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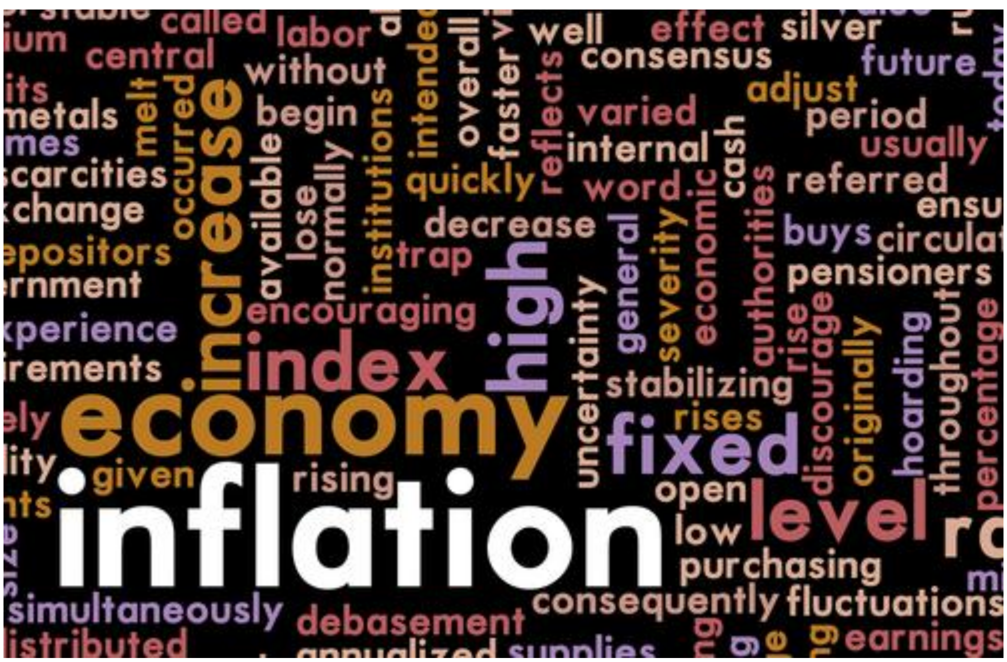
ONS - Pre-Announcement of Consultation on RPI Calculation Methodology

19th September 2012



The Office for National Statistics has announced that the National Statistician will shortly be consulting (from 8 October to 30 November 2012) on updating the calculation methodology for the Retail Price Inflation index.

This product is used as a key reference index for UK index-linked securities and derivatives as well as being the reference for some benefit increases in defined benefit pensions entitlement.

Full technical details are given on the ONS website but, in brief, the proposals are likely to remove some of the legacy technical anomalies around the mathematical aggregation of RPI price data in favour of the approach taken in the calculation of the Consumer Price Index.

The impact on the baseline RPI calculation is likely to be highly significant. The ONS provide a regular reconciliation of the differences between the values of RPI and CPI and the result of these calculation methodology difference is the most significant factor in this - for instance, in August 2012, the difference between the two approaches caused the RPI inflation figure to be 0.88% higher than it would otherwise have been - in other words 2.9% as compared to 2.0%.

This effect would ripple through in many ways, on balance likely not to be in favour of beneficiaries. On the plus side, utility bills and transport ticket prices might not increase so quickly due to lower RPI linkages. However, defined benefit pension increases and investments in index-linked gilts or National Savings are likely to be impacted.

Most defined benefit scheme funding positions are likely to improve, particularly for those schemes who have not substantially hedged inflation exposure; however they should ensure that investment managers and lawyers keep on top of these changes to ensure the scheme's investment interests are appropriately represented and protected.

It is possible that some few defined benefit schemes which have heavy CPI rather than RPI exposure but have nevertheless substantially hedged with RPI products could suffer a basis mismatch and a consequent increase in funding deficit - but this would be a rather rare case.

Please note that this initiative is entirely unconnected with the differences between RPI and CPI due to structural differences in handling housing costs. ONS has already consulted on this - see our previous update.

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