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Dear Hannah,

RIIO-T1/GD1: Office of National Statistics (ONS) Review of Retail Price Index (RPI) Methodology (Ref. 141/12)

We welcome the opportunity to respond to your consultation letter of 30 October 2012.

Our suggestion for dealing with potential changes to the calculation of RPI is a practical one, taking account of the timing of RIIO-T1 and RIIO-GD1, the need to deliver a "neutral" outcome for customers and investors, the need to demonstrate regulatory consistency to encourage investment, and reflecting the current uncertainty around the nature and impacts of any change.

The headlines of our suggested approach are:

- The impact of any of the changes to RPI methodology being considered, if implemented, would be likely to be highly material to licencees' ability to finance their activities under RIIO-T1 and RIIO-GD1, although many of the consequences cannot be predicted accurately in advance.
- Therefore, Ofgem should continue to use a measure of inflation for indexing both revenues and RAV which reflects the existing RPI calculation methodology (as published by the ONS or, when this ceases to be available, a pre-calculated uplift to "new" RPI)
- In the event that the impact on the costs of the regulated companies of any changes arising from the ONS consultation becomes clearer, and if continued use of the existing RPI calculation methodology is shown to be to the material detriment of companies or customers, either Ofgem or licensees should then be able to propose licence amendments. These would need to be demonstrably value neutral to all parties as compared to the intention of the original price control.

Introduction

The recent ONS consultation on the Retail Prices Index[1] put forward 4 options for amending the calculation of the index, in respect of the "formula effect". The first was for there to be no change to the methodology, but under the other 3 options there would be a substantial reduction in the expected future values of RPI (currently expected to be by c. 0.7% for Option 2 or around 1.0% for options 3 and 4)[2].

If after its consultation, the ONS recommends adopting any of the latter 3 options, and should it be approved by the Chancellor of the Exchequer, the change would be expected to be implemented from April 2013 onwards.

We set out in the remainder of our response our views on the areas in which the RIIO price controls are likely to be affected by the potential change to RPI, and, as a consequence, how the RIIO-T1 and RIIO-GD1 licences should be amended.

Effects on RIIO Price Controls

The main effects of the potential changes to the calculation of RPI would be felt in price controls through:

- Real price effects (RPEs);
- The Cost of Debt; and
- The cost of equity (including RAV indexation).

In respect of RPEs, there are certain costs, such as for materials, which are clearly not at all dependent on RPI values in the UK and, therefore, their nominal cost would not be expected to reduce because reported RPI has fallen. In this case, RPEs measured using "new" RPI would be expected to rise by the same amount as the fall in RPI caused by the change in the basis of calculation.

There are other costs, for example, labour costs, where historically there has been a link, at least in part to RPI. It is often argued that wage negotiators pitch wage claims having regard to the reported level of RPI. However, this does not mean that there has historically been an automatic "1 for 1" link between RPI and wage settlements, and even if it did, it would not guarantee that a structural reduction in the level of RPI would be automatically adopted by wage negotiators.

Therefore, for certain types of costs, RPEs would clearly rise to match the fall in reported RPI, but for others it is not possible to quantify the effects accurately in advance. We would expect these to become clearer some time after the change in RPI methodology.

In respect of the Cost of Debt Index there are a number of complex, interrelated issues. For the existing stock of debt, the Cost of Debt index has already been calculated using historic expectations of breakeven RPI and future interest costs (potentially even for index-linked debt) would not change as

[1] "National Statistician's consultation on options for improving the Retail Prices index", ONS, October 2012
[2] "National Statistician's consultation on options for improving the Retail Prices index", ONS, October 2012 Section 6

a result of a change in RPI methodology. As a result, corresponding revenues would need to continue to be indexed using RPI values produced on the same basis.

In respect of the cost of future debt, the effect on future corporate index linked and nominal debt costs would be unclear. The impact on gilt yields and break-even inflation would also be highly unclear. Furthermore, the ONS states in their consultation that some government index linked gilts may become redeemable in the event that a material change in the RPI calculation occurs, and there could even become index-linked gilts in existence at the same time with different RPI indexation.

It is evident that the effect on the actual cost of debt and also that allowed via the Cost of Debt Index due to a potential change to the calculation of RPI would not become clear until some time after the change was made.

In respect of the cost of equity, for RIIO the allowed real equity returns have been based on long term evidence which assumes that RPI continues under the current calculation methodology. Moreover, equity investors require returns which are competitive with the (risk adjusted) returns available from alternative investments in other industries and countries. Consequently, a structural fall of up to 1% p.a. in the level of RPI applied to both allowed revenues and the RAV, leaving the vast majority of other UK companies and all non-UK companies unaffected, would significantly reduce the relative attractiveness of investing in UK licensees.

It is clear that the effects of RPI changes in many of the areas above will only become clear some time after the event.

