Potential approaches for transition from RPI to CPI (updated)

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1) RPI remains key to the water industry

- RCV and its linkage to RPI has been fundamental to the success of the water industry. Any change from the current approach should be subject to a full impact assessment that considers all of the issues.
- Water industry has long dated RPI linked liabilities - some maturing after 2060. A premature move to CPI could be detrimental as the market for CPI debt is undeveloped. DMO (debt management office) are currently not issuing CPI debt.
- Our first paper discussed how a change of indexation of the existing RCV could result in a mismatch of revenues & costs and potentially harm investor sentiment (similar views have also been raised by key stakeholders* since).
- If a decision is made to move to CPI then the transition should be gradual, and possibly flexible, to give companies an opportunity to manage the hedge between their revenues and costs. This has been a key attraction for investors that has allowed companies clear access to markets at attractive terms – benefits of which are passed on to customers (lower bills at PR14 was one example of that). Every effort should be made to retain and build on that investor confidence.
- Our proposed approach (explained in further detail in this paper) mitigates many of the credit concerns raised and will allow companies the flexibility to transition at a pace that aligns to the maturity of their RPI exposures.

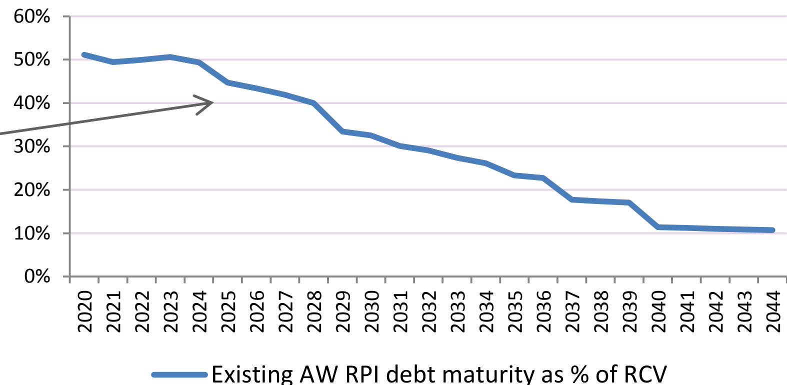
* Standards & Poors: *Proposed U.K. Water Regulatory Changes Could Dilute Utilities' Credit Quality*

Transition options

2.a) Ofwat proposal: convert 50% RCV at March 2020 to CPI

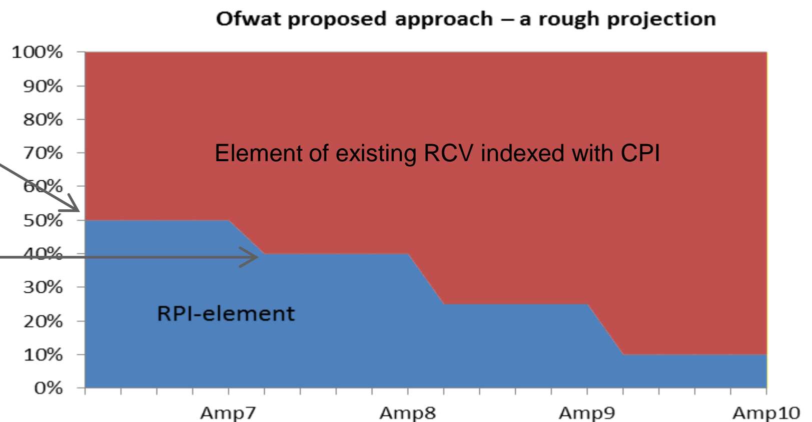
- ➢ Retain 50% linkage to RPI and intention to reduce RPI indexation in future
- ➢ Transparent method to calculate WACC on the basis of RPI and CPI.
- ➢ RCV proposed to split 50/50: this implies the element of RCV indexed by RPI continues to grow in nominal terms (new capex added equally to RPI and CPI element of the RCV). This is relevant for companies to implement risk-management processes.

- ➢ Graph shows maturity of Anglian Water's RPI linked liabilities as percentage of estimated RCV.
- ➢ A reduction in RCV indexation of RPI below these levels will require expensive hedging arrangements.



