# Appendix A: Guidance Consultation Issues and Taskforce Response

| GENERAL COMMENTS | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Guidance should be binding | Respondents argued that the guidance gives too much discretion and should be binding on all economic regulators (including CAA and ORR). | CCW, TMS, WaterUK, SGN | The guidance cannot be binding because it does not supersede legislation enacting regulatory powers and governance structures (e.g. boards). However, ORR and UREGNI have agreed to have due regard to the guidance in their future decisions, and the CAA will review this guidance in future with a view to assessing whether to do likewise. | Yes |
| Unclear role for guidance at CMA appeals | Respondents noted that it was unclear how the CMA would use such guidance and that this ought to be set out.<br>Some respondents (CCW) argued the CMA should adopt this guidance in its appeals. | CCW, WaterUK | The CMA has confirmed its expectation that the independent groups of decision-makers which it convenes to make decisions on regulatory appeals will have due regard to the guidance, alongside the other evidence and submissions received, and taking into account the relevant standard of review and legal grounds in a particular appeal. | Yes |
| Guidance should reflect principles from CMA PR19 redetermination. | Respondents argued that the PR19 redetermination decisions were undertaken on a more authoritative basis (i.e. 'best decision', rather than 'not wrong'), and so should carry more weight than the RIIO-2 decisions.<br><br>GIIA suggested regulators could simply do a data roll-forward of the PR19 CMA approach. | WaterUK , ENA, GIIA | The taskforce considers that the guidance should not be informed solely by a single panel's decision focusing on one sector and should instead consider a range of evidence, including new evidence in future. It agrees with the conclusion of the CMA panel in the RIIO-2 appeals that the decision in the PR19 water appeals did not set down the unquestionable methodological best practice that must automatically be applied in future regulatory determinations. | Yes |

| GENERAL COMMENTS | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Perceived overlap of recommendations 6 and 7. | WaterUK argued that recommendations 6 and 7 were saying something similar and could be merged into one. | WaterUK | The recommendations provide substantively different guidance. Recommendation 6 sets out the basis on which the cost of equity parameters should be combined from which to select a mid-point. Recommendation 7 states that regulators may use cross-checks to sense check the CAPM-derived point estimate, whilst advising that deviations from the midpoint of the CAPM must only occur if there are strong reasons for doing so. Recommendation 7 has been slightly redrafted to provide additional clarity | Yes |
| Frequency with which guidance is updated. | Responses proposed different periodic review frequencies:<br>- WaterUK said 6-10 years<br>- SGN said every 2 years | WaterUK, SGN | Regulators judge that there is to be limited benefit of constraining such updates to a review timetable that is predetermined at this point in time, but will signal in the annual Cost of Capital update whether updates are planned for the following year. | Yes |
| Process for reflecting and responding to company/investor views. | SGN argued that the document was not very 'in-depth' on reasoning for its recommendations. It proposed the UKRN should reflect company and investor views in the guidance and consult every 2 years, with clear process for responding to comments. It also suggested companies/investors should have a process for raising developments in markets and/or corporate finance theory. | SGN | The taskforce assess that stakeholders have had a chance to feed into the development of the guidance, and their views have been adequately considered.<br>There are some differences in approach across regulators due to interpretation of evidence and statutory duties – where these differences arise, they are set out in the guidance.<br>The guidance will continue to evolve and the regulators will continue to seek stakeholder views as they iterate it. | No |

| RISK-FREE RATE | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Convenience yield | Companies/investors argue that ILG yields understate the true risk-free rate and regulators should add an uplift for the ‘convenience yield’ or use a wider basket of proxies (especially AAA-rated corporate bonds).<br>- ENA suggests 50-100bps is the relevant uplift to reflect the convenience yield.<br>- Citizens’ Advice supported using unadjusted ILG yields. | UUW, WaterUK, ENA, Citizens Advice | The guidance document has been updated to reflect this issue. The taskforce agrees that the convenience yield is not a well-established topic in economic regulation, and note that there is extremely limited empirical analysis of the convenience yield in UK Gilts – particularly index-linked gilts at the 10-20 year horizon typically used by regulators for cost of equity estimation using the CAPM. For this reason the taskforce does not propose alignment to a particular stance, while noting this as an area that may benefit from further work. | Yes |
| Use of SONIA | ENA argued regulators should not use SONIA as a RFR proxy, in particular arguing that SONIA was just a noisier and more distorted version of the gilts curve. | ENA | The guidance has been amended to state the view of the taskforce that, despite the drawbacks of non-ILG RFR proxies (including SONIA), regulators agree that nearly any risk-free proxy stripped of accurately-measured risk premia should give a value close to the 'true' risk-free rate. In relation to term SONIA specifically, the Bank of England has assessed it to be a 'nearly risk-free rate' and that it is deep liquid and transparent at maturities of up to 50 years. This suggests that the rate of term SONIA (and potentially, other proxies) could provide a useful sense check to the ILG rate in times of ILG market volatility or to help define the range within which the point estimate for the risk-free rate should be drawn. | Yes |

