REFORM TO RETAIL PRICES INDEX (RPI)

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SUMMARY

The Retail Prices Index (RPI) is often used in property documents, for example for index-linked rents or adjustments to service charge caps. The Chancellor has said that RPI will be abolished in 2030. This article considers what might replace it.

BACKGROUND

RPI is a measure of inflation which measures the change in the cost of a representative sample of retail goods and services. In real estate transactions RPI is used to measure increases in rent, service charge caps (these are often index-linked by reference to RPI) and other payments and contract values, like ground rent. The RPI is the oldest measure of consumer prices in the United Kingdom, and is used across the entire economy, and in other financial contracts. It is calculated and published by the Office of National Statistics (ONS).

There have been long term recognised problems with the RPI in that it does not always accurately reflect the rate of inflation, sometimes underestimating inflation, but also significantly overestimating inflation. As far back as 2015 a review of price indices by the Institute for Fiscal Studies recommended to the ONS that RPI should be maintained as a legacy measure only, and in 2017 the Consumer Prices Index (CPI) including owner occupiers housing costs (CPIH) became the lead inflation index in ONS's statistical releases.

The CPI is a measure that examines the weighted average of prices of a basket of consumer goods and services such as transport, food and medical care. It is calculated by taking price changes for each item in the pre-determined basket and averaging them.

A number of consultations were launched in 2018/19 on whether for example pension schemes could move from RPI to CPI. Changes to the RPI can, in certain circumstances, require the consent of the Chancellor of the Exchequer before implementation. The UK Statistics Authority (UKSA) wrote to the Chancellor recommending that RPI should cease, and given the time constraints associated with the RPI ceasing (as legislation would be required to change it), in parallel RPI should be aligned with CPIH.

The rationale for the 2030 date is that the Chancellor had explained making changes before then would not be fair because holders of index linked government gilts (which don't mature before then) could lose out. The consultation proposed RPI continues, but the methodology should be changed to align the RPI with CPIH, so that any increases would be the same.

In November 2020 a response to the consultation was published.

SO WHAT SHOULD BE AN ALTERNATIVE TO RPI AND HOW WOULD IT BE MEASURED?

The Chancellor confirmed that the changes to RPI would take place so that the RPI index values will be calculated using the same methods and data sources as used for CPIH. The change will bring the methods and data sources of the CPI including CPIH into the RPI.

Over the previous decade CPIH has given a lower measure of inflation than RPI, around one percent lower per year on average. From 2030, the RPI measure of inflation is likely to be lower than it would otherwise have been by an average of one percent per annum, dependent on the economic climate. The RPI and CPIH will continue to be calculated and published as separate indices.

After 2030 the UKSA would no longer need the Chancellor's consent to implement the RPI proposed reforms.

HOW DO THE CHANGES IMPACT REAL ESTATE?

Because the CPIH gives a lower measure of inflation, rental increases are likely to be lower and so the returns will not be as great. Interestingly what came out of the response to the consultation was the focus on economic impacts and the value of those in coming up with a new measure.

Paragraph 44 of the response (see links below) sets out that in arguing that the consultation was too narrow, or that statistical rigor was irrelevant, many felt that the economic impacts should be the primary consideration. These economic impacts are discussed in more detail in section 6 of the response. However, to minimize such impacts, some respondents focused on the idea of setting the RPI equal to the CPIH plus an additional amount to reflect the difference in levels between the RPI and the CPIH. This idea was often summarized as 'CPIH+X'. Respondents primarily suggested that 'X' should be the average difference between the CPIH and the RPI, sometimes known as the “wedge”, or directly using 100 basis points, 1 percent in addition to the CPIH. This theme was present in 23 percent of the responses to question 1, and 10 percent of all responses. This was postulated equally by individuals and organisations. Landlords may want to incorporate this in their lease negotiations.

Economic factors are likely even more significant given the COVID-19 pandemic. It will be interesting to see if this impacts on the drafting in the months ahead.

USEFUL LINKS

Click the link to access the response to the consultation along with worked examples of methodology.

Click the link to access the Inflation and price indices.

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