



Cost of Capital Conference

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Progress towards PR19 – what we have done and what is still to do?

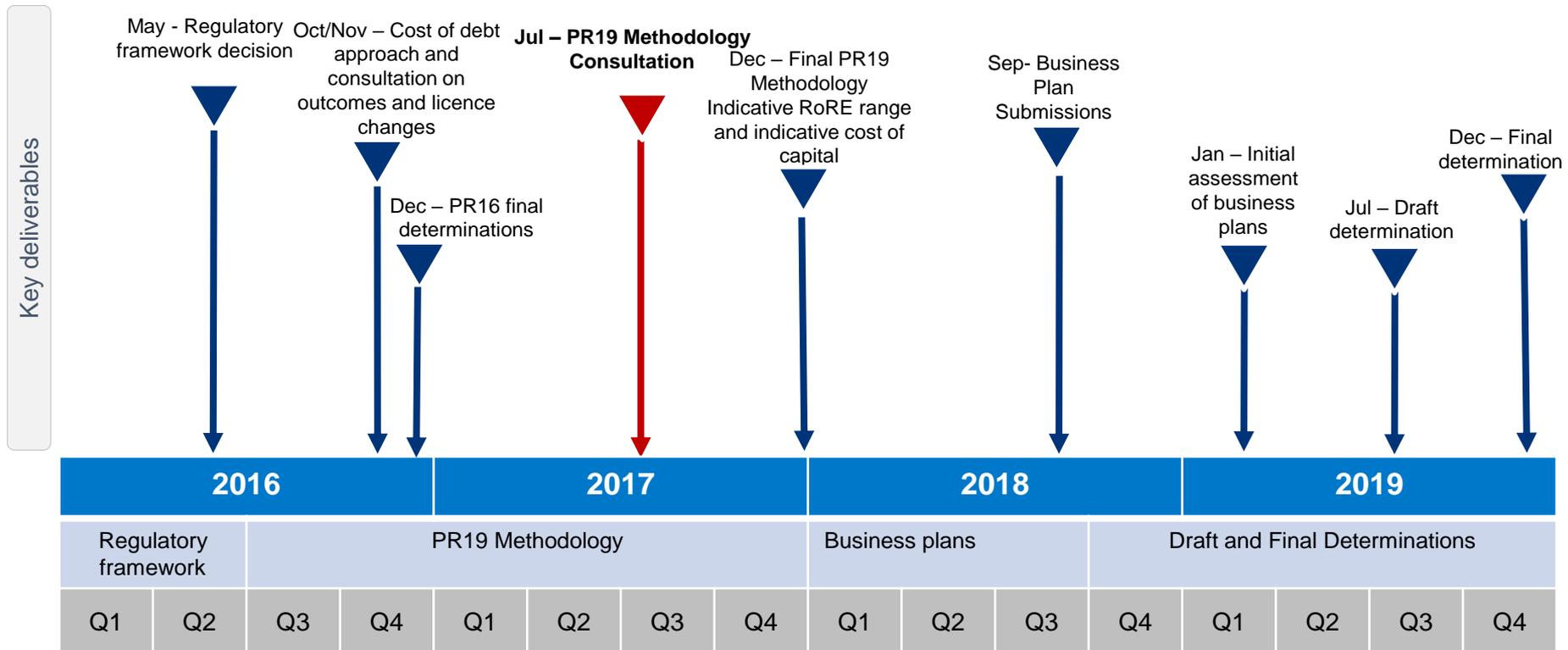
We have already decided some key elements of the regulatory framework