Ofwat proposal – existing RCV 50% CPI

If RPI indexation is reduced further whilst grandfathering existing RPI liabilities, future transition could follow a path similar to this (assumes hedging costs are avoided):



2.b) Hybrid approach : create new ‘CPI-RCV’; let existing 2020 RCV depreciate over time

- In this option the linkage to RPI is retained for existing 2020 RCV. This is then allowed to depreciate naturally with companies in control of the speed of transition through the use of run-off rates.
- New ‘CPI RCV’ is created. This gives a clear distinction between new and historic assets. Companies can choose to draw run-off (depreciation) predominantly from the RPI-RCV to accelerate the transition.
- As the existing RCV runs off, over time companies can re-finance RPI liabilities without the need for expensive hedging.
- Companies already manage PAYG and run-off rates (financeability tools); under this approach companies will also manage the transition to CPI. Given companies have different levels of RPI liabilities with varying maturities, it is sensible for companies to own the transition.

Pros

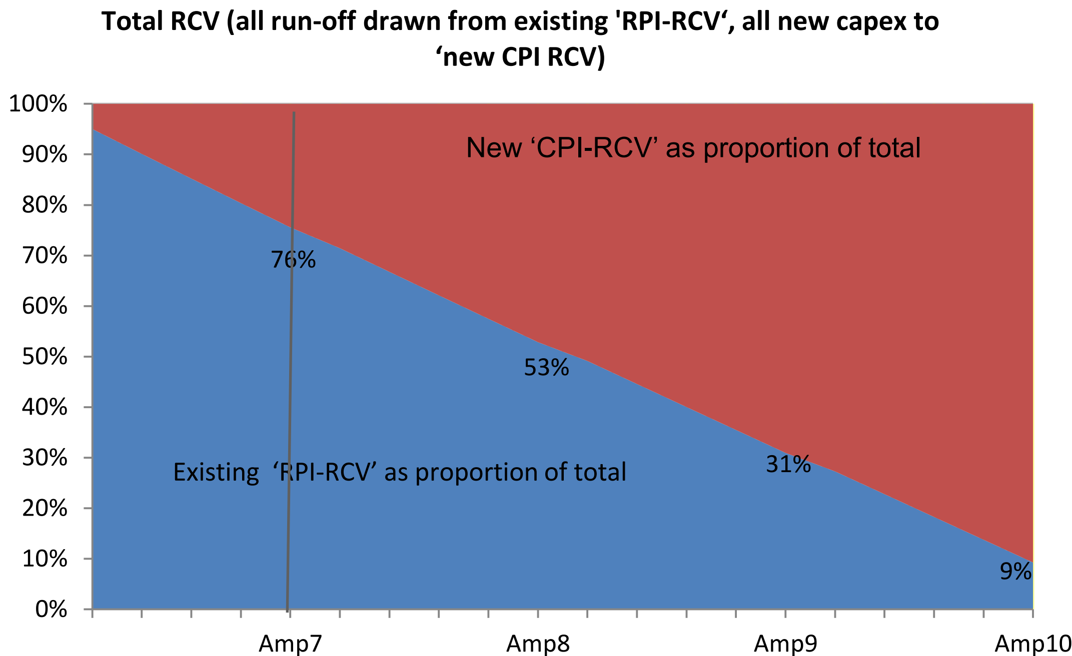
- Suitable for WASC’s and WOC’s (companies to take control of their plans including speed of transition to CPI)
- No spike in customer bills
- No mis-match of revenues & costs
- No hedging required. Allows time to manage transition in an orderly manner
- Allows time for CPI market to develop

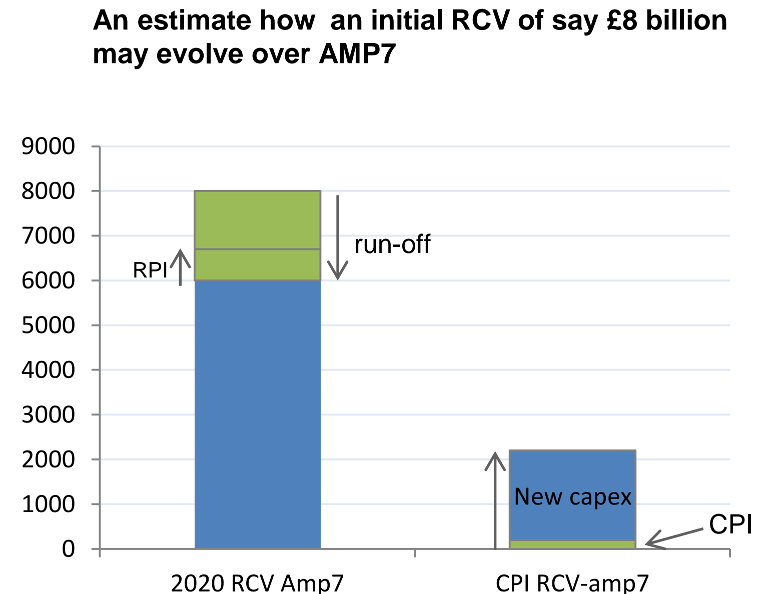
Cons

- RPI retained for a period of time (discussed in next slide)

2.b) How long before 2020 RPI-RCV is fully depreciated?

