Debt Indexation – Emerging Thoughts

Stephen Topping
Managing Consultant

24 November 2010

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Structure of presentation

- The issue
- Objectives
- What should be indexed?
- Tenor of debt
- Length of trailing window
- Credit rating
- Weighting of historic data?
- Conclusions

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Debt indexation – the issue

- Ofgem has proposed calculating cost of debt as long term trailing average of forward interest rates
- Our remit was to advise on the detailed design of such a mechanism
- We have taken the following as given:
  - The cost of debt should be indexed
  - The index should be a trailing average to reflect embedded debt

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Objectives

- We suggest objectives for an indexation mechanism should include:
  - Accuracy
  - Simplicity
  - Transparency
  - Credibility
  - Fully mechanistic
  - Cannot be manipulated
  - Preserves efficiency incentives

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

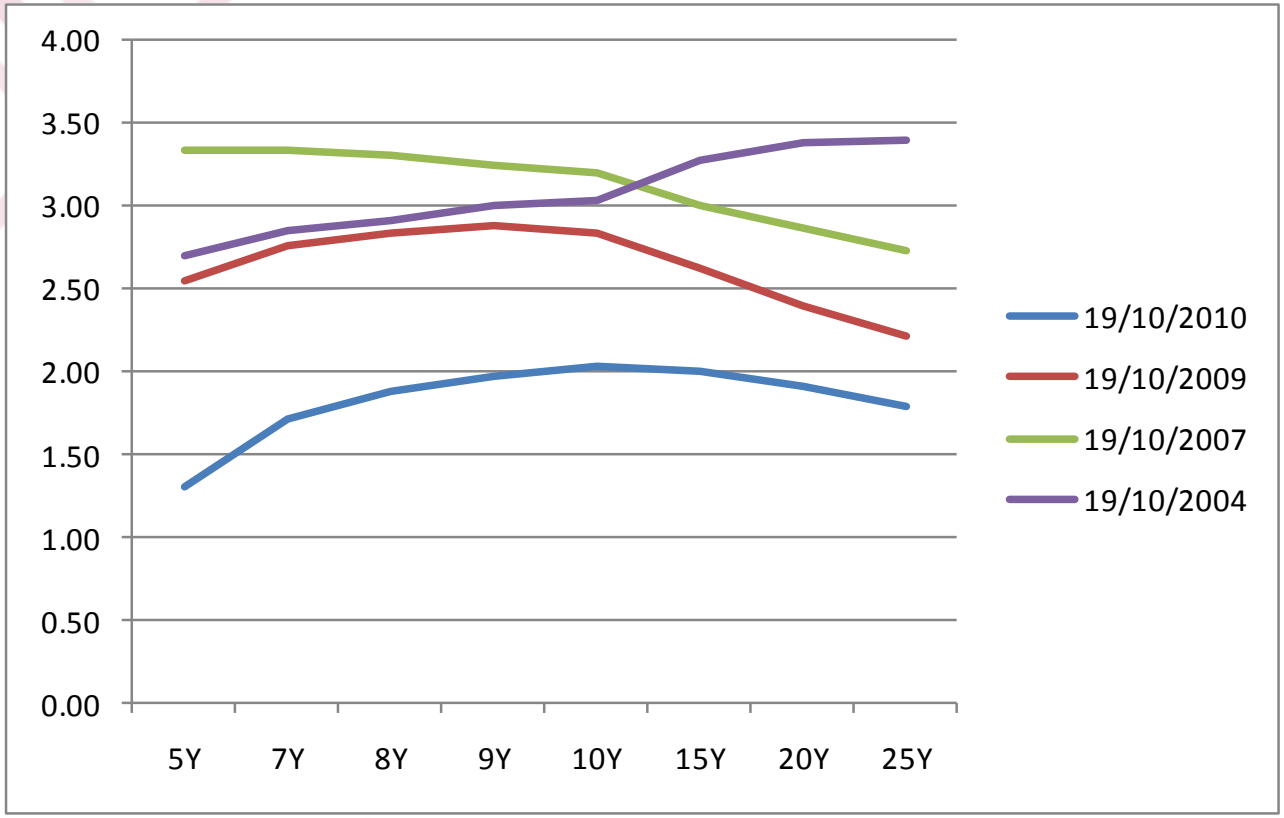
What should be indexed?