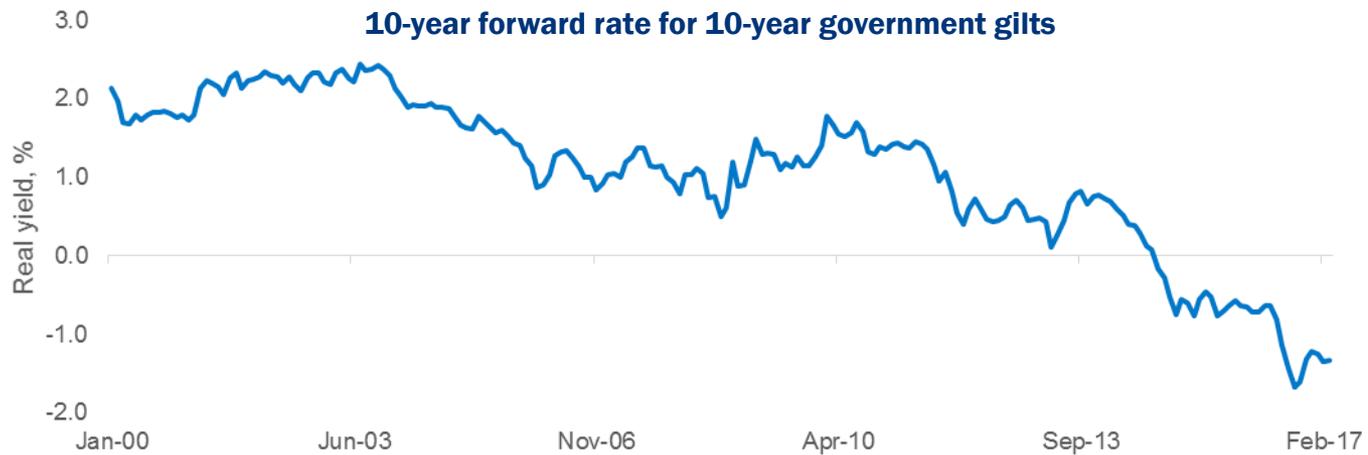
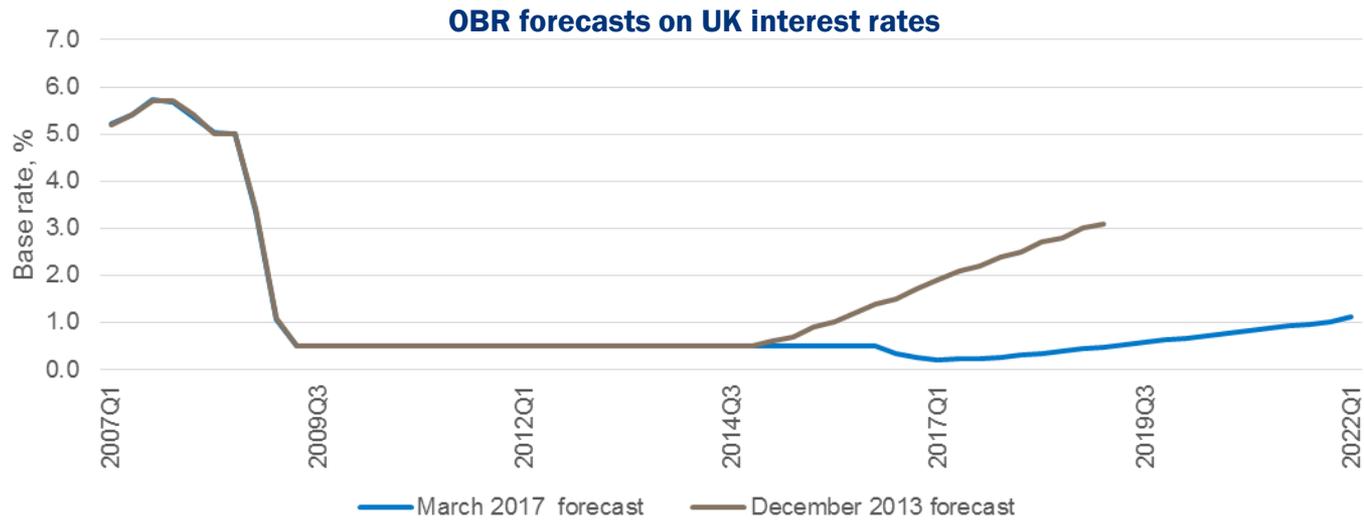
- Strengthened approach to customer engagement and outcomes
- CPI/CPIH indexation of price/revenue controls and the RCV
- Separate binding price controls for water resources and bioresources (and the broad outline of how these controls will operate)
- Information platforms for water resource and bioresource markets
- Greater use of markets in the financing and provision of new assets by third parties (direct procurement for customers)

The PR19 methodology will set out further detail of our regulatory approach.

