Cost of Capital – Terminology Buster

This terminology buster sets out the definitions of common terms used by regulators when discussing cost of capital and market returns. Its purpose is to provide interested parties with a basic understanding of the terminology used.

Term	Description
Accounting rate of return (ARR)	Accounting rate of return is the ratio of estimated accounting profit of a project to the average investment made in the project. The ARR concept recognises that within a year returns can be reinvested, and therefore earn the WACC by the end of the year.
Bayesian adjustment	A Bayesian adjustment places weight on a beta estimate of 1, i.e. in the absence of a better prior estimate, it makes an assumption that the company faces the same amount of systematic risk as the average firm in the market.
Beta, Asset Beta, Equity Beta	A Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. An Asset Beta is a measure of the inherent systematic riskiness of a business' operations, before allowing for gearing. An Equity Beta is a measure of the systematic riskiness of the return on ordinary shares relative to the market. It allows for the effect of gearing.
Blume adjustment	A Blume adjustment is used to reflect the observed tendency for equity betas to approach the market average over time.
Capital asset pricing model (CAPM)	An economic model that describes the relationship between risk and expected return for securities. The model states that the expected return of a security (or portfolio) is the rate of return on a risk-free security plus a risk premium. The risk premium depends on the volatility of the security compared with the volatility of a representative market portfolio. The CAPM is often used by regulators to calculate the post-tax cost of equity.
Cost of capital	The minimum expected return that providers of capital require to prompt them to invest in or lend to companies, taking into account the risks involved.
Cost of debt	The minimum expected return that providers of debt finance require to prompt them to lend to companies, taking into account the risks involved.
Cost of equity	The minimum expected return that equity investors require to prompt them to invest in companies, taking account the risks involved.
Debt	The financial liability that a company owes at a period in time to providers of debt finance.
Debt premium	A premium over the risk-free rate paid to the holders of debt.
Dimson adjustment	A Dimson adjustment is an adjustment made when calculating a beta using regression analysis, where share price changes lag movements in the market.
Embedded debt	Actual debt in a company's balance sheet.
Equity	The difference between the value of a business's assets and its liabilities. It is the stake in the business held by its shareholders. It is often referred to as ordinary share capital and includes the undistributed profits of the company.
Equity risk	A measure of the expected return, on top of the risk-free rate, that an investor

premium (ERP), or market risk premium (MRP)	would expect when holding the market portfolio. This captures the non-diversifiable risk that is inherent to the market.
Financeability/ financial sustainability	The ability of an efficient company to secure affordable and competitive financing and service its liabilities. i.e. the ability to secure debt that can be re-financed when appropriate and serviced efficiently.
Gearing	A company's debt expressed as a percentage of its total capital. In regulated utilities this is usually calculated as debt as percentage of its RAB. Other common measures include the ratio of debt to (debt plus equity) expressed as a percentage. Gearing can be calculated using wither net debt or gross debt
Indexation	The adjustment of an economic variable so that the variable rises (or falls) in accordance with the rate of inflation (or deflation).
Index-linked return	A return on an investment which is linked to a specific inflation index.
Leverage	See gearing above
Market risk premium	See equity risk premium above
New issue premium (NIP)	The NIP is a premium on the yields on existing debt which reflect the observation that when issuing new debt the issuer might have to offer a slightly higher coupon (yield) than the bonds already in the market.
Nominal rate	The nominal rate is the rate an investor expects to receive including expected inflation.
Notional gearing	An assumed level of gearing which is used by regulators in their assessment of companies, which may differ from companies actual gearing levels.
Pre-tax WACC	The pre-tax WACC is calculated using a pre-tax cost of debt and a pre-tax cost of equity, weighted by gearing. In effect it provides an allowance for corporate tax within allowed returns.
RAB, RAV or RCV	Regulated Asset Base (RAB), also referred to as Regulated Asset Value (RAV) or Regulated Capital Value (RCV). Although definitions may vary between users, the terms are often used interchangeably. The RAB is a regulatory concept used in the calculation of allowed revenue.
Rate of return	The annual income and capital growth from an investment, expressed as a percentage of the investment.
Real rate	The real rate is the rate an investor expects to receive before the impact of inflation.
Return on capital	A financial measure that quantifies how well a company generates returns relative to the capital it has invested in the business.
Risk-free rate	The theoretical rate of return on an investment with zero risk.
Small company premium (SCP)	A premium on the cost of capital that may be allowed to enable small companies to maintain access to the capital markets.
Specific risk	Specific risk is risk associated to a particular security, sector or industry. By diversifying (i.e. holding the market portfolio) investors are able to avoid specific risk.
Systematic risk	The risk inherent to the entire market. It is undiversifiable risk and therefore faced by all investors. The beta captures the extent to which the a security is

	affected by systematic risk
Total market return (TMR)	The total return on the market portfolio over a given period of time which includes all returns including interest, dividends, distributions and capital gains.
Vanilla WACC	The vanilla WACC is calculated using a pre-tax cost of debt and post-tax cost of equity, weighted by gearing.
WACC	Weighted average cost of capital typically estimated as an average of the company's cost of equity and cost of debt weighted by gearing.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and are usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.
Yield to maturity (YTM)	Yield to maturity is the expected rate of return earned by an investor who buys an investment today at the market price. It discount rate at which the sum of all future cash flows from an investment is equal to the price of the investment.