Potential approaches for transition from RPI to CPI

Contents

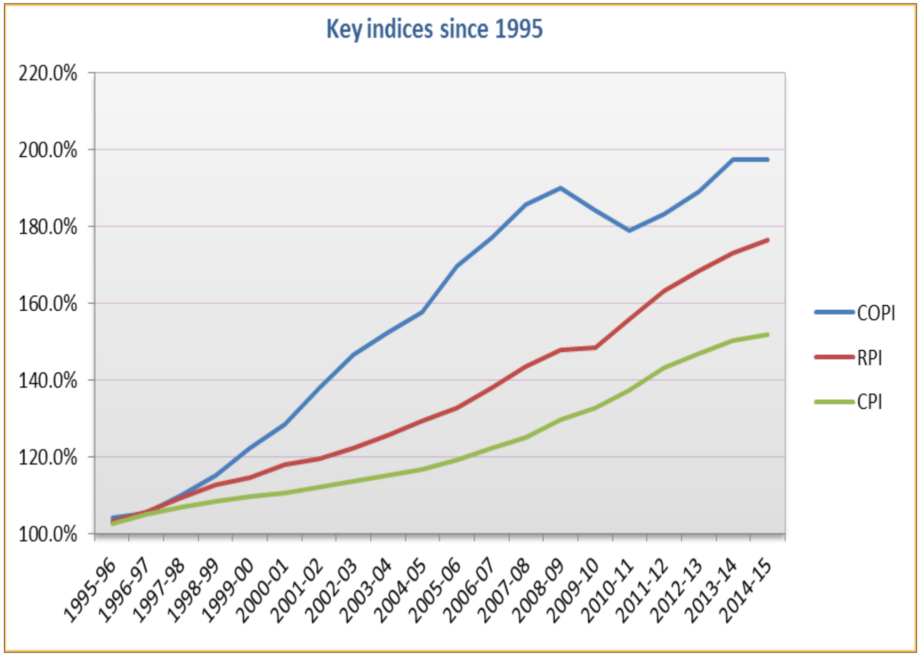
1) RPI remains key to the water industry

- RCV and its linkage to RPI has been fundamental to the success of the water industry and any change from the status quo should be considered very carefully
- Industry is expected to raise over £10billion of debt in current AMP, a large proportion of that is likely to be RPI linked.
- Availability of RPI linked debt has supported industry well given the gap between nominal costs and real funding. RPI debt has provided the bridge and reduced financeability concerns and this has allowed reduction in financing costs to be passed through to customer bills.
- A premature move to CPI could be detrimental as the market for CPI debt is almost non-existent
- Only if it becomes absolutely necessary, a transition to CPI should be considered
- This paper reviews two such options, both focussed on phasing out RPI

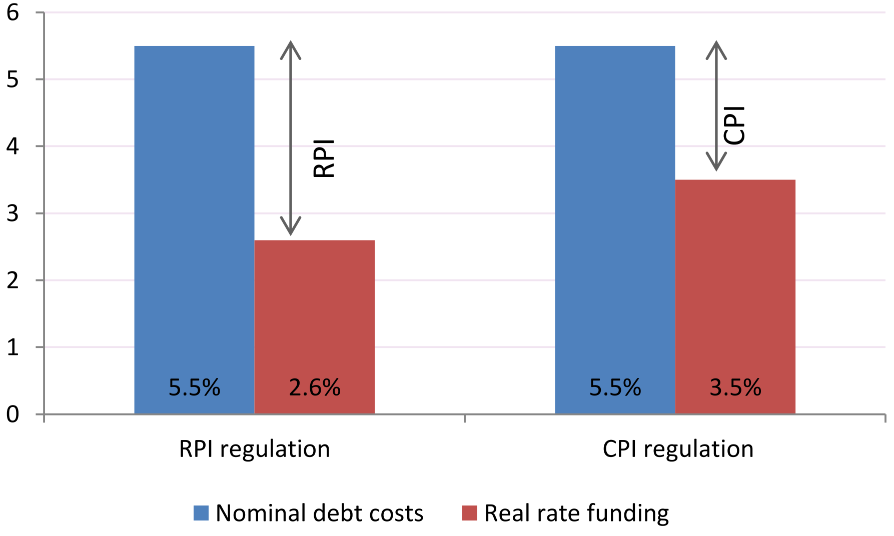
2) Key Implications (for companies and Ofwat)

