



**Ofcom's Approach To Risk In The Assessment  
Of The Cost Of Capital Second Consultation**

**Response On Behalf Of Easynet**

21 July 2005

## 1. Introduction

Easynet welcomes this second consultation on Ofcom's approach to risk in the assessment of the cost of capital, concentrating on BT's equity beta. It is especially welcome in the light of the settlement Ofcom has arrived at with BT concerning Equivalence of Input.

Easynet fully supports the response submitted by UKCTA: however Ofcom should take Easynet's views as expressed in this response in favour over the UKCTA response where there are differences.

## 2. General Comments

Overall we support the approach taken by Ofcom in this consultation. We believe that Ofcom is right to have calculated a lower group beta and that disaggregating that beta to just two component parts is more sustainable than the original three. We will however make some specific comments later about the level of both the group and disaggregated betas and the approach taken to derive them.

### 2.1 Timing of Next Review

Ofcom should consider the timing of the next review of BT's group beta and, in particular the beta which applies to the copper access network. There are two related reasons for us coming to this view.

First, from our analysis of the "Notice under Section 155(1) of the Enterprise Act 2002" (the Notice), the copper access network for the purposes of assessing the beta in this consultation will be the primary asset of the new Access Services Division (ASD).

Whilst the ASD will remain an operating division of BT Group, and not a separate company, BT is required under the Notice to provide fully separated accounts of ASD and, under paragraph 5.34 of the undertakings, to reward employees of the ASD based on its performance rather than BT Group's.

Specifically, paragraph 5.34 reads:

*5.34 BT shall as soon as reasonably practicable:*

*5.34.1 introduce new long term incentive plans for relevant ASD people including a deferred bonus plan ('new plans');*

*5.34.2 where a person has been granted an option over shares under the BT Group Global Share Option Plan or an award of shares under the BT Group Incentive Share Plan, the BT Group Retention Share Plan or the BT Group Deferred Bonus Plan and subsequently moves to ASD, use its reasonable endeavours to replace those options or share awards with share awards under the new plans;*

*5.34.3 ensure that, where a performance condition applies to the granting or vesting of an award under the new plans, that performance condition shall relate to the performance of ASD or some other appropriate index related to the objectives of ASD.*

We take this paragraph to mean that BT will need to find a method of rewarding and incentivising ASD employees in lieu of shares of BT Group and that it shall have to find a method of judging the performance of ASD in a equivalent manner to the way the financial markets judge BT Group's performance. This could mean that a quasi-share price would need to be calculated for ASD based on an accounting analysis of how the markets would judge ASD were it a stand alone company.

Secondly, the accounts of ASD will provide better evidence that Ofcom has already as to the demand and cost shocks that there division experiences, and therefore the level of risk of that business. We would expect there to be little in the way of either type of shock, given that demand for access is fairly inelastic to either supply or income and that the costs of copper are stable and known. However, the evidence that comes for ASD's operational accounts will provide evidence as to whether this expectation is proven or not.

We therefore urge Ofcom to undertake a further review of the beta appropriate to the ASD after one full year of operation and once its first year accounts are available and the performance of the division has been measured in accordance with paragraph 5.34.3 of the undertakings. We believe that at that time Ofcom will have a better pool of evidence on which to make an even more rational and objective assessment of the appropriate beta for ASD which should then be used in the assessment of its cost of capital.

We appreciate that it is important for regulatory stability that BT's cost of capital is set for a reasonable period of time. This is important for both BT and other companies when making investment decisions. However, the disaggregation of BT's beta is a significant break with previous practice and Ofcom should take all the evidence it can in the future to confirm that it has set the beta at a reasonable level. This does not mean that the central beta will need to be revised, only that the disaggregated beta of ASD can be confirmed or otherwise.

## **2.2 Scope of Copper Access**

We understand that the cost of capital for copper access will be applied at the product level to network charge controls for Wholesale Line Rental (WLR) and Local Loop Unbundling (LLU) but not to Partial Private Circuits (PPCs). We believe that Ofcom is correct in coming to this conclusion.

PPCs cover a range of bandwidths from low speed lines to very high speed LAN Extension Circuits. At the high end, PPCs are delivered over fibre rather than copper as DSL technology has a restricted bandwidth. We do not know the proportion of PPCs which are fibre based rather than copper but expect that it is substantial and is likely to grow as the demand for bandwidth increases.

Fibre is likely to be subject to a different set of risks on both the demand and the cost side such that if a fibre access network was a stand alone business it may well have a different beta to the more established copper network.