- This depends on a number of factors, key being: 1) level of prevailing RPI 2) level of RCV run-off* rate.
- If all new capex is added to the new 'CPI RCV', and all run-off was drawn from the existing '2020 RPI-RCV', we estimate that after 4 AMP periods, 'CPI RCV' will represent around 90% of the total RCV* (see graphs below).
- In response to the consultation by UK Statistical Authority, HMT reaffirmed that Government is commitment to use RPI untill the existing gilts mature (in 2068). Given water industry's debt maturity follows a similar time-frame (Anglian's existing RPI debt matures in 2062) retaining some RPI exposure to provide a natural revenue/cost hedge makes economic sense.



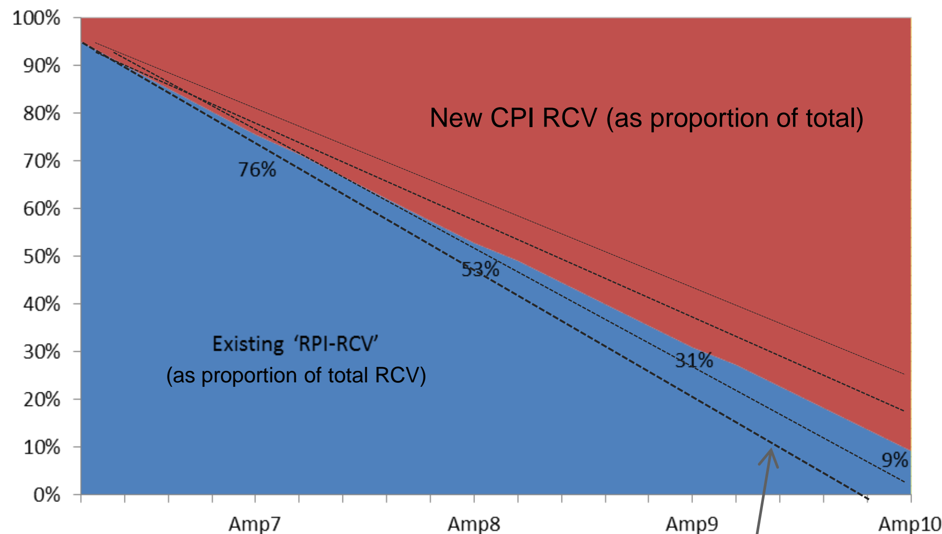


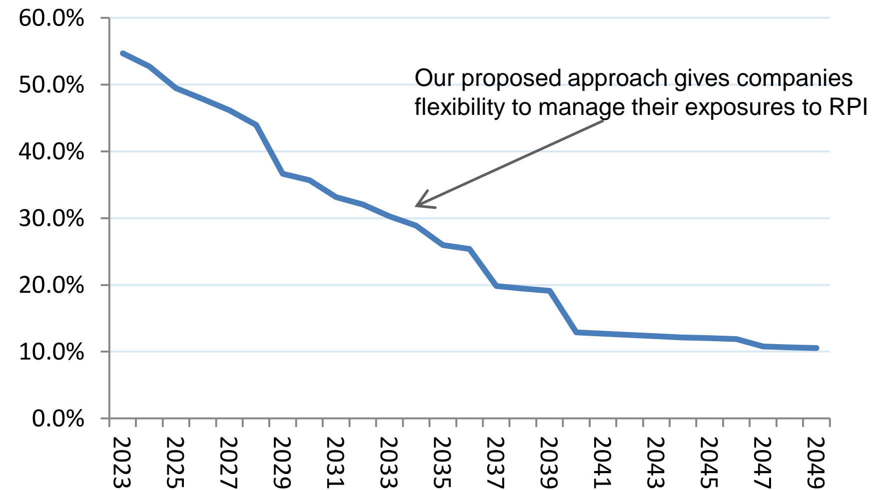
** RCV run-off represents the use & maintenance of assets during an AMP period*

*** Assume RPI =2.5%, RCV run-off =5%, Changes to these variables could accelerate or slow the transition*

2.b) Why companies need flexibility?

