needs to consider when making its determination for the price control period. The regulator would also examine how efficient the utility has been in terms of productivity during the previous period and ascertain the future plans of the utility, especially its targets for efficiency and productivity improvements.

At the end of the price review exercise, new tariff structures, inclusive of rates that closely track costs of the utility, will be in effect for a number of years. The utility would be receiving revenue in keeping with the established rates and would be required to carry out the work that it specified in its business plan and for which funding was approved by the regulator in its determination. The utility would also be required to submit periodic reports to the regulator on its performance from a technical and service quality standpoint, to ensure that it is performing as expected. Consumers would also be responding to new rates by making adjustments to their consumption patterns, where possible, to avoid sizable impacts to their overall bill. There may also be need for consumers to make one-off investments in more energy-efficient or water-efficient fixtures to lessen the impact of higher rates on their medium to long term utility bills.

3. Advantages of Conducting Timely Price Reviews.

3.1 Stability in the Utility Industry

Perfect stability in the utility industry describes a situation where there is simultaneous occurrence of allocative, productive and dynamic efficiency in the sector². Notwithstanding this theoretically ideal scenario, the underlying premise behind price reviews is to move as close as possible to this position. Section 6 (1) (c) mandates the RIC to ensure, as far as is reasonably

² Allocative efficiency refers to the output level at which price equals the marginal cost of production, productive efficiency occurs when the maximum number of goods and services are produced with a given amount of inputs, dynamic efficiency refers to efficiency over time and involves the introduction of new technology and working practices to reduce costs over time.

practicable, 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 necessary investments. Similarly, Section 6 (3) (a) of the Act outlines the RIC's obligation as it relates to the public interest and setting fair and reasonable rates. The Act indicates the RIC's responsibilities to both the customer and the service provider in bringing more stability for these stakeholders.

Even though the electricity, water and wastewater utilities are both state-owned entities in Trinidad and Tobago, they are not precluded from being affected by the evolving economic, social and technological structure of the country. In such a dynamic environment, the regulator possesses some degree of power to manage the effect these variables can have on utility prices and the rate structure.

A regulated utility may incur significant costs that are both uncertain and largely outside its control. For example; the utility's operational costs contain elements of variable costs such as fuel, materials and labour costs. Materials are a major input in the operations of the electricity utility and accounts for a significant percentage of the utility's operational costs. In fulfilling its mandate to ensure the service provider recovers sufficient return to finance investments, the regulator will consider increases in material costs when setting rates for the subsequent period. If the price review is not conducted in a timely manner, the utility will most likely not earn sufficient revenue to cover its costs and by extension, finance necessary investments.

The RIC is also expected to set a rate that is fair and reasonable to the customer however, increases in efficient costs should be reflected in rates. The more time that elapses before a price review is conducted, the larger the potential increase in customer rates. The cumulative effect of a delayed price review on rates may be onerous to administer over a relatively short period of time. Therefore, timely price reviews are important to providing some level of stability for utility rates and to avoid rate shocks.

3.2 Passing on Savings to Customers

The regulator determines a revenue requirement based on its assessment of the efficient costs of the utility to run its operations. The revenue requirement is the total revenue required by the utility to provide adequate service to its customers and earn a reasonable return on its investments over a specific period of time. Section 6 of the RIC Act speaks about the efficiency of the utility's operations and the role of the regulator as it pertains to same. The regulator is responsible for establishing measures that will incentivize the utility to become more efficient. Incentive regulation, which is utilized by the RIC, allows the utility to retain the efficiency gains that it makes for the duration of the regulatory control period and to utilize any gains as it sees fit. At the time of next price review these efficiency gains can be passed to customers in the form lower prices/rates. Efficiency savings can only be passed to customers in a timely manner if price reviews are conducted as scheduled.

3.3 Adjustments of Standards of Service

The RIC is mandated to determining rates and charges that are fair and reasonable to the customer, and concurrently seeks to ensure that the utility is able to provide a level of service that is of an acceptable standard. Deciding on the allowed levels of capital and operating expenditure are crucial factors when considering the quality of service. The regulator will want to ensure that sufficient capital and operational expenditure (Capex and Opex) is being allocated to maintain or improve the quality of service.

