

Cost of Capital Conference

Introduction

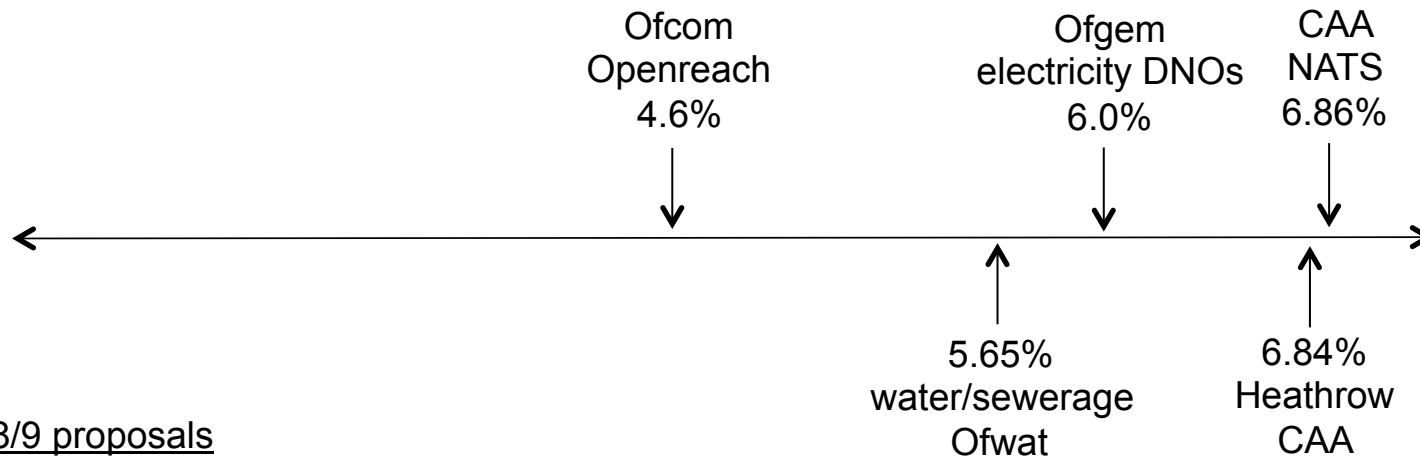
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Thursday 28 February 2019

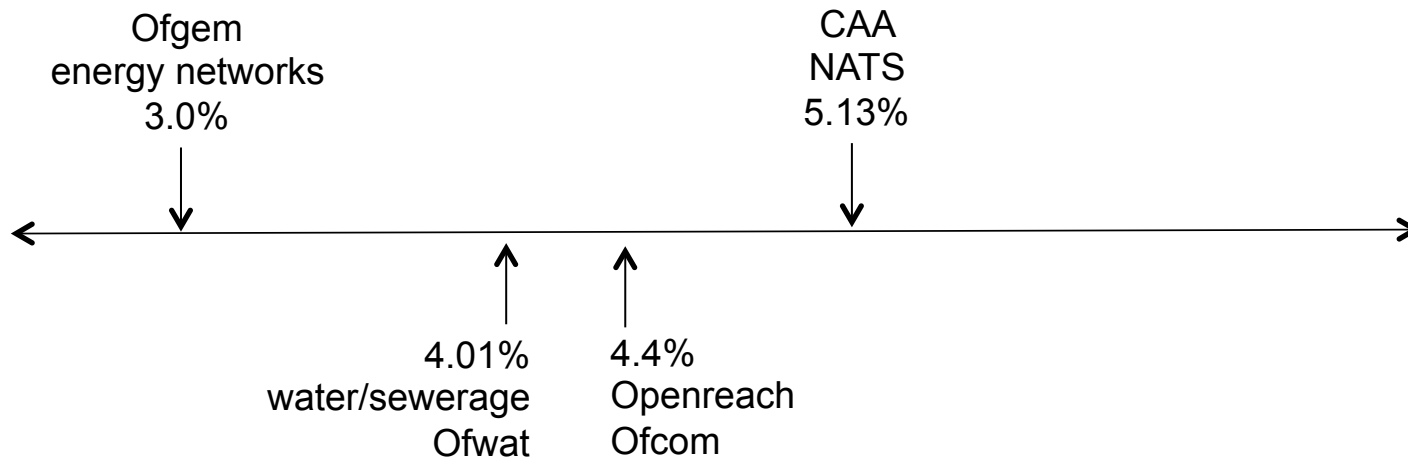
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Allowed Equity Return: Recent Developments

2014 decisions



2017/8/9 proposals



Expected Market Return

RPI-stripped equity market return assumptions

Decision	Expected market return assumption	Year
Competition Commission, NIE	6.5%	2014
CAA, Heathrow	6.25%	2014
CAA, NATS	6.25%	2014
Ofcom, BT	6.1%	2014
Ofgem, RIIO-ED1	6.5%	2014
Ofwat, PR14	6.75%	2014
CMA, Bristol Water	6.5%	2015
Utility Regulator, GD17	6.5%	2016
Utility Regulator, NIE	6.5%	2017

Expected Market Return

RPI-stripped equity market return assumptions (consultation proposals)

Decision	Expected market return assumption	Year
Ofwat, PR19	5.44%	2017
Ofcom, LLCC	5.8%	2018
Ofgem, RIIO-2	5.2% to 5.7%	2018
CAA, NATS	5.40%	2019

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Expected Market Return

- Drivers of a lower expected market return
 - dividend discount model computations
 - a revised understanding/interpretation of historical stock market returns?
 - informal market soundings

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Beta Estimation

- UKRN / Indepen reports have considered
 - econometric methods
 - sampling frequencies
 - estimation horizon
 - re-gearing of asset betas
- Ofgem: 60% debt-to-RAB = 54.5% gearing

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Risk-free Rate

- Real gilt market yields are negative
- Regulators are contemplating the use of a negative real risk-free rate
- What is the best proxy measure?
- Should the risk-free rate be indexed?

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Allowed vs Expected Return

- Wright et al: information asymmetry
- Evidence of recent price control out-performance in some sectors
- Ofgem: set the allowed return 0.5% below the mid-point estimate of the cost of equity