Cost of Capital Conference

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Introduction

John Earwaker

john_earwaker@first-economics.com

Starting Point for Today's Discussion

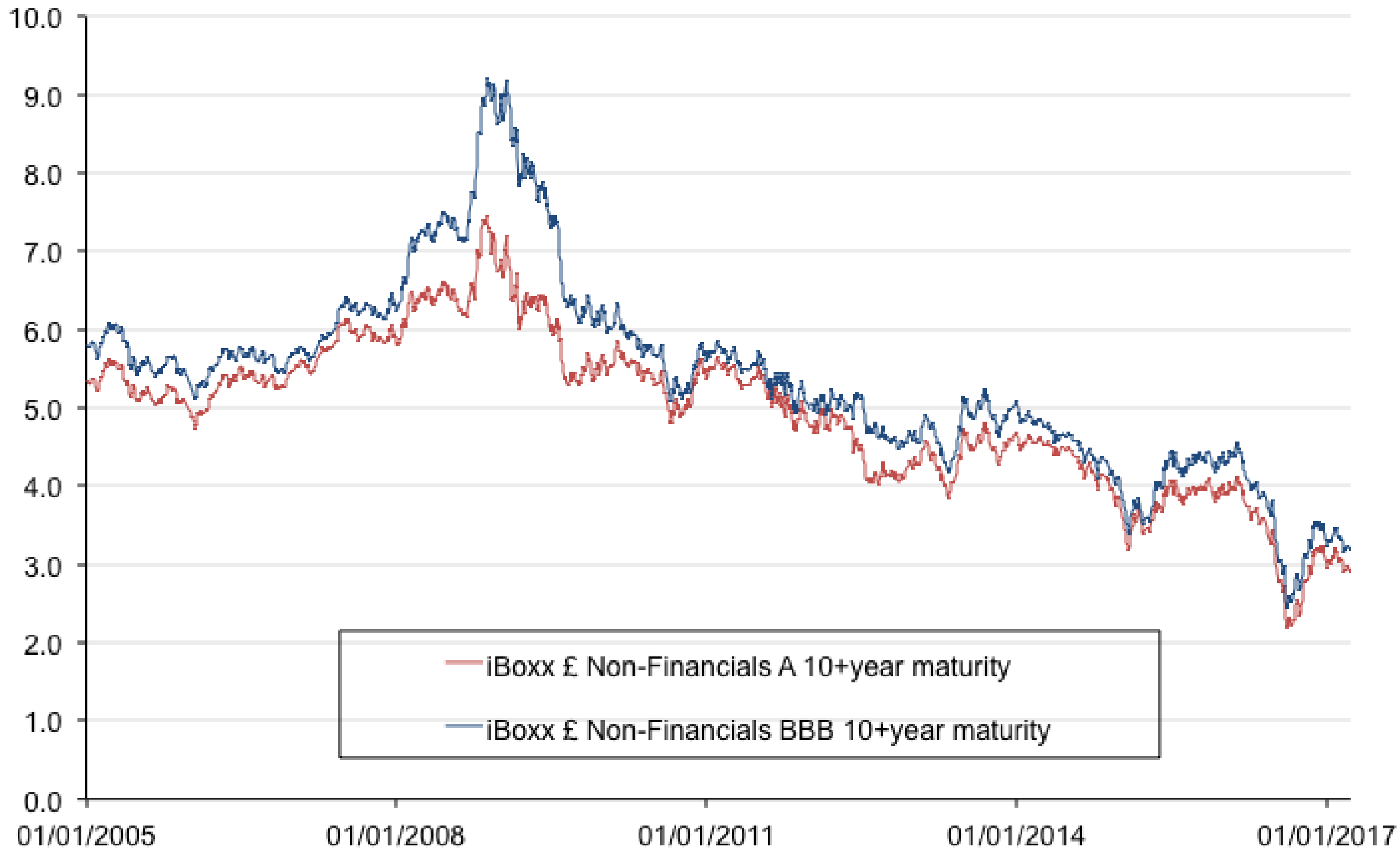
- Allowed costs of capital in the regulated sectors are heading down

$$\text{WACC} =$$

$$g \times K_d + (1 - g) \times K_e$$

- Lower interest rates imply lower allowed returns (see over)

Corporate Bond Yields (%)



Four Key Questions for Discussions

1. Has the cost of equity changed in recent years?
2. How should regulators deal with natural uncertainty about future market conditions?
3. Does it matter if lower returns put pressure on financial ratios?
4. Should regulators be setting RPI-, CPI- or CPIH-stripped rates of return?

Q1: Has the Cost of Equity Changed?

- Regulators have been factoring real, after-RPI total equity market returns of ~6.5% into cost of capital calculations (see over)
- This is equivalent to close to a 10% nominal return
- Have equity investors' expectations shifted down in line with lower interest rates?
- Or are future returns likely to be in line with long-term historical averages?

Expected Market Returns

Equity market return assumptions in recent regulatory reviews (real, after RPI)

Decision	Equity market return assumption	Year
CAA, Heathrow/Gatwick Airports	6.25%	2014
Competition Commission, NIE	6.5%	2014
Ofgem, RIIO-ED1	6.5%	2014
Ofwat, PR14	6.75%	2014
CMA, Bristol Water	6.5%	2015
Ofcom, BT Openreach	6.1%	2016
Utility Regulator, GD17	6.5%	2016

Q2: How to Deal with Market Uncertainty?

- People have not been very good at predicting financial markets
- Is it now obvious that regulators should be adjusting allowed rates of return within period?
- If it is, what are the key design issues?

Q3: What is a ‘financeability’ constraint?

- There is a view that financial ratios / credit ratings put a floor on allowed returns
- Is this right?
- The alternative view is that if ratios and ratings come under pressure, this shows that regulated companies need to finance more of their RABs and/or investment through equity

Q4: RPI or CPI or CPIH ?

- Some of the discussion today will reference the cost of capital in RPI-stripped terms
- Regulators have been signalling a move away from RPI
- Is CPIH or CPI the better alternative?