It is not only during a price review that quality of service standards can be reviewed, however, the price review sets the rates customers should pay which are directly related to the quality of service that is expected. The regulator is responsible for monitoring the performance of the utility and therefore considers the level of utility service required by customers and identifies areas of service improvements. It is important for price reviews to be on time so that utilities have sufficient funds to maintain levels of performance. An overdue price review may undermine the regulator's efforts in setting standards, as it would be difficult for the utility to achieve higher quality of service standards when there is not corresponding increase in revenue from rates.

Monitoring the utility's performance is an important function for the regulator, as adherence to quality of service standards has a direct impact on customers and indirect impact on the economy at large. Service interruptions and voltage issues ultimately lead to losses for commercial and industrial customers such as those incurred from damage to plant and machinery (voltage issues) and halts in production (service interruptions). Service interruptions and voltage issues also have a negative impact on quality of life for residential customers as it creates significant disruptions to households. Consequently, identifying and prioritizing quality of service standards is an important subset of the price review exercise.

3.4 Reduced Burden on the Government

The government of Trinidad and Tobago uses a combination of targeted and untargeted subsidies as a social policy measure in terms of making utility service more affordable to low-income citizens. Also, government subventions are used to assist utilities with covering its operational expenses. The burden of government subventions and subsidies is felt by the consumers and the government alike. In Trinidad and Tobago, over the 2007-2016 period an average of 52% of the country's revenue was allocated towards various subsidies and transfers³. Over the period 2014-2016, the average annual value of transfers and subsidies was \$380million to T&TEC and \$2.01 billion to WASA. This significant proportion of revenue could be otherwise injected in the economy. Moreover, for the government to maintain its current or an increased level of subsidies and subventions, it needs to have sufficient revenue. The government's main source of revenue comes from taxes which may need to be maintained or increased to facilitate the government's current subsidy/subvention initiatives.

On time price reviews will ensure that utilities recover its costs from rates and will need to rely less on government support. Also, the establishment of new rates including lifeline tariffs, will help address affordability for low-income customers, which lessens the burden of government financing same. Government revenues can then be redirected into other sectors of the economy that may bring about increased growth and development.

³ Spotlight on Trinidad and Tobago's Financial Circumstances: The Road Ahead. Presentation accessible at: <https://www.finance.gov.tt/wp-content/uploads/2017/09/Trinidad-and-Tobago-Economy-September-27-V3.pdf>

3.5 Resource Conservation and Intergenerational Equity

Cost-reflective utility prices send signals to customers to use the utility service efficiently. As time elapses without adjusting prices to reflect changes in costs, prices may not send the kind of price signals to consumers that may encourage efficient consumption. The more consumers pay attention to their consumption of utility services and make adjustments towards more prudent use, the less resources are required to deliver the service. This happens through a short term effect as less fuel and less operating costs are incurred by the utility when there is lower demand. There is also a long-run effect as the need for adding generation capacity to the network will diminish or at least be postponed, if prices cause consumers to shift demand away from peak loads. Tariff structure design and cost-reflective rates can influence consumption of the utility service. In particular, inclining block and time-of-use pricing are now commonly used features in many countries. Therefore, price reviews should be conducted on time to adjust rates to send the desired price signals to consumers to manage their demand.

A related issue is that of intergenerational equity, in the absence of on time reviews, it can be argued that the utility may defer needed investment or sustain losses, which in the case of state-owned and run utilities, is funded by either direct subventions or often government backed debt. It can be argued that this violates the benefiter pays principle. Hence, future customers may end up paying, at least in part, for services consumed by current customers for which those benefitting do not pay.

