Interconnector developers, OFTO
bidders, investors, financiers and
other interested parties

Making a positive difference
for energy consumers

Direct Dial: 0207 901 7468
Email: Scott.Laczay@ofgem.gov.uk
Date: 31 March 2016

Dear Stakeholders

Ofgem has taken the decision to retain RPI as the inflation index for the upcoming Offshore Tenders Round 4 and as the default for the cap and floor interconnector regime.

On 14 October 2015 we issued an open letter seeking views on moving from the Retail Price Index (RPI) to the Consumer Price Index (CPI) as an index applicable to future OFTO and interconnector licences[1]. We received 12 responses, which are summarised in Annex A. We have also attached all but one response, which was deemed confidential. We have therefore concluded with the following decision regarding indexation for future OFTO and interconnector licences.

1. Indexation for OFTO Tender Round 4 (TR4)

We have taken the decision to continue using RPI as the measure for indexation in TR4. We note the recent statement by the National Statistician[2] supporting CPIH. However, we recognise that CPIH is not yet re-accredited as a national statistic and we note the assessment by the UK Statistics Authority (UKSA) that further work is required to establish the credibility of the measure[3]. In addition, the UKSA has not yet issued a full report on its consultation that ended in September 2015[4]. Therefore, we consider it prudent to retain use of RPI for TR4. However we will continue to keep this issue under review prior to determining indexation for any future rounds beyond TR4.

A number of responses to the open letter highlighted concern regarding the lack of a liquid CPI linked debt market. While a change of index should be NPV neutral, we note the risks and have considered this in our decision. A developer also highlighted the potential benefits of aligning OFTO revenue indexation with the CPI linkage of their own CfD arrangements for future offshore wind farms. We also intend to consider this further in future rounds.

2. Indexation for Interconnectors in Cap & Floor Window 2

For interconnectors, whilst we will continue to consider RPI as the default index, we intend to create greater flexibility for developers to propose alternative arrangements, to be assessed alongside all other elements of consumer value when considering cap and floor submissions. Specifically, developers may request a variation to the regime to allow for

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2015/10/open_letter_indices_14oct_finalv2_0.pdf
[2] https://www.statisticsauthority.gov.uk/wp-content/uploads/2016/03/Letter-from-John-Pullinger-to-Sir-Andrew-Dilnot-090316.pdf
[3] https://www.statisticsauthority.gov.uk/news/assessment-statistics-on-consumer-price-inflation-including-owner-occupiers-housing-costs/
[4] https://www.statisticsauthority.gov.uk/reports-and-correspondence/consultations/

alternative indexation, such as CPI, at relevant stages of the overall cap and floor regulatory process.

3. Indexation for RIIO

A number of respondents also took the opportunity to share their thinking on indexation in relation to RIIO. Our decision in respect of offshore tender rounds and interconnector submission windows has no implications for our indexation approach for RIIO. Our current RIIO regimes will continue to use RPI during the current control periods. Paul Johnston's January 2015 report to the UKSA[5] and the National Statistician's latest thinking set out in his 9 March 2016 letter to Sir Andrew Dilnot[6] naturally raise questions around our longer term use of RPI. We do not expect to consult on our thinking on any changes in indexation for RIIO until the future role in the economy of an alternative measure of consumer inflation, which may be CPIH, becomes clear. Among other things, we would expect to consult on how we would put into effect any such change to ensure it is present value neutral.

4. Subsequent Review

We will continue to monitor the developments of wider discussions on indexation from the UKSA, ONS and other bodies including our stakeholders and intend to issue further guidance on our policy as those progress.

If you have any queries in relation to indexation matters relating to OFTOs or interconnectors, please contact Scott Laczay on 020 7901 7468 or at Scott.Laczay@ofgem.gov.uk. In relation to RIIO, please contact Ian Rowson on 020 3263 2786 or ian.rowson@ofgem.gov.uk.

Yours sincerely,

SJ Beel

Steve Beel
Partner, Competitive Networks

[5] https://www.statisticsauthority.gov.uk/wp-content/uploads/2015/12/images-ukconsumerpricestatisticsarevie_tcm97-44345.pdf
[6] https://www.statisticsauthority.gov.uk/wp-content/uploads/2016/03/Letter-from-John-Pullinger-to-Sir-Andrew-Dilnot-090316.pdf

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

ANNEX A – Summary of responses

We received 12 responses. Only some of these were in response to the question of indexation of future OFTO and interconnector licences. Other responses were to share views with regard to RIIO.

For OFTOs, all responses only considered full indexation of the TRS (as opposed to natural hedging) and making use of inflation swaps. Responses recognise the discrete nature of the projects and given their small size, the ability to engage even illiquid CPI swap markets if needed, though noting potentially higher associated costs versus RPI swaps.

Some responses noted concerns over mismatches of index, ranging from mismatches to key supply contracts as well as concern from generators over mismatch between income (eg. ROC/CfD) and related OFTO TNuOS charges. One response noted that it might be beneficial to match the indexation of generator revenues with OFTO's TRS through indexing by CPI, given that CfDs are CPI-linked. However, we note that the current TNuOS charging methodology may have to be amended to realise any benefits.

Most responses recognise that a change of index should be a neutral one from a longer term NPV perspective, albeit it would shift the profile of costs over times. Any negative impacts resulting from a change are viewed as being borne from increased perceived risks and engaging with an illiquid CPI debt market for the purposes of inflation swaps.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**