SP ENERGY NETWORKS

Network Planning & Regulation

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Dear Steve

Indexation for future OFTO and interconnector projects

In response to Ofgem's open letter seeking views on the Indexation for future OFTO and interconnector projects, SPEN wishes to express its current views on the future approach to indexation for RIIO. However, for the avoidance of doubt, SPEN will respond fully to Ofgem's initial strategy consultation for RIIO-2, in due course.

SPEN welcomes the reassurance from Ofgem that the purpose of the open letter is not to review indexation policy on any existing revenue arrangements, including RIIO-T1 and RIIO-ED1. It is essential that current price controls are not reopened unnecessarily.

SPEN does not propose to address the detailed questions, which primarily address the arrangements for future OFTOs, but wishes to make a number of more general points. Although there would be benefit from deciding on the indexation that would apply to RIIO-T2, GD2 and ED2, well before preparation of those business plans, we consider that Ofgem are pre-empting the outcome of the UK Statistics Authority own consultation, "Measuring Consumer Prices: the options for change", which consulted on the UK's range of consumer price statistics. The UK Statistics Authority is not expected to publish its final decision until 2016. At this stage, it is unclear which, if any, measure of consumer prices, that it may promote as the main measure of the change in consumer prices.

The UK Statistics Authority has now published a summary[1] of the responses to its consultation. This reports:

> "While there is general support for a identifying a main measure of price change across the economy, respondents are split on what this measure should be. Nearly half feel that it should be CPIH, while others feel that it should be the RPI or even the Household Inflation Index (HII) as proposed by the CPI/RPI user group and Royal Statistical Society (RSS). Those who do not support having a main measure of price change across the economy believe that a single index cannot be applicable for all purposes."

[1] UK Statistics Authority, Summary of Responses Measuring Consumer Prices: the options for change, November 2015

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Furthermore, as Ofgem note, Ofwat have considered indexation as part of its "Towards Water 2020" programme, which consults on policy issues for regulating monopolies. Ofwat emphasise the need for consistency in determining cost allowance and the cost of capital.

> "The choice of indexation method should not impact on the total level of returns earned by investors. In determining real costs and the real allowed cost of capital, we would use a consistent approach to the level of inflation. For example, if CPI was used rather than RPI, then the cost allowances and the cost of capital would also be determined using CPI rather than RPI."

At Ofwat's recent workshop, "Regulating monopolies", they highlighted four overarching issues that they need to consider:

1) Whether RPI is losing legitimacy
2) A change in the measure of inflation could have undesirable bill impacts
3) Investor concern that any change would lower long term returns
4) Existing debt is indexed to RPI, so costs may arise

Ofwat's own analysis shows that there would be an undesirable increase in customer bills, in the years following a move to CPI indexation.

Ofwat and Ofgem have previously claimed[2]:

> "The issuing of index-linked debt by a regulated company (given the current regulatory approach to setting price controls) would provide a better match between cash inflow received from consumers and cash outflow to investors. This is because index-linked debt has an interest cost that reflects a real rather than a nominal coupon. The same effect can be produced through adopting financial swaps that convert the company's liability to pay from nominal interest to real interest (with the inflation added to the principal sum borrowed) or by manufacturing synthetic index-linked debt instruments with the help of financial intermediaries."

Regulated utilities have considerable levels of index linked debt, although the extent of this varies across sectors. In recent price control reviews, Ofgem has assumed, as an input to the relevant Price Control Financial Model (PCFM), that a quarter of the licensees' debt is RPI-linked. Moving from RPI to CPI indexation would mean companies bear the risk that revenues change at a different rate to debt indexation and/or costs.

Although, in theory, it may be possible to hedge this risk, at least to some degree, it would not be costless. Swap providers charge a credit spread and inflation swaps create a contingent liability, with the potential for significant breakage costs in the event that the swap needs to be cancelled. Ultimately, these costs would be borne by the consumer. Moreover, inflation related instruments and derivatives, such as index-linked gilts and inflation swaps are based on the RPI.

