SCRAG/9 WP/13
10/10/08

SADIS COST RECOVERY ADMINISTRATIVE GROUP

NINTH MEETING

(London, October 30 2008)

Cost of Capital
(presented by the United Kingdom)

REFERENCES
SADIS Agreement
SCRAG Report 8

1. INTRODUCTION

1.1 Article IX of the SADIS Agreement states that:-

Determination of costs
1. The costs to be shared among the Parties shall be the full costs to the United Kingdom of employing fully or in part the facilities and personnel listed in Annex II to this Agreement for the purpose of providing, operating and maintaining the SADIS, including depreciation of assets and cost of capital and an appropriate amount for administration.

1.2 In Annex III of the SADIS Agreement, chargeable costs includes:

d) Cost of capital
This falls into two basic categories. The first is the interest on debt capital (other than equity). The second is the appropriate cost of capital applied to equity. The latter would be defined as fixed and net current assets minus long-term debt. The rate to be applied either would be set by an independent economic regulator appointed by the United Kingdom Government or should be derived from the average government bond rate in the United Kingdom for the preceding year.

2. Cost of Capital applied to Met Office activities for SADIS.

2.1 Met office cost of capital has been calculated based on the weighted average of loan capital and equity capital in accordance with the principles in Annex III of the SADIS agreement. The calculated value is 5.48%. This percentage is applied to an equitable share of total Met Office assets employed in provision of the SADIS service. The SADIS agreement recognises that costs such as administration, buildings etc. are chargeable costs and it therefore follows that the cost of capital charge should cover all assets supporting those activities as well as assets directly employed on SADIS activity. In common with the principles applied to non-competed Government business within the Met Office, the equitable share of assets attributable to SADIS is calculated by reference to the ratio of SADIS operating costs to total Met Office costs applied to total assets. This is applied through conversion to a mark-up on cost. Details of the calculation are provided at the Appendix overleaf.

3. **Action by the Meeting.**

The SCRAG is invited to note the information in this paper.

Appendix A. Met Office Calculation of Mark up %

Total Met Office

		Year end	31/03/2007	31/03/2008
	Fixed Assets		187,147	181,248
	Net Current assets		24,458	32,940
A	**Net Assets**		**211,605**	**214,188**
	Long Term Liabilities		-12,905	-8,400
	Total (Equity)		198,700	205,788
	Loans			
	Less than 1 year		2,533	2,663
	More than 1 year		6,769	4,106
			9,302	6,769
	@4.45%	4.45%	4,900	3,752
	@5.65%	5.65%	4,402	3,017
	Average Interest		5.02%	4.98%
	Target return on Equity		5.50%	5.50%
B	**Average return**		**5.48%**	**5.48%**
			06/07	07/08
	Total revenue		170,956	176,580
	Profit on ordinary activities		7856	12643
	Gross operating costs		163,100	163,937
	Corporate development		3768	4252
	Exceptional costs		7561	-925
C	**Net operating cost**		**151,771**	**160,610**
			Mark up	**Mark up**
	Return on capital (AxB/C)		7.6%	7.3%
	Recovery of corporate development cost		2.5%	2.5%
	Total Mark up on service cost		10.1%	9.8%

Recovery of Corporate development and exceptionals is based on estimated long term average