REGULATED INDUSTRIES COMMISSION

Approach to Setting Operating Expenditure for Price Reviews

March 2022

This document is a summary of RIC's approach to setting operating expenditure for the Trinidad & Tobago Electricity Commission and is being published for the information of stakeholders as part of the second Price Review for the utility.

Summary Document

PURPOSE OF THE DOCUMENT

Operating expenditure (Opex) are the day-to-day costs of running the utility and typically include cost for generation, fuel, repairs and maintenance, staffing and overhead costs. Opex accounts for a very significant portion of a utility's total costs and are directly recovered from customers through tariffs. As a result, such costs can have notable impact on the final bills paid by customers. This paper examines the RIC's proposed approach to assessing the utility's forecast operating expenditure (Opex) for the forthcoming regulatory control period. It also reviews the actual Opex of the Trinidad and Tobago Electricity Commission (T&TEC) over the first regulatory period (2006-2011) against what was approved by the RIC.

RIC'S APPROACH TO ASSESSING OPEX

The regulator's task is to understand what represents a reasonable allowance for the operating costs of the utility, that is, a level of costs that can realistically be expected to be incurred if the utility is run efficiently, within the constraints it faces. Most regulators utilize a broadly similar approach to setting Opex, one that is based on a review of historical expenditure and consideration of whether future activities justify an increase in expenditure. The RIC utilized the following process to determine its allowance of Opex for the first regulatory period:

Determining the Baseline Opex:

Determing the normal operating costs of the utility using a base year as the starting point for setting forward allowances and analyzing expenditure by function.

Assessing the Scope for Efficiencies:

Adjusting baseline costs utilizing benchmarking and 'best practice' targets for certain controllable costs.

Specification of Generalized Efficiency Factor:

Adjustments are made to reflect future efficiencies expected of the utility, through productivity improvements based on historical efficiency rates.

Efficiency Carryover Mechanism:

This enhances the incentive for the utility to achieve efficiency gains, as it is permitted to carry these gains from one period into another.

FURTHER CONSIDERATIONS AND RIC's PROPOSALS FOR THE SECOND CONTROL PERIOD

The RIC intends to continue to utilize the combination of approaches and techniques identified above for the allowed level of Opex over the second regulatory control period. It should be noted that there are certain elements of regulatory judgement that is required in the process of arriving at efficient Opex, some of which are discussed below.

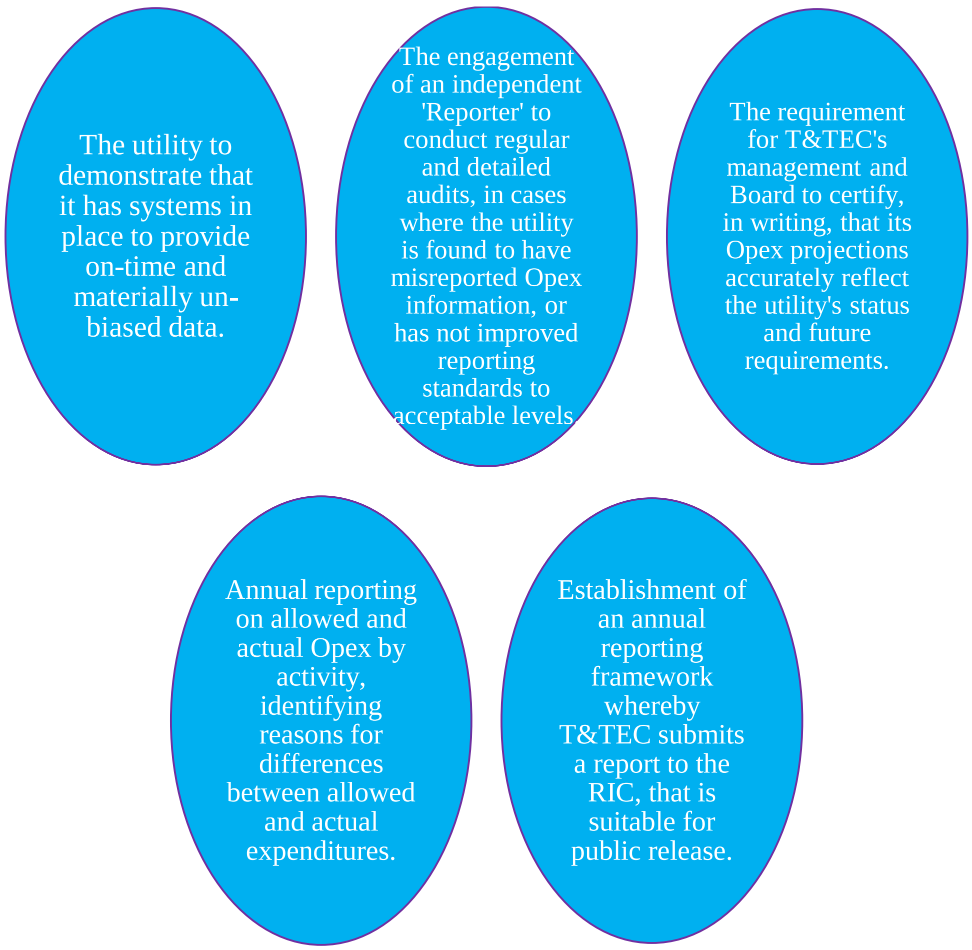
- Allowed revenue must offer a reasonable prospect for the utility to recover its efficient costs (including a reasonable rate of return). The risk of not doing so entails undermining incentives for efficient expenditure and investment.
- The high proportion of costs that are uncontrollable limits the scope for cost reduction. However, the RIC has an obligation to ensure that costs that are inefficient or unnecessary are not allowed but, at the same time, to make an allowance for any additional costs arising out of new obligations.
- Estimating efficient costs purely on the basis of benchmarking is not recommended given the practical problems of finding good comparators, as utilities differ in size, structure and may face a variety of external operating environment factors.

The RIC intends to ensure that the targets which it sets for T&TEC, focus on the achievement of specific outputs/outcomes and that the utility's management is subject to strong incentives for good performance. In this regard, some of the measures will include:

Options for incentivizing achievement of output in State-Owned Utilities

- Reputational incentives (e.g. poor performance to be reported in the media).
- Stricter cost management through analysis of actual cost savings against target levels.
- Regular publication of regulatory accounts in accordance with the regulatory accounting guidelines established by the RIC.
- Advocating for the implementation of Management Incentive Plans (MIP) which includes tying pay (and bonuses) to performance.
- Recommending the strengthening of governance regimes to better align the incentives of the Board and managers, with clear service quality and financial performance objectives.

In addition to the incentives discussed above, the RIC and T&TEC have already embarked on a collaborative data mapping exercise to increase the effectiveness of the regulatory data collection and reporting process that currently exists. In its continuing efforts to improve reporting compliance and reliability of data from T&TEC, the RIC will also give consideration to the following:



Finally, most regulators use different mechanisms and tools to address unforeseen costs and to mitigate risks, as some uncertainty will inevitably remain when setting price limits. Some of the mechanisms to address uncertainty include cost pass-through allowances for uncontrollable costs, reopeners (if revenue falls short by a specified minimum amount), logging up and down (inclusion of expenditure not previously allowed) and interim determinations. The RIC will continue to use these mechanisms when necessary and where appropriate.

All persons wishing to comment on the document, “The Approach to Setting Operating Expenditure for Price Reviews” are invited to review the main document and submit comments using any of the options provided.