- Options include:
  1. Index total cost of debt
  2. Keep risk free rate fixed, and index debt premium
  3. Keep debt premium fixed, and index risk free rate just for the cost of debt
  4. Keep debt premium fixed, and index risk free rate for both cost of equity and cost of debt
- We recommend option 1, given objective of accurately reflecting actual cost of debt

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Tenor of debt

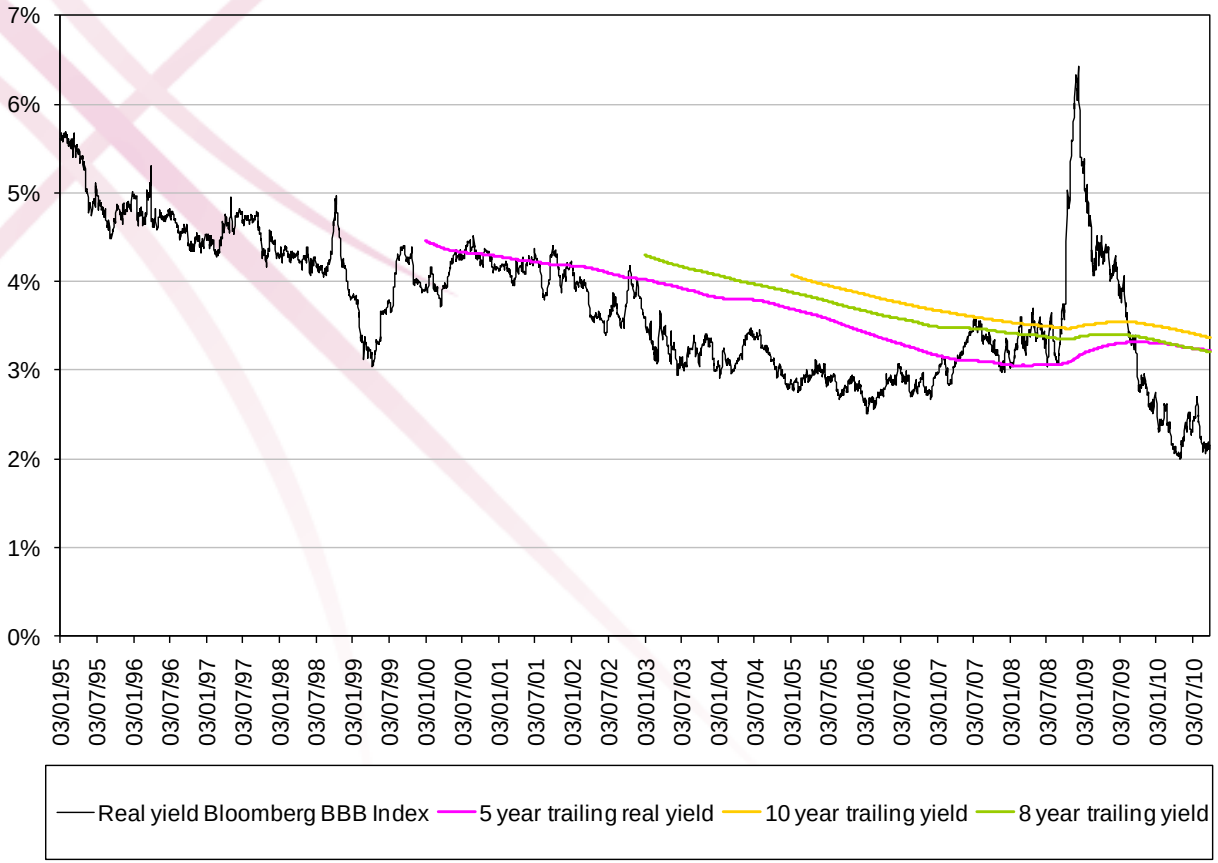
Real Yield Curve for BBB category Fixed Rate Corporate Bonds



Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Length of Trailing Window

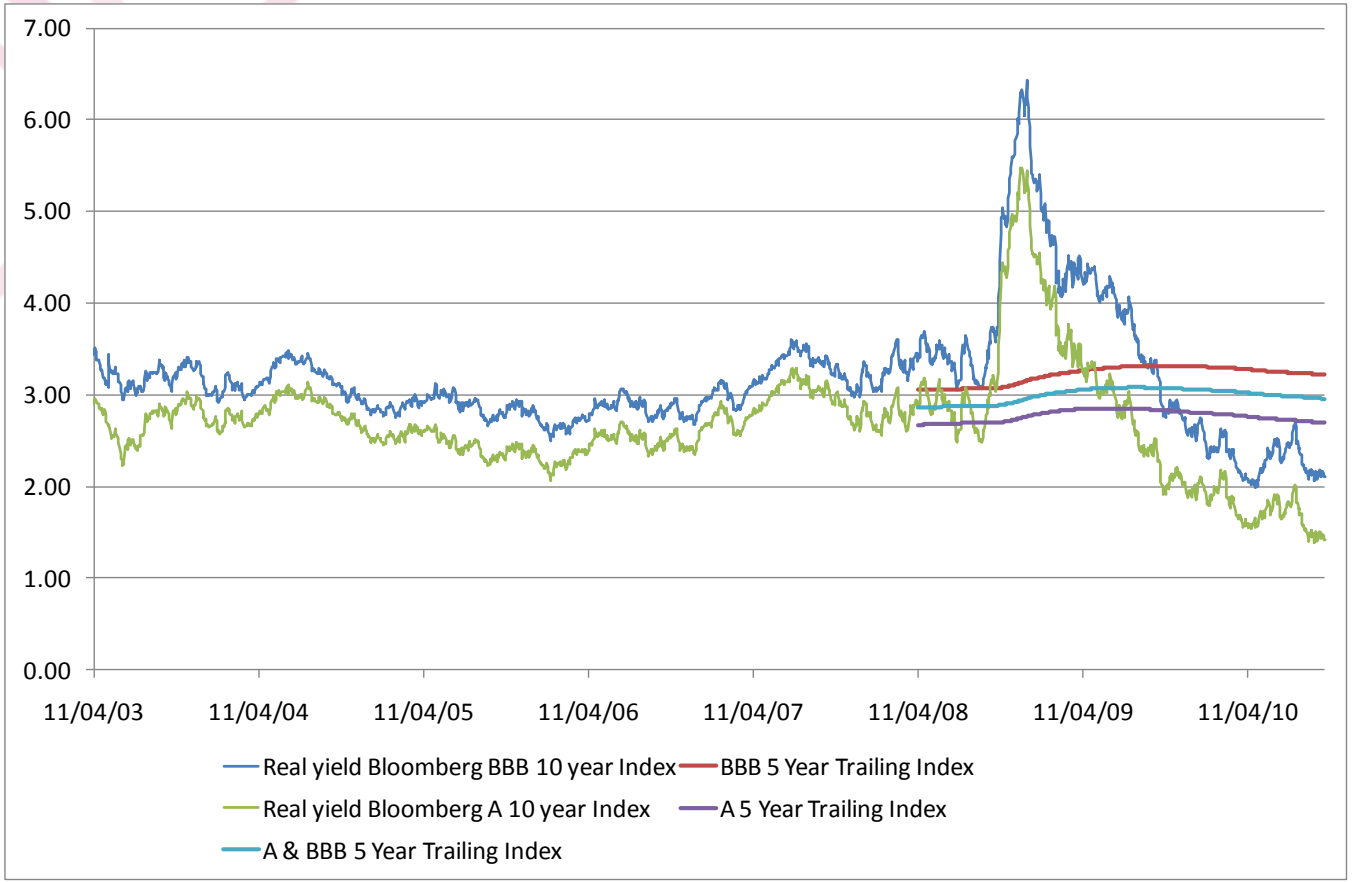
Implied Real Cost of Debt Using Bloomberg BBB 10 Year Index



Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Credit rating

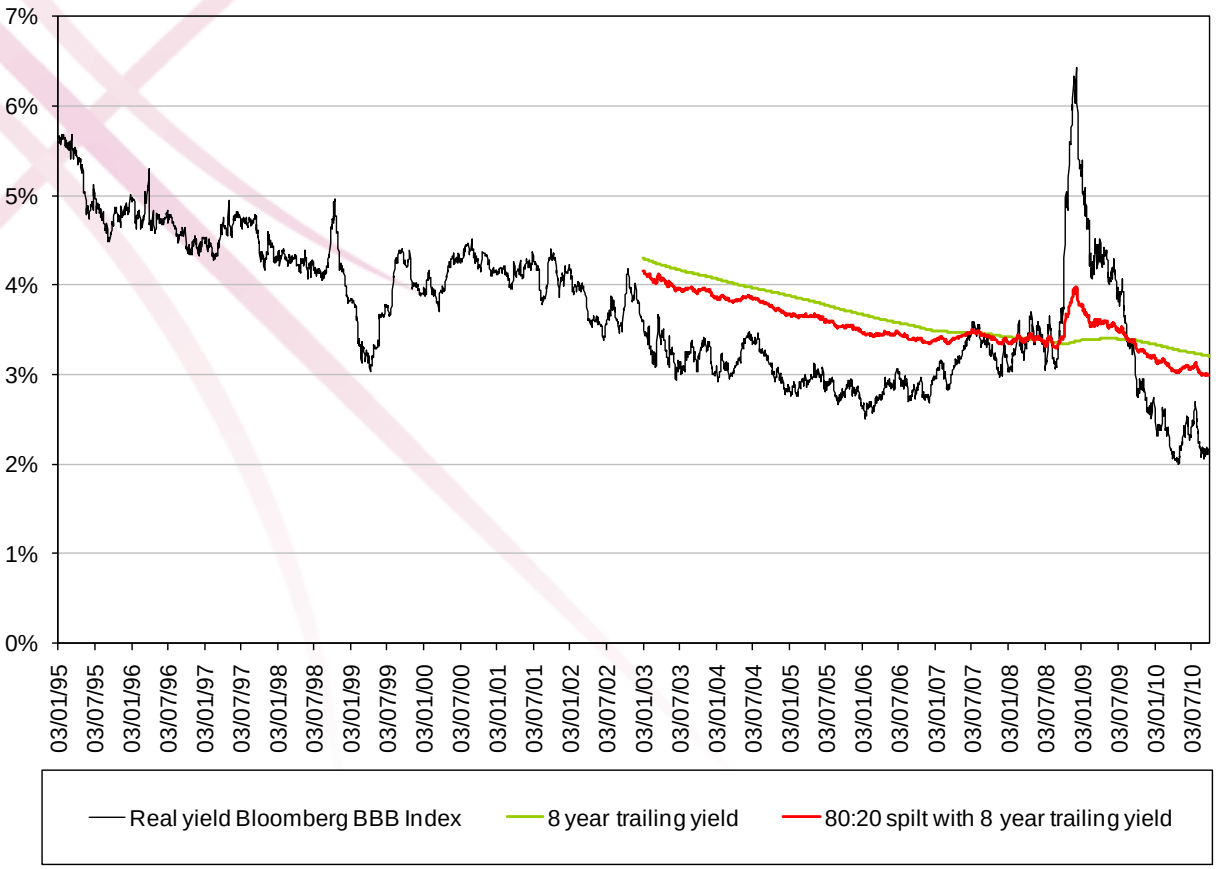
Implied Real Cost of Debt Using Bloomberg 10 Year Index (5 year trailing average)



Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Should historic data be weighted?

Implied Real Cost of Debt using Bloomberg BBB 10 Year Index



Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.

Conclusions

- In summary, we recommend:
  - Indexing total cost of debt
  - Using 10-year bonds
  - Using an 8-year trailing window
  - Using an average of A and BBB rated bond indices
- On weighting, we conclude:
  - May not be sufficient data to weight by annual RAV additions, which suggests use of simple average
  - Could possibly weight current / historic data based on assumed split between fixed / variable rate debt

Note: This presentation was made to a stakeholder meeting on 24th November. The views expressed in the presentation are those of the consultancy concerned. They are not the views of Ofgem and where those consultants are working for Ofgem, final reports have yet to be received and no decisions have been made on the material by GEMA.