Ofcom's approach to risk in the assessment of the cost of capital

Cable & Wireless response to Ofcom consultation

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CABLE & WIRELESS

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Executive Summary

Cable & Wireless are encouraged by Ofcom's decision to review the central value of BT's beta and consult further on the disaggregation of beta.

Ofcom's proposal to reduce the value of beta that it uses for BT is clearly justified by the evidence set out. However, we believe that the overall values for BT's weighted average cost of capital proposed by Ofcom in this consultation are still too high. We believe that this is due to the cumulative impact of a number of conservative estimates for the parameters used in the capital asset pricing model approach. Although Ofcom is right to take a conservative approach in order to help ensure stability the combined impact is too much.

The second issue in this consultation is the disaggregation of the cost of capital into a figure for the 'low risk' access business and a higher figure for the higher risk 'rest' of BT. We support Ofcom on this proposal although we are concerned about the amount of BT's access network that the lower cost of capital will be applied to. Where assets are re-usable between different services and/or customers we believe that the level of risk is more closely aligned with assets rather than products. Therefore the lower cost of capital should be applied to all BT copper access lines and potentially to BT's access fibre as well.

Introduction

Cable & Wireless welcomes the opportunity to comment on this consultation concerning Ofcom's approach to risk in setting BT's cost of capital. For the avoidance of doubt our comments in this response relate only to the setting of BT's cost of capital.

In our response to Ofcom's previous consultation on this subject we set out our views on a range of parameters that influence the overall cost of capital and we particularly welcome Ofcom's decision to review the overall value for BT's beta in the light of the evidence provided. The other key element of this consultation deals with the issue of disaggregating the cost of capital between different parts of BT's business.

In this response we cover some general points in the introduction and then go on to answer the specific questions posed by the consultation document.

Application of the disaggregated cost of capital

As we understand Ofcom's proposal the lower cost of capital associated with the lower risk part of BT's business would be applied to the copper access network. Moreover, we understand that it may only apply to a subset of the copper lines in that network, those used for line rental (including WLR) and LLU, but excluding those used for low speed Partial Private Circuits (PPCs).

Cable & Wireless believe that most of the physical copper infrastructure can be re-used to carry different services or to support different customers in the same local area and therefore the risk is more closely aligned with specific assets rather than specific products.

Where business customers connected using a PPC change their service it will probably be to an LLU based service, which will still be supported over copper, but even if they migrate to a fibre based connection the likelihood is that it will still be provided using BT infrastructure and therefore the duct can be re-used. If the building ceases to be used, or becomes served by an alternative providers' infrastructure, it will be possible to re-use all but the final drop in order to serve other customers in the same local area; and in part we expect the cost of the final drop will have been recovered by the connection charge.

There is an argument that PPCs make use of multiple copper pairs whereas today's xDSL technology can support the same bandwidth on a single pair and, as a result, future xDSL may lead to a net reduction in copper lines required to support business customers. This may be true, but also the increase in bandwidth demanded by customers may lead to the take-up of bonded xDSL to increase bandwidth, or multiple lines. However, we do not see this issue as being different to residential customers cancelling their second lines when they take-up broadband services.

Therefore, we strongly believe that the cost of capital applied to the capital employed for the copper access network should be applied to all copper access lines, irrespective of the service they are supporting. We do not necessarily believe that this requires an immediate re-opening of the PPC charge control, but the next time it is reviewed it the new cost of capital should be applied. We observe that the combined impact of cost of capital, cost of copper, the new PPC structure coming out of the TSR settlement and a potential change from Ofcom's own initiative investigation into PPC trunk pricing probably justifies the charge control being re-visited earlier than had originally been planned.

In fact, Cable & Wireless would go further. We believe that BT's monopoly within access services extends to fibre as well as copper and indeed there is a significant amount of sharing between the duct used to support copper and that to support fibre access. Therefore we advocate the use of the lower cost of capital for the entire physical infrastructure that forms BT's access network.

Approach to the review

In the previous consultation Ofcom set out to review only a couple of parameters that are used within the capital asset pricing model (CAPM) approach to calculating the weighted average cost of capital. Cable & Wireless among other respondents raised issues related to some of the other parameters and now Ofcom has decided to review the central beta used for BT. We welcome this but believe that in a review of this nature Ofcom should consider all of the main parameters together rather than a few at a time.

Throughout the review Ofcom tends to take a conservative view when estimating the value of the parameters used in the calculation. We understand the reasons for taking this approach and support Ofcom in its objective to maintain stability to this calculation and resultant charge controls. Taken individually the estimates used by Ofcom may seem reasonable but cumulatively we believe that they may lead to a result that is too conservative.

