Your Ref: 56/11

Lloyds Court
78 Grey Street
Newcastle upon Tyne
NE1 6AF

Hannah Nixon
Partner, Transmission
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

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Dear Hannah

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

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

Thank you for the opportunity to comment on your open letter consultation dated 19 April 2011 on the way forward in dealing with the retail prices index (RPI) indexation of allowed revenue in the forthcoming RIIO price controls (T1 and GD1) and the TPCR4 rollover.

We agree that the current approach to RPI indexation (the use of a lagged index as a proxy for the current rate) can give rise to a material and unintended discrepancy between costs and revenues if there is volatility in the index. In some cases this can result in merely a time inconsistency; in others it can confer windfall gains or losses. A mismatch can arise in any given year if there is a lag between the time when the licensee experiences the effect of the inflation and the time at which this is reflected in allowed revenues. It is certainly true that the mechanism in use in electricity distribution, where the indexation is based on the movement in the RPI in six months of one year (July to December) compared with the movement in the same six months in the previous year, carries the risk that spikes (up or down) that occur in the six months that are not part of the indexation will never be captured by the indexation mechanism, even though they may be presumed to have had an impact on the licensee's costs in the year (i.e. there is a potential mismatch between costs and revenue). In general, we are supportive of the Ofgem proposal to use forecast RPI growth with an ex-post true-up for the RPI indexation of allowed revenue.

From a distribution network operator (DNO) perspective, as a result of the lagged effect and the six month reference period, we think that we are likely to be under-remunerated for our costs when compared to the target level that was assumed as part of the current price control settlement (DCPR5). The table below shows our numerical illustration based on the current DNO indexation method.

| | 2008/09 | 2009/10 | 2010/11 (first year of the price control) |
|---|---|---|---|
| Efficient cost of activity in outturn prices | | | 100 |
| Annual Inflation (April-March average RPI) | 3.0% | 0.5% | 5.0% |
| Deflates to 2007-08 prices | | | 92.1 |
| Licence inflation (July to December average RPI applied) | 4.07% | 3.82% | -0.39% |
| Re-inflated cost included in allowed revenue outturn prices | | | 99.1 |
| Shortfall in cost recovery | | | 0.9 |

Forecast RPIs from May 2011 HM Treasury report

Your proposal would eliminate the systematic potential for the errors at the next price control that we have described above. This failing would not normally be material but, given the recent volatility that we have experienced in RPI movement, which Ofgem has recognized, it is likely to have a significant impact. This is demonstrated in the table above and is likely to result in electricity distribution companies receiving less income than is necessary to recover the DPCR5 target level of efficient costs. Whether this will be the case will depend upon the movement in the index in the remaining years of DPCR5. We would be interested to learn whether it is your intention that any under/over-recovery from the DPCR5 period will be trued-up at RIIO ED1 or whether you intend to introduce the proposed mechanism without such a true-up at RIIO ED1.

Whilst, in general we welcome Ofgem's proposal on the future indexation of allowed revenues, we have concerns over the statement that this would contribute to a lower cost of capital. In normal circumstances the variability caused by the current method is so small as not to be material and it is only the unprecedented market conditions that have caused the more significant variability. Ofgem has not determined the allowed cost of capital taking into account these abnormal conditions, so we are not convinced that removing this in future will have any discernible effect on the cost of capital at the next price control review. Moreover, as a licensee is equally likely to win or lose from the current arrangements, it is not clear to us that the WACC will be materially impacted by a change to the treatment of the RPI. We would be interested to know whether Ofgem has tried to quantify the impact within the RORE model.

If the suggested approach were to be implemented, we believe that the 'HM Treasury Forecast for the UK Economy' should be used in the forecast because of its transparency and availability. However, we would suggest that the highest and the lowest forecasts within this report should be removed from the calculation to provide protection against the effects of outliers in the dataset. Alternatively, a modal average could be used instead of an arithmetic mean to achieve the same purpose. We do not consider the Bank of England forecast to be the most appropriate data source for this purpose. That report contains only CPI data and simply adding 0.5%, as suggested in the consultation, is too crude an approach to provide an accurate forecast. We agree with Ofgem's view on the use of an Ofgem commissioned RPI forecast as we believe that this would be no more beneficial than the HM Treasury Forecast but it would lack the transparency and authority of that forecast. We also agree with Ofgem that it is not necessary for each DNO to produce its own forecast, as there would be a lack of consistency across the DNOs and a common approach would give suppliers one fewer variable to be concerned about in different operating regions.

We agree that Ofgem should include a true-up adjustment to allowed revenue to account for any difference between the outturn RPI and the forecast RPI that has been used to set use of system tariffs.

On the subject of the discount/interest rate to apply to the true-up, we consider a 'bank base rate plus' approach (i.e. similar to the one used for over/under recovery of $I_t$+1.5%) to be more appropriate than using the WACC. The price controls tend to use the approach of the bank rate (plus a percentage) where the intention is to try to capture the impact of variation in regulated income on the cash balances held by the licensee. We think that the proposed inflation true-up is conceptually close to this and it therefore should be treated in a similar way.

Yours sincerely

John France

**John France**
**Regulation Director**