WALES&WEST UTILITIES

Mr Steve Beel
Associate Partner
Electricity Transmission
Ofgem
9 Millbank
London
SW1P 3GE

Wales & West House
Spooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spooner Close
Celtic Springs
Coedcernyw
Casnewydd NP10 8FZ

Telephone/Ffôn: 0800 912 29 99
Fax/Ffacs: 0870 1450076
Email/Ebost: enquiries@wwutilities.co.uk
www.wwutilities.co.uk

9th December 2015

Ofgem consultation on RPI vs CPI for the OFTCOs and Interconnector Licences

Dear Mr Beel,

Wales & West Utilities Ltd (WWU) is a licensed Gas Distribution Network (GDN) providing gas transportation services for all major shippers in the UK. We cover 1/6th of the UK land mass and transport gas to over 2.5 million supply points.

WWU has a significant interest in Ofgem's current consultation on reviewing the index against which price controls are measured.

We are pleased to have the opportunity to respond to Ofgem's consultation and set out our views on the consultation in general terms. We should say at the outset that, in line with Ofgem's normal process, a clear timeframe with a committed end date would be useful to all stakeholders, so that any uncertainty that may arise in the mind-sets of key stakeholders can be moderated.

1. **Raising new debt**

Regulated entities have the choice to raise debt at fixed or floating nominal interest rates or interest rates linked to an inflation index. Currently the only efficient inflation linked index debt market is the RPI index linked market, which is significantly smaller than the nominal rate market. The CPI linked debt market is very immature and until the government issues significant debt linked to CPI the position is unlikely to change. It would not be appropriate to move away from an RPI indexed price control until the market in the alternative indexes' debt has become sufficiently mature. Therefore we think the consultation should be deferred until this condition is in place.

2. **Actual nominal costs of a regulated entity should not be affected by the index used**

The underlying costs of efficiently operating a regulated utility for the benefit of the end consumers should not change based on the index used by the regulator to set the control. Therefore, any change in the index within the control will result in the need to reset the underlying price control settlement in order to keep the overall price control settlement whole.

In addition, there are liabilities of the regulated entity, such as WWU, which have been linked to RPI. Moving to CPI will lead to increased cost and uncertainty for those regulated businesses. For example, absent a CPI debt market, WWU has to raise either RPI linked debt or fixed rate debt, each of which would create a structural cash flow mismatch to CPI based cash flows from the business.

3. The wedge between CPI and RPI

Historically, and as shown in future index forecasts, CPI inflation runs at a rate lower than RPI inflation, with the difference between the two indices not being constant over time. As stated above, because a regulated entity's costs are fixed in nominal terms the price control settlement would need to be adjusted for this "wedge" between the inflation allowed under RPI and the equivalent under CPI.

The size of this wedge changes over time and moving from RPI to CPI would require the regulator to estimate the size of the wedge across the duration of the price control period. This would result in an increase in the uncertainty over the control period and the risk taken by consumers and investors. It would, we feel, undermine the strength of the current regulatory environment.

The wedge has historically fluctuated from over 1% to under 0.5%.

If CPI was to be applied to the brought forward RAV balance of GDNs there would be a corresponding impact. Because CPI is traditionally lower than RPI, to hold the regulated entities whole, lower P_0 cuts (or even P_0 increases) at the start of new controls are likely to be required. These reduced reductions, together with the difficult challenge of dealing with the RPI-CPI wedge, could impede transparency of the regulatory model and create significant challenge in maintaining trust and confidence with stakeholders, notably consumers and investors.

In addition, as CPI grows more slowly during a control than RPI, the annual movements in allowed revenues will be greater in real terms than they would have been under an RPI linked control, assuming nominal values would be kept whole. Again complicating transparency with key stakeholders.

4. Differences between OFTCOs and other Ofgem regulated businesses

Lastly, and importantly, we note that there are differences between the OFTCOs and the more traditional Network Operators (NWO's) (the EDNs and GDNs). This is because the OFTCOs do not have a large historic RAV balance on which RPI indexation is earned as part of a price control settlement, and can enter into contracts and negotiations with a CPI link as a consideration, without legacy contracts in place.

It may therefore be easier to adjust the OFTCOs price control onto a CPI basis than the more traditional regulated businesses, and as such extrapolation to the wider energy business sector should be cautioned. However OFTCOs would face the issue of the absence of a mature debt market should CPI linked be desired, as raised in point 1 above.

Should Ofgem require any further information on the matters raised above, we would be pleased to discuss them.

Yours sincerely,

Steve Edwards
Head of Regulation
Wales & West Utilities Ltd

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Celtic Springs,
Coedkernew, Newport NP10 8FZ
Registered in England and Wales number 5046791