Therefore we urge Ofcom to take care when setting the values for individual parameters. There may be some merit in also considering the most accurate measure for each individual parameter and then considering the overall effect that the more conservative estimates have on the final result. In view of this we are particularly concerned that Ofcom's central estimate for BT's beta is still too high.

In the remainder of our response we set out our answers to Ofcom's specific questions

Responses to Ofcom's Questions

***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?*

Cable & Wireless welcome Ofcom's decision to review the central estimate for BT's beta following evidence from various respondents including ourselves. In the light of the evidence presented previously and the additional evidence that Ofcom has obtained from the Brattle Group we agree that the previous estimate of 1.3 for BT's beta is too high and the figure should be revised downwards

We agree with Ofcom that each of the different estimates has its own merits and the decision of how to determine the value to use is somewhat subjective and cannot be simply based upon a weighted average of the estimates provided. We also agree that long term stability in the figures used is important and therefore there is merit in adopting a slightly conservative approach in order to help smooth out the effects of fluctuations in the estimates from one period to another.

However, in reviewing the extent to which Ofcom has adopted a conservative approach we consider comparisons between the previous estimate and this proposal:

- On the basis of simple average of the estimates used in September 2004 the figures averaged 1.25 and Ofcom used a slightly higher beta of 1.3. The revised estimates average at 0.88 where Ofcom proposes a considerably higher figure of 1.1
- On the basis of the UK daily estimate, which UKCTA believe is the estimate to which most importance should be attached, the estimate from September 2004 was 1.29 and Ofcom used 1.3. The latest Brattle Group estimate on this basis is 1.0 whereas Ofcom's proposal is to use 1.1

On the basis of these comparisons we believe that Ofcom has become more conservative in its approach since the September 2004 review. As we discussed in the introduction to this response Ofcom has taken a conservative approach in many areas of the overall calculation and the cumulative effect could result in a figure that is materially too high.

Overall, we believe the Brattle Group's conclusion that the beta for BT is 1.0 already reflects a slightly conservative estimate in that they note that other estimates point to a lower beta but they have concerns over those estimations. Evidence that we gathered for our April response to the earlier consultation suggested that the beta was 0.96. Therefore, Cable & Wireless favour the use of 1.0 as the central beta used in the calculation of BT's cost of capital.

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?*

Throughout the consultation process Ofcom has made use of evidence that it has gathered itself, from independent experts and from respondents to its consultation documents. There are two main aspects to this evidence; that used to estimate the central value of beta and that concerning the disaggregation of beta. It is the latter that is the most difficult.

We believe that this evidence and Ofcom's analysis of it clearly suggests that BT's access network is less risky than BT as a whole and there appears to be little evidence to the contrary. However, given the absence of pure access competitors it is not possible to provide firm evidence that supports the absolute level of disaggreagation. This does not mean Ofcom would be wrong to disaggregate.

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?*

As we stated in our answer to question 10 we believe that the evidence presented by Ofcom overwhelmingly points towards the access business being less risky than BT as a whole but it is harder to translate that into a specific level of disaggretation for beta.

As part of our response to the previous consultation we included some research by JP Morgan that suggested the average adjusted beta for a named set of utility companies is 0.56. This is 0.4 points below our estimate for BT's beta and we believe that this provides some guidance to level of disaggregation that we might expect.

In its document Ofcom has used an assessment of the impact that the level of disaggregation has on the value of the 'rest' beta. We have considered the similar analysis using a central beta of 1.0 and the two-way disaggregation that Ofcom proposes.

Access beta **40%**	**Rest beta** **60%**
0.6	1.27
0.7	1.20
0.8	1.13
0.9	1.07

We believe each of these figures could be considered plausible values of beta for the rest of BT. However, we feel that 0.1 point below the group average is almost certainly too little and 0.4 points would be hard to justify and therefore Ofcom would be justified in using either 0.2 or 0.3 points below the group average for the access 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?*

Ofcom have set out the impact of their proposals on the pre-tax Weighted Average Cost of Capital (WACC) for BT's access business (10.1%) and the rest of BT (11.5%). We believe that the figures presented are still too high.

In our previous response we had calculated figures of 8.2% for BT's access and 9.9% for the rest of BT. Also, Cable & Wireless note that recently both Ofwat and Ofgem have reviewed the cost of capital that they use in setting regulated charges for distribution businesses. Ofwat decided on a pre-tax cost of capital of 7.3% and Ofgen are using 6.9%. While neither of these can be directly compared with BT's access business we do observe that there is a considerable difference between these figures and Ofcom's proposal.

In our opinion the reason that the figures are too high is probably down to the cumulative effect of conservative estimates for each of the input parameters. We believe Ofcom can afford to be slightly less conservative than it has been.

Cable & Wireless plc
Lakeside House
Cain Road
Bracknell
Berkshire
RD13 3[rd]

www.cw.com