TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

The Association of Corporate Treasurers

Comments in response to

National Statistician's consultation on options for improving the Retail Prices Index

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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org. Contact details are also at the back of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

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General comments

The ACT is conscious that this consultation is primarily on statistical methodology and best practice which is not within our area of expertise. However treasurers and their companies are users of the RPI and as such we would assume that the ONS produces statistics in order for them to be used and therefore must logically take into account the impact on users.

We hope and assume that as a public body the ONS does have regard to the public good and the uses of its outputs rather than simply producing them in isolation.

As explained in your consultation the impact of the main proposed changes in methodology could reduce the RPI by between 0.25 and 0.95 percentage points offset by a possible increase of up to 0.09 percentage points from the housing rental data changes. While these figures may sound small, of course relative to the net profit margin in many businesses they can be material and can be material in relation to activities of the not-for-profit sector that often operates close to break-even. Compounded over the years the effects could be dramatic for many organisations if they are unable, as many will be unable, to recover losses.

There will be winners and losers. The overall effect will be marginally to reduce activity levels.

As a professional body we do not argue the cause of any particular interest group but we make two important points.

First, given the time likely to be needed for organisations, particularly smaller ones, to realise the effects on them and then to undertake necessary changes in prices or charges or make cost reductions or reduce activity levels or withdraw from some activities is quite extended, introduction of such a significant change as soon as March 2013 is unduly hasty.

For any organisation that has any linkage to RPI in its income or expenses it will need to adjust its budgets and plan numbers and amend its strategy and immediate plans. This is particularly the case for companies in the regulated sector where long-term pricing models are used in deciding allowable price increases.

Depending on the terms of contracts, those linked to the RPI may need to be renegotiated. This may be provided for in the contracts. If not, change may not be possible until the contract comes up for renewal and this may be several years. Where regulation uses inflation as measured by RPI in controlling the charges of, for example, utilities, regulatory action may be needed or revised assumptions published for future pricing periods. Again, an extended timetable is likely.

If, however, the RPI changes are deemed fundamental in that such a very large change was not in the contemplation of the parties, contracts may fail altogether and this could be very disruptive. Again extended time periods are likely to be needed to sort things out – and it must be recognised that in such cases significant value shifting between the parties may be unavoidable and some organisations will fail.

Given this background, we would suggest that, even if the changes are decided quickly, they should be for implementation no earlier than March 2015 so as to reduce the disruption for those affected.

Secondly, and as further described in the detailed responses below the disruption to all manner of contracts could be widespread. We therefore also propose that the existing RPI

methodology is retained and continues to be published alongside any “new” RPI. Given that the proposal being considered relates to the mathematical handling of the data rather than the collection of the data we expect that the extra burden of calculating and publishing two indices will not be significant and certainly not excessive. Of course if the underlying data on which the calculation is based are published, others would be able to calculate the (old style) index and publish that, but it would be more orderly if the ONS undertook that task.

On choosing a formula for the elementary aggregate:

1) **Which option proposed would you prefer?**

   Our concerns are for good notice of change and for continuity of publication of an old-style index and not about particular new methodology. Option 1 of no change would clearly present fewest complications to users but nonetheless we can accept that from a best practice point of view and for the sake of better international comparability options 2 to 4 may be preferable.

2) **What are the methodological considerations behind your preference?**
   N/A

3) **Do the options for improving the RPI have any impacts you would like to make the National Statistician aware of?**

   The use of RPI indexation is widespread in all manner of commercial contracts and in particular in various financial instruments or arrangements. If the changes to the RPI are significant this might then raise the question as to whether the contract is frustrated because RPI as envisaged no longer exists or whether there is some pre agreed replacement language. Alternatively, in the absence of any change/modification language the contract may just carry on with RPI, as adjusted.

   Companies which have borrowed by issuing RPI indexed linked bond will often have terms included that if there is a fundamental change in the index it requires an expert to be appointed to determine changes to the Index with the intention that the changes should leave the issuer and the noteholders in no better and no worse position. The expert has in effect to adjust back to the old index formula. It is not clear how that will work in practice. This would be an example where the continuation of availability of an index calculated on the “old” RPI basis would be very helpful and important.

   It is worth noting that a number of outstanding index linked bonds provide that if the expert is unable to make a determination of the required adjustment (which would leave the issuer and the noteholders in no better and no worse position), the bonds may have

to be redeemed. A flood of early redemptions would have serious cash flow implications for our members and could lead to considerable market disruption.

There is the further commercial effect that often the issuers of indexed debt are regulated entities where their income is RPI linked in some way, so that the interest cost and their income match and are “hedged”. Many of these indexed bonds have maturities that are 20 year or longer and the risk is that this matching will be lost if their regulators move to the “new” RPI for income setting – and there may be pressure to do this as at first glance that would look more favourable for consumers.

Utilities, telecoms companies and housing associations and PFI projects will be the sorts of sector affected. These entities, and others, may also have entered into indexed interest rate swaps to create a particular hedge against the RPI too. Our view is that ISDA swaps will just adjust automatically to the new RPI, unless there is specific language in the swap documentation.

The compounding effect of small changes to long-term contracts may mean that some contracts are badly affected.

Conversely the investors in indexed bonds will also be affected. Investing institutions may also hold index linked government gilts. In relation to index linked Treasury Stock issued prior to 2002, if there has been a "fundamental change in the Index which would be materially detrimental to the interest of the stockholders” then HM Treasury is required to offer to buy back the outstanding Gilts, although commercially this is unlikely if the current interest rate environment persists.

Companies will also suffer an impact from their pension schemes although the exact amount will depend on the investment strategies deployed. The liabilities of the pension scheme are often linked to RPI up to a maximum of 5% pa inflation, so if the new RPI is lower this will be favourable for the company. The same schemes will no doubt also be holding index linked bonds or Gilts which, depending on terms, may or may not suffer a reduction in interest if the new RPI is lower.

Long term supply contracts, building contracts and rental agreements can include RPI linkages too. And your annex A lists further users and uses of RPI.

The use of RPI as a reliable and stable basis for contracts and regulations is so widespread that any changes may have significant, but difficult to foresee, repercussions across the economy, particularly if the changes are introduced rapidly.

We therefore propose that the “old” index continues to be produced in parallel with the “new” index. Over time, and very quickly in many cases, users will adjust to incorporate the “new” index into their businesses. The situation can then be reviewed in, say, 10 years time. By that point any discontinuance if the old index will be far less disruptive.

We note that running two indices will be more costly for the ONS but for the welfare of the economy as a whole that extra cost must be tiny compared with the disruptive costs and renegotiations required if the “old” RPI is terminated peremptorily. Continuing to run the “old” style index may not be politically satisfactory if the government is trying to create the mindset in the population that the new RPI and the CPI are the more representative indices but as an independent body we hope that political considerations do not trump practical considerations. As noted above, publication of the underlying data may allow others to calculate and publish an “old” style index, but the authority of the ONS is important in giving confidence to users.

As an alternative, we wonder whether there could be some consideration given to introducing the planned changes to the formula over a transition period of, say, five or ten years. In each year during the transition period a limited number of items in the index basket would be calculated using the modified formula. The idea would be to ensure that there is no "fundamental" or significant change to the index.

4) Do you support the proposal to change the source for the data for private housing rental prices?

Yes.

5) **Please provide any comments you would like to make in respect of this proposed change.**

Moving to collect housing rental data from the Valuations Office Agency plus the Scottish and Northern Ireland sources vastly increases your data base so on the face of it should be an improvement on the current process.

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The Association of Corporate Treasurers

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Our 4,200 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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