

2014 Price Review
Business Plan Supporting Appendices
Inflation Indexing

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Section 1. Introduction

As with all key assumptions within our plans we have sought third party assurance if it is available. This means the assumptions are more reliable and present a central position on risk between our customers and us. The two key indexes used within the plan are Retail Price Index (RPI) and Construction Output Price Index (COPI).

Section 2. Retail Price Index

We have used an RPI index provided by Frontier Economics. This index is consistent with the implied inflation used to calculate the real cost of debt in the calculation of the cost of capital. For the period 2013-14 to 2015-16 the inflation rate is based on the market implied inflation rate for the period September 2013 to March 2016, hence the flat rate of 2.71% for that period. This two and a half year period is the shortest projection period available.

Table 1 Table 1 RPI Forecast and actual

Year	Inflation	Cum.	RPI
2012-13			244.7
2013-14	2.71%	2.71%	251.3
2014-15	2.71%	5.49%	258.1
2015-16	2.71%	8.35%	265.1
2016-17	2.73%	11.31%	272.4
2017-18	2.87%	14.51%	280.2
2018-19	3.08%	18.03%	288.8
2019-20	3.25%	21.87%	298.2
Average 2015-20	2.93%		

For the period 2020-21 to 2024-25 we have assumed an inflation rate of 3% per annum.

RPI is used in a variety of places within the plan:

1. Conversion to outturn costs and to move between price bases;
2. Assessment of historic legacy adjustment;
3. RCV uplift; and,
4. Calculation of real debt cost.

Section 3. Construction Output Price Index

COPI has been assumed to be equal to RPI for the years 2013-14 and 2014-15. Beyond the 31st March 2015 we have not included a COPI forecast as Totex is assumed to be inflated by RPI from that point on. Therefore the COPI figures to 2015 are as follows:

Table 2 COPI Forecast and actual

Year	Inflation	Cum.	COPI
2012-13			113.6
2013-14	2.71%	2.71%	116.7
2014-15	2.71%	5.49%	119.8

COPI is used within the plan:

- CIS mechanism historic adjustment and,
- Capital cost adjustments.

Section 4. Table A9 – Inflation measures – Table commentary

Retail price index

Line 1-13

These lines have been updated to the latest published RPI index.

Line 14

The annual inflation forecast upon which our plan is based is 2.71% for 2013-14. With the updated actual RPI values entering 2.71% in line 14 for 2013-14 gives the incorrect RPI index in Line 22. We expect the index in line 22 for 2013-14 to be:

$244.7 * 1.0271 = 251.3$ – any other figure would be inconsistent with our plan.

To achieve this with the table formulas that Ofwat have specified we have backsolved the value in 2013-14 for line 14 to be 2.22.

Line 16-21

We are forecasting COPI to be equal to RPI for future years.