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Hannah Nixon
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Ofgem
9 Millbank
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By email only to Joanna.Campbell@ofgem.gov.uk

1st June 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.

Please note that this response should be regarded as a consolidated response on behalf of UK Power Networks who operate three electricity distribution licence holding companies – Eastern Power Networks plc, London Power Networks plc and South Eastern Power Networks plc. For convenience, the three licensees are collectively referred to as "UK Power Networks" throughout.

I can confirm that this response is non-confidential and can be published via the Ofgem website.

The existing indexation formula used in licenses has served as an effective indexation mechanism since the mid 1990s. The majority of the period of its use has seen stable retail price inflation i.e. the differences between the six monthly average and the twelve monthly average and from one year to the next has not been materially to the benefit or detriment of either the regulated company or customers.

Ofgem's letter raises two issues with the current mechanism. Firstly that the use of lagged values for indexation can result in costs and revenues not moving in sync from year to year. Secondly, and more materially, that disjoints in the allowed revenues, caused by each price control review, must be appropriately uplifted from their base year to the starting year of the control. If a price control continued indefinitely (or were adjusted annually in line with costs/performance) then the use of lagged indexation would not be material because all costs and revenue movements would even out over time (assuming reasonably stable RPI).

It is the impact of a price control with its material one off adjustments to allowed revenues (as against costs) that causes UK Power Networks to debate the continued effectiveness of the current lagged indexation mechanism. When coupled with the ending of the relatively stable inflation levels of the 1990s and early to mid 2000s we consider that a change is appropriate.

A number of approaches are identified which would go some way to addressing this issue. We believe that any solution to this problem, whilst attempting to provide the intended protection, should not result in other material anomalies being created. Also it is clearly undesirable that this results in a significant ex-post true-up. We would agree that transparency and hence predictability is important, particularly in respect of the retail suppliers and their ability to set charges for consumers.

Having considered the approaches laid out in the letter, we believe that Ofgem's proposed approach provides the best way forward. It is our opinion that it is clear and transparent and does not have a number of the deficiencies of the other mechanisms.

We also support the suggestion of a two-year lag in the true-up, as this will ensure that the timing of adjustments is as close as is practical to the actual experience of inflation.

The use of forecasts for indexation requires the application of a revenue neutral truing up mechanism and we concur with Ofgem's view that the regulatory rate of return is the appropriate discount rate for such an approach. UK Power Networks considers that the forecast and truing up mechanism should apply to any and all elements of the price control that are subject to indexation terms.

We endorse Ofgem's proposal to adopt the HM Treasury forecast as its source for RPI. We do not believe that it would be efficient for different parties to be commissioning their own RPI forecasts, nor is it necessary for Ofgem to do so, when there are a number of reputable published forecasts available. We have experience of using this forecast within UK Power Networks and believe that its derivation from a number of independent forecasters provides a strong foundation for near-term RPI forecasts.

Finally we agree that this decision should apply to the revenues currently under review, namely RIIO-T1, RIIO-GD1, TPCR4 rollover, TIRG and TII

If I can be of any further assistance in respect of this response, please do not hesitate to contact me on 07875 112948

Yours sincerely

Keith Hutton
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UK Power Networks