To: Mark Toner

From: Richard Schmalensee

Re: Dr. Martin Lally's *Review of Submissions on the Risk-Free Rate and the Cost of Debt*

Date: July 31, 2023

I appreciate the opportunity to reply to Dr. Lally's latest attempt to use my 1989 *Journal of Regulatory Economics* paper to support his argument that if a regulator determines a regulated firm's cost of capital every T years, it must use T-period bonds in that determination. I lack the time and, at this point, the patience to provide a detained critique of Dr. Lally's latest argument, but I want to make it clear that, as I indicated in my two submissions to the Australian Energy Regulator (AER), I agree with the assertion by Oxera (2023, section 2.3) that there is "*no clear precedent academic or otherwise on the term that should be used to compute the risk-free rate*." They are correct that my 1989 paper establishes no such precedent.

As I noted in the first of my submissions to the AER, when I showed a draft of my 1989 paper to my MIT colleague Stewart Myers, he pointed me to 1972 paper of his in the *Bell Journal of Economics and Management Science* in which he had asserted the same basic result, though without proof:

> If a regulatory commission decides to allow a return R, and adjusts the utility's prices frequently enough that the utility always earns R on a book basis, then the utility will always earn the same true return R. (note 38).

Myers clearly asserts that this statement is true for *any* regulator-determined R, and he implicitly asserts that it is true regardless of how depreciation is computed. The final statement, that "the utility will always earn the same true return R" is equivalent to the NPV=0 principle. All this is perfectly consistent with my 1989 paper. The only mention of periodicity in Myers' assertion is the requirement that "the utility *always* earns R on a book basis," where *always* must mean whenever depreciation is charged and the accounting ("book basis") rate of return is computed.