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Hannah Nixon
Partner, Transmission
Ofgem
London
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26 May 2011

Dear Hannah,

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

Thank you for the opportunity to comment on the above consultation. In short we believe the issue raised is valid and would lead to network companies being unable to recover efficient costs. We welcome the fact that Ofgem have recognised this.

NGN supports Ofgem's proposed approach to use forecast RPI to set allowed revenue and have a "true up" for outturn RPI on a two year lag. This option provides the desired protection against the inflation risk identified and provides the necessary transparency for shippers and suppliers to set their charges. On the subject of inflation forecasts we agree with Ofgem that the HM Treasury Forecasts for the UK Economy are the most appropriate source out of the options presented in the letter.

Due to the unique combination of factors which have led to this issue arising it is difficult to argue that the identified problem is a clearly recognised feature of the regulatory framework to the extent it can be regarded as contributing a premium in the present cost of capital. Specifically:

- the mechanics of Ofgem's lagged indexation has varied between the regulated sectors and also between subsequent price controls for the same company. As such there is no unambiguous universal methodology regarding Ofgem's application of lagged RPI indexation and therefore the potential consequences are also not necessarily obvious;
- as far as we aware neither Ofgem nor its predecessors articulated this as a feature of the regulatory framework at previous price control reviews (i.e. that the lagged indexation mechanism could permanently introduce negative inflation into regulated prices); and
- given the above two points this is a "grey" area of the regulatory framework and it is arguable that the market were ever fully cognisant of it. It is therefore questionable that such risk had been priced into market data used to set cost of capitals at previous price reviews. It is unlikely that in respect of inflation risk market perceptions currently differentiate regulated utilities from the wider economy and nor will they do so after this proposal is implemented.

Responses to the specific questions raised are set out in Appendix 1 please let me know if you would like any clarification of any aspect of this letter. .

Yours sincerely

Haren Thillainathan
Regulation Manager

APPENDIX 1

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

Yes

Do you agree with our proposed approach as outlined above?

Yes

If not, are there any improvements or adjustments that could be made to the proposed approach that would make you agree with it?

If not, what alternative do you propose and why?

If we were to implement our proposed approach, which forecast of RPI do you suggest is used for setting charges? Are there any better sources than those identified in this consultation?

We agree with Ofgem that the forecasts published by the HM Treasury in the Forecast for the UK Economy are the most appropriate source to use out of the options presented. It should be noted that there is some subjectivity in how the Treasury calculates the average of the forecasts and the numbers published are not always reconcilable. Therefore the level of transparency and foresight around these numbers may be limited.

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

Yes

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?

Yes