



Making a positive difference
for energy consumers

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

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Dear stakeholders

We are seeking views on moving from RPI to CPI as an index applicable to future OFTO and interconnector licences.

We would like to invite interested parties to provide their views regarding indexation for future OFTO and interconnector projects by the date of 9th December.

The purpose of this open letter is to invite views on any potential obstacles to such a change in approach to indexation and whether this should impact on the timing of when a change should be applied (e.g. whether to introduce changes to new projects in 2016 or at a later date). We will take account of those views and potential impacts, such as those on investor appetite, financeability or long-term management, before concluding our approach for future projects.

Background

RPI has been used as the preferred means of indexation in network price controls since privatisation. However, relevant authorities have highlighted that indices other than RPI may better serve consumers and investors alike, by being more accurate and consistent with international best practice.

A UKSA Assessment of the RPI in March 2013 found that methods used to produce the RPI (in particular, its use of the arithmetic Carli formula) were not consistent with international best practice¹.

In January 2015 a report by Paul Johnson of the IFS for the UK Statistics Authority recommended that government and regulators switch from RPI to an alternative measure of indexation going forward (citing CPI-H as a particular option). The UKSA have recently closed a consultation on the options for measuring consumer prices and we understand that it intends to publish a final response in early 2016².

Ofwat have also recently published a discussion paper that includes consideration on the

¹ <http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html>

² <https://consultations.ons.gov.uk/uksa/measuringconsumerprices>

appropriateness of a move to CPI as an inflation index. The feedback period for this has recently closed³.

OFTOs and interconnectors

Current OFTO and interconnector licences maintain RPI linked revenues and cap and floor levels to provide protection to the companies against economy-wide inflation and protection to consumers from potential over-pricing of inflation risk.

In the OFTO sector we are particularly mindful that the majority of investors to date have relied on the swaps market to manage their exposure to RPI given the long-term nature of their revenue arrangements. We anticipate this may continue to be the case and will be applicable in the interconnector market also.

In addition, biddable indexation was introduced for the most recent OFTO tenders. With biddable indexation, bidders are allowed to choose the proportion of their revenue that they wish to have indexed, to ensure an efficient and appropriate matching of index linked income with inflation based liabilities.

We now consider that it may be appropriate to consider a change of inflation index for upcoming OFTO and interconnector projects. Furthermore, we welcome input on whether a change would be appropriate to be applied from 2016 (thereby impacting the next OFTO tender round and interconnector window) or whether it would be appropriate to consider a delay to a later round of projects.

Existing arrangements

The purpose of this open letter is not to review indexation policy on any existing revenue arrangements (RIIO-1 which runs to 2021, 2023 for electricity distribution, or existing OFTOs or interconnectors, including those for which we have selected preferred bidders or granted C&F arrangements). However, we do anticipate considering indexation as part of our strategy for RIIO-2 at the relevant time in the future.

Aside from responses to the questions set out overleaf, we therefore welcome stakeholders' views on our future approach to indexation for RIIO should they wish to share them at the current time, and will use any such responses in developing our initial strategy consultation for RIIO-2.

For any further information about this letter and to provide responses by the deadline of 9th December please contact Scott Laczay at scott.laczay@ofgem.gov.uk or 0207 901 7468.

Yours sincerely

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³ http://www.ofwat.gov.uk/pricereview/water2020/pap_tec201507monopolies.pdf

Questions to stakeholders

We would ask respondents to this letter to please consider the following questions in relation to new OFTO and interconnector projects, and to provide supporting information or analysis wherever possible:

1. Would moving to CPI affect investor appetite for projects going forward and if so explain why and how these obstacles might be addressed?
2. Would a change to CPI affect the financeability of projects? Please indicate which project types you are considering and what the impacts may be.
3. Please comment on whether CPI is in your view an appropriate index to move to or whether you have a preference for another measure of indexation (e.g. an alternative CPI-based measure) and why?
4. In your view what effect on the consumer or other industry participants (such as offshore windfarm generators) do you think a move to CPI would have?
5. For OFTO projects, would a change to CPI impact on your strategy for biddable indexation, and if so what are the impacts. In your view would this result in a benefit or additional cost to the consumer?
6. Are there any other challenges you foresee a change of index may bring? How could these be resolved?
7. Are there any consequences to timing we should be aware of regarding a move to CPI (or another index) and how should we manage these?