Although the Monetary Policy Committee (MPC) inflation target is currently set in terms of the CPI, the MPC draws on a wide range of external indicators to assess whether inflation expectations remain well anchored. Some of these measures are not direct indicators of

[2] Ofwat and Ofgem, Financing Networks: A discussion paper, February 2006

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expectations for CPI inflation. For example, measures derived from financial instruments reference RPI inflation, and the surveys of households ask about general price movements, not a specific price index. (See Table A "Indicators of shorter-term inflation expectations" and Table B "Indicators of longer-term inflation expectations", in the Bank of England Quarterly Bulletin 2014 Q2, pp150, 151.)

Following consultation by the Debt Management Office (DMO), the government decided not to issue CPI-linked gilts. This decision reflected concerns related to:

- the depth and sustainability of CPI-linked gilt demand;
- the potential inclusion of owner occupiers' housing (OOH) in the CPI
- fragmentation in the index-linked gilt market, and associated illiquidity.

In its response to the UK Statistics Authority consultation on measuring consumer prices, HM Treasury (HMT) states:

> "The government remains committed to using RPI e.g. in existing index-linked gilts which currently run out to 2068, and HMT and DMO have a long-established practice whereby the market is consulted prior to the introduction of any new type of debt instrument."

We are aware of only three issues of CPI-linked bonds, none of which were issued by private sector companies:

1) £200m bond issued by the Greater London Authority (GLA) to part finance an extension to the Northern Line,
2) £150m (including GBP100m initially retained by the Council to provide access to future funding) of bonds to be issued by Warrington Borough Council. The proceeds will be spent on asset and infrastructure within the borough of Warrington, and the bulk is expected to be used on the Council's £100m new Town Centre development in Bridge Street, Warrington.
3) £100m bond issued by the Church of England Pensions Board to finance the purchase of houses to be rented to retired clergy and their spouses.

In comparison with the hundreds of billions of pounds of debt that will be required to finance UK infrastructure, these amounts are very small and the bonds appear to be illiquid.

Ofgem previously considered indexation as part of the RPI-X@20 project, which was comprehensively consulted on. Ofgem's RIIO decision document[3] sets out the clear support for retaining RPI indexation:

> "In responses to the Recommendations consultation there was universal support for retaining RPI as the inflation index for the price control and a number of respondents explicitly agreed with the rationale that we had set out for retaining the RPI. We have also discussed our analysis and assumptions with a range of experts including leading academics in the field, the Bank of England and the Debt Management Office (DMO). We have had strong feedback, particularly from the academics, that it is essential that there is consistency between the indexation of the price control and the basis for establishing the

[3] RIIO: A new way to regulate energy networks, Final Decision, October 2010

> allowed return. Their view on whether RPI or CPI is preferable for indexing the price control depends on the maturity and liquidity of the respective index-linked bond markets."

Ofgem recognised the importance of the index-linked gilt and bond markets to the choice of RPI or CPI indexation. Clearly, the financial markets remain almost exclusively for RPI-linked instruments and the market for CPI-index linked gilts and corporate bonds has not developed.

Ofgem also considered that a move to CPI indexation would increase the complexity of the price control and reduce transparency, as compensating adjustments would need to be made to other components of the price control package.

Many of the current investors in network companies are pension funds which are attracted precisely because of the RPI-linked indexation. Ofgem should consider fully how a move to CPI indexation would affect the relative attractiveness of such investments, the transactions costs associated with raising finance from a different set of investors, who may be prepared to accept CPI indexation, the costs of rebalancing companies' debt portfolios, the increase in inflation related risks, potential hedging costs, and the consequential impact on the cost of equity.

Furthermore, moving away from RPI indexation would have wider impacts on the risk profile of our licensees. Such a move would have a significant impact, particularly if applied to debt and pension costs. To preserve present value neutrality, other elements of the price control package would have to be adapted accordingly. These would include the treatment of pensions, movements in relative costs and prices, and the cost of capital.

In conclusion, we do not believe that Ofgem has demonstrated the benefit to customers of moving away from the long established RPI indexation.

Finally, we note that the statutory duties of the UK Statistics Authority and those of the Gas and Electricity Markets Authority (GEMA) are different. GEMA should not simply rely on the view of the UK Statistics Authority when fulfilling its own statutory duties, as that would leave GEMA's decision open to challenge.

SPEN wishes to participate fully in any process that Ofgem proposes to consider and/or develop the approach to indexation for RIIO-T2 and RIIO-ED2, together with any compensating adjustments to these price controls. We should like to have early sight of Ofgem's proposed work programme on indexation.

Yours sincerely

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