- Our example on the previoius slide assumes a uniform depreciation of existing 2020 RPI-RCV. Around 55% of Anglian Water's existing debt is linked to RPI (c50% as a proportion of RCV); if grandfathered, we estimate that at 2040 this could still be between 10%-15% of total debt at the time.
- However, industry has varying levels of RPI debt obligations and maturities. Our proposed approach gives each company the flexibility to draw down existing RPI-RCV at a pace that supports their financing requirements.
- Companies already manage PAYG/run-off rates, this will be an extension of that existing flexibility which would allow companies to own transition and therefore manage financeability. This will mitigate revenue/cost mis-match issues discussed in our previous paper (also raised by S&P*)





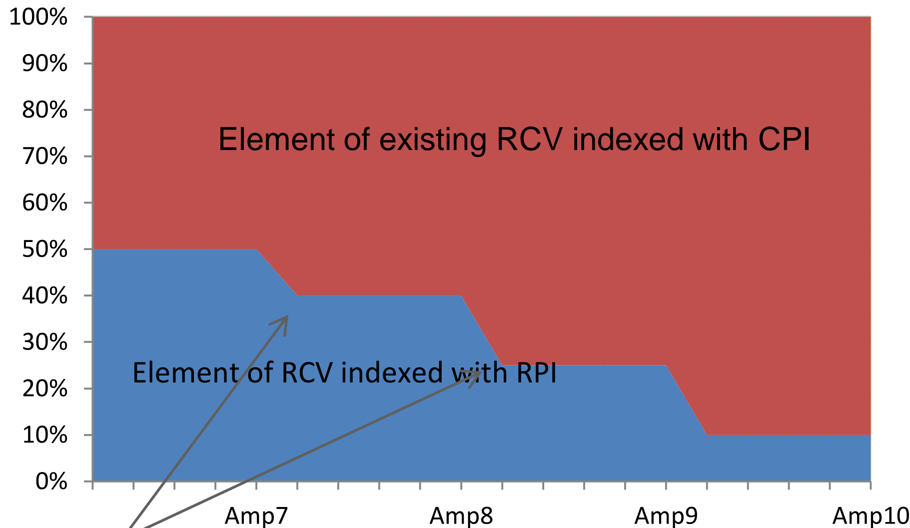
Companies may choose to align pace of transition to maturity of their RPI exposures

* Standards & Poors: *Proposed U.K. Water Regulatory Changes Could Dilute Utilities' Credit Quality*

3.a) Which approach best balances risk and interests of the industry?

- By 2020, we estimate that industry's RPI linked debt liabilities will be around £30billion (financing strategies already in place, CPI market undeveloped), some of that existing RPI linked debt will mature after 2060.
- It seems safe to assume that RPI will need to be retained for a significant proportion of RCV to maintain a natural revenue/cost hedge. (we remain of the view that synthetic hedging will be expensive and inefficient and therefore should be avoided)
- One fixed solutions will not suit all companies due to factors discussed earlier (varying RPI exposure and maturities etc)
- **Given the diversity of RPI exposures, companies should be allowed the flexibility and tools to manage their respective transitions.**

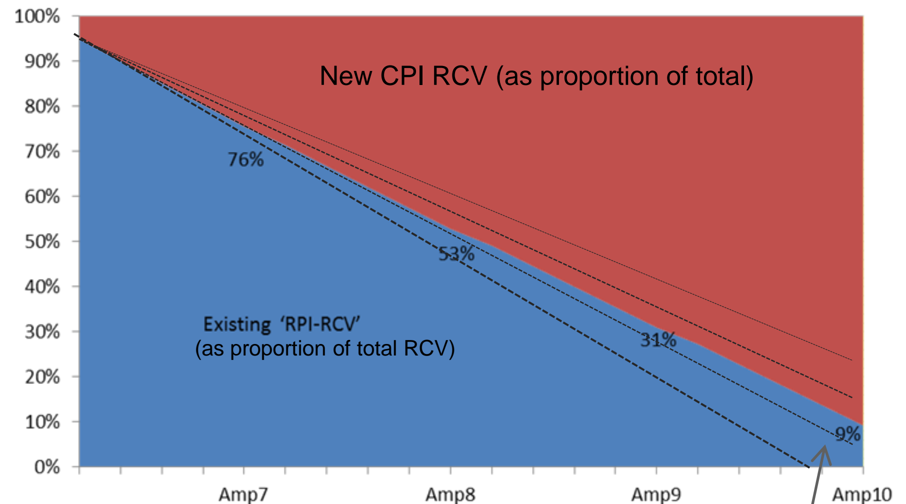
Estimated CPI transition of Ofwat proposed approach



Grandfathered RPI liabilities to remain in near future

Graph-1

Total RCV (all run-off drawn from existing 'RPI-RCV', all new capex to 'new CPI RCV)



