CEPA

Cost of Capital Conference 2019

The Risk-Free Rate

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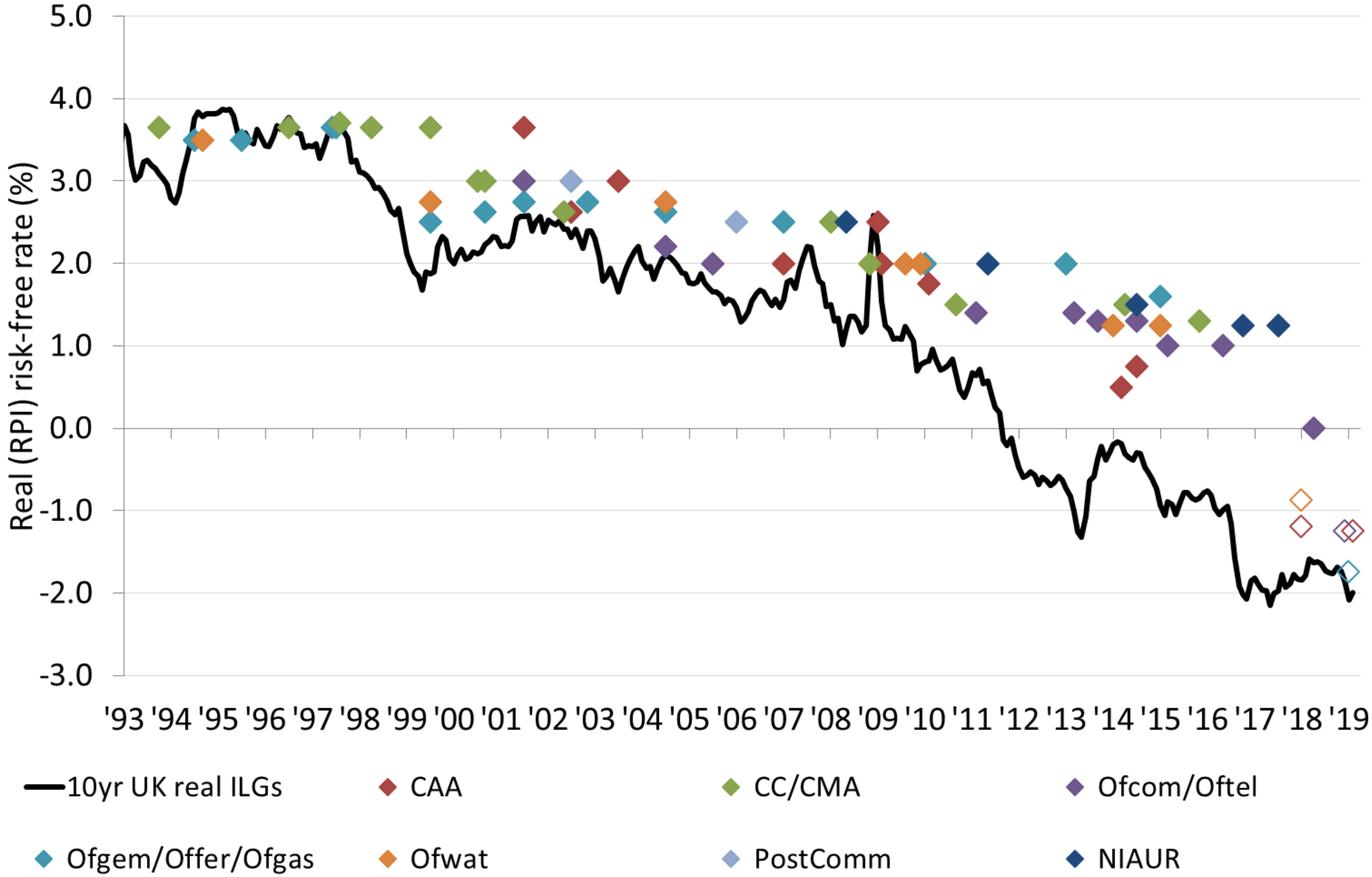
Decisions on the risk-free rate



Note: draft decisions are represented by outlined shapes.

