

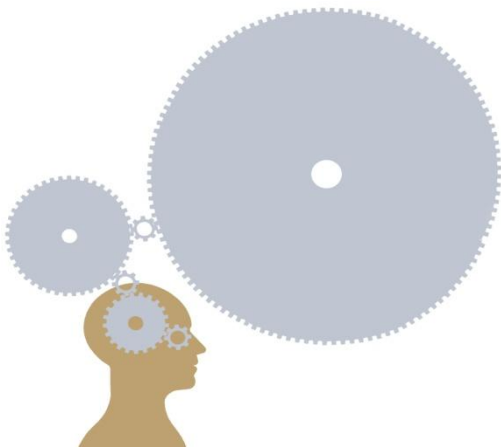
# Cost of equity in RIIO-T1 and RIIO-GD1

Stakeholder workshop on RIIO-T1 and RIIO-GD1

Dr Luis Correia da Silva, Managing Director

Peter Hope, Senior Consultant

November 24th 2010



## Context for the reviews

Financial crisis



Uncertainty about  
the true cost of  
equity for energy  
networks

Lack of data to estimate  
cost of equity



Increasing CAPEX  
requirements



High cost if  
investment incentives  
are insufficient

## Cost of equity in previous reviews

- pre-DPCR5, range of 6.5–7.5% used for cost of equity, based on long-term market equity returns
- criteria determining the point estimate within the range included:
  - DPCR4: ‘investment focus’ of the review
  - TPCR4: equity beta less than 1 (as against implied 1 in DPCR4)
  - GDPCR: risk no lower and could be higher than transmission
- final estimates were in the top half of the starting range—ie, 7–7.5%
  - long-run investment decisions were taken on this basis
- at DPCR5 there was a switch to the bottom half of the range of long-term market returns—point cost of equity of 6.7%
  - no clear risk-based justification for this shift
  - possible interaction with IQI and RORE

## Cost of equity issues for the first RIIO reviews

- longer-duration cash flows
- longer price controls
- more powerful incentivisation of outputs
- indexation of cost of debt
- relatively low risk-free rates combined with relative stability in long-term market equity returns

## Considerations for the initial cost of equity range for T1 and GD1

- longer duration of cash flows will entail more risk
- more high-powered incentives, not least as a result of longer price controls, will entail greater risk
- higher risk implies lower notional gearing
- indexation of the cost of debt will not necessarily reduce risk (see later presentation by WWU)
- low risk-free rates imply higher equity risk premia when overall equity market returns are stable
- the link between cost of equity/WACC and the use of RORE needs to be clearer than it was in DPCR5

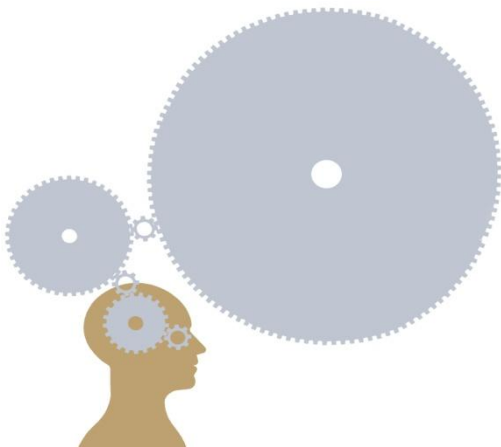
[www.oxera.com](http://www.oxera.com)

Contact:

Luis Correia da Silva

+44 (0) 1865 253 035

[luis.correia@oxera.com](mailto:luis.correia@oxera.com)



Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Company accepts no liability for any actions taken on the basis of its contents.

Oxera Consulting Ltd is not licensed in the conduct of investment business as defined in the Financial Services and Markets Act 2000. Anyone considering a specific investment should consult their own broker or other investment adviser. The Company accepts no liability for any specific investment decision, which must be at the investor's own risk.

© Oxera, 2010. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.