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Dear Hannah

Open letter consultation response on the RPI indexation of allowed revenue in the forthcoming RIIO price controls.

Thank you for the opportunity to respond to Ofgem's proposed modification to the future indexation of allowed revenue in future price controls. Whilst we are not currently affected by these proposals, you have identified the potential read-across into the RIIO ED1 price control review. We therefore urge Ofgem to consider our views before making a decision for all future price control reviews.

The issue raised by National Grid represents a significant issue for the RIIO-T1 and RIIO GD1 price controls. Ofgem are correct to recognise the need to address this issue appropriately as it may result in the failure to discharge their statutory duties to ensure that efficient companies are appropriately financed. However, we must also recognise that the change in DUoS revenue indexation is being requested following a very unusual economic event (ie negative RPI). We do not believe that this one off event requires a change to the indexation of all future price control revenues. The existing mechanism provides protection and predictability for customers and investors.

During our DPCR5 discussions with Ofgem, we noted similar revenue indexation issues where the negative RPI did not reflect the changing cost base of the network companies. At that time, Ofgem required companies to bid for changes in the cost base which exceeded RPI through a Real Price Effect allowance (RPEs). This approach appears to have been rejected for RIIO GD/T1 as you note that it will not allow Ofgem to demonstrate that it has discharged its financeability duties. We suggest that as long as Ofgem provide sufficient allowances, it could appropriately discharge its responsibilities.

We have identified a number of issues with Ofgem's proposed response to the indexation issue.

<u>Increased charge volatility</u>

The approach introduces another mechanism which will increase revenue volatility alongside the additional uncertainty mechanisms required under the RIIO based price controls. Whilst we accept that many of the uncertainty mechanisms proposed for the forthcoming price controls will provide protection to customers and networks, charge volatility creates issues (and additional risks) for suppliers which are priced into customers bills. Introducing this additional charge volatility into future price controls which provides little benefit to customers, networks or suppliers and appears unwarranted.

Use of HM Treasury forecasts

Ofgem's proposal to use HM Treasury data to project future RPI may create a number of practical issues for the companies and Ofgem. Whilst we believe that the HM Treasury data would be the most appropriate source of RPI forecasts (due to its transparency, availability, cost effectiveness and independence), the monthly report only provides forecast RPI for the current financial year. Ofgem would have to use the longer term forecasts which are published twice a year. For April price setting purposes, Ofgem will have to use November forecasts. This means that Ofgem will be using forecasts which are 6 months out of date to set prices (which is likely to reduce the accuracy of the forecasts and increase the volatility of charges).

We have also observed that the data set historically has systematically underestimated the RPI data. The table below illustrates that the forecast data (reported as Ofgem's proposed mechanism would set revenues) remains locked around the long term expected RPI (based on the Bank of England CPI target of 2.0% plus 60bps for RPI calculation differences). This results in underestimated inflation in the majority of years (with the notable exception in 2009when the economy suffered deflation for the first time in 60 years). The result for DNOs will be delayed collection of the differential of forecast and actual RPI revenue uplifts.

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
HM Treasury Projection %	2.40%	2.40%	2.70%	2.70%	2.10%	2.50%
Jan to Dec RPI	2.83%	3.19%	2.49%	5.81%	-0.53%	4.62%
Difference	0.43%	0.79%	-0.21%	3.11%	-2.63%	2.12%

This effect could, in a period of high inflation, reduce revenues in the early years of the price control and defer them to later periods. We estimate that this could defer tens of millions of pounds of revenue into future price controls. The biggest impact of the RIIO price controls is the deferral of revenues to companies resulting in a tightening of financial ratios, the introduction of Ofgem's proposals would delay cash flows further and exacerbate potential financing issues. The introduction of additional mechanisms which could defer revenues whilst costs are increasing is unnecessary.

Impact on Cost of Capital

Ofgem suggests that the proposed mechanism will lower the company cost of capital. We disagree with this statement as the proposal has been suggested to address a single concern relating to indexation of base year revenues at a time of deflation. The existing mechanism would, at all other times, have provided the same level of inflation protection. As we discussed during DPCR5, the cost base of network companies has an imperfect relationship to RPI and companies will always have to manage the risk that RPI plus RPE allowances are insufficient to cover inflation in the basket of goods used by network companies. The proposed mechanism introduces additional risk for companies and delayed revenues which could require a cost of equity increase, whilst leaving companies exposed to the differential between their cost base and RPI.

In summary, we do not believe that the proposed new indexation mechanism is appropriate or neccessary. We recommend that Ofgem retains its existing indexation methodology which has provided stability and protection for customers, suppliers and networks over previous price controls, and ensure that the very real issues that arise as a result of negative RPI are addressed via the calculation of RPE allowances that are sufficient to compensation network operators both for negative RPI and for the real difference between expected changes to cost base and RPI.

Additionally we stress that Ofgem must not adjust the indexation mechanism for the RAV. This treatment is fully understood by investors, customers and regulators and should be protected.

If you have any questions, please feel free to contact me or any of my team.

Yours sincerely,

Paul Bircham
Customer Strategy and Regulation Director