ORR’s Indexation Proposals

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ORR's Indexation Proposals

Important that there is clarity about what is being proposed, and the rationale for it.

In CP4:

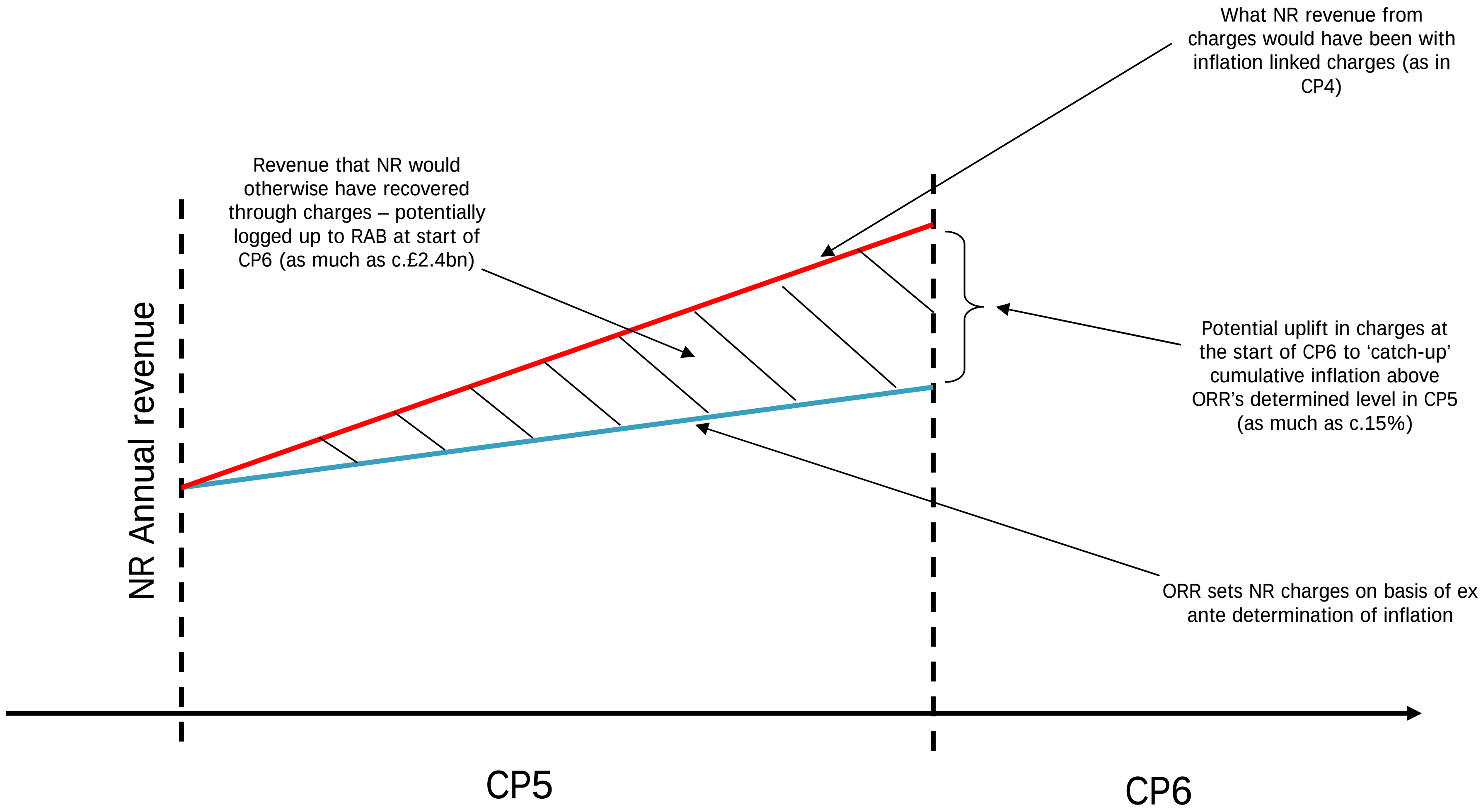
- ORR determination was in real prices (before inflation)
- Determined charges are uplifted annually by actual inflation