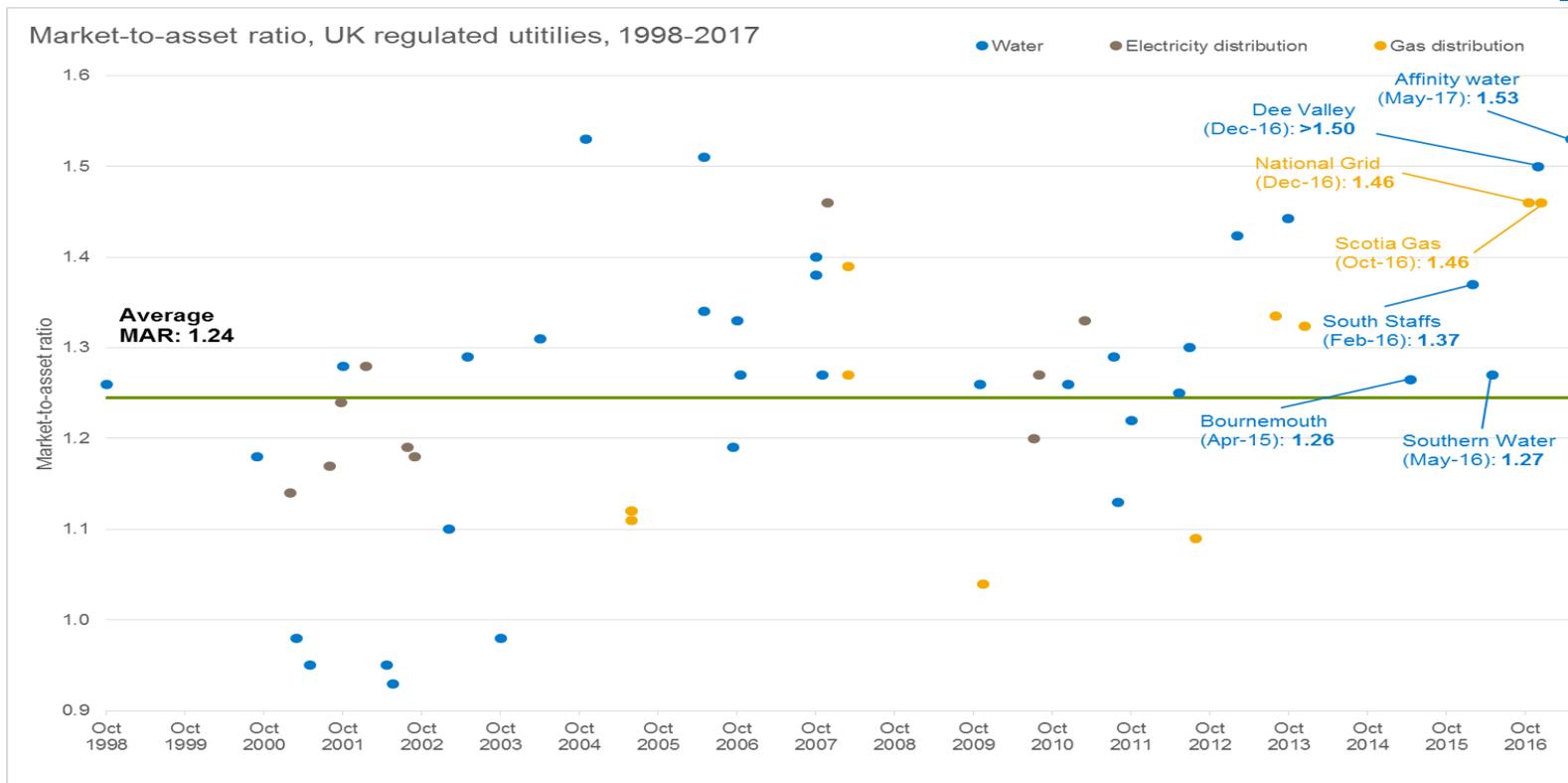
In particular our expectations of what we expect to see in company business plans, how we will assess those business plans and our approach to intervening if companies do not submit good business plans.

