Debt Indexation

Ofgem Stakeholder workshop on RIIO-T1 and RIIO-GD1 – Financeability

24th November 2010

Charles Hazelwood

Wales and West Utilities

Competition Commission

Bristol Water – Competition Commission Reference 4th August 2010

"Bristol Water's return on its RCV should be equal to its expected cost of capital"

"Long-run averages are relevant only to the extent that they affect the cost of capital in that [Price Control] period."

"It is sometimes suggested that regulators should seek explicitly to set required return equal to some concept of long term average cost of capital rather than the expected cost of capital for the specific price-cap period. We do not consider this would be consistent with our duties in this determination."

Is this change in approach to a mechanistic trailing debt index which will not necessarily reflect expected future cost of capital consistent with Ofgem's financing duties?

Risk and Uncertainty

The implication of RIIO documentation is that debt indexation provides regulatory certainty - *"a commitment to remunerating efficiently incurred debt costs"* and consequently reduces risk *"should provide comfort that new debt, financed at efficient rates – even at levels higher than the allowed return – will be fully funded in the future"*

Our concern is that annual adjustment of Cost of Debt increases uncertainty and risk

- Licensees exposed to risk of under-performing against debt index unless they re-structure existing and future debt to match the index.

- Currently, Licensees assess the Final Proposals "in the round" – including a comparison of existing and expected future cost of debt with cost of debt allowance in Price Control Period. If Final Proposals are not accepted then this can result in referral to Competition Commission

- Use of debt index means that this assessment cannot be done with precision, which changes the balance of risk to equity and consequently increases Cost of equity

- Changes in allowed income increase volatility of transmission and distribution pricing – uncertainty for customers

High Cost of Debt

Licensee mitigation to exposure to underperformance against debt index would be to restructure existing and future debt to track the debt index.

Licensees debt is currently structured to be consistent with the long term nature of business and be compliant with key Credit Rating Agency and common debt covenant criteria

- Bonds already issued long duration
- Banks reluctant to lend >3, possibly 5, years
- Debt covenant normally requires
  - no more than 40% of debt/RAV to fall due for refinance within each of the current and subsequent Price Control period.
  - Significant proportion (75%+) of future cost of debt fixed over the current and subsequent Price Control period

Debt re-structure to match debt index will be difficult, expensive, (due to restructuring/transaction costs and market premia as NWO's "chase" the index) and may impact Credit Rating

Practical Considerations

Consumers will effectively fund cost of debt at Index values

- **Is this the most "efficient" debt structure?**
- **Cost of Equity to reflect the risk of being unable to match the index**

The appropriate reference index to use?

- corporates, utilities or a bespoke index?
- credit rating – BBB?
- is 10 years is the appropriate tenor of debt and the appropriate period for considering the trailing average?

"Basis" differences between the observed index and Notional Company debt costs – will need to adjust for:

- credit rating
- inflation - cost of debt allowed is "real"
- actual gearing within the index population and the notional position assumed by Ofgem
- structural enhancements in the index as compared to the notional position
- the amount, if any, of inflation linked debt assumed within the notional gearing

Costs incurred by Licensees as part of debt funding which are not included in observable index:

- costs of successively raising debt (including arrangement fees, legal costs, rating costs)
- costs of pre-funding capex and repex programmes (e.g. cost of carry or commitment commission)
- differentials between bank and capital market debt costs
- new issue premia on bond issue
- liquidity premia arising from:
  - all NWO's seeking to match issuance against the index tenor
  - deal size – 6.25% of RAV (1/10th of notional gearing of 62.5%) will not meet bond issue "liquidity" criteria of approximately £200m unless RAV is £3.2bn for each Licensee.
- hedging costs
- Rating Agency charges (a license requirement)
- other costs (e.g. Agency and Trustee fees)