The position is analogous to Ofgem's consideration during the RPI-X@20 review of whether to move to CPI rather than RPI indexation. Here Ofgem supported making adjustments to RPEs and allowed returns to reflect any move from RPI to CPI indexation. The Recommendations document[3] states that:

- "*Whether a switch to CPI indexation would be in consumers' interests depends on how the choice of index affects other aspects of the price control framework, including the setting of the allowed return*." (Para 11.40)
- "*With a wholesale move to CPI we would: set total allowed expenditure using RPEs relative to CPI; index the allowed return and other elements of the control by CPI; and as part of this change the way that we set the allowed return, to take account of the CPI rather than RPI indexation*." (Para 11.48)
- "*Retaining the faster growing RPI index does not mean that consumers are paying more than necessary or, on the flip side, that there is systematic over-rewarding of shareholders. We can calibrate other elements of the price control package to reflect the use of RPI indexation*." (Para 11.56)

Further, the subsequent decision document then contained the following, "*We have had strong feedback, particularly from the academics, that it is essential that there is consistency between the indexation of the price control and the basis for establishing the allowed return*." [4]

[3] "Regulating energy networks for the future: RPI-X@20 Recommendations: Implementing Sustainable Network Regulation", Ofgem, July 2010
[4] "RIIO: A new way to regulate energy networks", Ofgem, October 2010, Paragraph 5.3

Proposed licence changes

From the section above, it is clear that a material change to the basis of calculation of RPI would be likely to have a material effect on licensees' ability to finance their activities, but this cannot be reasonably quantified until some time after any change is made.

Assuming that the ONS decide to change the basis of the calculation of RPI, the most sensible approach to indexation is therefore to use values of RPI calculated using the present methodology. The ONS has stated that it will continue to publish RPI using the present basis for a transitional period, so this data should be available. Should this cease to be published, it should be possible, either from data the ONS has already published, or using the data to be published during the transitional period, to work out what uplift should be applied to "new" RPI to replicate the present calculation.

In the event that either Ofgem or licensees find robust evidence that the continued use of the present RPI calculation would be expected to have material detriment to either companies or consumers, either should then be able to propose a licence modification to use a different basis of indexation, such as "new RPI" plus x%.

Because the RPI change is likely to have a material impact on licensees' financeability, we believe that the alternative approach of using "new" RPI in the licence and then reviewing the impact of the change subsequently would be likely to lead to significant financial underperformance and so concern investors (on whom we rely), and would therefore be unwise.

Furthermore, we note that the whole RIIO process to date has been carried out assuming use of the present RPI calculation, and therefore, for internal consistency and balance, it would be logical to continue to apply future values of RPI as calculated in this way.

The consultation paper asks two further specific questions, being:

- Is an application window needed?
- Is there a need for a materiality test?

Under our proposed approach, the continued use of the present RPI calculation would not require either an application window or a materiality test. However, the issues are still relevant because, under our proposed approach, if either Ofgem or licensees can show that continuing to use RPI calculated on this basis would be expected to have a material detriment to either companies or customers, they should then be able to propose a licence modification.

Under these circumstances and under our proposed approach, it would seem sensible for there to be an annual application window, covering not just this particular change to the RPI formula, but also any future material changes to this or other parts of the calculation of RPI. It would not seem logical to restrict the licence condition to one particular change, when, in future, other changes could also be significant.

In respect of the application of a materiality test to any change away from the present calculation of RPI, it would seem logical for a 1% of allowed revenue materiality threshold to apply, this applying to total financial impacts (including indexation of the RAV).

Conclusion

The potential changes to the basis of calculation of RPI are likely to have a material impact on licensees' ability to finance themselves under RIIO-T1 and RIIO-GD1 but are difficult to quantify accurately in advance. The impacts will be felt through RPEs, actual debt costs and allowances via the Cost of Debt index, the return on equity and RAV indexation. In the analogous position where Ofgem considered switching from RPI to CPI indexation, it also recognised that changes to inflation indexation would require changes to assumed levels of RPEs and allowed returns.

We propose that:

- Ofgem should continue to use a measure of inflation for indexing both revenues and RAV which reflects the existing RPI calculation methodology (as published by the ONS or, when this ceases to be available, a pre-calculated uplift to "new" RPI).
- Once the impact of the ONS decision on the costs of the regulated companies becomes clearer, and if continued use of the existing RPI calculation methodology is shown to be to the material detriment of companies or customers, either Ofgem or licensees should be able to propose licence amendments. These would need to be demonstrably value neutral to all parties as compared to the intention of the original price control.

Because the RPI change is likely to have a material impact on licensees' financeability, we believe that the alternative approach of using "new" RPI in the licence and then reviewing the impact of the change subsequently would be likely to lead to significant financial underperformance and so concern investors (on whom we rely), and would therefore be unwise.

Under our proposed approach there does not need to be an initial application window or materiality test. However any subsequent proposal by either Ofgem or the licensee could be made in an annual application window, subject to a materiality test of 1% of turnover, this applying to total financial impacts (including indexation of the RAV).

Yours sincerely

[By e-mail]

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