- **Existing RPI linked debt** : A move to CPI will create a disconnect between revenues and existing costs (slide 6)
- **Higher bills**: Bills will need to increase on transition to reflect 'real' CPI funding
- **Cost assessments:** Companies plan 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 currency appropriately (see graph)
- **Financeability –** Financeability testing will become key focus for stakeholders as WACC funding will reflect CPI, and costs are likely to remain nominal or RPI linked (market for CPI debt is in infancy). Notional financeability tests may need to be redrawn

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



Transition options

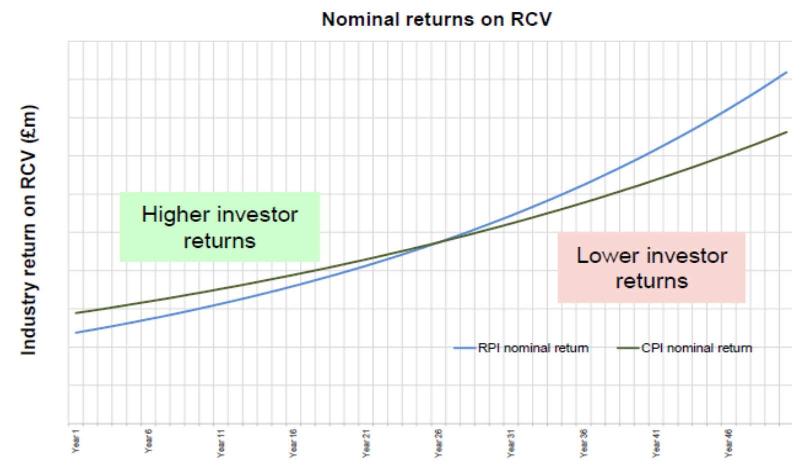
3) Option 1: Full change to CPI

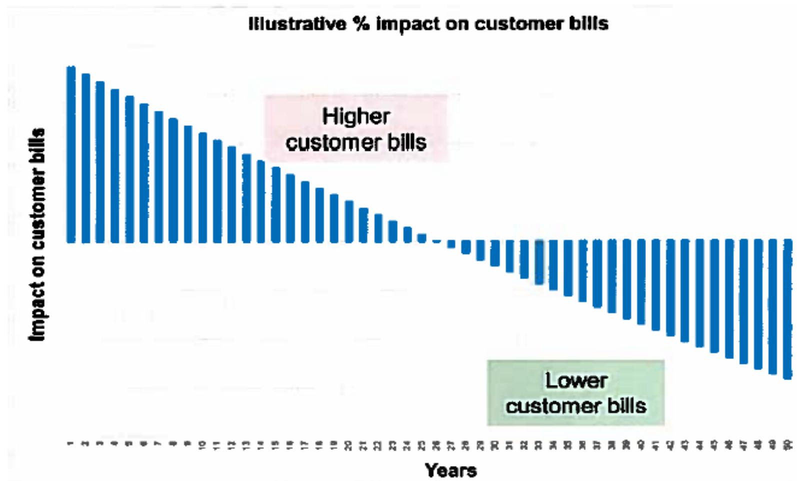
- Ofwat note RPI linked liabilities may need to be hedged ‘it will not be costless’
- Change will be value neutral for customers and investors