### 3. Questions and Answers

**QUESTION 9 – Do stakeholders agree that Ofcom should revise its central estimate of BT's equity beta downwards from 1.3 to 1.0, 1.1, or 1.2? Which of these figures is the most appropriate?**

In response to Question five of the first cost of capital consultation we commented on the wide range of beta estimates for BT and wrote:

*Given such a wide variation in BT's estimated beta, it would seem appropriate to undertake a fresh review of BT's equity beta rather than simply transfer the beta used in the PPC charge control*

We are, therefore, delighted that Ofcom has chosen to take this course of action and very much welcome Ofcom's undertaking of this new review of the equity beta by the Brattle Group.

However, we are somewhat concerned by Ofcom's suggestion to maintain the equity beta for BT in the range 1.0 to 1.2 which seems to be against its own evidence and logic. Our concern arises from two points:

1. First, in paras 3.15 to 3.18<sup>1</sup> of the consultation document, Ofcom discusses the use of daily and monthly data frequency for assessing the beta. In para. 3.16 Ofcom points out that one of the inherent weaknesses of monthly frequency is the sensitivity to day of the month on which the sample is taken. Ofcom refers to the evidence in the Partial Private Circuits (PPC) consultation which showed estimates of BT's beta fluctuate widely across values depending on which day of the month is used.

The Brattle Group is also more in favour of a daily interval. In states in Section 2.2 of its report (Beta Analysis of British Telecommunications: Update June 2005):

*"In our July 2002, December 2003, February 2004 and April 2004 ... (w)e found strong evidence that a daily sampling interval produced more robust results. We see no reason to change this approach, and continue to use daily sampling intervals in the current analysis."*

In para 3.18, Ofcom states that it is prudent to place a degree of weight on both daily and monthly estimation techniques. However, in coming to its final conclusion on the BT Group beta of between 1.0 and 1.2, however, Ofcom seems to have placed rather more emphasis on the monthly data sampling which is the only one to show a beta in excess of 1.0.

We are also somewhat concerned at the discrepancy between BT's beta calculated on the monthly and daily bases which seems at variance from long term studies. Davies et al<sup>2</sup> calculated the average betas across a sample of the UK's largest 100 companies by market capitalisation (which would include BT) for both daily and monthly returns over a five year period. They found almost no difference between the average beta: a daily beta of 1.07 and a monthly beta of 1.08.

<sup>1</sup> Unless otherwise state all references to paragraph numbers refer to paragraphs in the second consultation document.

<sup>2</sup> Davies, R. Unni, S. Draper, P. & Paudyal, K, (1999) *The cost of equity capital* London, Chartered Institute of Management Accountants.

Of course it could be that the discrepancy between BT's daily and monthly beta is an outlier, but a difference of 40% compared to an average difference of just 1% does lead us to question whether the monthly beta used in Ofcom's analysis should have much weight placed upon it.

2. Secondly, Ofcom discusses in para 3.21 the appropriate index for estimating the beta and concludes that "some weight should be given to beta estimates measured against international indices in addition to domestic ones".

We fully agree with Ofcom on this point and again referred to the internationality of BT's shareholder base and its importance as an international stock in answer to question five of the first consultation on this subject.

However, Ofcom seems to have placed very little weight on the measures of BT's beta against international indices, which show a beta of just 0.5.

Overall, Ofcom seems to be proposing a beta for BT Group that does not fit with its own evidence as summarised in Figure 4 of the Consultation Document. A simple average of the four estimates shown in that table produces a beta of 0.9 at one decimal point. This places equal weight on the four methods of calculating the beta and therefore seems to us to be the most appropriate.

However, one of the methods used by the Brattle Group employs the Dimson Adjustment. This is a statistical technique employed for estimating the beta of share which may thinly traded on certain days which may otherwise bias the results of daily data intervals. As a FTSE 100 company we believe it is unlikely that BT's shares will be thinly traded and that therefore less weight should be given to the beta calculation including the Dimson adjustment. Averaging the remaining three methods results in a beta of 0.97 which we believe to be a reasonable assessment of BT's Group beta.

We therefore believe that the evidence provided by Ofcom points to a BT Group beta of 0.97.

## **1 QUESTION 10: What is the view of respondents of the standard of evidence used by Ofcom in this second consultation, when added to that outlined in the first consultation?**

We applaud Ofcom for the thorough way in which they have researched the question of BT's beta. The new analysis conducted by the Brattle Group is both thorough and balanced and provides an excellent picture of the risk associated with BT's equity relative to relevant indices.

Further, the analysis conducted by PWC is also of a high standard and again balanced in its assessment of how to disaggregate BT's beta between its copper network and its ICT businesses.

Whilst accepting that the calculation of a beta and its disaggregation is at least partly a matter of judgement we nevertheless think that the standard of evidence used by Ofcom provides it with the basis to make a more objective assessment of the beta than they seem prepared to do. In para 3.30 Ofcom states that "a strong element of judgement is required in assessing the different available estimates". This maybe so,

but there remains in our view sufficient objective evidence to reduce the element of judgement further than Ofcom believes it can.

