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Hannah Nixon
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:

27th November 2012

Dear Hannah,

RIIO-T1/GD1: Office of National Statistics (ONS) review of Retail Prices Index (RPI) methodology

We have reviewed the consultation issued by the ONS and recognise the implications of this review of the RPI calculation and composition. The various options proposed in this consultation could have significant implications for the protection afforded to network companies by the annual indexation of revenues. The implications for the regulated networks can be categorised into two separate areas.

Setting Price Controls

Ofgem must consider how it responds to this potential change in RPI and what the most appropriate treatment for each regulated sector would be. This is likely to be determined by timing of the price control reviews. For the Gas and Transmission networks, the proposal to include a reopener which would allow the networks to ask Ofgem to review the implications of the change in ONS' methodology for calculating RPI is sensible. We agree that both Ofgem and the companies should be able to trigger a reopener and that a reopener window should help with resourcing but that the window should be triggered by the ONS decision on the need for an adjustment rather than a specified date. We also agree that a materiality test should be included. Whilst we agree that materiality threshold can be set by reference to a percentage of reveneue, it is important that the calculation of the impact includes all components of the price control, including RAV indexation. Companies should be compensated for the full impact of the change, not just the amount above the threshold.

Ofgem's current uncertainty mechanism to address above RPI cost increases must recognise the potential changes to the future RPI level. We expect that certain costs may move with the changing RPI (ie general labour settlements, rents etc). At the same time, some costs will remain linked to commodity costs, currency markets and specialist markets (as recognised in the existing RPE methodology). The prescribed methodology should ensure that appropriate compensation is provided but the scale of the allowances will be significantly higher than any previous price control. The obvious concern is that these RPE allowances are fixed at the point of the price control and may not provide the same level of risk mitigation. Additionally, the transfer of funding from an annual index to a forward looking allowance will increase the risk that either efficiently incurred costs are unfunded or that customers pay significantly more than necessary (depending on the outcome of actual cost and RPI).

At present, the RAV is uplifted by RPI to partially reflect the actual cost of borrowing debt and equity. The modified RPI will have implications for setting the real cost of equity and debt. Ofgem must consider these implications when setting the future cost of equity and ensure that the cost of debt mechanism covers efficient incurred costs once RPI has been adjusted.

For RIIO-ED1, Ofgem must ensure that the RPE allowance setting methodology takes appropriate account of the change in the method and scale of funding of efficient costs and that the cost of debt index and allowed cost of equity reflect the increased level of risk associated with funding via allowances.

Modifying Existing Price Controls

For the remainder of DPCR5, it is important to ensure that companies receive appropriate compensation for the change in the differential between their costs and their revenues. Ofgem should include an uplift to future revenues, based on the specified adjustment set out by the ONS in its final consultation. This will have an impact on the 2014-15 revenues which are based on the July to December 2013 RPI and on indexation of 2013-14 and 2014-15 RAV. We believe that the most pragmatic approach would be to adjust the associated RPI indices to take account of the RPI formula effect.

Yours sincerely,

Sarah Walls

Sarah Walls
Head of Economic Regulation