



The beginning of the end for RPI indexation of price controls?

Ofwat’s decision to begin a transition from RPI indexation to either CPI or CPIH indexation from 1 April 2020 increases the likelihood that other regulators will follow suit in future price reviews.

RPI versus CPI

The incentive model of regulation first developed in the UK when BT was privatised in the 1980s has traditionally been referred to as RPI-X regulation. The concept involves setting prices in advance for a number of years to provide regulated firms with strong incentives to increase efficiency. To take account of inflation, this was implemented by indexing prices to the Retail Price Index (RPI) less a pre-determined X factor.

In the past, the RPI was the standard measure of inflation in the UK. However, in 2003 the UK government altered the Bank of England’s inflation target from RPIX to CPI.¹

There are two main differences between the RPI and the CPI:

- The goods included within the basket used to measure inflation are different. Of particular significance is the fact that CPI excludes housing costs.
- The averaging method used to produce the index differs.² The effect is that RPI inflation is generally higher than CPI inflation (although this will not always be the case given that the baskets contain different goods).

In March 2013, the UK Statistics Authority (UKSA) cancelled the designation of the RPI as a National Statistic, on the grounds that the methods used to produce the RPI were not consistent with international best practice.

In a review for the UKSA published in January 2015, Paul Johnson advised:

“ONS and the UK Statistics Authority should re-state its position that the RPI is a flawed statistical measure of inflation ... whose use should be discontinued for all purposes unless there are contractual commitments at stake. ... Government and regulators should work towards ending the use of the RPI as soon as practicable.”

In this review, Paul Johnson also recommended that CPIH should be adopted as the UK’s main price index. CPIH is calculated using a similar methodology to the CPI, but is based on a wider basket of goods, including an allowance for housing costs.

Current regulatory practice

While some regulators have already switched to using CPI, the RPI is still being used as an inflation index in a number of regulated sectors. The table below summarises current regulatory practice.

Current regulatory practice

Regulator	Price review	Inflation index
CAA	Heathrow Q6	RPI
	Gatwick Q6	RPI
Ofcom	LLU charge controls 2014-17	CPI
	WLR charge controls 2014-17	CPI
Ofgem	RIO price reviews	RPI
	OFTO TR4	RPI
ORR	Network Rail CP5	RPI
Ofwat	PR14	RPI
WICS	Strategic Review of Charges 2015-21	CPI

Ofwat’s Water 2020 decision on indexation

In May 2016, Ofwat published conclusions from its Water 2020 review of how it regulates the water and

¹ RPIX is the Retail Price Index excluding mortgage interest payments.

² The RPI is based on arithmetic averaging, while the CPI is based on geometric averaging.

wastewater sectors.³ Alongside changes in other areas, Ofwat decided to move away from RPI indexation. In particular:

- From 1 April 2020, prices will be indexed using either CPI or CPIH instead of RPI.
- From the same date, Ofwat will also begin a transition to using CPI for indexation of the Regulatory Capital Value (RCV). Fifty per cent of the RCV will be indexed to RPI at 1 April 2020, with the remainder of the RCV plus all new RCV additions being indexed using either CPI or CPIH.

Ofwat stated that the choice between CPI and CPIH would be settled as part of the 2019 price review.

The fact that different inflation indices will be applied to different parts of the RCV means that Ofwat will also be applying two different figures for the real cost of capital.

Ofwat will reconcile for the difference between the RPI and CPI/H forecast for setting price limits and the actual out-turn for the RPI-linked cost of capital that applies to the RPI-linked part of the RCV.

Ofwat stated that these changes to inflation indexation will be NPV-neutral for a notionally efficient company.

Conclusion

Regulators in a number of sectors are currently still using the RPI for inflation indexation, despite the concerns identified in recent years about the quality of the RPI as a statistic. Ofwat's decision to move to CPI indexation for prices from 1 April 2020 and to transition towards CPI indexation for the RCV from the same date sets an important regulatory precedent. This precedent is likely to encourage other regulators who have not yet done so to move towards CPI indexation at future price reviews.

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Europe Economics is an economics consultancy with an extensive track record advising on price controls issues.

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³ Ofwat, "Water 2020: our regulatory approach for water and wastewater services in England and Wales", May 2016.