

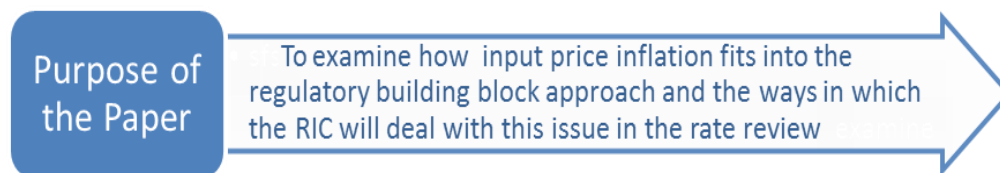
The Treatment of Input Price Inflation in Price Reviews

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This document is a summary of the RIC's approach to the treatment of input price inflation, within the second price review for the electricity transmission and distribution sector.

Summary
Document

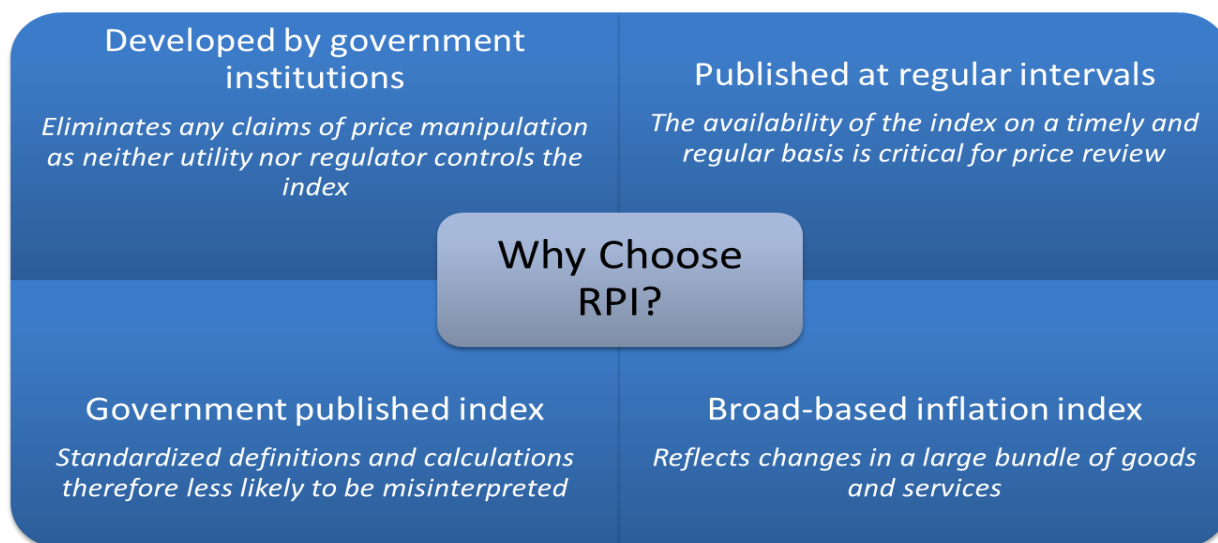
The Treatment of Input Price Inflation in Price Reviews



An important issue faced by all utility regulators is the treatment of input price inflation in price reviews. The price of inputs directly impacts operating costs which occupy a significant portion of the service provider's total costs that need to be recovered from customers through rates. Where the price of inputs may be increasing, or may become more volatile, regulators employ various assumptions and methods for estimating the effects at the start of the price control period. Under incentive regulation, consideration must be given to a suitable cost inflation index, for the Opex and Capex components in establishing the revenue requirement. Ideally, the various components of the service provider's cost base should be indexed using specific deflators. However, in the absence of these, measures of inflation such as the Consumer Price Index (CPI) or the Retail Price Index (RPI) may be used as an overall deflator to index for cost inflation in the price review.

Setting Revenue Allowances

Under incentive-based regulation, commonly referred to as the RPI-X approach, allowed revenue is indexed to take into account price inflation. The index that is used should be the best reflection of the increases in prices to be faced by the utility. Also, the index needs to be practical to implement, robust and transparent. While the bundle of domestic products and services used in determining the RPI may not bear a strong resemblance to the inputs of the electricity industry, the RPI provides a useful surrogate for the input price indexes in the absence of an electricity-specific cost index in Trinidad and Tobago.



