

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

2nd Consultation in relation to BT's equity beta

UKCTA Response to Ofcom Consultation

Submitted to Ofcom: 22nd July 2005

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

It has not been possible for UKCTA to reach full consensus and reconcile the divergent views of our members on this consultation. Please be aware that a separate response will therefore be submitted by ntl.

Introduction

UKCTA welcome this opportunity to comment on this second Ofcom consultation on the approach to risk in the assessment of the cost of capital. UKCTA support Ofcom's decision to review BT's central beta and the proposals to introduce disaggregation.

UKCTA understand that the lower cost of capital may only be applied to a subset of the copper access lines, presumably those used for exchange line services and metallic paths for LLU but excluding those used for low speed PPCs.

UKCTA believe that PPCs could be considered to also be part of the subset, however there may be challenges for Ofcom in doing so.

It is generally accepted that the vast majority of the assets are re-usable even if a particular customer switches to a different provider or service. The copper, with the exception of the final drop that will in part be recovered by the initial connection charge in any case, can be re-used to serve any customer in that local area. The duct, which is likely to be the largest single element of cost, can also be re-used to serve other customers in the same local area and also, if the customer migrated to a fibre based service, the duct may be re-usable for that too. Therefore, as the level of risk is more dependent upon the type of asset rather than the service running over

the asset, UKCTA believe that the de-averaged cost of capital should be applied to all the copper that used for access in BT's network.

However, for PPCs one needs to take into account that the move away from leased line services onto broadband may result in some assets not being re-used. For instance, a customer moving from a multi-copper pair HDSL2 PPC service to a single pair SDSL service is unlikely to then take up additional services that would re-use the spare pairs left by such a move. Also, if the leased line is moved to a SMPF based service, then clearly the copper making up the HDSL2 service will be stranded.

However, with the exception on the final drop BT could re-use the copper and duct for service delivery to different customers, so the limit of the stranded asset would be the final delivery to the customer's premise.

UKCTA would therefore like to request that Ofcom re-consider the question of PPCs being in or out of the applied subset before making a final decision

During the last consultation phase Ofcom indicated that only BT's ERP and beta were to be re-examined, however Ofcom is now embarking on a wider looking review. UKCTA are concerned that a piece meal approach produces an inferior review compared to a comprehensive review of all components. UKCTA would urge Ofcom to consider all elements of BT's cost of capital during any future reviews. Specifically, UKCTA would highlight the following issues relating to the risk free rate, the debt premium and gearing:

Risk Free Rate

Ofcom in paragraph 2.48 indicates that during the PPC review, Ofcom used a 3 month average of the then latest 5 year gilts, which leads to the risk free rate being set at 5%. Ofcom also recognises that using a similar methodology would lead to a lower Risk Free Rate estimate - down to 4.5% at the time of publication of the first consultation. However we note that Ofcom is again adding what could be construed

as excessive conservatism by proposing a value of 4.7% on the grounds that this would be consistent with a real risk free rate of about 2% and a rate of inflation of around 2.6 to 2.7%.

UKCTA notes that, as of 18th July, the average of for the past 3 months data for 5 year gilts has gone down from 4.5% to 4.26%, which includes an average of 1.7% for real risk free rate and an implied inflation rate of 2.56%¹.

UKCTA also notes the most commentators now believe that UK base interest rates have peaked during this cycle, with most expecting a fall in August 2005. This view has been reinforced by the fact that four out of the nine members of the Bank of England Monetary Policy Committee voted for a rate cut in July.

UKCTA would recommend that Ofcom uses as a maximum a value of 4.5% for the risk free rate, as this would be a conservative rounding up of the current benchmark of 4.26%.

Debt Premium

UKCTA notes that Ofcom proposes to use 1% as the debt premium – as used in the PPC charge control. At the time of the PPC charge control (Sep. 2004), Ofcom had already used a conservative estimate of 1% when the benchmark for a yield for A-corporate was 0.74% (as stated in paragraph 2.50). Today, Ofcom estimates that this has not changed even though the benchmark for corporate debt with A- rating has now decreased down to 0.64%.

UKCTA notes that Ofcom has become much more conservative on in its approach since the PPC Review in September 2004 and would urge Ofcom to reconsider the debt premium estimate of 1% towards a more relevant 0.6% or 0.7%.

