Q. Calculations of a required rate of return on equity often include an allowance for flotation costs. Please explain the history and the rationale for the inclusion of such an allowance in this calculation.

A. Dr. Booth has been using 50 bps for at least 20 years. It used to be a contentious area and at one point Dr. Booth saw evidence of every issue a company had made to try and track actual costs, which seemed very cost ineffective at the time. In response a consensus seemed to emerge at 0.50% and this has been a non-contentious area in most jurisdictions, the exception is the Regie which generally uses 0.35%.

The issue cost adjustment is meant to cover the costs of raising equity that are not recovered directly in the revenue requirement, unlike the debt issue costs that are. These costs are mainly the after tax investment banking fee and the discount the stock goes out at relative to the market price. If these costs are 5% then the stock has to trade at a market to book of 105 so that the utility can always net out book value and avoid dilution.

Using the DCF model the fair ROE is determined by the expected dividend yield plus growth. If issues costs are 5% so the utility nets out 95% of the market price the ROE has to be as follows:

$$ROE = \frac{d}{P * 0.95} + g$$

In this case the opportunity cost on the market price equals the fair ROE on the net proceeds. With a 4% expected dividend yield and growth the investor wants an 8% return on their market value. However, with 5% issue costs the fair ROE has to be increased by 0.21% to 8.21% so that 8.21% on the net proceeds supports the market price. With 10% issue costs for a smaller utility the adjustment would be 0.44%. However, for larger utilities that have dividend reinvestment plans or can use bought deals the issue costs are often negligible.