

COST OF CAPITAL

A Consultation Paper

Volume 1



**Office of Water Services
JULY 1991**

COST OF CAPITAL
A CONSULTATION PAPER
VOLUME 1

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Annexes

- 1 Conceptual approaches to the cost of capital
- 2 Dividend Growth Model
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PREFACE

- 1 This Consultation Paper sets out the approach the Director General of Water Services proposes to adopt in determining the cost of capital to be reflected in the price limits that are set for water, and water and sewerage companies. Although many of the issues discussed are technical, the conclusions are central to the future financial position of water and sewerage companies.
- 2 Ofwat welcomes comments on the matters raised in the paper, and in particular on the questions set out in Chapter 7.
- 3 Comments should be sent to the Director General by 30 November 1991. Unless indicated to the contrary, any comments received will be placed in the Ofwat library.

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STATEMENT BY THE DIRECTOR GENERAL OF WATER SERVICES

A Purpose of the consultation

The Water Act 1989 places a duty on the Director General to act in the manner best calculated to ensure that appointed water companies can finance their functions (in particular by securing reasonable returns on their capital). A duty is also placed on him to protect the interests of customers.

When setting the original price limits (K factors), the Secretaries of State made their judgements on this reasonable return. When revising such price limits, and in setting new ones at a periodic review, I have to make my own judgements. I believe this is best done after consultation with the companies, their customers and the wider public.

Ofwat, and its financial advisers, have made an assessment of the evidence, which is presented in the form of ranges rather than point estimates. Absolute precision is not possible in this area. In deciding on individual price limits, I will have to exercise difficult judgements, taking account of interpretations of the evidence as well as the evidence itself. When making these judgements, I will explain my reasons and relate them to the evidence in this consultation document and to further evidence which may be submitted in response to it.

My judgements will be subject to appeal to the Monopolies and Mergers Commission.

B Special position of the water industry

Investment and revenue

The water industry is in the unusual position of experiencing slow growth for its product, relatively slow technical progress and yet a very large investment programme.

Heavy investment is necessary to remedy past neglect and to bring the quality of drinking water and waste water discharged to rivers and the sea up to standards set up by European Directives.

