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Dear Joanna,

### **Consultation on RPI indexation of allowed revenue**

1. I am writing in response to your open consultation on RPI indexation of allowed revenue in the forthcoming RIIO price controls (T1 and GD1) and the transmission price control rollover. Thank you for the opportunity to comment on your proposals.
2. I fear that your proposed approach could bring additional complexity without a good reason. Your consultation letter seems at risk of overstating the case in favour of your proposed approach, in two different ways:
  - (a) The numerical example illustrates a problem that arises from inconsistency between deflation adjustments and inflation adjustments. There are other ways to address this problem which are less complicated than your proposed approach.
  - (b) You claim that your proposed approach provides full protection for the network companies against inflation. This is not the case.

### **Complexity and administrative burden**

3. Your proposed approach would bring additional complexity to the price control licence. It would require a definition of what inflation forecast to use, a new formula to adjust allowed revenue according to forecast RPI growth and a new formula to adjust allowed revenue according to differences between forecast RPI growth and actual RPI growth. This will take time and could go wrong.

### **The source of the problem in the numerical example**

4. Annex 1 to your letter provides a numerical example which illustrates a problem with the current approach to RPI indexation. My reading of the example is that it shows that a problem exists if:
  - (a) You start with a nominal expenditure forecast for the financial year 2013/2014.

- (b) You use percentage changes in the RPI over successive financial years to deflate that forecast to 2009/2010 prices.
  - (c) You take that deflated forecast and inflate it back to 2013/2014 prices using a different measure of RPI growth which is based on the percentage changes in the average monthly RPI between the previous two calendar years.
5. The source of this problem is an inconsistency in the RPI adjustments used for deflating and then inflating the expenditure forecast. There would be a similar problem if you were to take a forecast for 2013/2014, deflate this to 2009/2010 prices using the CPI and then inflate it to 2013/2014 prices using the RPI.
  6. In this example, the problem can be addressed by using the “Licence inflation” RPI adjustment for any deflation to 2009/2010 prices.
  7. The proposed true-up is not necessary to address the problem identified in Annex 1.

### **Alternative options that are less complicated**

8. You seem to recognise that it is unnecessary to introduce a series of annual true-ups to address the problem identified in Annex 1. In particular, you identify an alternative option that is described as “ex ante adjustment to allowed revenues for the expected size of the mismatch, but continue to use the current approach to RPI indexation”. You discount this option because network companies “would still be exposed to an element of RPI inflation risk”. This criticism does not make sense.

### **RPI and input price inflation**

9. Page 2 of your letter says that your proposed approach “provides full protection for the network companies against inflation”. This is not the case. The changes in prices faced by network companies (for example for wages and materials) will not be the same as the price changes measured by the RPI. Even in circumstances of high inflation in the British economy, it seems unlikely that the input price changes that network companies experience will match the RPI measure.
10. RPI indexation provides *some* protection to companies against unexpectedly high input price growth. But any RPI indexation mechanism will leave companies facing financial risks related to input price changes.
11. Once you recognise the limited and incomplete nature of the protection offered by RPI indexation, the change to the method for RPI indexation looks less attractive than if the proposed RPI indexation method were to give “full protection”.

### **Implications of these points**

12. Chapter 11 of Ofgem’s *Handbook for implementing the RIIO model* (October 2010) explains how you will manage the use of uncertainty mechanisms such as RPI indexation. It indicates a process under which mechanisms are refined to limit their potential downsides (e.g. complexity). This process does not seem complete in this case. You identify a problem with the current arrangements for RPI indexation as the

basis for a change, but your proposed approach would bring unnecessary complexity. There are simpler ways to address that problem.

13. There may be other reasons to move to your proposed approach. But the case for doing so is compromised by over-stating the protection against inflation that it will provide network companies.
14. I hope that you find these comments useful.

Yours sincerely,

**Nicholas Francis**  
**Partner**