| RISK-FREE RATE | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Risk-free (RPI-CPI(H) wedge) | ENA argued that regulators should not assume a zero wedge post 2030 but assume the same wedge for this period between now and 2030. | ENA | The taskforce continues to consider that the UKSA's proposed 2030 RPI reform will need to be carefully considered by regulators using inflation assumptions to convert index-linked gilts to a CPI or CPIH basis. Using the historically-derived long-term RPI-CPI 'wedge' prior to the UKSA announcement would not be correct, as following the planned UKSA reforms the wedge between RPI and CPIH will be zero as they will be calculated in an identical manner. | No |
| Indexation | National Grid argued that the guidance should support indexation given how uncertain interest rates have been recently. | National Grid | The taskforce agrees that indexation is one way of mitigating forecast error. It considers that the decision on whether to index the RFR component of the cost of equity should remain with each regulator, given the interactions with the other elements of the price control methodology. | Yes |

| TOTAL MARKET RETURN | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Weight placed on the 'Ex-ante' approach to estimating TMR | Respondents were divided:<br>- UUW, and ENA argued for less weight on the 'ex-ante' approach due to its reliance on subjective assumptions.<br>- WaterUK argued for placing weight on both the ex-ante and ex-post analysis.<br>- National Grid argued regulators should just use 'ex post' approaches. | UUW, WaterUK, ENA, National Grid | The taskforce continues to consider that regulators should draw on ex-ante as well as ex-post approaches to estimating TMR. Ex-ante approaches are well established and have featured in multiple regulatory determinations and CMA redeterminations. They are also supported by the extensive academic literature to support the view that ex-post equity returns over the past 120 years were not expected by investors (the 'Equity Premium Puzzle'), and by Dimson, Marsh and Staunton, curators of the equity return dataset used by all regulators to set ex-post and ex-ante TMR. The taskforce considers that a degree of subjectivity is inherent to all approaches (including ex-post), and that this should not therefore disqualify ex-ante approaches. | No |
| Measure of inflation used to deflate historical equity returns | Respondents were divided on which historical source of inflation to use:<br>- National Grid and UUW favoured the use of historical CPIH.<br>- WaterUK and ENA favoured weight on CPIH and RPI, but more on the former.<br>- National Grid argued that the use of the CED within the updated 2022 composite CPIH series understates TMR. | National Grid, UUW, WaterUK, ENA | The taskforce considers that the use of a composite CPI or CPIH series (i.e. including backcast data) is likely to be preferable to relying on RPI. This is as RPI is flawed, upwardly-biased and inconsistent as an inflation measure, and both the 2015 Johnson Review and the UKSA have urged government bodies to stop using it. Finally, RPI is unlikely to be relevant to the market's expectation of forward-looking real returns over a 10-20 year investment horizon, given the UKSA's proposal to bring the data and methods of CPIH into RPI from 2030 onwards. | No |
| Definition of TMR | Citizens' Advice argued that regulators were wrongly using a basket of equities when they should be using the average return in the economy across all assets. Given this would involve debt, the use of equity indices gives upward-biased estimates. | Citizens' Advice | The taskforce agrees that, in principle, the TMR should be the average return across all financial instruments, including debt, derivatives, etc. This would however be impractical to calculate due to the requirement to gather accurate returns data on such a wide range of assets, as alluded to in the PR19 and RIIO-2 appeals. For this reason the guidance recommends retaining the approach of relying on the return on a broad index of equities to inform the ex-post and ex-ante TMR. | No |

