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Indexation for Future OFTO and Interconnector Licences

This response is provided on behalf of Scottish & Southern Energy Power Distribution (including SHE transmission, Southern Electric Power Distribution and Scottish Hydro Electric Power Distribution). We welcome the opportunity to respond to Ofgem's recent open letter on the above topic. We are responding in particular to the request for views on the future approach to indexation for RIIO price controls, in the context of this potential move for future OFTO and interconnector projects.

The issue of indexation for RIIO price controls was considered as part of the RPI-X@20 review back in 2010. Its conclusions stated the important factor, in deciding whether RPI or CPI is preferable for indexing the price control, is the maturity and liquidity of the respective index linked bond markets. At the time of the RPI-X@20 decision[1], it was stated that the UK Debt Management Office (DMO) noted 'there was limited likelihood of CPI indexed bonds being issued in the near future'.

Subsequent to the RPI-X@20 review the DMO consulted on issuing CPI linked bonds in 2011, and after careful consideration and taking into account the feedback received to the DMO's consultation, the Government decided not to issue CPI-linked gilts in 2012-13. The Government judged that issuance of CPI-linked gilts in the near-term would be unlikely to be cost-effective and would involve a number of risks, and that they would keep the case to issue CPI-linked gilts under review. There is still no evidence in late 2015 from the DMO, or indirectly from the market, which would suggest issuance of CPI gilts by the DMO in the near future.

Additionally, were the DMO to issue CPI-linked gilts then a stable, liquid and significant market would consequently need to develop before the introduction of CPI indexation could realistically be considered. This is because the less mature the market, the higher the extra costs of re-financing (or issuing new debt) on a CPI basis, which would need to be borne by customers. Currently the CPI market is very small, and even in the medium term it may not be sufficiently developed to permit utility companies to issue CPI debt in the volume, and at the yields, currently achieved for RPI debt. It would not be acceptable for energy networks to incur these extra costs of linking debt to CPI, when they are due to a change in regulatory policy and not inefficient financing by NWOs.

Notwithstanding the issue of the feasibility and cost of CPI linked debt, it must be remembered that long term investors in UK energy networks made their investments on the basis of RPI indexation, not CPI. Furthermore, investors value certainty and there would be significant concern with regards to the value of their investment and returns remaining value neutral, not eroding, under CPI indexation, and the

[1] Ofgem: RIIO: A New Way to regulate Energy Networks (2010)

general regulatory uncertainty such a change could cause. The concern relating to returns would be that to maintain the same nominal cost of capital rate, under CPI indexation, an increase in the real cost of capital would be required.

Implementing this change would cause a significant rise in customer bills over a number of years, until the impact of a declining RAV outweighs this. Also clear differentiation needs to be made between consideration of an appropriate index for a new business, to one which has a legacy of many years of RPI indexation, for which CPI indexation implementation would be costly and detrimental to customers and investors alike.

Also, it should also be noted that CPI, like RPI, would be a non-specific benchmark for NWOs and thus its basket of goods and services does not include costs particular to a NWO, such as construction materials. This is reflected in the detailed analysis performed by regulators, for example Ofcom (2013) concluded in its assessment of BT's costs[2] that 'we have not found a strong correlation that would indicate linking non-pay cost inflation to either RPI or CPI'. RPEs are the mechanisms whereby adjustments to the particular costs relevant to a NWO are made.

In conclusion the lack of a mature and liquid CPI-linked bond market, the costs of financing based on CPI, impact on customer bills, investor confidence in the sector and the fact it remains a non-specific benchmark for NWOs are all important reasons why a switch to CPI indexation is not feasible. Notwithstanding this, any move to CPI indexation should only be on future investment. The historic RAV, and the related allowed return and depreciation, would need to be indexed at RPI - as the historic investment was made on this basis.

Finally, we would like to add that inflation indexation is a complex and very broad issue, which requires a much wider and more thorough debate than through a consultation primarily focused on OFTOs and interconnectors. We would welcome the opportunity to discuss setting up a holistic process to review inflation indexation across energy networks.

Should you require any further information with regards to our response then please do not hesitate contacting me at malcolm.burns@sse.com .

Yours sincerely,

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cc: Ian Rowson, Associate Partner, Regulatory Finance and Governance

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[2] Ofcom, Fixed access market reviews: Approach to setting LLU and WLR Charge Controls (2013)