Key issues with this approach

1. **Mismatch of revenues and costs** : slide 6
2. **Hedging** is prohibitively expensive – very limited market. Who should pay?
    - This will be a new layer of banking costs that neither party (customers or companies) should bear particularly given the change is driven by external factors.
3. **Retrospective**– RCV’s linkage to RPI is ingrained 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 to solve bills in the short-run however this will not resolve long-term financeability (see slide 6)
    - if CPI does not recover from the current levels, bill impact could be much larger
5. **Financeability :** Ofwat’s financing duty will become critical with the mis-match of revenues and costs
6. **CPI market not developed:** Companies have large financing needs. CPI market is still in infancy

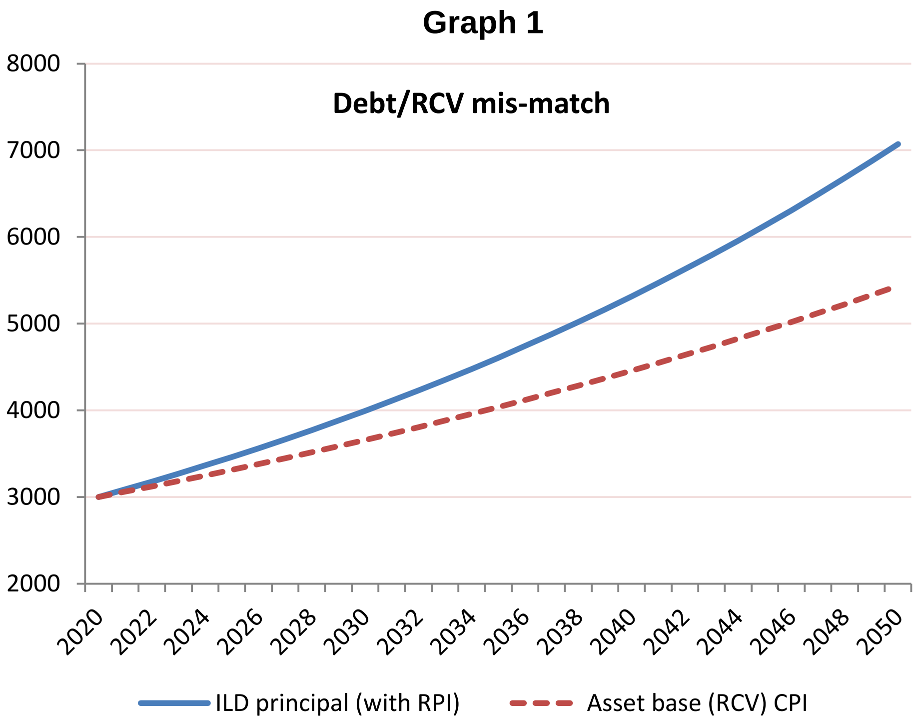
Graphs from Ofwat presentations

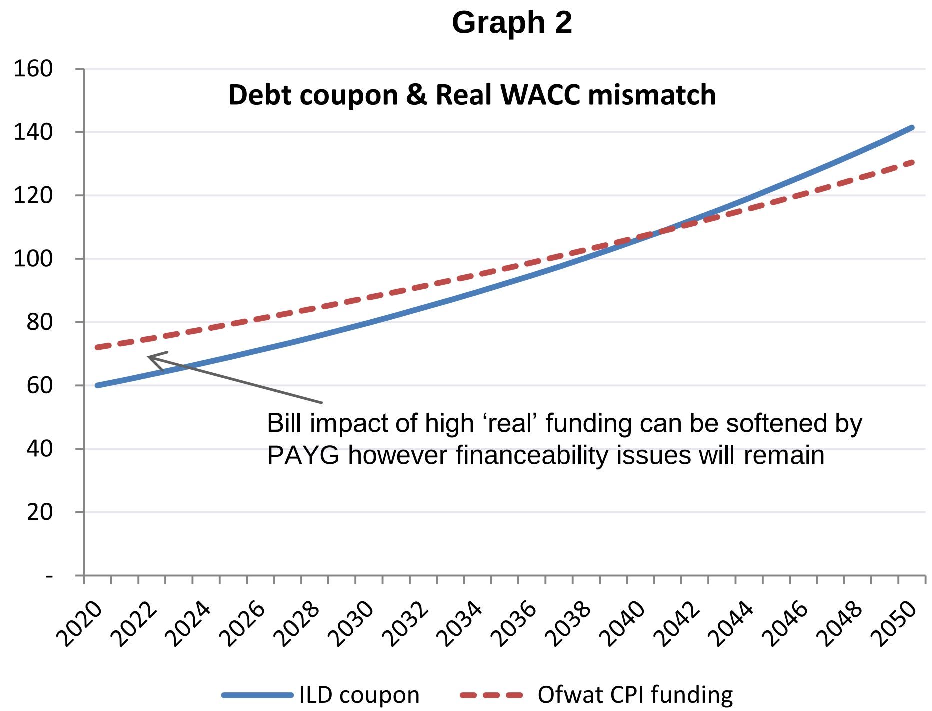




Option 1: RPI linked debt (Cost / funding mismatch)