| TOTAL MARKET RETURN | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Ex-post estimators | WaterUK argued that regulators should place weight on the 'non-overlapping arithmetic estimator', following the CMA PR19 panel's decision. | WaterUK | The taskforce notes that the non-overlapping estimator typically leads to estimates that are volatile year-on-year due to small sample sizes. It asserts that regulators may use both approaches, while recognising that there remains a role for judgment in interpreting the data and deriving a range for the historical ex post evidence. | Yes |
| Reversal of 'lower for longer' | Respondents argued that the reversal of 'lower for longer' interest rate environment used to justify lower TMR should logically mean higher TMR now that rates are higher. | UUW, National Grid | While noting there is some evidence of a correlation between TMR and the risk-free rate evident in historical data, the taskforce continues to consider that the most transparent and defensible way of estimating TMR for regulatory purposes is to draw primarily on ex-post and ex-ante approaches. Regulators are able to use more recent market data to cross-check their CAPM-derived cost of equity estimate, which provides a safeguard against long-run historical approaches becoming too decoupled from the market return requirement implied by more recent data. | No |
| Link between RFR and TMR | GIIA argued that TMR estimation should reflect the sensitivity of regulated asset prices to changes in RFR – recent rises saw big falls in stock prices (implying higher yields). | GIIA | The taskforce notes the long-standing practice of using total return (i.e. capital growth plus dividend) as the metric for informing TMR, rather than yield. Whilst agreeing that regulated utility share prices may respond to short-term interest rate movements, the taskforce considers that market-based cross checks such as Market-to-Asset Ratio (MAR) analysis constitute a more robust basis for sense checking the CAPM cost of equity, as opposed to projecting forward any estimated relationship between TMR and interest rates. | No |

| TOTAL MARKET RETURN | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Stability of TMR | SWB argued the guidance should recognise desirability of stability in TMR between control periods to promote a long-run focus | SWB | The guidance states that in recent determinations UK regulators have estimated TMR directly (as opposed to calculating it based on an estimate of the risk-free rate and equity risk premium). While noting that Australian and European regulators adopt the latter approach, the taskforce considers that, in terms of consistency over time and between the UK sectors, continuing with this approach is preferable. | No |

| EQUITY BETA | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Length of estimation period for equity beta | Responses varied:<br>- UUW argued for regulators having some discretion over the form of beta used to account for changing market conditions.<br>- WaterUK argued that the estimation period should be aligned with the CAPM horizon (i.e long: 15-20yrs)<br>- ENA argued data should be sufficiently representative and frequent. | UUW, WaterUK, ENA | The taskforce agrees that varying sector-specific characteristics and data availability issues make it important to not fetter the discretion of regulators in this area. This guidance accordingly states that length of estimation window and data frequency should be a matter for regulatory judgment. | Yes |
| Gearing and de-gearing | Respondents supported the standard (Harris-Pringle) approach to de- and re-gearing.<br>- WaterUK and National Grid did not support using market value gearing as estimates were too volatile<br>- Water UK argued guidance should specifically recommend "'using the established Harris-Pringle approach" and book value debt. | UUW, WaterUK | The taskforce agree that the Harris-Pringle formula is a well-established way of unlevering raw beta data, and currently supports that regulators should be free to use this formula in future. Data availability for market value debt is more limited than for book value, but the Taskforce continue to consider that it is reasonable to consider market value in cross-checking the re-levered beta which is based on book values. | No |

| EQUITY BETA | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Backsolving debt beta | Respondents were opposed to backsolving debt beta based on the figure that makes the forward-looking WACC invariant to notional gearing. | WaterUK, National Grid | The taskforce does not propose that debt beta should be chosen to keep the WACC constant, however it notes the issues around de- and re-levering beta identified by Wright and Mason in the 2021 report 'A report on financial resilience, gearing and price controls'. The authors note that regulators have typically assume debt beta is small and constant – and that this drives a WACC that is sensitive to gearing, contradicting the Modigliani-Miller capital irrelevance theorem that underpins the Harris-Pringle formula itself. Furthermore, differences in notional and actual gearing can give rise to implausibly large changes in the cost of equity. Regulators identify this as an area that may benefit from further work to better reflect the impact of gearing on return required. | Yes |
| Reflecting Covid-19 affected data | WaterUK argued that the guidance should provide an indicative range for the weight the pandemic-affected period should have in the overall beta estimate, to ensure it is not overweighted. | WaterUK | The taskforce notes that the impact of large-scale systematic risk events will vary by sector depending on the form of the control. For instance, UK airports were particularly affected by the Covid-19 pandemic due to being exposed to demand risk, whereas water networks are protected from demand fluctuations through having a revenue control. This suggests a 'one-size-fits-all' approach for regulators is not appropriate, and regulators must be free to exercise their judgment in a manner best suiting the prevailing circumstances. | No |
| Beta 'aim up' | ENA alluded to evidence that the CAPM tends to underestimate the return on equity of stocks with a beta <1, and so regulators should pick in the upper end of the beta range. | ENA | The taskforce recognises the academic literature devoted to testing the empirical fit of the CAPM to data, which recognises that the CAPM imperfectly predicts returns. It nonetheless considers the CAPM should be the primary model for allowed return estimation, on account of its widespread acceptance and use in financial and regulatory contexts, and its implementability as a model. On balance, the taskforce consider that the use of market-based cross-checks are sufficient to ensure that using the CAPM to inform the allowed return on equity does not result in a figure excessively out of line with market expectations. | No |

