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Date : 1st June 2011

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

Dear Joanna,

Thank you for the opportunity to respond to this consultation.

We broadly support the proposal to adjust the method by which RPI changes are factored into allowed revenue. However, there are a number of considerations which must be taken into account before a final proposal can be adopted.

Current approach

At present, there is no specific true up which accounts for the deviation between actual RPI and calculated RPI. However, a natural true-up does occur in the long term as actual RPI fluctuates from year to year. In this regard, any forecasting which is based around a projected fixed rate of RPI does not reflect the real nature of RPI movement and revenue adjustments.

We do not recognise the analysis used to describe the perceived problem. As the business plans are submitted in the same price base as the price control calculations and resultant revenue allowances, we are not sure why these would need to be deflated and then re-inflated to enter the first year of the price control.

However, we do agree that a specific true-up would be a useful improvement to RPI corrections. That said, the proposed true-up is merely a timing change and does not provide any reduction in risk to companies. Therefore, it would not be appropriate to revise the cost of capital as a result of this timing change.

An alternative proposal which avoids forecasting RPI

We agree with the proposal to introduce an automatic true-up of RPI. This will effectively move the correction from a natural long term true-up to a specific short term true-up.

The proposed approach uses forecast RPI data for the current year. However, given that there is to be an ex post true-up within two years, it may be more appropriate to use the most recent actual data rather than use forecast data. In line with the RIIO March Strategy Document, this recent actual data would be over a calendar rather than financial year.

An alternative proposal, which would avoid the need for forecasting RPI, could work as follows for financial year 2013/14 (where the base year is 2009/10):

- The business plans are submitted in 2009/10 prices and hence revenue terms in the licence are presented in 2009/10 prices.
- In January 2013, revenue calculations would take place for year 2013/14. These calculations would include a factor for RPI change from the base year which would be based on the percentage change in average RPI between April 2009 – March 2010 (actual data) and January 2012 – December 2012 (actual data). This would ensure that the calculated difference between 2009/10 prices and 2013/14 prices is informed by the nearest available **actual** RPI data.
- There would be a true-up in January 2015, which would feed into the 2015/16 revenue calculations, using the variation between calculated RPI and actual RPI. This true-up would reflect the difference between the following two calculations –
 1. Calculated RPI – percentage change in average RPI between April 2009 – March 2010 (actual data) and January 2012 – December 2012 (actual data), as used to inform the 2013/14 revenue calculations in January 2013, and
 2. Actual RPI – percentage change in average RPI between April 2009 – March 2010 (actual data) and April 2013 – March 2014 (actual data)
- This would result in a small true-up adjustment and thus would not contribute to tariff volatility.

This option would remove any requirement to forecast RPI, is in line with the proposal to move to a calendar year RPI assessment in the RIIO March Strategy Document and implements an ex post true-up within a shortened timescale.

Importantly, it also provides certainty to customers over the basis for tariffs as actual, rather than forecast, RPI is used. It allows suppliers to undertake tariff forecasting on a well understood, consistent basis.

We believe that the new proposal should be reflected in the licence through an amended RPI term and a new true-up term.

What should the new method apply to?

RIIO-T1 and RIIO-GD1

We agree that the new method should apply to RIIO-T1 and RIIO-GD1 base revenues from 2013/14, and RIIO-ED1 from 2015/16.

TPCR4 Rollover

We are not yet clear on the outcome of the licence drafting for the TPCR4 rollover. If the prices to be used for the rollover are 2009/10, then we believe it could be appropriate to use the new method. However, if the prices to be used are 2004/05, then we believe that the existing method should be applied to ensure consistency with the rest of TPCR4.

This matter will require careful consideration during the licence drafting for the TPCR4 rollover.

TIRG Revenues

We do not believe that it is appropriate to apply the new method to TIRG revenues. A clear policy decision has been made, by Ofgem, to allow the TIRG mechanism to endure throughout its lifecycle and any proposal to amend the mechanism would be a move away from this agreed policy.

TII Revenues

It is not yet clear how the TII RAV additions will be rolled into RIIO. As such, we believe that further work is required before any new method is applied. We expect that some kind of indexation adjustment will be required in order to move the TII revenues into RIIO and propose that this will require careful consideration to ensure that consistency is maintained. We expect companies will put forward proposals in this regard in their business plans.

Other areas of the licence

We would expect the new method to be applied to other relevant areas of the licence, for example, the incentive revenue. In this example, for the Electricity Transmission licence, the RPI change is a factor which is reflected in the Adjusted Base Revenue calculation. In turn, the incentive calculations refer to the Adjusted Base Revenue. This should mean that, as long as the new method is applied consistently to the Adjusted Base Revenue term, it should automatically feed through to the incentive calculations. However, careful attention should be given to this during the drafting of new licence conditions.

We would expect that the rollover and RIIO Licence Drafting Working Groups will work on any proposed amendments to the RPI methodology and will consider these points during the process.

If you would like to discuss our response or require further information, please do not hesitate to contact me.

Yours sincerely,



Samantha Ridsdale
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