Graph-2 (Hybrid approach)

Transition flexibility will help maintain investor sentiment & keep bills low

3.b) Our proposed approach provides an effective mechanism

Meets customer needs	√
Works for investors	√
Aligns with the position of ONS & UK statistics	√
Almost guarantees a value neutral WACC	√
Financeability & Affordability	√

Meets customer needs

- ✓ no immediate rise in bills
- ✓ no synthetic hedging required
- ✓ maintains regulatory stability (in long-term interest of customers)

Works for investors

- ✓ no mismatch of revenues and costs
- ✓ allows time for CPI market to develop
- ✓ no synthetic hedging required

Aligns with the position of ONS & UK statistics

- ✓ provides a timeframe for the replacement of RPI

Almost guarantees a value neutral WACC

- ✓ completely separates CPI WACC & RCV
- ✓ provides future clarity & Regulatory certainty

Financeability & Affordability

- ✓ companies in control of the transition

Summary

- Ofwat proposal alleviates some concerns however a number of issues remain.
- We think the case for a change of indexation of existing RCV and likely benefit to customers has not yet been made. If a decision is taken to move to CPI then the transition should be gradual and flexible to give companies an opportunity to manage the hedge between their revenues and costs.
- Given a move to CPI will have a direct impact on affordability & financeability, it seems sensible that companies should own the tools to manage the change.

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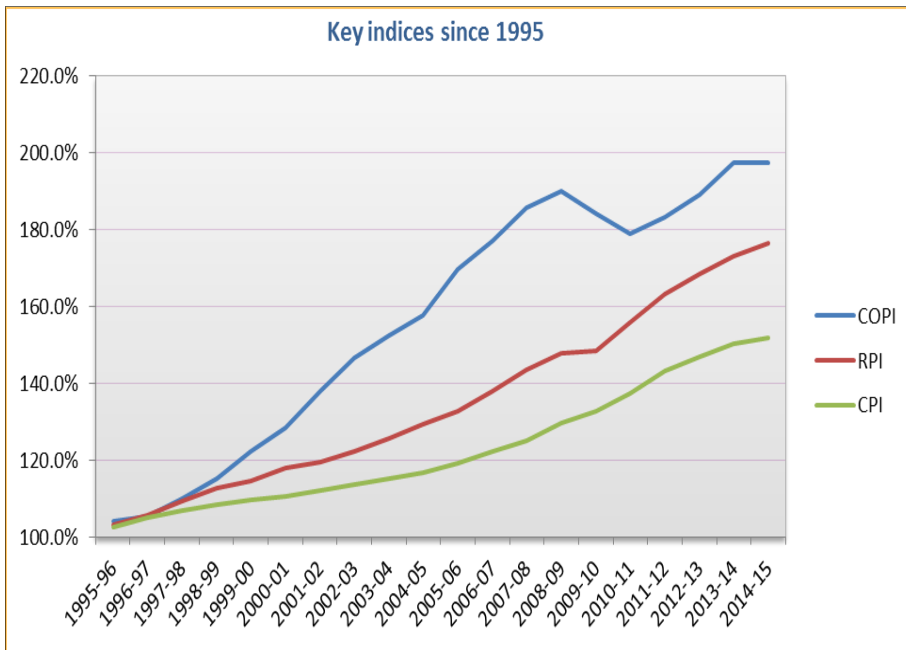
Appendix

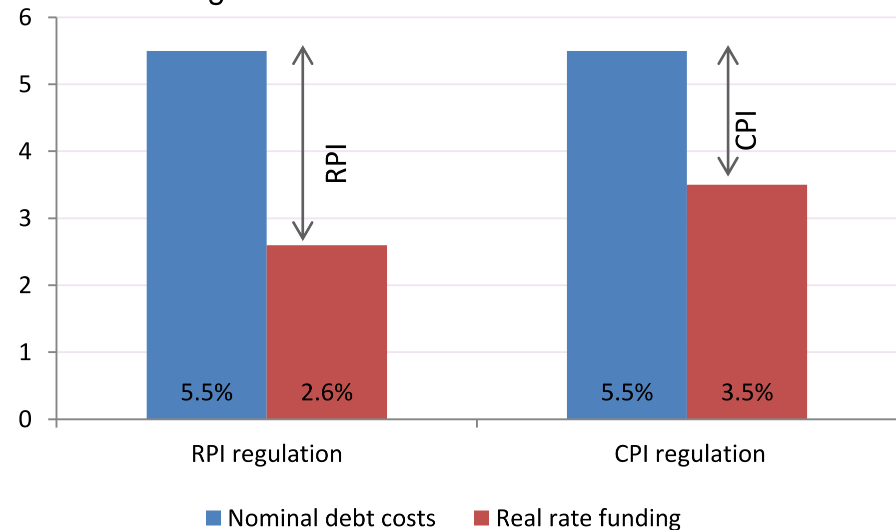
1) Key Implications of change (for companies, customers and stakeholders)