This will cover our approach to individual elements of the price control such as affordability, resilience and financeability.





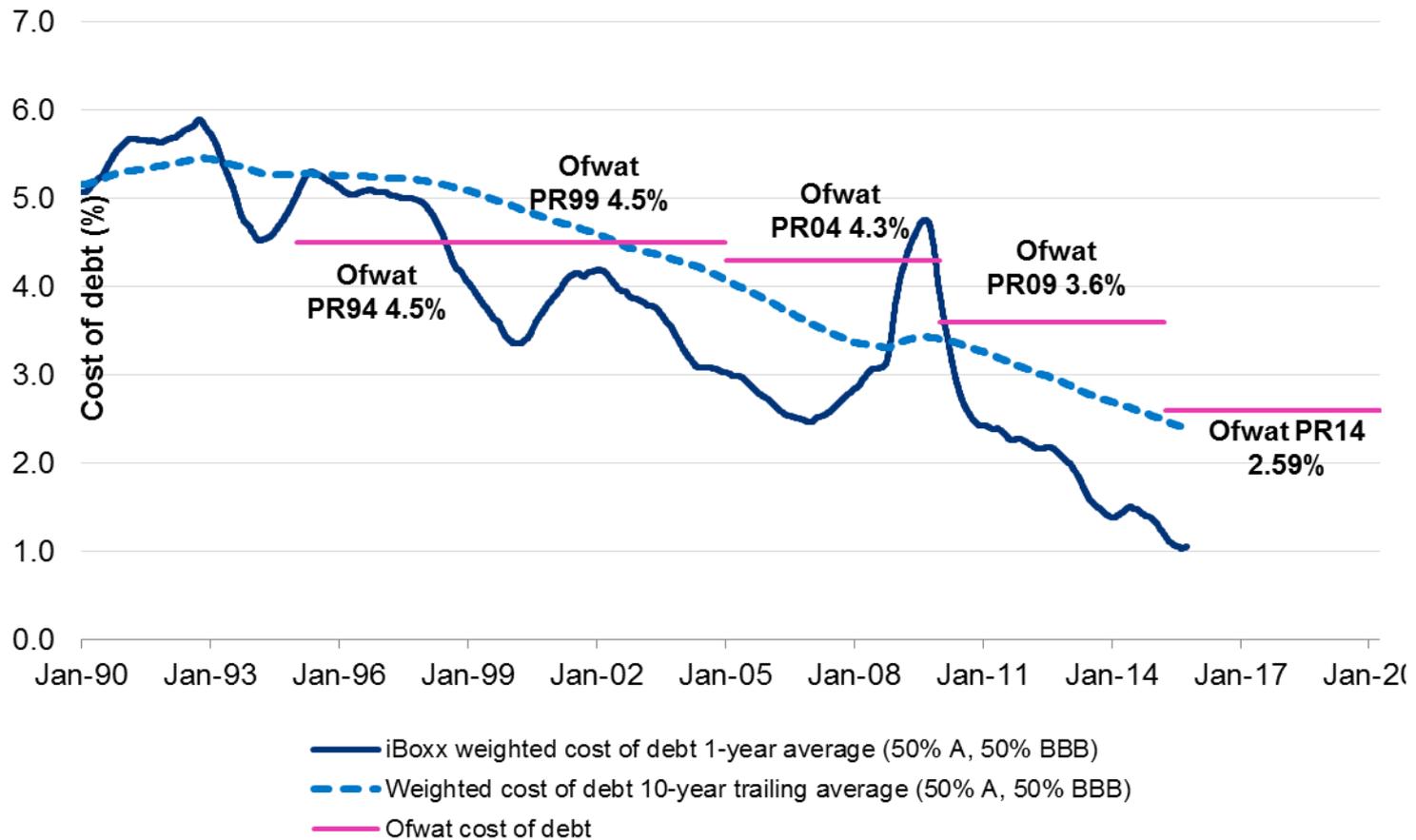
Cost of equity – Market to asset valuations