¹ Source <http://213.225.136.206/statistics/yieldcurve/index.htm>
 Ofcom's approach to risk in the assessment of the cost of capital – 2nd CD
UK Competitive Telecommunications Association

Gearing:

Disaggregation of BT's overall WACC between differing areas of risk is supported. We fully support Ofcom's intention to disaggregate the equity beta between low risk copper access and the rest of BT's business. However, we see Ofcom's failure to apply this approach to gearing as a serious oversight. We believe that the case for disaggregation is clear - a network business can support much higher levels of debt than competitive businesses. The average assumed gearing for BT as a whole of 30% - 35% masks a significant range that exists within the company's activities. UKCTA believe that the efficient level of gearing for the network element to be between 50% - 60% based on available evidence from the energy and water sectors. Reflecting the efficient level of debt for the network element of BT's activities will aid Ofcom's analysis relating to those outlined in this response, namely:

- Setting charge controls and price caps
- Conducting competition analysis
- Valuing the future cash flows

We would urge Ofcom to disaggregate gearing in any future review.

Q & A

In the following section, UKCTA responds to the specific questions posed in the consultation document.

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?*

UKCTA welcome Ofcom's decision to review the central estimate for BT's beta following evidence from UKCTA members to the first consultation. 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

UKCTA agrees 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

Using these comparisons UKCTA believe that Ofcom has become more conservative in its approach since the September 2004 review. We also note that Ofcom is conservative on many other aspects of the WACC calculation and that there is no analysis as to the extent of the combined effect of these estimates.

Overall UKCTA 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. Therefore, UKCTA 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?*

Ofcom's first consultation investigated the level of the access beta by examining the beta's for UK utilities; betas for US LECs and the income elasticities of demand for access services compared to other telecoms services. UKCTA believe that this was a reasonable approach and that the results strongly suggested that BT's group beta should be disaggregated, with the access beta set below the betas of other parts of BT. Our only concern about this analysis was that the central BT group beta used was too high which also impacted on the proposed access beta.

We believe that Ofcom's second document adds and supports the conclusions of the first document where disaggregation of beta is concerned. UKCTA believe that all the different types of analysis performed by PWC strongly suggest that the access network has a lower beta than BT as a whole. Although PWC find it difficult to put a precise figure on the level of the access beta, we fully support their view that this, like the establishment of the beta overall, is not a mechanistic process and instead a matter of judgment i.e. there 'is for example, no precise, accepted estimate of BT's group beta available to Ofcom but nevertheless Ofcom needs to adopt a figure in order to apply the CAPM framework in setting regulated prices and therefore uses its judgment of the best figure, given the available imperfect evidence' (page iii) and iv) PWC). Further we believe that the type 1 and type 2 analysis undertaken by Ofcom is also convincing i.e. the risk of not disaggregating (and this being incorrect) is greater than the risk of disaggregating (and this being incorrect).

Where the number of categories is concerned, UKCTA support Ofcom's decision to reduce the number of categories from three to two i.e. to have a single category covering medium and higher risk activities. We agree that 'the single key factor ... is whether 'other regulated' activities (e.g. fixed geographic termination) are more or less risky than BT group as a whole, and whether this view is supported by available evidence' (para 4.53). Deciding which products would be in medium or high risk

groups would be very subjective. UKCTA are also unsure what type of proxy could be used to objectively set a 'reasonable' beta for the high risk group. Previously Ofcom left assigning rates of return to the higher risk group according to what was 'left over' after de-averaging access and setting the middle group at the group beta rate. We are not sure that this is really adequate. One possibility would be to use a beta for ICT (as identified in the PWC document) but this may not be appropriate if not all the services in the higher risk group were ICT services.

Hence we agree that two groups are probably better than three – given the problems of identifying which products would be in the middle or high risk groups and the problems of assigning appropriate betas to the high risk group. However, we believe that the number of categories should be reconsidered at the time of the next significant BT price control review.

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?*

With regard to the appropriate level of disaggregation of equity beta, UKCTA support Ofcom's view that 0.2 below its central estimate of BT's equity beta represents a conservative level of disaggregation for the equity beta of BT's copper access network. However, we believe that given Ofcom's tendency to continuously adopt conservative levels for CAPM components and coupled with Ofcom's reluctance to adopt disaggregated project gearing, we would not support any lower level of disaggregation.

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?

UKCTA welcome Ofcom's review of certain key components of the WACC. However, as explained in our introduction, UKCTA would have preferred Ofcom to consider all elements of BT's cost of capital in parallel. UKCTA also note that Ofcom have chosen to adopt a conservative stance on every component being reviewed in isolation. The cumulative impact of this approach is considerable as it is likely to result in a materially different outcome than one derived using a joined up approach. UKCTA would request that Ofcom conducts some analysis to assess the cumulative impact of considering these components in isolation.

-End-