- **Existing RPI linked debt** : A move to CPI will create a disconnect between revenues and existing costs (slide 6)
- **Higher bills**: Customer bills will increase on transition to reflect 'real' CPI funding (impact can be softened by altering PAYG)
- **Cost assessments:** Companies plan their expenditure and funding in terms of RPI . A move to CPI means price-review models will need to capture underlying real price pressures to reflect the change of index (see graph)
- **Financeability –** Financeability testing will become the key focus for stakeholders as future WACC funding will reflect CPI, while large proportion of costs are likely to remain nominal or RPI linked (market for CPI debt is in infancy). Notional financeability tests may need to be redrawn

Cost assessments: A move to CPI could reduce cash totex funding unless modelling reflects the change appropriately



Nominal costs vs Real funding: Ofwat's financing duty ensures the gap between the nominal costs & the real funding is met



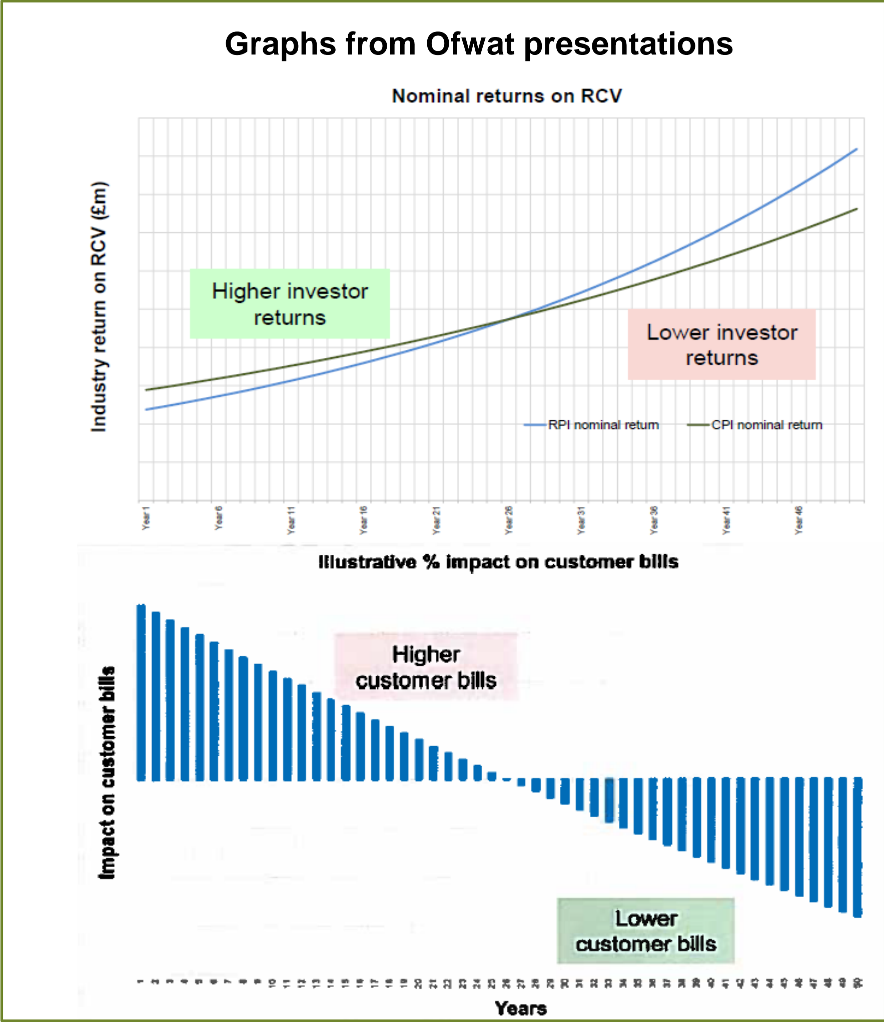
2.a) Full change to CPI – Key issues

➢ Ofwat noted that RPI linked liabilities may need to be hedged - ‘it will not be costless’