| EQUITY BETA | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| What to do if no 'pure play' comparator | BT considered the guidance should deal with the scenario relevant to them of their regulator not having a 'pure play' comparator to derive beta estimates. | BT | The guidance clarifies that the beta from listed comparators may have to be adjusted if their characteristics or circumstances are materially different to those of the notional company. | Yes |
| Operational gearing | BT considered the guidance should refer to operational gearing (high share of fixed to variable costs) | BT | The guidance clarifies that regulators may need to consider operational gearing in specific, limited circumstances, as an additional driver of beta regulators may need to consider when de- and re-levering. This is more likely to be relevant in sectors where companies are exposed to demand risk. | Yes |
| Biases in the standard regulatory approach | Citizens' Advice argued that regulators should correct biases in the standard regulatory approach to beta estimation:<br>- They should not place weight on short-run betas, given the bias from index investing<br>- They should use world betas in the regression, which exhibit lower correlation with water stock returns | Citizens' Advice | While noting Citizens Advice's views on index investing and its potential upward bias on shorter-term (e.g. 2 year) betas, the Taskforce consider that more research is needed to quantify the size of this distortion, before considering whether it justifies excluding betas with shorter estimation windows.<br><br>The guidance clarifies that using World betas would in practice be beset with difficulties, such as identifying the appropriate World Index and proxy for the World risk-free rate, and controlling for exchange rate effects. The taskforce therefore continues to endorse the long-standing regulatory approach of estimating betas from the markets in which the regulated companies operate and markets from which the estimates of the risk-free rate and total market return are derived. | Yes |
| Limitations of historic betas | GIIA argued that if regulators are lowering gearing due to higher future risk, historical betas may understate future betas | GIIA | The guidance has been amended to note that the use of historical data to set beta offers an approach to the setting of beta that is transparent and which can be replicated. Betas are forward-looking as share prices embed investor expectations about the future, and so expectations of future risk should be reflected in the CAPM estimate of the allowed return on equity. To the extent that this capturing of future risk is only partial, the future period affected will over time come to be included in | Yes |

| EQUITY BETA | | | | |
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| | | | the estimation window, and so will be reflected in the allowed return. Regulatory judgement will be important to calibrate the length of estimation window needed to derive a beta estimate that is reflective of systematic risk in the ensuing control period. | |
| Unique Sector Risk | SGN argued there is limited scope for standardisation here; guidance should recognise that unique risks must be assessed and accounted for, and in particular asset stranding risk from electrification to achieve net zero. | SGN | The taskforce agrees that sector-specific risks are a relevant consideration for regulators when setting allowed revenues, but does not consider that reflecting these risks requires a change to the draft guidance. Regulators will continue to reflect sector-specific risk when using the CAPM, to the extent that it is embedded in the betas of sector companies. Where it is necessary to rely on comparators from other sectors, the guidance already provides for regulatory judgement to be employed in reflecting the relative business risk between the sectors. | No |

