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Your ref 141/12

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Date 26 November 2012

(By e-mail)

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Dear Hannah

ONS Review of Retail Prices Index methodology

I am replying, on behalf of SP Transmission, SP Distribution and SP Manweb, to Ofgem's consultation open letter, dated 30 October 2012, concerning the ONS review of its methodology for calculating the Retail Prices Index (RPI).

The timing of the ONS' consultation and the proposed date for the implementation of any changes to the calculation of the RPI means that the ONS' decision cannot be taken into account prior to Ofgem publishing Final Proposals for National Grid's (NGET and NGGT) and the GDNs' RIIO price controls. We are also concerned that any changes to the calculation of the RPI will also affect the Scottish TOs' RIIO-T1 price controls, RIIO-ED1 and the remainder of DPCR5 for the electricity DNOs.

As you are aware, the RPI is currently used to index allowed revenues and the Regulatory Asset Value (RAV). For these purposes, even small changes in the calculation of the annual change in the RPI would have a significant impact over the 8 years of a RIIO price control, due to the mathematical effect arising from compounding, year on year. For example, if the annual change in the RPI is reduced by 25bps, from, say, 2.75% to 2.5%, the reduction in the nominal value of the RAV would be $(1.0275)^8 - (1.025)^8 = 2.4\%$ by the end of the price control period. For an 85bps reduction in the annual change in the RPI, the reduction in the closing nominal value of the RAV would be 8%. Any change in the annual RPI calculation will result in a significant reduction in the closing nominal RAV value and, consequently, higher Debt/RAV ratios. In turn, these would be expected to be reflected in lower credit rating scores.

Moreover, the nominal value of each of the RAVs will continue to grow more slowly beyond the end of RIIO-T1, GD1 and ED1.

Similarly, investors, including bond-holders, who set required returns in nominal terms, will require a higher real return to compensate them for the lower than expected increase in the RPI.

Furthermore, underlying actual costs for DNOs do not change as a result of the way in which the RPI is calculated, so revenue should not be reduced.

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We therefore support the inclusion of a re-opener for RIIO-T1 (including the Scottish TOs) and GD1 in the forthcoming licence modifications. In principle, we are supportive of an application window but are mindful that conceivably there could be delays in the implementation of the change to the calculation of the RPI or that further changes to inflation measures could be implemented in future, for example, if changes are phased. It seems that the ONS' and CPAC's work programme on consumer prices is not yet complete and further development of price indices will continue.

The Consumer Prices Advisory Committee (CPAC) Annual Report for 2012 states:

“The Committee believes that the timing is now right to formally set out new a strategy for consumer price statistics and, over the past year, it has advised ONS in the development of this strategy. The strategy includes the production of CPIH, which will be published alongside the CPI and RPI. This will continue the development of a ‘family’ of indices that meets the needs of different users and different purposes in the UK. Harmonisation between the measures will be sought where it is sensible to do so, using consistent methodologies and reflecting appropriate populations and coverage.”

We, therefore, suggest that the application window(s) is (are) framed relative to the timing of the implementation of the change(s) in the calculation of the published RPI.

For administrative simplicity, it would seem easier if the re-opener was triggered by Ofgem, so as to avoid multiple applications from network operators, potentially at different times. However, individual licensees may wish also to have the right to trigger a re-opener if, for any reason, Ofgem did not itself trigger it. Consideration should also be given to the potential appeals process if, for example, Ofgem decided not to change the price control to the degree requested.

Any assessment of materiality should be made across the price control period as a whole, due to the effect of compounding annual price changes, year by year, through the price control period. It would not be sufficient to consider the impact of a single year's change, as this would substantially understate the overall impact.

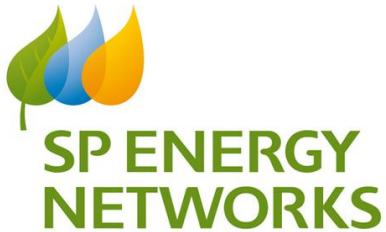
As regards electricity distribution, different approaches will be required for the remainder of DPCR5 and RIIO-ED1. For the remainder of DPCR5, we propose that price indexation continues to use inflation figures that are calculated using the existing methodology for the RPI. We are hopeful that the ONS will continue to publish supplementary figures, which will continue to be calculated on the existing basis, to allow calculation of the average for July to December 2013, which applies to allowed revenue for 2014/15.

The impact on RIIO-ED1 should be more fully assessed following the ONS' decision and the implementation of any change to the calculation of the RPI from February 2013. At this stage, we highlight the potential impact on the estimation of real price effects (RPEs) for ED1, as these will have been estimated using RPI figures which have been calculated on the old basis. In addition, there will be wider effects on returns and financeability, which will need to be considered.

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Regulation & Commercial

We shall continue to support the RIIO licence drafting working group to ensure that appropriate licence modifications are made for RIIO-T1 and RIIO-GD1. We shall also continue to support the working groups for RIIO-ED1, including, in due course, that for licence drafting.

Yours sincerely

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