Analyst quotes:

Credit Suisse: “The challenge for UK utility companies is that capital is oversupplied and returns have fallen to low levels. Whereas c10-20% post-tax nominal equity IRRs were achievable across 2008-13, we think those have now halved in recent years.”

Macquarie: “We estimate baseline RORE at 4% real, in line with our current cost of equity (7% nominal at 62.5% leverage). This would already be the lowest allowed regulated RORE in the UK since privatisation and is lower than the CMA determination of the cost of equity based on long-run beta, risk free and ERP calculations.”



September 2017 consultation

- Considered principle of debt indexation; not detailed mechanics
- Proposed index cost of new debt only; embedded debt set in similar manner to the past
- Preference for end of period true up adjustment
- Debt indexation based on nominal index, adjusted for outturn inflation

Outcome

- Majority of consultation respondents either supported debt indexation, or gave conditional agreement, depending on the detailed mechanics
- Concerns about treatment of inflation

Workshop – January 2017

- Considered possible mechanics of cost of debt mechanism
 - In period vs end of period adjustments
 - Calculation options - debt profile for the notional company, calculation of applicable interest rate
 - Index choice – tenor, options - iBoxx corporate non-financial, iBoxx utilities, Bloomberg, BoAML Corporate / non-gilt
 - Inflation adjustment – outturn, breakeven inflation, Bank of England inflation target
- Takeaway message – simplicity, transparency, legitimacy

Next step – Consultation proposal - July

Managing risk and uncertainty

- All businesses have to deal with risk and uncertainty in operating and planning their activities
- As with PR14, we will apply a high evidential bar where companies propose uncertainty mechanisms at PR19, given the risk mechanisms implicit within the controls

Within a price settlement

1 Use of inflation in price controls

2 5 year price controls

3 Totex cost sharing and special cost factors

4 Outcome Delivery Incentives

5 Revenue true ups

6 Possible mechanisms for tax and cost of debt

All of these reduce companies' exposure to unexpected variations in costs and/or revenues by allowing some of the unexpected variation onto customers through changes in bills

Possible issues for PR19?

National Environment Programme

- Potential issue in regards to timings of development of National Environment Plan
- Both EA and NRW are working with companies to manage issues associated with uncertainty that the different planning cycle brings

Business rates

- Timing of the business rates revaluation in PR14 cycle meant that uncertainty mechanism was created for all companies
- Currently not clear that the level of uncertainty is as great as PR14

Brexit

- The UK will continue to be bound by EU law until it is no longer a member.

CPI or CPIH?

In May 2016 we said we would transition from RPI; companies accepted the licence modification necessary to move away from RPI. We have committed to determine whether the transition will be to CPI or CPIH by January 2018.

Since May 2016 several relevant factors have changed:

- The National Statistician stated intention to work towards designation of CPIH as a National Statistic as early as possible
- CPIH is now the ONS' headline measure of inflation and the focus of its inflation commentary
- The UKSA not yet conferred CPIH as a National Statistic but reconsidered at 25 April Regulation Committee meeting
- Some (limited) issuance of CPI linked debt:
 - £100m by MGT Teesside,
 - £40m in two tranches by U UW and
 - £210m by Banks Renewables