In short, we believe that Ofcom should have had the courage of its own convictions to come to an assessment of the beta more solidly based on that evidence.

**QUESTION 11: Based on the available evidence, what do respondents think would be an appropriate level of disaggregation for the equity beta of BT's copper access network? Which of the following levels would be most appropriate: (a) 0.3 points below the group average; (b) 0.2 points below the group average; (c) 0.1 points below the group average; (d) 0 points below the group average?**

Disaggregation to just two levels of beta (copper access and rest) is more sustainable than three levels. In particular, the lack of pure-play comparators, as discussed by PWC, means Ofcom needs to make a value judgement as to the level of the disaggregated beta. Whilst the evidence of the central beta is strong (and stronger than Ofcom seems to believe itself), the evidence for disaggregating the beta to three component parts is less compelling.

We support Ofcom's decision to simplify the disaggregation to just two levels: the copper access network and the rest of BT.

In our response to the first consultation, we argued that an appropriate beta for the copper access network would be 0.8 based primarily on the betas of the US telecoms companies shown in Figure 10 of the first consultation document.

A copper access beta of 0.8 would be 0.3 or 27% below Ofcom's proposed Group beta of 1.1. Applying the same proportion to our recommended central beta of 0.97 results in a copper beta of 0.7, 2.7 points below the group beta.

**QUESTION 12: What is the view of respondents on Ofcom's proposed estimates of the WACC for BT's copper access business and the rest of BT?**

Following on from the arguments above, Easynet believes that the proposed estimates of BT's WACC in Figures 9 and 10 of the consultation document are too high. We have reproduced the high gearing (35%) WACC calculation below substituting our own estimation of a copper access beta of 0.7.

In our response to the first consultation we argued that the Equity Risk Premium should be 3.5% and have therefore used this figure in the calculation below.

**Table 1: Revised BT WACC (Gearing = 35%)**

	<b>BT Group</b>	<b>Copper Access</b>	<b>Rest of BT</b>
Risk Free Rate	4.7%	4.7%	4.7
ERP	3.5%	3.5%	3.5%
Equity beta	0.97	0.7	1.15
Cost of Equity	8.1	7.15	8.7
Debt premium	1.0	1.0	1.0
Cost of debt (pre tax)	5.7	5.7	5.7
Corporate tax rate	30%	30%	30%
Cost of debt (post tax)	4.0	4.0	4.0

Gearing	35%	35%	35%
WACC (post tax)	6.6%	6.1%	7.0%
WACC (pre tax)	9.4%	8.7%	9.98%

These estimates of BT's WACC are about 1.5% below those set out in Figures 9 and 10 of the second consultation document. It is therefore fair to judge whether they are reasonable or too restrictive.

In its response to the first consultation on this subject, Cable & Wireless provided two tables: one showing the pre-tax cost of capital for major European incumbents and the other showing brokers' estimates of BT's cost of capital. We have reproduced these tables below, incorporating our own estimate of BT Group's cost of capital for comparison and our own calculation of Ofcom's estimate based on a BT Group beta of 1.1 and a gearing of 35%.

**Table 2: Pre-tax cost of capital for major European incumbent telcos**

<b>Company</b>	<b>Pre-tax cost of capital</b>
BT (Easynet estimate)	9.4%
BT (Ofcom)	10.94
France Telecom	10.4%
Deutsche Telekom	9.2%
Telecom Italia	13.5% (currently under review)
Telefonica	10.85%

Source: Cable & Wireless/Cullen International/Own estimate

Our estimate would mean that BT would have a cost of capital in line with that applied to Deutsche Telekom, at the lower end of the group. This contrasts with Ofcom's estimate which would give it a WACC higher than all other major incumbents apart from Telecom Italia, which is currently under review.

**Table 3: Brokers' estimates for BT's cost of capital after-tax**

<b>Broker</b>	<b>BT Cost of capital after tax</b>	<b>Date of publication</b>
Easynet estimate	6.6%	
Ofcom estimate	7.6%	
Morgan Stanley	7.1%	Feb '05
Lehman Brothers	8%	Feb '05
Deutsche Bank	7%	Dec '04
Citigroup	7.5%	Nov '04
UBS	7%	Feb '05

Source: Cable & Wireless/Own estimate

Our estimate results in BT having a slightly lower WACC than the brokers calculated but not significantly different. Again Ofcom's estimate places BT's WACC as the second highest of the group.

This comparison suggests to us that using central beta of 0.97 and an ERP of 3.5 results in a fair cost of capital for BT Group in line with other major European telcos and brokers' estimates.

On this basis, we believe that Ofcom's estimate of BT's WACC is too high and that our estimates are fair and in line with other European regulated operators.