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Dear Steve

Open letter consultation - moving from RPI to CPI as an index applicable to future OFTO and interconnector licences (the Consultation)

1. Thank you for the opportunity to respond to the Consultation. This letter is the response from Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) Plc.

2. The Northern Powergrid group of companies does not own or operate any offshore transmission (OFTO) or interconnector licensees. It is however possible that the company may do so in future, and it also has a direct interest in the form of indexation used in future RIIO price controls. We have therefore provided a brief response on the over-arching issues that the Consultation raises, rather than responding to the detailed questions (many of which are aimed at companies and investors that are already directly participating in OFTO sector).

3. Overall, the choice between CPI and RPI indexation in relation to new licensees is in essence a neutral one *provided that there is sufficient investor demand for CPI indexed assets*. If, however, there is insufficient demand, then there may be costs associated with using CPI indexation. Ofgem should therefore assess this carefully before taking its decision, and we hope the responses to the Consultation will provide Ofgem with the evidence base it needs.

4. That said, a move to CPI should not be expected to result in *better long term value* when compared to RPI indexation. It simply represents a changed approach to the profiling of cashflows over time. It is important that any informed debate of the issue recognises the following points, which are often lost in more superficial treatments.

    a. CPI inflation generally runs at a lower level than RPI inflation. Commensurate to this, investors in CPI linked assets will expect an equivalently higher real cost of capital (and similar uplifts in other price control parameters such as real input price growth assumptions).
    b. There is a strong correlation between RPI and CPI inflation, meaning that the likelihood of CPI inflation exceeding (or undershooting) investor and Ofgem expectations by a certain margin is no lower or higher than for RPI inflation.
    c. The formula used to calculate both RPI and CPI inflation is backed by legislation that helps to limit the extent investors may perceive risks associated with future

changes – use of an alternative price index subject to weaker protection from changes could raise the cost of capital.

d. There may be some second order impacts of the choice of indexation on financeability, since CPI indexation implies higher base cost of capital cashflows (and commensurately lower RAV indexation) than RPI indexation. These issues should however not be a central factor in choice of indexation method, since financeability issues can be addressed directly through other means without reference to indexation.

5. Turning to the question of indexation of *existing* network assets, including those covered by traditional network price controls, Ofgem should ensure it does not make any changes which undermine investor confidence. If Ofgem has created any legitimate investor expectations that existing assets would continue to be treated on an RPI indexation basis, then Ofgem should honour its promises. If Ofgem did not do so, this could weaken investor confidence in regulatory commitments and raise the cost of capital for new and existing assets.

6. It is also important that Ofgem does not make any changes before the necessary conditions are in place. For instance, the existence of a liquid market in CPI linked bonds and gilts is an essential precursor for setting indexed financial elements of the price control (such as the cost of debt) on a CPI linked basis. If any change to CPI indexation were made before there was sufficient, proven, investor demand for CPI linked assets the change could also be directly detrimental to consumers by increasing the overall cost of capital.

7. Lastly, even if Ofgem considers it appropriate to consult at future price controls on a move to CPI indexation, the point still applies that a move to CPI indexation would not secure better value for consumers (as set out in paragraph 4 above). It is important that this point is recognised in any properly balanced debate of the topic.

8. I hope the contents of this letter are helpful as you take into account the views of respondents to the Consultation, and would be happy to discuss the issues further if there would be benefit to you in doing so.

Yours sincerely

Keith Noble-Nesbitt

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