Our understanding of ORR's approach is:

- ORR considers that this will create a new incentive on NR to keep its cost increases below inflation
- It would 'set' a fixed ex ante indexation e.g. 3%
- Charges would be uplifted by the ORR determined 'indexation' each year instead of by actual inflation
- If ORR's determined indexation is lower than actual inflation (subject to some ORR tests) would be logged up to the RAB from start of CP6
- From CP6, NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5
- Possible 'deadband' re-opener

Pictoral representation of the Proposal

(assuming inflation ends up being higher than ORR's determination)



Issues - 1

- ORR considers that this will create a new incentive on NR to keep its cost increases below inflation
- We do not accept that there will be significant incentive effects from this policy. NR has a natural incentive to keep its costs as low as possible.
- All other regulators express their incentive targets as RPI-X targets, as they consider inflation to be exogenous to regulated companies.
- If one did consider there to be incentive effects from an ex ante indexation it would seem to really matter whether ORR's chosen indexation level turned out to be above or below outturn inflation.

Issues - 2

- ORR 'sets' a fixed ex ante indexation e.g. 3%

This is a very hard thing to do, up to 6 to 7 years ahead. Inflation is particularly volatile/uncertain at the moment because of the recession, banking crisis and resultant QE.

Issues - 3

- Charges would be uplifted by the ORR determined ‘indexation’ each year instead

The ‘significance’ of this policy would be very dependent on the level of indexation that ORR sets. If it ends up being very similar to outturn inflation, then there would be a limited impact on NR’s finances.

If the ORR indexation is (say) 3% lower than outturn levels, there would be significant additional funding exposure for NR (c.£2.5bn) which will need funding in future control periods.

If the ORR indexation is (say) 3% higher than outturn levels, there would be significant additional revenue will have accrued to NR from current customers, to the benefit of future customers.

Issues - 4

- If ORR's determined indexation is lower than actual inflation (subject to some ORR tests) would be logged up to the RAB from start of CP6

This could create additional debt which will then need to be funded in the future. This could make the industry less financially sustainable in the future.

Future customers will be paying higher charges at the expense of CP5 customers.

(The opposite could also be true, of course)

