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Dear Mr. Beel

OFTO and Interconnector licence consultation on moving from RPI to CPI

Thank you for the opportunity to respond to your open letter on a possible future transition from the Retail Prices Index (RPI) to some form of the Consumer Prices Index (CPI) as a means of adjusting a price control for inflation. We respond from the perspective of informing your consideration of any change in the next RIIO price reviews and we comment on the assumption that CPI is systematically lower than RPI.

Summary recommendations

Although the technical deficiencies within the construction of the RPI are noted we do not believe that the overall benefits to customers of moving RIIO price reviews to a CPI based index have yet been demonstrated. Indeed there is the likelihood that prices for current customers would increase and that overall such a potential change has significant disadvantages for the following reasons:

- As previously noted by Ofgem, an established and liquid market in CPI index-linked gilt instruments would be required by Network Operators (NWOs) to allow them to continue to raise a proportion of debt linked to the indexation of a CPI linked Regulatory Asset Value (RAV). Such a market development would also be required to derive the CPI based real cost of equity and debt components within a changed Cost of Capital allowance. Such a market does not exist at this present time and the UK Government Debt Management Office has stated it has no plans to issue CPI linked gilts. Without market derived CPI real rates any construction from the existing RPI rates would be dependent upon a wholly subjective, and likely changeable, estimate of the RPI less CPI "wedge".
- If all the components of the price review were to be consistently amended then there would be no impact on the total costs to customers over time. There would however be an increase in the proportion of costs borne by current customers from future customers, since the real cost of capital would increase. It's important that Ofgem understand and recognise that the appeal of a price reduction for customers simply because CPI is lower than RPI is illusionary.
- Introduction of CPI is likely to introduce extra risk for equity and debt investors, particularly pension funds where their existing liabilities are predominantly RPI- rather than CPI- linked. The matching of RPI linked returns to RPI liabilities has been a key aspect of the attractiveness of UK energy networks and a change or transition will create complexity and increase the relative riskiness to be reflected in costs for customers.

As a consequence of the concerns set out above our current view is to retain use of the RPI (and RPEs) to compensate for inflationary effects faced by the NWOs and set WACC and RAV indexation linked to RPI. However, we recognise that maintaining the status quo may be unattractive to Ofgem and any such decision would need justification in the light of recommendations in the Johnson review. Whilst we consider that the benefits to customers of

maintaining the RPI link can be demonstrated we note that other economic regulators have and are considering the issue and we will contribute to any further debate.

We also note that the position may evolve as a result of the UK Statistics Authority's decision, due in 2016, responding to the Johnson Review.

The following sections explore the reasons for our conclusions in a little more depth.

CPI linked gilt and debt markets not yet developed

In the RIIO handbook Ofgem stated as the conclusion of its consultation and consideration of the RPI-X review, in October 2010, in respect of a potential change to CPI:

> *"While we recognise that there may be a case for moving to indexation using the consumer prices index (CPI), there are significant practical problems with a wholesale move to CPI as corporate and government index-linked bonds continue to use RPI as the relevant index.*
>
> *If a market in sterling CPI indexed bonds were to develop we would revisit this issue at future price control reviews".*

There is no evidence that this test has been met or indeed looks anywhere like being developed in the foreseeable future.

We note the Johnson review states[1], but does not include as a formal recommendation:

> *"The issuance of index-linked gilts is more complex, but government should move away from selling gilts linked to the RPI, subject to consultation and assurance about the demand for CPI or CPIH linked gilts."*

However in 2011 the UK Debt Management Office consulted on the potential demand and benefits of issuing CPI Gilts and decided against this. The review attracted responses from a large number of UK investment institutions including the Association of British Insurers. The resulting report concluded that there was insufficient demand in the long-term to sustain a liquid market in CPI linked gilts and decided against issuance in 2011-12. It went onto say that for any potential issuance in the future:

> "*the Government would need to be satisfied that any demand for CPI-linked gilts would be sufficiently strong and sustainable and that issuance would be cost-effective*"[2]

In June 2015 the first CPI-linked sterling bond was issued by the Greater London Authority however the development of a genuine market to enable effective CPI price control indexation has a long way to go. Oxera Consulting concluded in its July 2015 Agenda paper "Index-linked bonds 2.0: introducing CPI-linked securities" that:

> *"Over time, a shift in regulatory policy towards linking price rises to CPI would widen the pool of potential borrowers in the CPI-linked bond market. However, given the infancy of CPI-linked bonds and the lack of pricing benchmarks, it is unlikely that private organisations will be in any hurry to issue CPI-linked debt. The onus on broadening this market is therefore likely to remain with government bodies in the foreseeable future."*[3]

Combined adjustments to future price review components result in no customer benefit

A price review needs to effectively compensate network companies for the inflationary pressures they face over the review period. Neither RPI nor any CPI alternative fully matches a network

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[1] Page 14 Summary and recommendation

[2] Executive summary UK Debt Management Office CPI-linked Gilts: Response to Consultation 29 November 2011 http://www.dmo.gov.uk/documentview.aspx?docname=/publications/giltsmarket/consultationpapers/cons20111129.pdf&page=consultation

[3] http://www.oxera.com/Latest-Thinking/Agenda/2015/Index-linked-bonds-2-0-introducing-CPI-linked-secu.aspx (Section: Impact on regulated utilities)

operator's expenditure profile. At the DPCR5 and RIIO price control network operators were allowed Real Price Effect allowances (RPEs) as the regulator's best estimate of the additional outlays they would face , over and above RPI. Whilst there may be subjectivities about the quantum of RPE's, based on the best available data and range of forecasts, this established principle underlines the fact that if a price review were to be expressed in CPI terms rather than RPI then the amount of RPEs would need to increase.

