CPI Indexation

We do not support Ofwat's proposal to apply CPI indexation to revenues and the RCV, with a transition period involving RPI indexation to 50% of the RCV for 2020-2025.

The indexation of revenues and the Regulatory Capital Value (RCV) to RPI has been a significant feature of the regulatory framework for a considerable time. It is well understood by stakeholders, particularly investors, and therefore any changes need to be applied carefully.

We have examined the Ofwat proposal in detail, and unlike all of the other proposals in the Water 2020 consultation (which we support) we do not support this proposal because we do not believe it will deliver the best outcome for our customers.

Under the Ofwat proposal bills and service levels will remain the same, and whilst bill volatility will be reduced, it will be significantly outweighed by costs associated with:

- **reduced transparency for customers** – companies will need to offset the price impact through the use of PAYG levers. This itself raises issues as Moody's have expressed concerns that continuous use of regulatory levers to offset bill increase could weaken confidence in the regulatory framework effecting credit quality and ultimately increasing the cost of debt;
- **additional risks for companies** – due to the mismatch between costs and revenues which creates basis risk and hedging costs; and
- **increased uncertainty for investors –** because there is only clarity about how indexation will be applied for the 2020-25 period; and because rating agencies do not recognise the use of PAYG (thereby creating risk of downgrades).

We consider that there are better tools available to reduce volatility and create an orderly transition away from the use of RPI – for example indexing old RCV by RPI and new RCV by CPI.

We are particularly concerned about the uncertainty that this proposal creates. In particular:

- there is no clarity about the transition period and instead the proportion of the RCV indexed by RPI would be subject to debate at each price control; and
- there is no certainty about when the alternative debt market for CPI linked debt will materialise. For example none of the three CPI linked debt issues to date are a robust enough benchmarks to indicate an emerging market. The Debt Management Office has stated that it sees no pressing case to issue CPI linked GILTs, widely accepted as the key step to establish a liquid CPI linked market.

This uncertainty comes at a time of significant regulatory change. For example in a 5 year period it is likely that competition will be introduced for (i) non-household retail services; (ii) sludge treatment and disposal; (iii) water resource capacity; and (iv) household retail services. Given the continued need for investment to meet the challenges facing the sector (see Ofwat July consultation), it doesn't make sense to unnecessarily increase uncertainty and risk.

This moves us away from 20+ year interest certainty model to a five year model. This distinction is important because the RCV represents a long term investment – ie, 20-30 plus years. By reducing the time horizon over which investors can see how their investment is remunerated, it undermines confidence in the regulatory framework and raises the cost of attracting new finance.

We think that Ofwat should consider a more structured transition away from RPI. This would involve differentiating between new and old RCV. This would:

- **be cheaper for customers as** it avoids the issues on the cost of debt and gives time for the CPI market to develop; and
- **underpins confidence in the regulatory framework** as historical investments will be remunerated on the basis in which the investments were made;
- **creates a clear transition plan** so investors understand how capital will be treated going forward.

Review of Ofwat proposal

Below we comment on the key aspects of the Ofwat proposal, covering (i) NPV neutrality; (ii) pace of transition; (iii) emergency of CPI linked debt market; and (iv) use of regulatory levers.

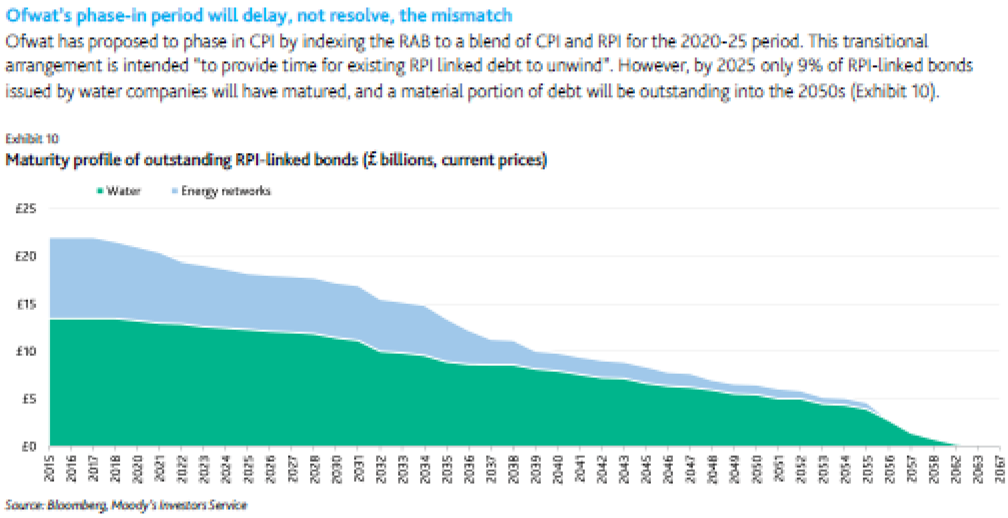
NPV neutrality

NPV neutrality is a key aspiration but it is reasonable for there to be doubt in companies' and investors' minds about the likelihood of actually achieving an NPV-neutral transition to CPI indexation. This is in part due to the technical complexity but also perceived pressure on Ofwat to reduce returns in light of bill increase during transition. We estimate that a 50% move to CPI could lead to a 3-4% increase in customer bills (using the methodology developed by First Economics). In light of the fact the next price review will likely coincide with the next election it is not unreasonable to expect the regulators to be under considerable political pressure to keep bill down.