3.6 Maintains a Robust Regulator

Utility regulation is a very specialized discipline. Effective regulation requires a strong regulatory framework (legislative and policy) and staff with knowledge and experience in the field. From an external point of view, price reviews are important for the regulator to fulfil its mandate and for the public to see that it is doing so. In most jurisdictions, the regulator is funded by taxpayers or ratepayers through different mechanisms. In Trinidad and Tobago, the RIC is funded by a Cess, which is essentially a tax on the utility sector (ratepayer funded). The regulator builds credibility when it does what it is supposed to do, which includes, determining rates,

establishing standards of service and assisting customers with unresolved complaints to the utility. For instance, the conduct of stakeholder consultations ensures that the RIC fulfils its obligations to consult with the public and seek their input in making its decisions. By doing so, the RIC is also adhering to foundation regulatory principles of transparency and accountability. Conducting a price review as mandated by the RIC Act is very likely to enhance the public's awareness and perception on the RIC's functions, inclusive of its rate setting function.

From an internal standpoint, the conduct of timely price reviews will also assist with staff development, staff morale and ultimately staff retention. As with any professional discipline, the general rule is that quality and speed of performance improve as staff get more experience on the job. Price reviews give the opportunity for all staff to get involved in the core work of the RIC, where significant knowledge transfer and learning-by-doing takes place. When reviews are conducted on a consistent and timely basis, the RIC's staff is able to keep skills current and become more efficient in subsequent reviews. Participating in the rate review process can also create room for employee advancement. Furthermore, conducting a rate review incorporates collaboration among all departments which fosters teamwork among staff. Improved skills and teamwork encourages employee motivation which can lead to a high level of staff retention which is important in highly specialized fields of study.

4. The Local Experience and Strategies on the Way Forward

The timeliness of price reviews in Trinidad and Tobago has been affected by a number of factors, which are discussed further below.

4.1 Legislative Issue

The RIC Act (1998) defines the powers and functions of the economic regulator of the electricity, water and wastewater sectors. The RIC commenced operations in 2001 and set out to carry out its mandate, in accordance with its parent legislation. By 2004, the RIC had established Quality of Service Standards for the electricity Transmission and Distribution Sector and by 2006, had successfully implemented its first Rate Determination for the Trinidad and Tobago

Electricity Commission (T&TEC). By 2011, the RIC was well underway to complete its second review of rates for T&TEC when the process halted as a result of a question regarding the ability of the RIC to proceed with a rate review in the absence of subsidiary legislation. This issue has now been resolved.

4.2 Availability of Data

Regulators rely on utilities to provide information in order to make its decisions. This high degree of information asymmetry makes it more critical for accurate and reliable data to be provided. The lack of timely data undermines the regulator's ability to make prudent decisions regarding the revenue requirement of the utility and tariff structure. In addition, the quality of data from the service provider is also vital to ensuring the regulator makes good decisions for the utility sector. The RIC recognized certain deficiencies in the preparation of information by the electric utility for regulatory decision making and recommended that a department be set up dedicated for this purpose, which was implemented several years ago. This has improved the timeliness with which information is received from the service provider and both regulator and utility continue to work towards improving the quality and reliability of data that is required for regulatory purposes.

4.3 The Availability of Resources

The price review exercise is time consuming and requires a certain level of expertise to be appropriately undertaken. Skilled resources are needed within both the regulatory body and the utility to successfully undertake the price review exercise. Regulatory staff need to be properly trained and competent to carry out the exercise. Similarly, the utility must possess staff that is equipped to respond to data requests and analysis as prescribed by the regulator. Additionally, sufficient time is needed to request, examine and assimilate the necessary data, perform calculations, conduct consultations and make adjustments to arrive at a final position on rates, quality of service and other obligations. The various components of the review need to be carefully coordinated to ensure a successful outcome.

5. Conclusion

Various stakeholders are affected by the timeliness of a rate review exercise including the utility, its customers, the Government and the regulator. The utility benefits when a rate review is conducted on time because it will be placed in a financial position to recover costs as incurred. The customer will have access to utility services at a fair and reasonable rate. The Government will be able to reduce its expenditure on subventions and subsidies and the overall population may benefit from redirected government expenditure. The retention of staff and public perception of the regulator will be enhanced when it conducts timely price reviews.

There are clear and cogent benefits to the conduct of on time price reviews and the RIC welcomes comments on the issues discussed herein.