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Dear Chris,

THE CMA'S RPE METHODOLOGY

Over the course of the last few months, we have shared with you our view that we would receive significantly higher real price effect (RPE) allowances under the methodology that the Competition and Markets Authority (CMA) published in April this year when compared with those Ofgem proposed in its draft determination.

You now have a Frontier report on the topic, submitted by the ENA on behalf of slow-track DNOs. I thought it would be worth highlighting how we interpret the figures in the Frontier report, since it will help you understand our views going into the final determination.

For the avoidance of doubt, when we consider what RPE allowance would be reasonable, we consider the RPEs we (and the wider sector) have actually experienced and are likely to experience in future. If we were to take a case to the CMA on this issue, we believe it would be interested in knowing what it actually costs to run a business in our sector. But we see many similarities between the RPEs we have experienced and those we calculate using the CMA's current methodology (in particular in relation to labour RPEs experienced between the base year and the start of the price control review period). So we think that, in addition to the fact that the CMA's methodology is the 'gold standard' regulatory precedent on the issue, that the methodology is a very relevant, evidence-based frame of reference for the Authority to consider in setting its final determination.

Frontier's terms of reference for its report involved a different question – what RPEs would the CMA's methodology yield if applied today? This gave rise to Frontier's 'headline result', from which various sensitivities were then tested.

The point I wished to highlight to you is that our starting point combines Frontier's 'headline result' with the assumptions underlying two of the sensitivities set out in the report.

- Firstly, we have no doubt that the CMA would adopt the sensitivity in row 4 of table 2 in Frontier's report, to align the methodology used to calculate RPEs with the way in which revenues will be uprated for RPI inflation in the ED1 price control. To do otherwise would be illogical.
- Secondly, the CMA calculated its wage benchmarks using wage settlements *for all the years for which it had data* (based on NIE's submission of a union document that was out of date by the time the case was heard). The 2014-15 wage settlements of DNOs were incorporated into the sensitivity Frontier shows in row 5 of table 2. Since these wage settlements are available they should be used. And in any case, it is unambiguous that

the CMA's established methodology would involve their use by the time any DNO's appeal of the RPE allowances reached a hearing.

Since Frontier's report shows the impact of each sensitivity independently, it did not show the combined effect of these two sensitivities when implemented together. We therefore commissioned Frontier to calculate this, and show the results in the table below.

	Slow-track total RPE allowances	Difference to Ofgem draft determination
CMA approach, with adaptation to its estimation of RPI forecasts	£265m	£343m
CMA approach, with adaptation to its estimation of RPI forecasts	£173m	£251m
Combined effect of two taken together	£341m	£419m

The figures demonstrate that these two adjustments have relatively little interaction with one another. Their combined effect is very close to figure which can be calculated by adding to Frontier's 'headline result' to the impact of the two sensitivities (relative to the 'headline result') taken in isolation.

This gives rise to our conclusion that the minimum uplift on the draft determination figures needed to reflect the CMA's precedent (and the actual RPEs we have already experienced) would be a £419m increase in Ofgem's view for slow-track DNOs, which would then of course have a lower impact on allowances post-IQI.

I also thought it was worth repeating that there is no need for a downwards 'RPI effect' adjustment to the CMA's methodology. This is because the CMA methodology calculates RPEs by subtracting the OBR's forecast for RPI inflation (or actual inflation where available) from a historical average of nominal price inflation in the relevant input category. The OBR's forecast (and the recent actual inflation figures) already factors in the effect of changes in ONS price data gathering routines so there is no need for a separate adjustment.

If anything, an adjustment may be warranted in the opposite direction, since the OBR over-estimated the size of the long-run gap between RPI and CPI inflation when it first calculated this in 2011.[1] New data published since then – the ONS RPIJ series - has proven this point (Ian Rowson should be able to confirm this to you). If the CMA were convinced that the OBR's forecasts needed to be adjusted for this standalone issue in order to be accurate, or if the OBR itself were to reflect the latest data in its RPI forecasts between now and any CMA appeal hearing, then the scenario set out in the last row of table 2 of Frontier's report would also come into play (in addition to the scenarios we mention above).

I hope this helps you understand how the views we have previously made clear on RPEs are confirmed by the Frontier RPE report.

[1] OBR, November 2011, Working paper no. 2, The long-run difference between RPI and CPI inflation. Tom Pybus, the OBR's senior staff analyst for macroeconomic forecasts, confirmed to us by e-mail on 2 September 2014 that this document sets out details of its assessment of the gap between RPI and CPI inflation, and that this gap forms part of its calculation of forecasts for RPI inflation

But I of course would be happy to discuss our reading of the relevant precedent from the CMA if it would be helpful to do so, and will make myself available at your convenience.

With kind regards,

Keith Noble-Nesbitt
Economic Regulation Manager