- **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 – graph 1.
  - Real funding to be higher in early years (CPI-WACC) –graph 2.





Conclusion: Increases customer bills, industry risk, requires expensive hedging

Option 2: Hybrid approach : create new 'CPI-RCV'; let existing RCV depreciate naturally

- Retain current RCV linkage to RPI and allow it to depreciate naturally.
- New 'CPI RCV' is created to make a clear distinction from existing liabilities.
- As existing RCV runs-off, this allows companies a transition period to naturally re-finance RPI liabilities without the need for hedging.
- Regulatory mechanisms can be developed to influence, to an extent, the speed at which old RCV is fully depreciated

Pros

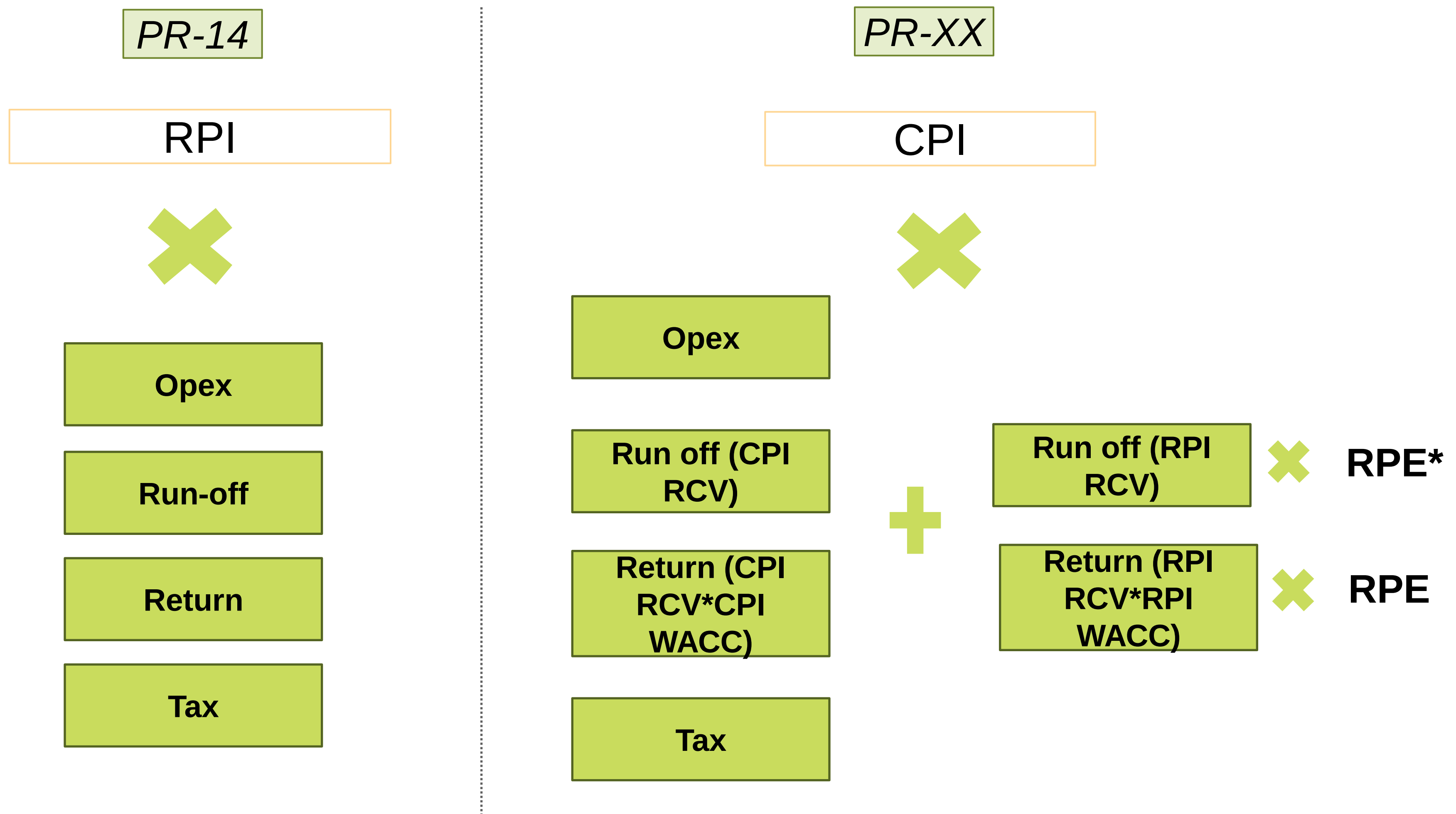
- No spike in customer bills
- No mis-match of revenues & costs
- No hedging needed. Allows time to manage transition in an orderly manner
- Allows time for CPI market to develop
- Simpler to implement than other approaches
    - Same method applies to WASCs and WOC's

