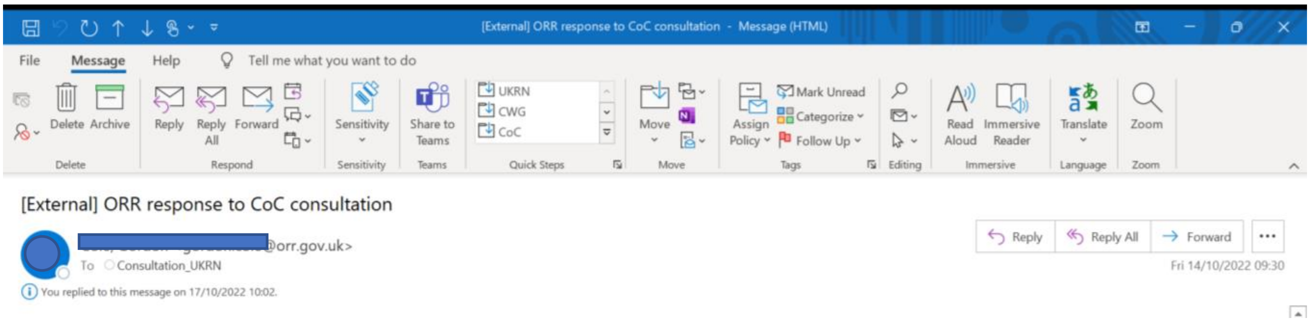

<u>I am responding to the UKRN cost of capital consultation on behalf of the Office of Rail and Road.</u>

Although cost of capital is not a core component of the methods in our periodic reviews of Network Rail and HS1, and our input to Road Investment Strategies, the matters in the UKRN consultation are relevant to our economic regulatory functions. Please find below our responses to the questions and recommendations:

Question 1) Do you agree with the proposed recommendations?
Yes. Please see our responses to the recommendations below.

Question 2) Do you have views on how this guidance could evolve over time, including views on potential issues for further investigation?
We consider that it is good practice to assess the effectiveness of the guidance from time to time. We think that other regulators who are more actively engaged with the UKRN's cost of capital working group are better placed to decide on how frequently the approach should be revisited and what potential issues should be investigated.

Recommendations
Recommendation 1 - Notional company: Regulators should continue to estimate the allowed rate of return in price controls based on the weighted average cost of capital for a notionally financed firm within their sector.
We agree that regulators should continue to adopt this approach unless there is clear evidence as to why it would not be suitable.

Recommendation 2 – CAPM: Since the cost of equity is not directly observable, it must be estimated using a widely accepted method. Regulators should continue to use the capital asset pricing model (CAPM) as their primary approach for estimating the cost of equity.
We agree that CAPM is the best available approach for assessing cost of equity.

Recommendation 3 – Risk-free rate: To estimate the real risk-free rate (RFR) within the CAPM, regulators should use recent yields on the index-linked gilts, with a maturity which matches the assumed investment horizon for their sector.
We agree that this is the most reliable data to assess the risk-free rate.

Recommendation 4 – Equity risk premium: Regulators should estimate the equity risk premium (ERP) within the CAPM as the difference between the total market return (TMR) and the risk-free rate (RFR). We recommend that the TMR should be primarily based on historical ex post and historical ex ante evidence.
We agree that this is the best available approach.

Recommendation 5 – Equity beta: Regulators should estimate equity beta for the notional company using comparable listed companies and standard regression techniques (i.e. ordinary least squares).

Where the listed comparator has different gearing to the notional company, regulators should continue to de-lever and re-lever the raw equity beta.
We agree that this is the best available approach.

Recommendation 6 – CAPM point estimate: The RFR, TMR and (re-levered) equity beta assumptions should be combined using the CAPM to produce a cost of equity range. The mid-point of the range should be used as the central estimate for the CAPM cost of equity.
We agree that this is the best available approach.

Recommendation 7 – Cross-checks: Regulators should only deviate from the mid-point of the CAPM cost of equity range if there are strong reasons to do so.
We agree that this is the best available approach, essentially that there should be a 'comply or explain' approach.

Recommendation 8 – Cost of debt: Regulators should estimate an allowance for an efficient company under the notional financial structure, with actual debt costs suitably benchmarked against other market evidence.
We agree that this is the best available approach.

Recommendation 9 – Gearing: The notional gearing assumption should reflect the balance of risks facing the regulated company and a wide range of benchmarks on gearing levels, not just that of the actual company (or companies) in question.
We agree that this is the best available approach.

[redacted]

[redacted]

25 Cabot Square, London, E14 4QZ
orr.gov.uk | Follow us @railandroad

ORR protects the interests of rail and road users, improving the safety, value and performance of railways and roads today and in the future.