Key issues with this approach

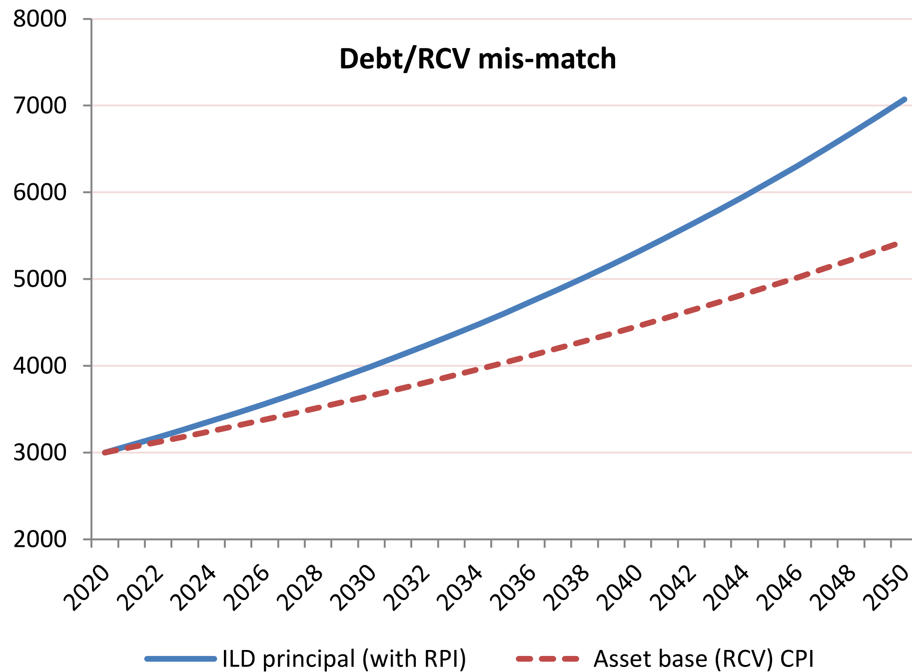
1. **Mismatch of revenues and costs** : (see page 5)
2. **Hedging** is prohibitively expensive – very limited market. Who pays?
    - This will be a new layer of banking costs that neither customers nor companies should bear given change is driven by external factors.
3. **Retrospective**– RCV’s linkage to RPI is deeply embedded in markets
4. **Bill impact:** a straight change to CPI will mean bills may have to rise by around 8% in real terms
    - Changing PAYG can solve bills in the short-run however long-term financeability concerns will remain (see page 5)
    - If CPI does not recover from current levels, bill impacts could be much larger
5. **Financeability :** Ofwat’s financing duty will become ever more important with the mis-match of revenues and costs.
6. **CPI market not developed:** Companies have large financing needs. CPI market is still in infancy