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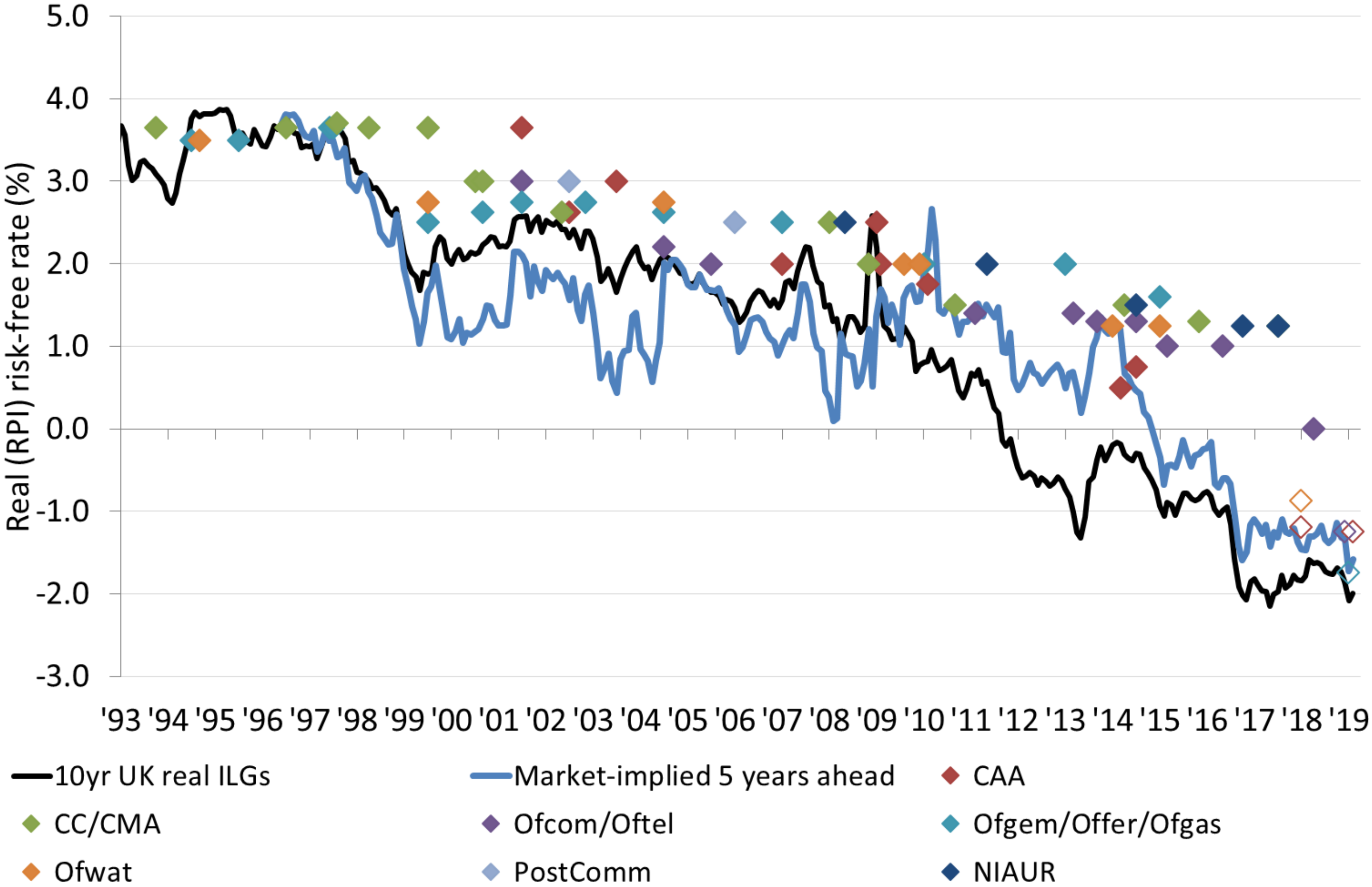