In addition to the mechanism for covering cost allowances, other parts of the price review package would need to change to ensure internal consistency. The adjustment to the indexation of the RAV over the long-term at CPI would need a corresponding adjustment to the real Cost of Capital allowances, funded in year. On the basis that the deduction from nominal to real rates would be smaller, then the resulting real Cost of Capital allowances would be higher. This would result in a higher cost for current customers and lower growth in the RAV off-setting costs in the very long-term to future customers.

As stated earlier, the ability to derive real cost of capital components (risk free rate for cost of equity and real cost of debt from indices of nominal bond yields) would require a developed market across the yield curve of CPI linked gilts.

Whilst it would be theoretically possible to create an estimated adjustment to RPI to derive "break-even" CPI this would be wholly subjective and subject to changes given that the RPI make-up is now locked whereas the CPI basket will update regularly over time.
It would similarly be possible to flex aspects of the regulatory allowances, such as depreciation lives or capitalisation to seek to off-set a higher cost of capital on current customers, but any such amendments would be inconsistent with the RIIO principles.

Another aspect of the price review that would require adjustment is in relation to pension deficit funding where the Scheme Actuaries continue to use RPI to calculate estimated liabilities and so any resulting deficit. The terms of the Electricity Supply Pension Scheme (ESPS) are fixed to RPI and cannot be changed without primary legislation. Therefore, even if the overall price review was indexed in CPI terms there would need to be a separate true-up mechanism linked to RPI for pension deficit funding.

Whilst ongoing pension service costs now form part of Totex the actual accrual rates to ESPS schemes will similarly remain RPI linked and so this would form another component of the RPE adjustment.

Overall then we see the need for a number of amendments to the components of a price review and it is not clear to us how these could be managed without added complexity and uncertainty to the process for customers, investors and other stakeholders.

Against these disadvantages we see no benefit to current customers who would in-fact have to pay more.

Investor appetite significantly based on RPI linked indexation
A number of the equity funds that invest in or control NWO's (including the ultimate shareholders of Electricity North West Limited) and a large number of debt investors that provide long-term debt to the sectors are largely holding the assets against long-term RPI linked liabilities. These are largely pension schemes and whilst there is a diminishing profile of funded RPI linked pension scheme liabilities the tail extends many years into the future.

The DMO consultation on potential CPI linked issuance referred to earlier, concluded that there was unlikely to be a matching growth in demand for CPI pension assets since many of the CPI linked schemes are not funded.

For existing equity and debt funded RAV there is a clear commitment to RPI indexation in recent price controls, notably in the RIIO handbook.

Therefore any proposals to change this basis would need to set out how this change to long-term equity return on the RAV can be balanced by other changes.

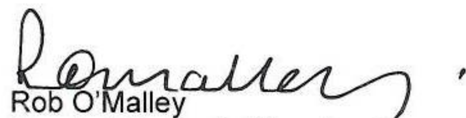
However where the network companies have committed to long-term debt or swaps linked to the RAV indexation, as assumed by Ofgem in the RIIO price reviews, there would be a potential increasing mismatch between CPI linked RAV indexation and RPI linked debt or swap liabilities. The market standard language in the debt and swap agreements covering a potential change of index, tends to refer to any changes to the publication of the RPI and its replacement with an alternative index. Such an event give the lenders the right to request a replacement index is mutually agreed which does not disadvantage the lenders. However in this potential situation RPI, as stated by the Office for National Statistics , will continue to be published but the price review basis potentially changes which would not trigger the clauses in the documentation and so the NWO's would be obliged to continue to pay RPI linked liabilities.

Alternative negotiations to amend long-term agreements with lenders where the lender prefers to maintain the link to RPI would be expensive and value destructive for companies and customers. In theory a market for RPI to CPI basis swaps could develop, that would enable NWO's to hedge this differential, at a cost. However this would again require the development of a CPI linked gilt market.

Conclusions
It is our contention that little has changed in the key criteria identified by Ofgem in the five years since the RPI-X@20 review decision. Therefore retaining the current position, using RPI for indexing a price control, is still the best option at this stage. It is difficult to see how the issue can be satisfactorily progressed until a credible CPI index-linked market for gilts and corporate debt emerges. It seems this will only happen by Government taking the lead and there is no evidence of the DMO revisiting its decision in 2011.

Whilst there may be a sense with Ofgem that a move to CPI is inevitable with a view that this will result in a reduction to current customer prices, as CPI is systematically lower than RPI, we urge caution. As we have shown the logical result from the required combination of changes to a price review is added complexity, increased risk and no overall price reduction to customers. At this stage we cannot see that this is in customers' best interests

Yours sincerely



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