Company of Proprietors of Whitchurch Bridge

Toll Application 31st October 2008

Dividend Policy and A Reasonable Return on Investment

1) Introduction

a) The dividend policy of the Company is determined in accordance with the legislative framework for the operation (Ref. Appendix A – Legislative Framework) which refers to "a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge as defined in Section 2 of the Whitchurch Bridge Act 1988", the relevant definition of "the Bridge" being "the Whitchurch Bridge of the Company and all the lands, easements, rights, Toll houses, Toll-gates, signals, offices and other assets of whatever description for the time being held or used by the Company in connection with that Bridge"

b) The operation of this policy requires therefore the determination of two factors

c) What is the value of the assets encompassed by the definition of "the Bridge"

d) What is a reasonable return on this investment.

e) These questions can be answered by reference to the accounts of the Company, and to comparable definitions for similar types of regulated undertaking, e.g. water companies.

f) This note will show that the actual return in terms of dividends paid over the last 15 years has been constrained below what would normally be regarded as a reasonable level of return in order to build up reserves within the Company

2) The Assets of the Company

a) The Balance Sheet of the Company as at 30th June 2008 defines the assets of the Company as follows

Asset	*Basis of Valuation*	*Value as at 30/06/2008*
Existing Bridge	Depreciated Replacement Cost	£148,101
Toll House	Valuation	£500,000
Toll Booth & Equipment	Depreciated Historic Cost	£109,711
Investments (Reserve Fund)	Cost	£1,429,499
Net Current Assets	Cost	(£35,308)
Total Net Assets		£2,152,003

b) The existing bridge is classified as a specialized property and is revalued annually on the basis of depreciated replacement cost (DRC). This is in accordance with UK and International accounting standards, for example International Valuation Guidance Note No8 (2005) http://www.ivsc.org/pubs/gn8-pfd2005.pdf and RISC Valuation

Information Paper No10 (2007), which has been adopted by HM Treasury for the Government Financial Reporting Manual (FReM)

c) The actual valuation of assets in similar regulated industries is the subject of extensive literature, of which the most relevant to this case is the water industry, which has a similar issue of valuing assets with a very long economic life in order to determine the level of charge for depreciation and dividend policy in relation to their water charges. There are basically two methods in use to determine Regulatory Capital Value for such assets

   i) Equivalent Asset Replacement Cost – i.e. the replacement value of the asset in its current form

   ii) Modern Equivalent Asset Value (MEA) – i.e. the cost of a modern asset that would perform the same function

d) The valuation used by the Company follows similar principles. The Equivalent Asset Replacement Cost is what is currently used in the accounts, i.e. the replacement cost of the Bridge, assessed by our consulting engineers at £3.542m as at 30th June 2008, less depreciation over a period of 111 years, assuming replacement in 2013. The Modern Equivalent Asset Value is in practice the reconstruction cost shown in the toll application, i.e. £3.22m as at 31st October 2008.

e) The depreciation charge in the annual accounts is based on the same principles.

f) The toll house was valued at 30th June 2008 by professional valuation, while other fixed assets are shown at cost less depreciation over their useful lives.

g) The value of investments as at 30th June 2008 represents the fund that has been accumulated to date towards the replacement of the bridge in 2013: in principle it should represent the replacement cost less the net value in the accounts, but in practice as shown elsewhere in this document the reserve fund currently falls short of this target. This fund represents assets held in connection with the future cost of the Bridge.

h) The implications of this method of valuation of assets held or used by the Company in connection with the bridge can be seen by following the historical and projected asset value of the Company, assuming replacement in 2013 and approval of this application, which can be illustrated below

Asset	*Value 30/06/1998*	*Value 30/06/2008*	*Value 30/06/2014*	*Value 30/06/2028*
Bridge at DRC	£200,000	£148,000	£4,100,000	£5,100,000
Investments	£672,000	£1,429,000	£0	£150,000
Loans	£0	£0	(£1,200,000)	£0
Other assets	£355,000	£575,000	£750,000	£1,000,000
Total Net Assets	£1,227,000	£2,152,000	£3,650,000	£6,250,000

i) The effect of this approach is that the value of the investment of the Company in the assets of "The Bridge" is defined consistently whether the Company is building up assets towards replacement, as now, or whether the bridge has just been replaced

but with the assistance of a loan, which reduces the net value, or whether it is part way through its life, as in 2029, but with funds already being built up towards replacement in a further 100 years time. The same principles are applied, with a vastly greater degree of complexity, by all regulated industries.

