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Dear Joanna

Open letter consultation on the RPI indexation of allowed revenue in the forthcoming RIIO price controls (T1 and GD1) and the TPCR4 rollover

1. As mentioned in the open letter consultation, National Grid brought the issue of the RPI indexation of allowed revenues to Ofgem's intention. We welcome Ofgem's prompt decision to consult on this issue. We believe the letter and supporting annex clearly explain both the cause and nature of the issue with the current approach to RPI indexation of allowed revenues.

Do you agree that the current approach gives rise to a material issue that needs addressing as part of the upcoming price control reviews?

2. Allowed revenues are currently indexed using a RPI_t term which takes a lagged measure of RPI. The current gas and electricity licences both compare a 6 month period in the year prior to that for which revenues are being indexed to the same 6 month period for the previous year. While the 6 month period chosen differs between the electricity and gas licences, the principle of using lagged RPI data is consistent between gas and electricity.

3. During periods of stable inflation the impact of using lagged RPI data is relatively minor. However, the volatility seen in the RPI index in recent years has exposed the fact that the use of lagged RPI movements can result in networks receiving too little or too much revenues. We agree with Ofgem's analysis that, left uncorrected, the shortfall in revenues for the RIIO-T1 and GD1 controls and roll over would be 3 to 4% per annum.

4. As illustrated in the annex to the letter, this issue is not a transitory one and will not correct itself. The process of setting revenues in the licence in fixed prices based on the average of the RPI index over a given formula year (2009/10 in this case), but then subsequently inflating those values using a lagged RPI adjustment term, means that the unusually low period of RPI inflation / deflation experienced during 2009 is used for all subsequent RPI adjustments in the forthcoming controls.

5. Unless the approach to indexing revenues is amended, we agree that network companies will face a material shortfall in the revenues they receive such that they will not be able to recover Ofgem's assessment of efficient costs.

Do you agree with our proposed approach as outlined above?

6. We agree with the proposed approach.

7. Considering the alternative options presented in the consultation:
   - The use of a different base year does nothing to solve the fundamental issue caused by using a lagged measure of RPI. We agree that using 2010/11 is likely to lead to network companies receiving too much income and do not believe it is in customer's interests to do this rather than address the root cause of the issue, namely the use of a lagged RPI measure.
   - An ex ante adjustment might remove the expected loss from the networks but would be a case of introducing a second compensating error rather than addressing the real issue. Also, as noted in the consultation, networks would still be exposed to RPI inflation risk.
   - While the use of an ex ante adjustment combined with a true up could remove the residual RPI inflation risk, such a solution is conceptually inferior to Ofgem's favoured approach.
   - We agree that relying on networks to forecast RPI growth with over recoveries passing through the correction factor unnecessarily exposes networks to the risk of penal interest charges due to unexpected RPI growth and makes it more difficult for suppliers to forecast charges.

8. The open letter consultation suggests that providing full protection for the network companies against inflation will contribute to a lower cost of capital than under the current approach. It is National Grid's belief that the prevailing view in previous price controls has always been that the current indexation mechanism already provided full protection against inflation. We believe the opening sentence of the open letter consultation supports this view point:

   *"National Grid (NG) have **brought to our attention** that our proposed approach to indexing allowed revenue in RIIO-T1, RIIO-GD1 and the TPCR4 rollover may not provide the **intended protection** against economy-wide inflation."*

9. It is only the recent profile of the RPI index that has highlighted the failings of the current protection mechanism. In this context, the changes proposed by Ofgem remove a risk that networks did not know they were exposed to. While, conceptually, improving the protection against inflation might reduce the cost of capital, in practice the proposals will simply avoid the need to increase the cost of capital to compensate for a risk that was not previously known or understood to exist and so was not remunerated by the allowed return.

If we were to implement our approach, which forecast of RPI do you suggest is used for setting charges?

10. We agree with Ofgem's initial view that the most suitable forecast to use is the average of the "New Forecasts" published in the November issue of the HM Treasury Forecast for the UK economy. The use of this forecast has several advantages over the alternatives presented:
    - It is based on an average of independent forecasters' predictions
    - It relates to RPI rather than CPI and so avoids the need to make adjustments to a CPI forecast to derive a RPI forecast
    - It is a report that is publicly accessible and so transparent
    - It avoids the need for either Ofgem or the networks to incur additional costs developing alternative forecasts

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Do you agree that a true-up should operate with a two-year lag?

11. We agree that a true-up should operate to ensure full protection from RPI growth. We also agree that the true up should operate with a two year lag on the basis that the data is not available until then.

12. Further, we agree that the true-up should be symmetrical, that it should be net present value neutral, and that the allowed rate of return is the appropriate discount rate to use.

Do you agree with the revenues (RIIO-T1 and RIIO-GD1, TPCR4 rollover, TIRG and TII) that we propose will be affected by our decision on this issue?

13. Yes, we agree that the decision should apply to the revenues proposed.

Yours sincerely

[By e-mail]

Paul Whittaker
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