



Appendix 2 to the consultation

Keith Noble-Nesbitt

7 January 2014

This presentation only covers appendix 2 of Ofgem's consultation

Issue	Covered?
<ul style="list-style-type: none">• Degree to which the consultation is consistent with the RIIO process to date	✗
<ul style="list-style-type: none">• Responses to the consultation questions	✗
<ul style="list-style-type: none">• Points on RPI inflation in appendix 2	✓

The appendix makes some firm statements that need debate

“[the ONS evidence] implies the need for equity return allowances has fallen by about 0.4 per cent” Ofgem consultation, paragraph 2.10

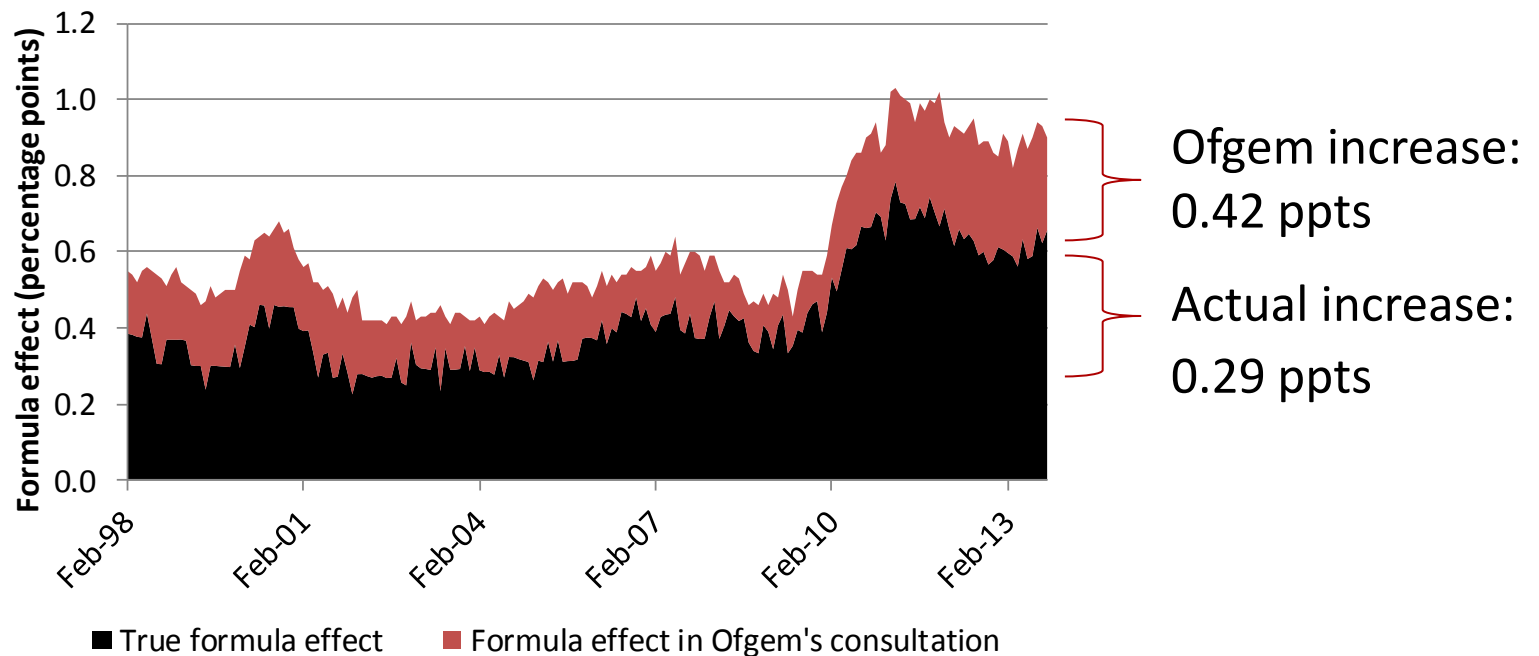
“It would be inappropriate to use relatively low housing inflation in recent years as a reason to disregard the impact of a marked and enduring change in the formula effect” Ofgem consultation, paragraph 2.20

In fact:

- The actual change in the formula effect is less than 0.4 percentage points
- It has been partially offset by a 2011 structural break in council tax
- Ofgem has already increased its view of long term RPI inflation since 2009

Ofgem has over-stated the increase in the formula effect

- The ONS figures quoted by Ofgem measure the formula effect that would exist *if RPI used the same weights as CPI*
- RPI doesn't use the CPI weights
- The true change in the formula effect can be estimated directly using the difference between RPI inflation and RPIJ inflation



There has been an offsetting structural break in council tax

- Ofgem's consultation concludes that the current low levels of housing cost inflation will not continue to offset the increase in the formula effect
- But the Localism Act (2011) means that council tax will rise much more slowly in future than over 1997-2009
- Council tax has a 4% weight in RPI, but is not included in CPI, so the effect is not negligible

	Rate of increase	RPI inflation contribution
1997-2009	6%	0.24 ppts
Likely future level	2%	0.08 ppts
Structural break	-4 ppts	-0.16 ppts

Ofgem has already increased its estimate of RPI inflation since 2009

- At DPCR5, Ofgem used an estimate of long term RPI inflation of 2.7%, based on advice from its advisers and city analysts
- In the RIIO price control consultations, it increased this figure to 2.8%
- ***Conclusion:*** Since 2009 Ofgem has already accounted for a 0.1 percentage point increase in the long term prospects for RPI inflation

Overall it is not clear that there has been any increase in long term RPI inflation prospects

- The actual change in the formula effect is less than 0.3 percentage points
- Half of this change has already been offset by a structural break in council tax increases brought about by government legislation
- A further 0.1 percentage points has been accounted for by Ofgem's own reassessment the level of RPI inflation consistent with 2.0% CPI inflation
- ... and this is before taking into account the facts that:
 - the formula effect appears to have settled back to lower levels after 2011, once the new data gathering rules had 'bedded in'
 - The UK statistical authorities have expended considerable effort in trying to find ways to reduce the formula effect by adjusting data collection guidance, and have not ruled out implementing such changes
- **Conclusion:** this is not an issue that needs to be adjusted for