Cons

- RPI retained for a period of time

Financial Modelling will reflect both indices over a transition period

Option 2: Financial Modelling of the Building blocks in CPI terms:



- Hybrid approach requires both inflators (RPI and CPI) to be used but charges to be set in CPI only.
- Financial Modelling will reflect an assumed wedge at the time of Determination; an ex-post true-up can take account of the actual gap between RPI and CPI over the amp period. This will be similar to the treatment of COPI in the previous Amps.

* *Relative Price Effect*

4) Comparison of the two methods (impact on key stakeholders):

	Option 1 (full change to CPI)*	Option 2 (Hybrid approach, new CPI RCV)	*Comment*
Customer bills	High	Low	*Impact of high real WACC*
Hedging cost	V High	None	*Very limited market to hedge RPI to CPI*
Regulatory risk	High	Low	*Involves retrospective change to RCV (to CPI)*
Customer and investor value	Low	Low	*Ofwat accept it needs to be neutral over long-term*
Regulatory & Financing complexity	High	Mid	*Notional financeability tests will need to be redrawn*
Future financing needs compliant	High	Low	*CPI market in infancy. Companies need to raise billions.*
Expected rating agency view	High	Low	*Mismatch of liabilities and assets. Fast money to solve bills/ratios.*

If change needs to be 'value neutral' to stakeholders, why choose a method that increases risk?

Other option involving partial change of existing RCV to CPI will have similar short-comings as Option-1

5) Summary

- Given limited market for CPI linked debt, RPI linkage to RCV should be retained.
- If it becomes absolutely necessary, Hybrid approach (create new CPI RCV) should be preferred over a full or partial change to existing RCV.
  - Benefits of maintaining the purity of existing RCV far out-weigh the cost and complexities of apportioning into CPI/RPI

Contacts:

Gagan Gulati

Head of Financial Planning & Analysis

Email: ggulati2@anglianwater.co.uk

Jean Spencer

Director of Regulation

Email: jspencer2@anglianwater.co.uk