3) A Reasonable Return on Investment

a) We have seen in recent years very wide fluctuations in what might be regarded as a normal return on investments. In the case of this evaluation, however it seems reasonable to take a long term view in comparison with other forms of investment.

b) Typical rates of return that have been regarded as reasonable in other relevant circumstances are as follows

i) Typical returns on assets in other regulated industries 7 - 8%

ii) Dunham Bridge Inquiry December 2006 6%

iii) Current yields on Government securities 3.5%

iv) Return on index linked Government securities 2.3%

v) Typical dividend yield on equity 4 – 5%

vi) Average nominal return on UK equities 1900 – 2003 11%

c) Again reference may be made to the determination of cost of capital in other regulated industries. The standard approach to this issue was set out in a detailed paper commissioned by a number of regulatory bodies and published in 2003 http://www2.ofcom.org.uk/static/archive/oftel/publications/pricing/2003/capt0203.pdf , see also an updated review published in 2006 http://www.sbs.ox.ac.uk/NR/rdonlyres/41985974-A198-442B-A733-09B3DBEF6E1C/875/RegulationandtheCostofCapital4.pdf . This approach depends on an assessment of the standard Capital Asset Pricing Model (CAPM) which takes into account the weighted average cost of capital between loan and equity finance. It should be noted that these models tends to assume that for most regulated industries the cost of equity capital is higher than the cost of loan capital, as equity cost is based on the risk free rate, plus the general equity risk premium, adjusted for the specific risk associated with the particular undertaking.. As noted above, the risk free rate can currently be assessed as about 3.5%, being the rate of return on government securities, and an equity risk premium of 4 – 5% is typically used in regulated industries to give an expected return on assets of at least 8%. Therefore typically a higher rate of gearing will lower the required cost of capital.

d) Against this background we can consider the return on assets available to shareholders in Whitchurch Bridge, both historically and as assumed in the toll application

	30/06/1999	*30/06/2008*	*30/06/2014*	*30/06/2029*
Net Asset Value	£1,227,000	£2,152,000	£3,650,000	£6,250,000
Dividend Payments	£28,200	£49,350	£84,000	£144,000
Return on assets	2.3%	2.3%	2.3%	2.3%

e) It can be seen that in this context the actual and forecast return on investment for the Company is significantly below what would be regarded as a reasonable return in any other situation, being comparable only to that on index linked gilt securities – however, it should be emphasised that returns on government products are regarded as "risk free" and hence they are lower than the higher returns demanded when holding equity interests which are subject to much greater risk.

f) The reason for such low returns to shareholders is that historically because of low toll levels the Company has for a long time been in a situation where the sums available for transfer to reserve funds have lagged behind the ever-increasing costs of reconstruction, and the present toll application in effect perpetuates this situation as for the next 20 years the Company will be either continuing to build up funds for that purpose or repaying loans taken out to finance the reconstruction costs.

g) An important implication of this situation is that the general assumption about gearing works in reverse: as the projected return on assets to Whitchurch Bridge shareholders is lower than the cost of loan capital, it follows that a higher proportion of loan capital increases the weighted average cost of capital (WACC) to the company. Therefore a reduction in the value of borrowing required to finance the reconstruction of the bridge in 2013 leads to a lower economic cost for the undertaking as a whole. This can be seen in the table below

Date	*Return to shareholders %*	*Loan finance cost %*	*WACC at 0% gearing*	*WACC at 25% gearing*	*WACC at 50% gearing*
2008	2.3%	n.a.	2.3%	n.a.	n.a.
2014	2.3%	7.0%	2.3%	3.5%	4.7%

4) Conclusion

It can be concluded from this analysis that the return on investment assumed in the toll application is in fact below the level that would normally be regarded as a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge. Therefore the weighted average cost of capital used in the evaluation of the required level of toll charges is likewise very low in relation to comparable industries, and is fully supportive of the proposed level of tolls being neither more nor less than required in accordance with the relevant statutory directives.