| COST OF EQUITY: CHOOSING A POINT ESTIMATE AND CROSS-CHECKS | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Cross-checks drawn from the margin between the cost of debt and the cost of equity. | Respondents argued that the margin between the cost of new debt and the cost of equity in recent regulatory decisions was unrealistically low given the higher risks faced by equity investors.<br>- ENA proposed the use of Oxera's ARP-DRP analysis to cross check the CAPM CoE.<br>- GIIA suggested regulators should revert to using the upper bound CoE from ranges to reflect this | ANH, UUW, ENA, GIIA | While recognising the principle that equity bears more risk than debt and so should normally receive a higher return, the Taskforce considers that it would not be appropriate to use historical relationships between the two rates as a cross-check. In particular, comparisons may be misleading if they compare a regulatory cost of equity founded on a long-run average 'through-the-cycle' TMR with cost of new debt based on recent data, or do not control for changes in inflation expectations over time. The taskforce notes (in common with the PR19 and RIIO-2 CMA panels) that ARP-DRP analysis is not a useful cross-check as it presupposes the CAPM inputs which the exercise purports to sense check. | Yes |
| MAR analysis is unreliable as a cross-check. | Respondents argued that MAR analysis is too unreliable to be used as a cross check to the allowed return on equity, as confounding factors cannot reliably be stripped out. It was argued that the use of recent market data can give volatile estimates due to fluctuating market valuations | UUW, WaterUK, ENA | The taskforce agrees that MAR evidence requires careful judgment, but assess that uncertainty from confounding factors can be addressed through presenting implied cost of equity results as ranged estimates. Regulators should consider MARs data over a suitably long period (e.g. several months) – or several transactions if focusing on unlisted equity - to gain assurance that conclusions are not overly influenced by transient volatility in share prices. | Yes |
| Regulators should aim up. | Respondents argued regulators should aim up due to uncertainty around CAPM estimates, because of the relatively more damaging risk of sub-optimal levels of investment, asymmetric incentives, and financeability.<br>- WaterUK suggested a default 10-20bps from the central CAPM estimate, with further | UUW, WaterUK, ENA, National Grid, GIIA, | The taskforce was not convinced that responses added material new evidence or argumentation to warrant departing from the approach set out in the draft guidance.<br>As customers ultimately bear the cost of any aiming up adjustment, regulators agree there must be clear and convincing evidence to support that this is in their best interests. Regulators agree that any decision to aim up | No |

| COST OF EQUITY: CHOOSING A POINT ESTIMATE AND CROSS-CHECKS | | | | |
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| **Issue:** | **Description of issue** | **Raised by:** | **Response:** | **Guidance change?** |
| | adjustment possible following the application of a framework for assessing the needs case.<br>- Citizens' Advice agreed with our recommendation to pick a central CAPM estimate and to have a high bar for deviating from this. | Citizens' Advice | must be justified on a case-by-case basis by an assessment of the extent to which existing regulatory mechanisms can address these issues, or whether alternative mechanisms could do so in a more targeted manner. | |
| MFMs as a cross check to the CAPM cost of equity. | Respondents argued there was scope to explore the role of Multi-Factor Models (MFMs) as a cross-check to the CAPM cost of equity. | WaterUK, National Grid | The taskforce considers that MFMs are an extension of the CAPM rather than a truly independent cross-check. In addition there is some doubt over the out-of-sample predictive power of MFMs, with previously-identified factors (e.g. size) fluctuating in significance over time. The taskforce does not consider the suggested MFM cross-checks to be appropriate for inclusion in this guidance, but is willing to consider this issue further if evidence suggests such models meet evidential, transparency and stability thresholds that would justify placing weight on their results | Yes |
| Financeability as a cross check to the CAPM cost of equity | SGN argued that achieving financeability on a notional basis is an important cross-check to the allowed return on equity, and if it is not achieved the cost of equity methodology should be reviewed to ensure it is robust before other remedies are considered. | SGN | The taskforce continues to consider that customer interests are likely to be better served by alternatives to uplifting the allowed return on equity in response to a financeability constraint (e.g. assumed equity injections). In particular, this is as such adjustments are one-sided in favour of companies – there is typically no provision to adjust down the CAPM allowed return on equity if it results in cashflows that are stronger than required to achieve credit metrics consistent with the target credit rating for the notional company. | No |

| COST OF EQUITY: CHOOSING A POINT ESTIMATE AND CROSS-CHECKS | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Choosing a range | It was argued that the central CAPM estimate will only be a good starting point if the estimation approaches do not impart a skew to the estimates. Regulators should ensure this is the case and that the point picked for each parameter is the most plausible.<br>National Grid noted that this point might not necessarily be the centre of the parameter range. | National Grid, BT, GIIA | The taskforce continues to consider that regulators should aim to derive the low and high ends such that the range could be assumed to be broadly symmetric. If it is not possible to derive a symmetric range for the parameters, regulators should explain the reasons for the asymmetry and why the mid-point of the range is not appropriate. | No |