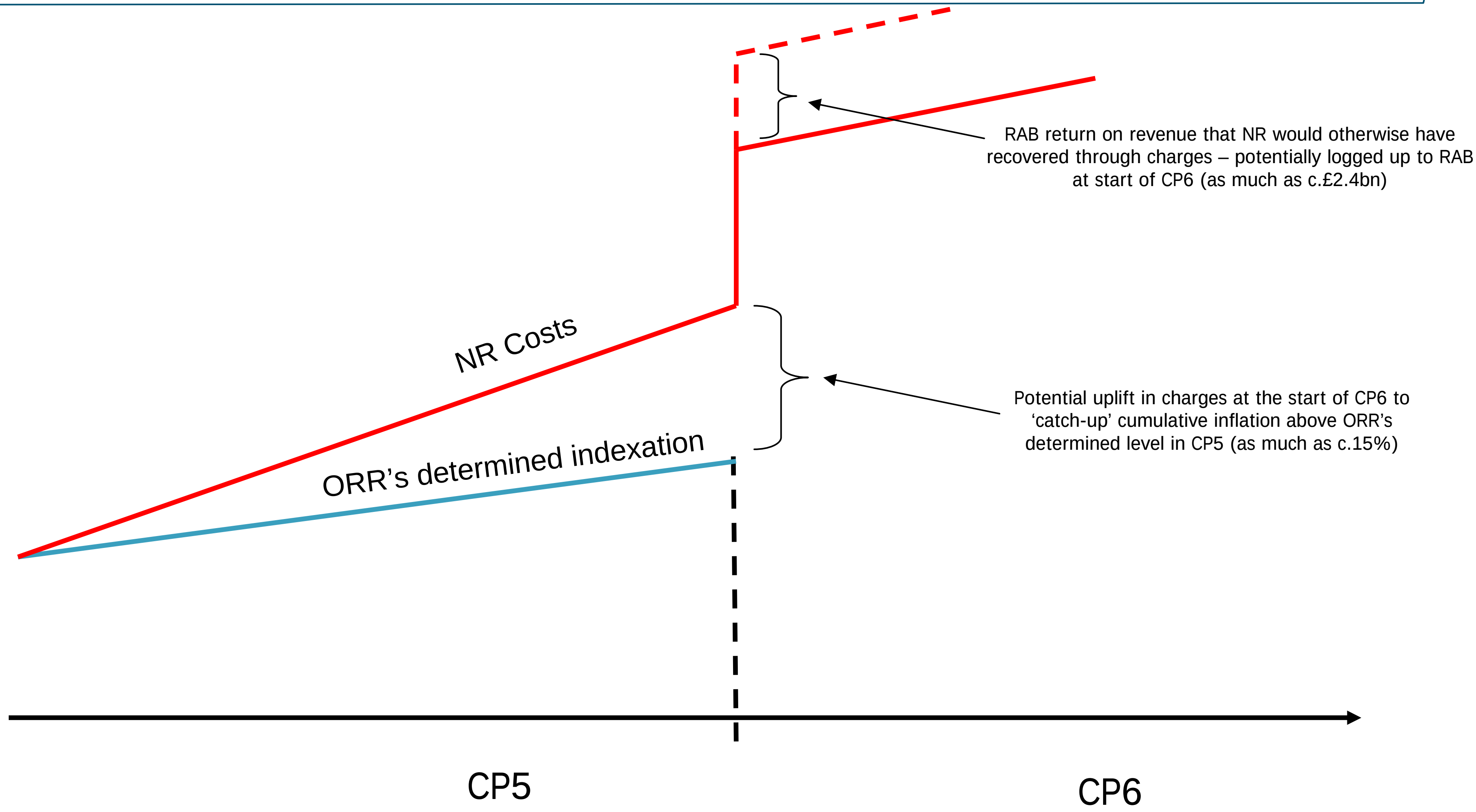
Issues - 5

- From CP6 NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5

This could create a price 'spike' in CP6 when past inflation is factored into CP6 prices. (see next slide)

The opposite could also be true, of course.

…from CP6 NR's base costs, and thus CP6 prices would also be 'corrected' for the difference that arose during CP5



Summary of Issues - 1

- Weak / no additional incentive properties
- Potentially even more complex regime (especially with possibility of ‘deadband’ reopeners)
- Potential extra NR debt (or over-recovery) of between £400m and £2.4bn
- Inter-generational issues for any CP6 adjustments
- Price spike / dip at the start of CP6
- Timing is tricky (inflation is particularly uncertain at the moment)

Summary of Issues - 2

<u>IN ADDITION</u>:

- Makes the business more uncertain to people we borrow from (could affect our borrowing rates)
- No regulatory precedent (could affect our borrowing rates)

Our Emerging View

- We do not accept the incentive argument
- We have a natural incentive to keep our costs down
- We consider that HMG is best placed to manage inflation risk
- We consider that this is all about apportioning risk between NR and our funders
- We understand that DfT finds it difficult to budget with exposure to inflation

Our Emerging View

<u>HOWEVER, BEING PRAGMATIC…</u>

- If this policy is implemented we would need more financial headroom to absorb possible risks of inflation being higher than ORR's determination of it
- We would also need to be careful about the impact on our P&L
- Any variation in determined and outturn inflation should be automatically adjusted for, at the start of CP6
- The deadband re-opener idea is likely to be too complex
- All variations from *ex ante* assumption should be added to RAB to avoid unnecessary complexity which will add no value and could have perverse effects