

Joanna Campbell
Ofgem
9 Millbank
SW1P 3GE

Your ref

Our Ref

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Contact / Extension

Jeremy Blackford
0151 609 2346

Dear Joanna

RPI Indexation of allowed revenue for RIIO-T1 and the TPCR4 rollover

Introduction

I am responding on behalf of SP Transmission to Ofgem's consultation on the RPI indexation of allowed revenue for RIIO-T1 and the TPCR4 rollover.

We believe that RPI indexation is a fundamental feature of the price controls for energy network companies, and that it is essential that this is applied in an effective and transparent manner. We would be extremely concerned if the way in which RPI indexation were to be applied did not ensure protection from economy wide inflation, as measured by the Retail Prices Index (RPI).

Issues with the current approach

Our analysis of the current approach set out in Ofgem's March 2011 RIIO T1 Strategy Decision documents, demonstrates that there would be a significant mis-match between the RPI indexation of allowed revenues and the actual inflation between the base regulatory year (2009/10) and each of the regulatory years during the price controls for RIIO-T1 and the TPCR4 rollover. This is illustrated in Figure 1 below:

New Alderston House, Dove Wynd, Strathclyde Business Park, Bellshill, ML4 3FF

Telephone: 01698 413000, Fax: 01698 413053

www.scottishpower.com

Figure 1: Mis-match between allowed revenue and actual costs



As Ofgem recognise, the proposed lag in the RPI data used for indexation of allowed revenue would result in the allowed revenue falling significantly below that required to compensate for actual inflation between the base regulatory year (2009/10) and subsequent regulatory years for RIIO-T1 and the TPCR4 rollover.

This issue also applies to indexation of revenue for Transmission Investment for Renewable Generation (TIRG) and Transmission Investment Incentives (TII).

Proposed approach

We have reviewed the potential alternative approaches. We agree that it is necessary to remove the lag in RPI indexation given the swings in RPI movements over the last 2-3 years. This would require the use of forecasts of RPI growth. As forecasts will inevitably be subject to inaccuracy, it will be necessary to make an ex post adjustment to take into account any differences between the forecast RPI and the subsequently published outturn RPI.

RPI forecast

We have considered the availability of independent RPI forecasts. We agree that the average of independent forecasts that are published in the HM Treasury publication of forecast for the UK Economy is currently the most appropriate. These forecasts are in the public domain and are currently published on a quarterly basis. We agree that the average of the “New Forecasts” for the RPI, as published in November, should be used. We also agree that a simple pro-rata adjustment to the forecasts for calendar years should be used to calculate the figure for the regulatory year (i.e forecast inflation for the regulatory year t (1 April t to 31 March) should be calculated as $0.75 \times (\text{forecast RPI growth for calendar year } t) + 0.25 \times (\text{forecast RPI growth for calendar year } t+1)$).

True-up adjustment

We agree that there should be an adjustment to allowed revenue to account for the difference between the forecast RPI and the outturn RPI.

As the outturn RPI for regulatory year t (1 April to 31 March) would not become available until April in regulatory year t+1, the revenue adjustment should be applied in regulatory year t+2 1 (i.e. we agree that a two year lag for the true-up should apply). This would reflect the difference in the outturn RPI from the forecasts published in November in regulatory year t-1. For example, for the TPCR 4 rollover:

- the RPI forecast for 2012/13 would be published in November 2011;
- the outturn RPI for 2012/13 would become available in April 2013; and
- the true-up adjustment would be applied to allowed revenue for 2014/15.

NPV neutral

We agree that the revenue adjustment should be net present value (NPV) neutral, where the discount rate is set equal to the allowed WACC.

Transmission revenues affected

For the TOs, the revenues affected are:

- TPCR4 rollover base revenue for 2012/13
- TIRG and TII revenues from 2012/13
- RIIO-T1 base revenues from 2013/14

For electricity distribution, similar proposals should be consulted on as part of RIIO-ED1.

I hope that this is helpful but please contact me if there are any queries.

Yours sincerely



Jeremy Blackford
Regulation and Commercial
SP Energy Networks