Pace of transition

The use of RPI linked debt gives companies certainty on their interest cost over the life of the investment in the RCV. While Ofwat's proposal may mitigate some exposure by retaining sufficient RPI linked RCV for the next period there is still uncertainty around the period of transition and impact beyond 2025.

We currently have £1.2bn of index link debt, the fair value premium of the debt in last year's accounts was [£89m] and much of the debt is long dated (85% ending after 2050). While we hold relatively lower levels of index linked debt than some of our industry peers we are would still be likely to face some exposure to basis risk if Ofwat chose to transition over a 3 AMP period. Moody's note on transition to CPI (January 2016) addresses a similar issue. Their analysis indicates that by 2025 only 9% of RPI linked bonds will have matured.



The current Ofwat proposal only gives minimal assurances on how the transition will be managed beyond 2025 **moving us away from 20 year interest certainty model to a five year model at a time of major sector change**.

Emergence of CPI linked debt market

Compounding this issue is the **lack of an established alternative CPI linked debt market**. We note that all of the 3 issuances are below our minimum size (£500m) and have a much shorter duration relative to our debt profile.

The availability and pricing of derivatives is not clear at this stage while the cost of exiting the current debt is prohibitive (as evidenced by the current fair value premium). The issue of hedging basis risk is inexplicitly linked to financing costs, covered in the next section.

The Water UK report by NERA highlights that *"investors expect cost of finance will increase due to increase exposure to* ***basis risk*** *and the absence of a CPI government gilt market. In the short to medium term investors are concerned about the miss-match between the RPI linked debt on companies' balance sheets and a CPI linked RCV, or basis risk, which may need to be hedged. However, investors considered that instruments to hedge CPI risk are imperfect, and would involve higher financing costs. For example, CPI-linked products generally have a substantively shorter duration than the tenor of RPI debt (e.g. up to 5 years), commonly include break clauses, and are higher cost than RPI-linked products."*

New debt is likely to be more expensive due to the loss of access to cheap RPI-linked debt and an inability to substitute to CPI-linked debt. Again referencing the findings of the NERA paper, "*the Debt Management Office has stated that it sees no pressing case for issuance until there is evidence of substantive demand for CPI related products, resolution of uncertainty over the definition of CPI (notably, the treatment of housing costs), and resolution of risks around market fragmentation. The pension markets remain focussed on hedging its RPI linked exposure.*"

We acknowledge an increase in CPI linked liabilities could increase demand in the future but there is little evidence at present. Ofwat's paper recognised there have only been three issuance to date and these have been below £300m benchmark. The absence of CPI index linked GILTs would seem to undermine the assertion that there is large scale pent up demand for CPI linked debt at present.

Use of regulator levers

If the resultant bill increase from CPI indexation of the RCV is not initially affordable and further use of PAYG is required, this could lead to negative perception on the sector due to the increase in complexity. The regulatory model is becoming increasing complex and further manipulation of PAYG / run off rates hinders transparency of returns. We have a concern that continual manipulation of the PAYG and run off rates is not sustainable in the long term.

Rating agency Moody's did not recognise PAYG adjustments included in the Severn Trent Final Determination in their assessment of credit metrics indicating a lack of trust or full comprehension of the purpose of the tools. In their January 2016 note on transition to CPI in the water and energy sector Moody's do recognise that the higher current returns could be credit positive but this is dependent on the price increases being acceptable to customers and that pressure to offset the bill increase could erode confidence in the regulatory framework.

Moody's state "*Use of regulatory levers to offset bill increases could erode confidence in the regulatory framework. By permanently capitalising a larger share of total expenditure, it is possible to protect customers from bill increases. However, if revenue deferrals are imposed on companies such that the "allowed" return can never be realised, our current view of the regulatory framework could be weakened."*

The RCV was invested for 20-30 years i.e. an investment for the long term. Manipulation of this investment using PAYG reduces transparency of the returns on that investment. If 'allowed' returns can never be realised due to deferrals to address affordability the current view of the sector could be weakened.

Our proposal

We propose that RPI should be retained for indexation of the RCV but if RPI is deemed unsustainable a better transition would be to retain RPI for the pre 2020 RCV.

Customer bills: Our proposal would avoid or mitigate the bill impact to a manageable level without the need to use regulatory levers. If PAYG or run off rate adjustments are used to offset the bill increase it creates more complexity and reduced transparency as in effect it remains a RPI based control.

Transition: Under our proposals the transition would be more gradual than the Ofwat proposal and a better match for the maturity profile of existing RPI linked debt.

Financing costs: In the absence of a liquid market for CPI linked debt and instruments we feel our proposed options are more pragmatic. It will enable retention of long term interest stability for legacy investment. New financing requirements for new growth can be made in the context of amended regulatory framework.

Negative perception / credit risk: Our proposal reduces the risk of requirement of use of PAYG or run off rates and impact of transparency and confidence in the regulatory framework.

NPV neutrality: Our proposal would retain more confidence from the investment community.

Volatility and forecastability: Addition volatility of RPI to CPI will create additional volatility in customer bills. The issue of additional volatility of RPI impact on RCV indexation is not material and can be addressed through the existing midnight adjustment to the RCV.

In conclusion

Ofwat's proposal will not deliver benefits to customers however it gives rise to added risk and uncertainty. We propose that RPI should be retained for indexation of the RCV but if RPI is deemed unsustainable a better transition would be to retain RPI for the pre 2020 RCV. This avoids the issues on cost of debt, maintains investor confidence, creates long term certainty and gives more time for alternative finance markets to establish themselves. We reiterate our earlier point our proposal is cleaner and cheaper for customers and better for investors.