energynetworks association

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9 Millbank
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Dear Steve

Re: Moving from RPI to CPI as an index applicable to future OFTO and interconnector licences

This letter is on behalf of both our gas and electricity members, who own licensees across Transmission and Distribution in Great Britain. We note that the specifics of the above consultation letter focussed on OFTO and interconnector licences. However, our members welcome the acknowledgement within the letter of the potential wider implications for the RIIO-2 price controls and future control periods. This response highlights some of the circumstances needed, changes required to RIIO and the further considerations necessary before the RIIO price controls could adopt CPI as an index. Our members would highlight that applying CPI indexation to a well established industry with a strong history of using RPI is quite different from applying it to new industries.

Need to reach a conclusion well before RIIO-2: Our members welcome the chance to start considering these issues now. Indexation is a cross cutting issue which impacts on all energy network price controls. It's important that the implications across all energy networks are considered and that there is a clear conclusion before policy development for RIIO-T2 and GD-2 commences. This will allow policy development to take full account of any change, rather than being developed in parallel. Our members would welcome further clarity from Ofgem on how this work will be taken forward for the RIIO-2 price controls and the proposed timeline.

Work undertaken in RPI-X@20 review: As you will be aware, the issue of indexation for the RIIO price controls was considered back in 2010 as part of the RPI-X@20 review. The conclusions of that review stated that the important factor in deciding whether RPI or CPI is preferable for indexing the price control depends on the maturity and liquidity of the respective index linked bond markets[1]. At the time of the RPI-X@20 decision, the UK Debt Management Office (UK DMO) stated that "there was limited likelihood of CPI indexed bonds being issued in the near future. Further should such a market emerge, there was a need to allow the new market to 'settle down' before we use it for price control purposes"[2]. Our members still fully support the conclusions and views of the UK DMO.

[1] https://www.ofgem.gov.uk/sites/default/files/docs/2010/10/decision-doc_0.pdf p26

[2] https://www.ofgem.gov.uk/sites/default/files/docs/2010/10/decision-doc_0.pdf p26

If Ofgem is considering moving away from RPI, our members would like to see firm evidence of how the conditions outlined above have been met. A significant move from the UK DMO to issue CPI indexed bonds on an ongoing basis would be a good sign that a liquid market in CPI linked bonds could materialise. Our members consider that even if a liquid market materialises it would need to be stable and of significant size as a precondition for CPI indexation to be introduced.

Impact on investment and financeability of energy networks: You'll be aware that the Government has highlighted that over £40bn of investment is required in UK energy networks by 2050 if the UK is to meet carbon targets and maintain the current high levels of reliability[3]. In addition, many of our members have key long term debt investors, including pension funds that have been attracted because of the RPI indexation over the life of their investments. As you will be aware, equity and debt investors appreciate regulatory certainty and therefore would have significant concerns with a change to CPI indexation that may lead to uncertainty and loss. In addition, differentiation needs to be made between an appropriate index for a new business to one which has a legacy of RPI indexation and where a move to CPI indexation could be costly to customers and investors alike. Ofgem will need to demonstrate that any move to CPI indexation does not jeopardise existing investment, and new investment required to meet Government objectives and deliver outputs for customers. Equally, it would be helpful to members if Ofgem models and explains the impact of any move to CPI indexation on customers, investors and the financeability of network companies.

If Ofgem chose to make a regulatory change to CPI indexation, our members would highlight that the costs of re-financing or issuing of new debt would fall on customers, since it would be inappropriate to ask network companies to fund these costs. In addition, since a commitment to RPI indexation for the regulatory asset value (RAV) was given at previous price controls our members consider that the historic RAV and the related allowed return and depreciation would still need to be indexed at RPI.

Customer benefits: In the context of any change to future RAV indexation, there are a number of changes to the price control package which would have to be made if indexation was linked to CPI to ensure that customers and members would not incur loss. As highlighted above, these include the cost of capital and also real price effects. We assume that values in nominal prices would not change, so once the adjustments to other aspects of the price control are made, so our members would question whether a move to CPI indexation would provide any benefits to customers and could increase customer bills in the short term. Therefore, we would welcome Ofgem's justification of the customer benefits of moving to CPI indexation.

Process: Our members would highlight that this is a complex area and caution is essential. While we welcome the specific consultation on indexation for OFTOs and interconnectors mentioning the wider implications of the RIIO price controls, it deserves a more thorough debate within the RIIO context. In addition, there is a considerable volume of ongoing work in this area. The UK Statistics Authority has issued its own consultation on the issue, with a decision not expected until later in 2016[4]. Ofwat is also undertaking analysis is this area and is considering many of the

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[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/394509/DECC_Energy_Investment_Report_WEB.pdf p7

[4] http://www.statisticsauthority.gov.uk/reports---correspondence/consultations/index.html

issues raised in this letter, including the impact on customer bills[5]. Our members would urge Ofgem to outline the work programme to assess indexation for the RIIO-2 controls which can facilitate a wider debate and take account of the work already ongoing in this area.

I hope these points provide a useful starting point for the policy development in this area. Our members are keen to work with Ofgem in this area. If you have any questions on the points raised in this letter, please contact mark.askew@energynetworks.org.

Yours sincerely

David

David Smith
Chief Executive

cc: Ian Rowson, Associate Partner, Regulatory Finance and Governance

[5] http://www.ofwat.gov.uk/wp-content/uploads/2015/10/pap_tec201507monopolies.pdf see pages 19-21