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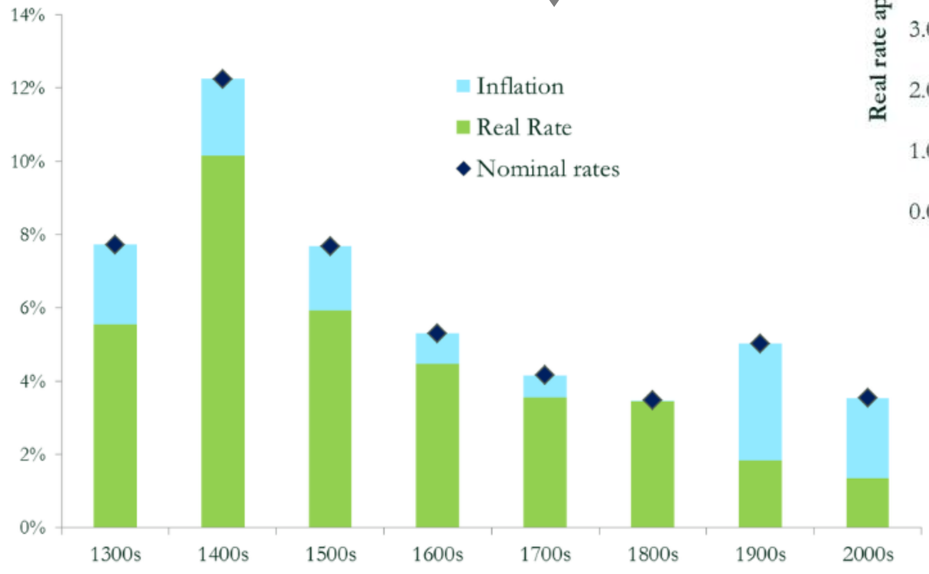
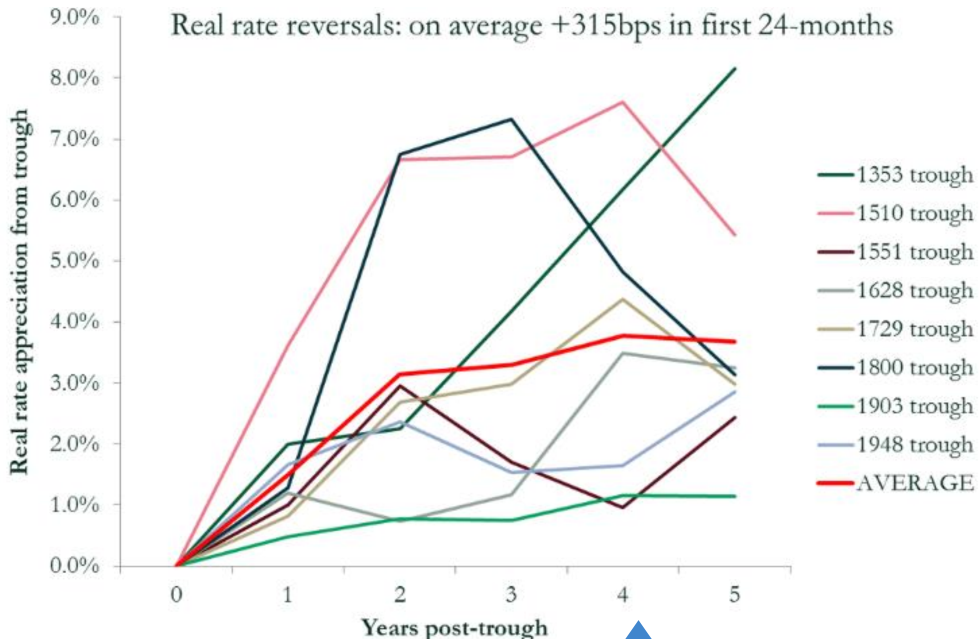
Digression: long-term context

The trend towards lower real risk-free rates is centuries old…





…but real risk-free rate 'troughs' can reverse rapidly and significantly

Source: BOE Staff Working Paper, Paul Schmelzing (2013)

Indexation of the cost of equity

Potential advantages	Challenges
• Releases regulator from an impossible forecasting task: recent annual revenues have been at least **£200m** higher as a result of forecasting error • Aligns trends in cash returns and cash (debt) costs: a **100bps** risk-free rate movement could increase interest cover by around **0.05 points** in a rising market	• Absence of CPI(H)-linked evidence base complicates matters • Require a mechanistic calculation (e.g. timing, reference index) • Cash returns become less predictable • Uncertainty over relationship between RfR and ERP • Evaluation based on steadily falling market?

Risk-free rate accuracy becomes more important with lower beta.