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Dear Steve,

Ofgem's open letter consultation seeking views on moving from RPI to CPI as an index applicable to future OFTO and interconnector licences

National Grid Electricity Transmission plc (NGET) owns and operates the electricity transmission system in England and Wales. National Grid Gas plc (NGG) owns and operates the gas transmission system throughout Great Britain and through our gas distribution business we distribute gas to approximately 11 million offices, schools and homes. This response is on behalf of both NGET and NGG.

Whilst the purpose of your recent consultation letter was to seek views on indexation for future OFTO and interconnector licences, it also indicated that views would be welcome on the approach to indexation for future RIIO price controls. This letter provides some preliminary comments on the latter, rather than replying to the specific questions in the consultation letter which were in relation to new OFTO and interconnector projects.

There is a clear distinction between financing new investments (such as new OFTOs and interconnectors) and financing an existing RAV, where, for example, investment was made against an expectation of a particular form of indexation (RPI) and long-term funding arrangements that are compatible with this framework will often have been put in place. These differences should be taken into account when considering the form of indexation which is to be preferred in a particular case.

The lack of a mature and liquid market for CPI-linked debt is a significant issue when considering a potential future move from RPI to CPI indexation, as Ofgem have previously recognised[1]. A deep and stable market in CPI-linked debt would be a pre-requisite for a wholesale move to CPI indexation for a RIIO price control, and should be considered a factor in assessing the readiness for any move to CPI for any part of any future licence or price control.

[1] "*RIIO: A new way to regulate energy networks: Final Decision*" paragraph 5.3, October 2010, Ofgem

In contrast there continues to be a large and long-established market for RPI-linked debt. It is likely that the UK Statistics Authority (UKSA)/ONS will continue to publish RPI for many years, given the significant amount of index-linked gilts in issue (some of which don't mature until 2068), and the Debt Management Office continues to issue long-term RPI-linked gilts.

At this stage it is difficult to be certain what approach will be most appropriate for future RIIO controls in the longer term. However, there would be advantages from Ofgem giving clarity over the likely approach to indexation for RIIO-2 sooner rather than later, given:

- the long term nature of the networks' businesses, and the need for networks to secure that they have appropriate financing arrangements in place to ensure their financial stability and that they can meet their requirements into the future;
- the benefits of regulatory stability; and
- the likelihood that, as Ofgem has now raised this issue, if uncertainty persists until the RIIO-2 strategy consultation (and beyond), this is likely to increase regulatory uncertainty and so increase the cost of capital.

Given the significance of indexation and the complexity of the issues that it involves in a RIIO price control, a thorough consultation process should be undertaken before considering making changes to the approach for future RIIO price controls. This would benefit from being supported by a full cost-benefit analysis and impact assessment.

Investors in regulated networks are believed to have valued the indexation link to RPI, and any move away from the current RPI-based indexation in future RIIO price controls has the potential to increase the risk profile of network companies and/or cause networks to incur additional costs. Any adverse effects on cashflow metrics and financeability, whether in the shorter or longer-term, would also need to be taken into account. For these reasons a change to indexation from the current approach could increase the cost of capital and required return for RIIO-regulated networks, which would not appear to be in the interests of their customers and consumers.

Ofwat's recent consultation on indexation has highlighted the intergenerational impacts on revenues that a future change in indexation would be likely to cause, and these would need to be carefully weighed up alongside other decisions in price controls which affect the intergenerational balance of charges (e.g. asset lives). Given that a move from RPI to CPI indexation would be likely to increase consumer bills in the short and medium term, it might be expected that there would need to be a clear case for changing the indexation approach before this would be acceptable to certain key stakeholders including consumers.

Lastly, it should be noted that any move away from RPI indexation for RIIO price controls could have multiple effects through different elements, mechanisms and parameters within the controls. If the approach to indexation was to be changed these would all need to be considered and appropriate adjustments made throughout.

We look forward to engaging further with Ofgem over the next couple of years and in the run-up to the RIIO-2 strategy consultations to help ensure that future price controls contain appropriate indexation arrangements, which do not adversely affect consumers and other stakeholders by undermining the stability and predictability of the regulatory framework.

Yours sincerely

[by email]

Richard Allman