

ECTA Response to ERG consultation on the IRG Regulatory Accounting working group's paper on WACC – November 2006

Summary

ECTA welcomes the ERG's guidelines on the calculation of WACC, an important element in ensuring that incentives remain for investing in infrastructure, whilst at the same time avoiding excessive prices for access to the detriment of consumers and the development of the market. Whilst we find the document technical and comprehensive, we nonetheless have a number of important suggestions:

- The paper should give more focus to and examples of practical experience in calculating the WACC in addition to the theoretical grounding
- The ERG should recommend as best practice that NRAs consult openly on the calculation of the WACC and underlying assumptions
- The document should address more clearly some key issues in relation to next generation access, and in particular the degree to which such investments may be risky – or otherwise
- ECTA's supports the principle of more closely aligning the WACC with actual levels of risk in the activities concerned, reflecting the fact that some aspects of the network may resemble utilities whilst others may carry greater risk. Additional focus on this issue in the paper would therefore be welcome.

ECTA and its members remain at the disposal of the IRG to discuss any of these issues further.

Response

ECTA welcomes the IRG Regulatory Accounting working group's paper entitled 'Principles of Implementation and best practice for WACC calculation'. The paper provides a useful reference manual for the various approaches available to an NRA in calculating the WACC given differing circumstances or information sets.

In setting and assessing regulated prices, the value of the WACC can have significant implications for the incentives of the regulated firm and for competition. The WACC will typically apply to wholesale network services with significant capital employed. Given the correct economic signals to investors, core networks are likely to be replicated whereas duplication of access and backhaul networks is highly unlikely (except in central business zones). Access and backhaul networks are likely to remain the focus of enduring SMP for incumbent operators. The WACC that the regulated entity is permitted to include within its prices for access and backhaul

services is therefore an essential element of pricing for electronic communications services, with a wide economic impact.

The WACC is important to entrants in deciding whether to build networks or buy services. Miscalculation of the WACC and the related distorted prices will feed misleading information into those decisions, as well as any market entry decision more generally. The WACC is also important to incumbent operators. If the WACC is set too low, the regulated entity will have less incentive to make capital investments, including necessary maintenance and repair. If the WACC is too high, the resultant high prices for services can inhibit competition and be detrimental to consumers. All of these lead to inefficiencies, misallocation of resources and reduced overall economic welfare.

The IRG paper highlights the complexities involved in setting the appropriate WACC. Each parameter in the WACC can be estimated using different methodologies, each method having its own benefits and detriments. Further, the inputs into those different methodologies to calculate parameters are also subject to conjecture and practical difficulties. However **the paper remains at an academic level and does not give enough consideration to the practical issues** of the application of the WACC in a converged and fast-changing industry.

ECTA requests that **greater transparency by the NRA in calculating the WACC is included in the paper as best practice guidance**. Given the uncertainty surrounding the calculation of the parameters and the importance of this calculation for setting access prices, ECTA believes that each NRA must engage in discussions and consultations with industry on this matter.

The dynamic and changing nature of the telecommunications industry through investment, innovation and convergence is not adequately addressed in the paper. These raise further questions about the appropriateness of differing methodologies of calculating, and applying, the WACC.

For example **many incumbents have plans in relation to Next Generation Networks, or Next Generation Access networks, yet the paper does not provide sufficient detail on this crucial topic**. Any consideration of the WACC should include a specific and careful debate about these network investments. There is debate about how innovation and investments should be rewarded but it is far from clear that these investments should give rise to an increased WACC. NRAs will need to consider the following types of questions carefully:

- Why are these investments taking place?
- Are they inherently riskier than other investments?
- How can any apparent increase in risk be mitigated?
- What is the appropriate level of reward for this scale of investment?
- What impact, if any, should there be in the WACC?
- How do you account for migration from the legacy network to the NGN?
- **Should NRAs consider calculating different WACCs for different activities performed by incumbent operators?**

This last question merits some amplification. The activities in which incumbent operators are engaging carry various degrees of risk, and involve different levels of capital. For example, financial analysis suggests that the asset beta of fixed access services which are a legacy from previous monopolies is close to that for utilities - clearly this beta will be more relevant in assessing the WACC for LLU than the beta for the business as a whole. In the same way, some new investments (where there is demand uncertainty and these do not merely constitute replacements or efficiency upgrades) may carry higher risk. ECTA believes that this is an important question, and urges NRAs to treat it as a material consideration in any national consultations involving WACC calculation, and in any decision which imposes price-regulation on dominant operators.

Another very important consideration in the list above is the level of risk – a risk premium should not be granted merely on the basis that an investment appears new or involves large sums. For example in the Netherlands, planned investments for the ‘all-IP’ programme including next generation access and core networks are €1.5bn, yet at the same time KPN is planning to recover €1bn+ through sale of the local exchange buildings that will be made redundant under these plans.

ECTA encourages the IRG, in providing best practice guidance for NRAs in calculating the appropriate WACC, to require NRAs to consider these challenging issues in a full and transparent manner