| COST OF DEBT | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Adjustments to benchmark index should be ruled out | Respondents argued that the guidance should say that adjustments to benchmark index for reasons of tenor should not be made:<br>- WaterUK said this was because the CMA rejected this at PR19.<br>- UUW argued that this was because lower tenor instruments have a higher liquidity cost which offsets any upfront yield advantage. | UUW, WaterUK, GIIA | The guidance clarifies that an adjustment to the index may be appropriate where there is strong and consistent evidence that suggests the unadjusted index is likely to provide a poor proxy for the notional company's cost of debt. In making such an adjustment, regulators should clearly set out the evidence base informing their decision, and the size of adjustment made. | Yes |
| Derivative costs should be allowed | Respondents argued that the cost of derivatives should be allowed for:<br>- UUW said this was as companies use swaps to achieve a share of IL debt in the notional structure<br>- WaterUK said this was as the CMA included swap costs in its allowance for the PR19 redeterminations. | UUW, SGN, WaterUK | The guidance clarifies that UK economic regulators have not historically tended to make allowances for the costs of derivatives in the allowed return on debt, and it supports a continuation of this policy. Derivatives are put in place for a variety of reasons, many of which relate to treasury management choices of particular companies that may not reflect the financial structure of the notional company – and so do not need to be included the notional allowance. | Yes |
| Insufficiently prescriptive guidance | WaterUK argued that the guidance was too loose and that it should say more on cost of debt estimation, or that it could just cover the cost of equity. | WaterUK | The guidance recognises that the cost of debt is an area where it is appropriate for regulators to take different approaches, recognising that circumstances across the sectors can be very different. | Yes |

| COST OF DEBT | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Reflecting inflation | Respondents argued regulators should use long-range forecasts by OBR or the BoE target, even if it looks like the target won't be hit in the near term. It was argued that a change to this principle should require extensive consultation. | National Grid, SGN | The guidance clarifies that it is acceptable for regulators to draw on medium term forecasts or an assumption such as the Bank of England's inflation target to deflate nominal debt costs to a real rate. Recognising the value of predictability and stability when attracting finance that may span several control periods, regulators agree that early signalling and an evidence-based rationale will be necessary to manage the effects of a change of approach in this area. | Yes |
| Reflecting expected returns, not the coupon rate. | Citizens' Advice argued that regulators should use expected returns – not yields – to estimate the allowed return on debt. To use the latter would be to overstate the allowance. | Citizens' Advice | The taskforce notes the 2018 UKRN Cost of Capital Study recommendation that allowances based on yield-to-maturity should contain a downward adjustment to convert them to expected returns, reflecting the expected default rate and recovery rate. While the taskforce agrees that default risk lies outside the CAPM framework, it results in a premium that must be paid by utility company issuers of debt, and so it reasonable that it should be reflected in the efficient benchmark. | No |
| Assumed tenor of debt. | BT argued that regulators should assume debt of tenor equal to asset life, to reflect investor risk over lifetime of asset. | BT | The taskforce does not agree that it is necessary to assume that the notional company issues debt of tenor matching the life of assets. It continues to consider that the methodology for setting the allowed return on debt should incentivise companies to strike a balance between minimising interest costs and managing risk. In general this should be achieved by regulated companies issuing at a diversified range of tenors. | No |

| NOTIONAL STRUCTURE | | | | |
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| Issue: | Description of issue | Raised by: | Response: | Guidance change? |
| Notional company assumptions should be funded | UUW argued that if the notional company were considered to be publicly listed and 60% geared, the settlement should also provide for costs of this (i.e. steady and adequate dividend payout, cost of raising equity on public markets). If assuming flexibility of equity financing from private equity model, the settlement would need to reflect typically higher gearing and dividends.<br><br>National Grid argued that changes in notional gearing between periods should fund cost of e.g. raising equity to achieve this. | UUW, National Grid | The guidance clarifies that where regulators decide to change the notional structure from one period to the next, it is reasonable that they consider whether the change is feasible for the notionally structured company, reflecting also the policy objectives of the sector in question. | Yes |
| Gearing | UUW and WaterUK argued there was no case for notional gearing to be lower than 60%, and that the figure should place weight on actually observed gearing levels given these are more likely to represent optimal capital structure.<br><br>GIIA argued the implication of risks leading to lower gearing being appropriate were the same as saying WACC should be higher. | UUW, WaterUK, GIIA | The guidance does not propose a reasonable range for values which notional gearing should lie between, and the taskforce agrees that this should reflect the particular circumstances of the sector in question and the policy priorities of its regulator. | No |