Other Options to Manage Uncertainty with Input Costs

Indexation is not the only way in which rate reviews take into account the changes in input prices. Indeed, indexation is often supplemented by additional mechanisms to deal with uncertainty in input prices. Additional options are summarized below:

Costs are treated as pass through items

- The degree of pass through can vary and is applied in conjunction with other mechanisms

Fuel Adjustment Clauses

- Ensure a better alignment of cost recovery in terms of cost causality;
- Help to stabilize operating margins of utilities and therefore increase the utility's ability to pay its bills;
- Reduce exposure to rate shocks as prices closely track fuel cost over time

Ad-Hoc Allowances

- Allows the service provider to recover additional costs
- Usually applied in respect to Capex

Cost Drivers for Non-Controllable Costs

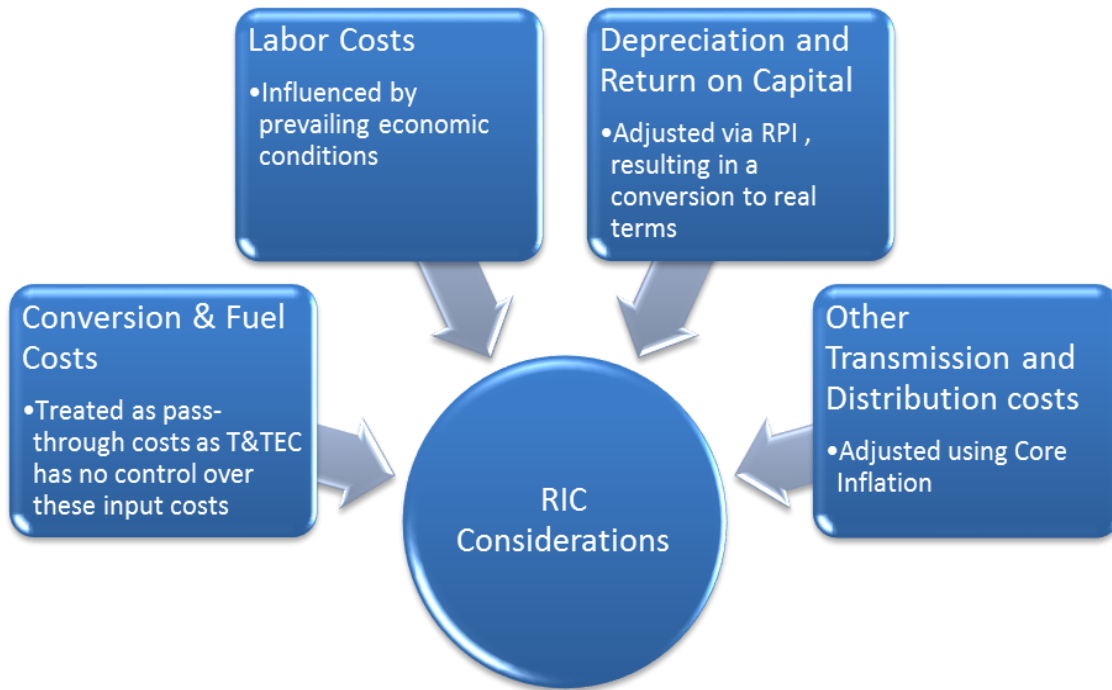
- Help to preserve purchasing power as these cost driver allowances will take effect as input prices fluctuate.

Interim Determination

- Service provider has option to apply for an interim determination to mitigate an adverse effect of changing market conditions

RIC's Approach to Treating Input Prices

T&TEC is required to submit its business plan to the RIC very early in the rate review, which should contain information and evidence that underpin their assumptions for ongoing efficiency, including justifications for input price inflation. In assessing the various input cost categories, the RIC will consider the evidence presented by T&TEC and conduct its own internal analysis.



All persons wishing to comment on the Treatment of Input Price Inflation in price reviews are invited to review the main document and submit their comments using any of the options provided.