Cost of Debt Indexation – initial views

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CEPA presenting viewpoint based on ongoing work for Centrica plc

Agenda

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Indexation

"The cost of debt embedded in the allowed return will be a backwards looking determination, based on a long-term trailing average of forward interest rates. There will be an annual adjustment in the allowed return on debt, based on movements in the trailing average rather than making a step movement at every price control. The index will likely be based on the real yields of sterling issuers of a similar credit rating to regulated utilities."

Ofgem RIIO principles

- Ofgem's announcement of cost of debt indexation is welcome but open questions remain in four areas:
  - how to set the index;
  - what portion of debt it applies to;
  - by what mechanism do adjustments flow through to revenues; and
  - what is the wider regulatory framework for governing the mechanism across price controls.

Indexation – Principles

Decisions on the detail of cost of debt indexation are non-trivial as they are likely to be in force for a long period.

- Customers and NWOs will benefit from the indexation mechanism if it has the following characteristics, amongst others:
  a. the resulting allowed cost of debt is an accurate reflection of the efficiently incurred cost of debt for NWOs;
  b. automatic adjustments are credible over time;
  c. the index retains positive incentives for companies to finance themselves;
  d. customers are protected from unnecessary price volatility; and
  e. regulatory discretion is reduced across price controls.
- Note: Data availability is crucial and contingency methodologies should be established for if data becomes unavailable

Indexation – Mechanism for adjusting revenues

Ofgem should ensure that NWOs are kept whole but also that prices are not subject to unnecessary volatility: logging-up can help achieve this as part of a wider mechanism to deal with uncertainty.

- Annual adjustment to the allowed cost of debt, but resulting revenue adjustments should normally be by way of logging-up / down and inclusion in the subsequent price control period.
- Logging-up / down provides:
  - certainty for the company that the efficiently incurred costs will be rewarded;
  - a netting out effect for +ve / -ve movements; and
  - price stability for consumers
- Within-period financeability concerns could be addressed by allowing revenue adjustments to be brought forward where a company gives evidence that it would face significant financeability / creditworthiness issues as a result of the delay.

Indexation – Which index?

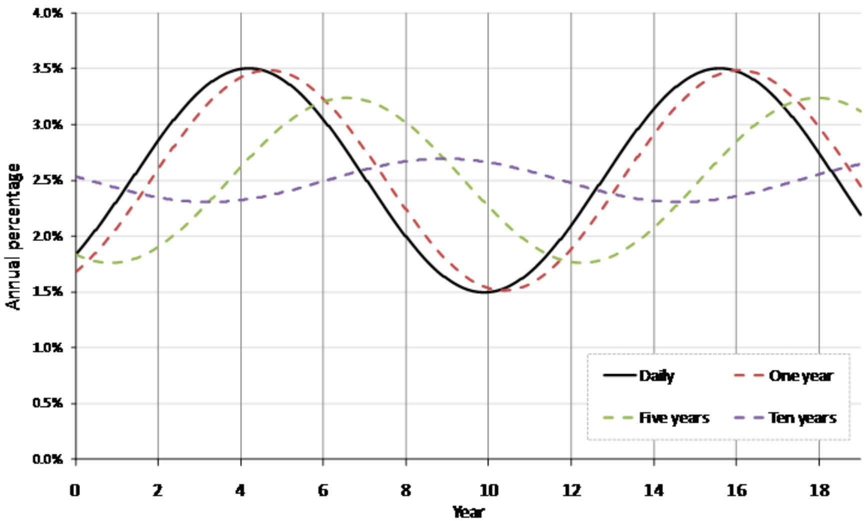
Inflation adjustment methodologies are important

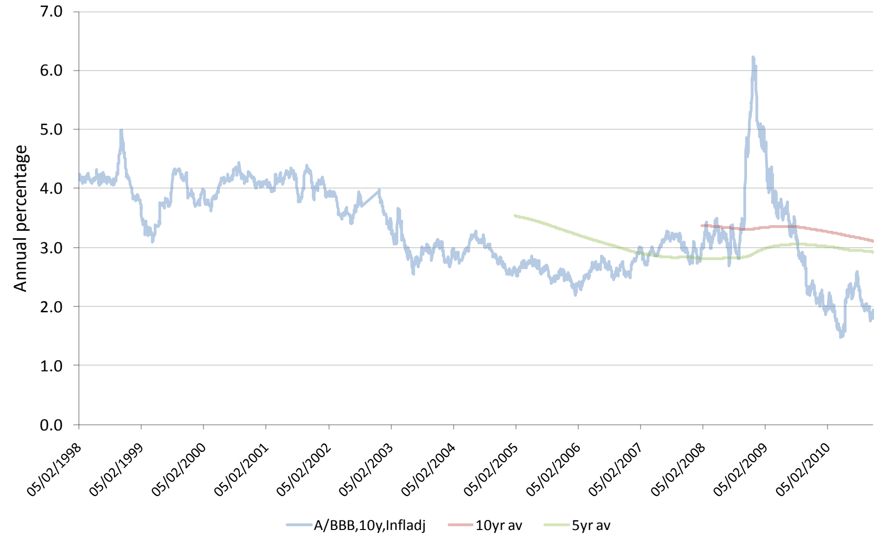
- Ofgem should identify a methodology that provides a good proxy for actual inflation expectations.
- BoE approach using difference between nominal and index-linked gilts well established.
- Alternatives include BoE forecasts and ex post adjustments .

Ofgem should be confident that the maturity and rating selected delivers an allowed cost of debt that reflects an efficient debt portfolio for NWOs

- Small design choices have an accumulating impact.
- The closer the index can be tailored to efficient NWO financing, the more accurate it is likely to be over time.
- Factors that affect the starting level (e.g. credit rating) are the most important to get right.

Indexation – How far to look back?





Trailing average length and weighting will be important variables for determining credibility.

- A long trailing average will take greater account of embedded debt costs whilst a shorter trailing average more reflective of spot rates will, by definition, mean the index will more closely match financing costs likely to be faced by companies for new debt.
- The 10 year trailing average is currently c.100+bp in excess of spot rates and, unless there is a sharp rise in interest rates, is likely to continue to provide headroom.

Indexation – What does it apply to?

Ofgem should apply cost of debt indexation to the full notional debt

- From the RIIO principle is not immediately clear that all notional debt (the notionally geared RAV) will be indexed.
- Whilst there are arguments in favour of a split, we support the view that all notional debt should be indexed i.e. embedded and new, rather than Ofgem adopting an explicit split.
- Indexing all notional debt has an effect broadly similar to a blended split cost of debt where both the historic cost of raising debt and the cost of raising debt today are considered.
- This helps ensure that current rates have an influence, while reducing the scope for windfall losses or gains on existing financing arrangements.

Conclusion on cost of debt indexation

- No index will be perfect, but key concerns are:
  - Good fit with efficiently financed entity.
  - Clear rules for implementation.
  - Logging-up to deal with predictability.

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