The regulated firm and the DCF model: Some lessons from financial theory

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Abstract

This paper explores lessons from established financial theory for allowed rate of return calculations within the constant-growth dividend (DCF) framework. Analysts using this model have been wedded to the conventional cost-of-equity formula. We set forth equivalent alternatives which make the analysts' task easier, more precise, and more confident. What is even more important, we derive a set of consistency conditions that must be observed for the appropriate use of the model. We also use a basic capital-market principle to determine an alternative, flotation-cost adjusted, rate of return, an expression which provides useful insights for regulatory participants.

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