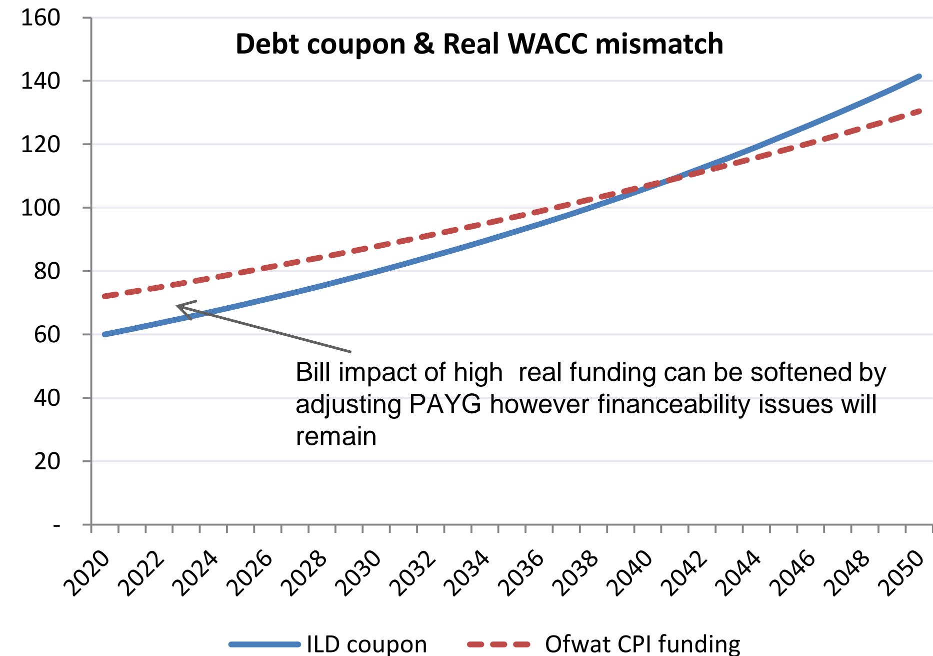
Graphs from Ofwat presentations



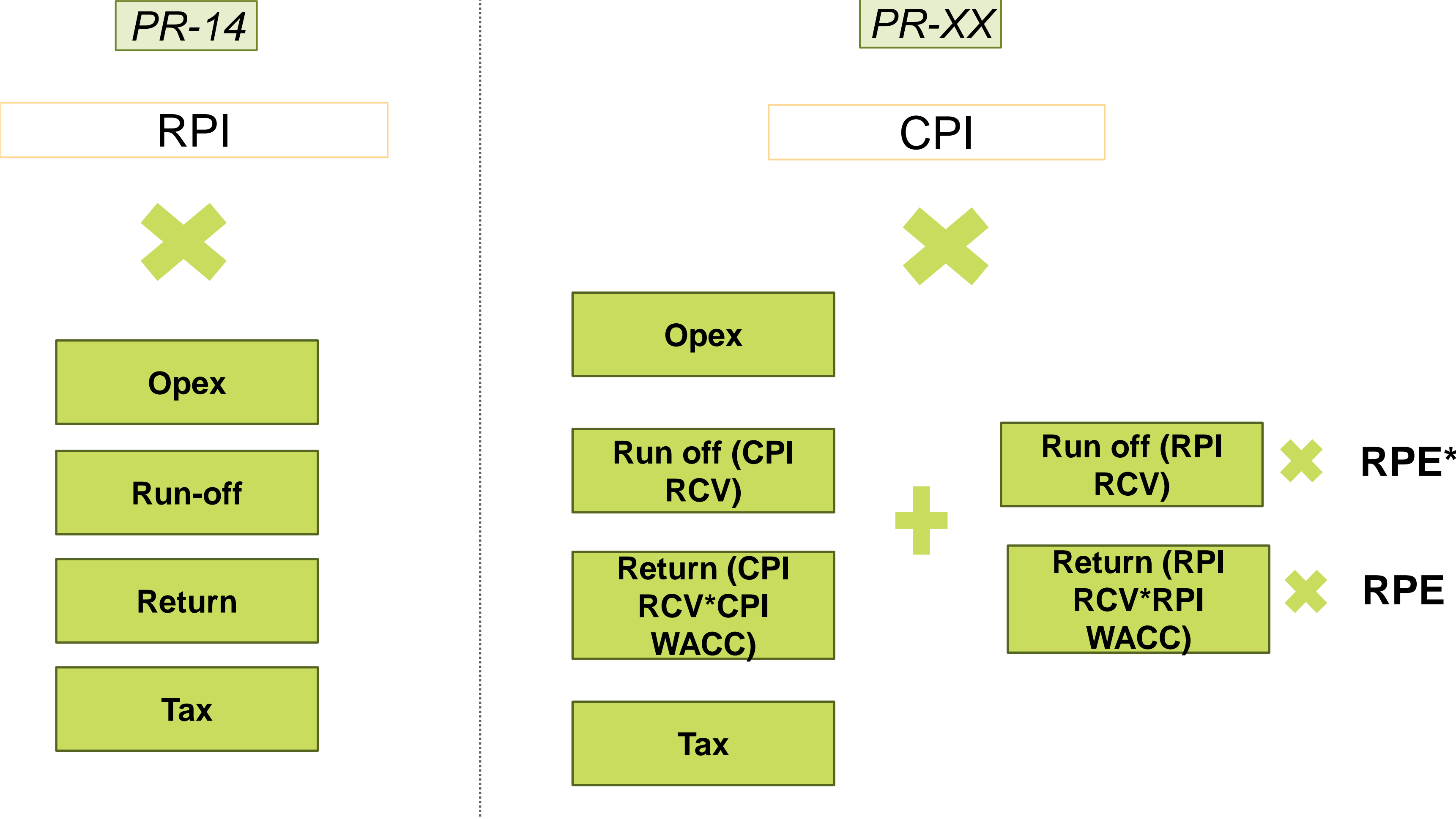
2.b) Full change to CPI - Cost / funding mismatch

- **Existing RPI linked debt** : A move to CPI will create a mismatch between revenues and costs.
  - Debt principal, linked to RPI, to grow faster than the corresponding asset base (CPI) creating an asset/liability mismatch at maturity. See graph-1.
  - Real funding will be higher in early years (CPI-WACC). See graph 2.





2.c) Financial Modelling of the Building blocks in CPI terms:



* *Relative Price Effect*