

ECS WACC Review - 2011

Statement on revised WACC rates

April 2011

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1 INTRODUCTION

In April 2008, the Malta Communications Authority (hereafter “the MCA”) published a decision and further consultation¹ on Estimating the Cost of Capital (hereafter “Decision and Further Consultation”). Subsequently, in August 2008, the MCA also issued a Report on Consultation and Decision² (hereinafter “Final Decision”). The aim of these documents was to set out the methodology that those providers of electronic communications services (“ECS”) having Significant Market Power and which are subject to the separated accounting obligation (hereafter “SMP Operators”) have to follow when compiling their respective weighted average cost of capital (“WACC”) rates.

The MCA had also stated that going forward, operators with SMP status and having the accounting separation obligation were required to submit revised WACC rates to the MCA by the end of February on an annual basis.

2 RESPONSES RECEIVED

All SMP Operators submitted their WACC calculations to the MCA for review on time. In total the MCA received submissions from three mobile operators and one fixed operator. The MCA reviewed the submissions to confirm whether they are in line with the methodology outlined in the Decision and Further Consultation published in April 2008, and the subsequent Final Decision issued in August 2008.

In its decisions, the MCA endeavoured to achieve regulatory consistency with the objective of establishing a fair and appropriate cost of capital. To this effect, a range of parameters for the different variables making up the cost of capital were established. Namely, these were:

- Target gearing structure;
- Risk free rate;
- Equity risk premium;
- Beta values; and
- Debt premium

¹ Decision and further Consultation on Estimating the Cost of Capital April 2008

² Estimating the Cost of Capital: Further consultation on Beta Values – Report on Consultation and Decision August 2008

In its review, the MCA sought to verify that SMP operators applied these set parameters consistently.

3 MCA APPROACH AND DECISION

In its calculations, the MCA applied the parameters set out in the 2008 decisions.

With respect to the risk free rate, the MCA was keeping track of the movements in the current yield to maturity on Malta Government Securities (“MGS”) to monitor how the prevailing global economic environment was impacting on the risk free rate.

In its approach to determine the risk free rate, the MCA made reference to the 2015 and 2020 MGS and where there was more than one bond maturing in a particular year, the average current yield to maturity of the bonds maturing in that year was taken.

In arriving at the WACC rates established in the statement published in April 2010, the MCA had worked out the risk free rate as an average of the current yields to maturity as at the end of each quarter (i.e. March 2009, June 2009, September 2009 and December 2009). This was done to mitigate against the effect of short term cyclical variations.

The MCA considers this to be a fair approach and has followed the same methodology for this year’s calculation. The average of the yields as at the end of each quarter of 2010 was taken (i.e. March 2010, June 2010, September 2010 and December 2010). The resulting WACC calculations of both the Fixed and Mobile ECS operators are presented in Appendix 2. The MCA hereby mandates that WACC rates are revised to these new rates (i.e. Fixed Market – 12.56%, Mobile Market – 13.73%). These revised WACC rates shall be applied to regulatory accounting periods ending on or after 31st December 2010.

4 WAY FORWARD

Calculations from SMP operators³ for the next review of the WACC rates will fall due by end of February 2012. Going forward, the MCA intends to keep the methodology under review by keeping under scrutiny any developments on the subject, as well as keeping track of any developments occurring at the international level.

³ Including newly designated SMP operators.

APPENDIX 1 – Illustrative results of risk free rate calculation

Listed Malta Government Securities - YTM				
	Mar-10	Jun-10	Sep-10	Dec-10

5.90% 2015 II	3.28	2.78	2.65	2.93
5.90% 2015 II	N/A	2.89	2.76	3.07
7.00% 2015 III	3.35	2.97	2.83	3.16
7.00% 2015 IV	3.35	2.97	2.83	3.16
3.75% 2015 VI	3.33	2.95	2.81	3.13
3.75% 2015 VI FI	N/A	2.95	2.81	3.13
3.75% 2015 VI FIB	N/A	N/A	2.81	N/A
Average	3.33	2.92	2.79	3.09
Low Estimate				<u>3.04</u>

5.20% 2020 I	4.24	4.03	3.79	4.36
4.60% 2020 II	4.23	4.01	3.78	4.35
4.60% 2020 II FI	4.23	4.01	3.78	N/A
7.00% 2020 III	N/A	N/A	3.84	4.40
Average	4.23	4.02	3.80	4.37
High Estimate				<u>4.11</u>

APPENDIX 2 – Illustrative results of WACC estimation

The tables hereunder illustrate the resulting calculations of the WACC rates for the mobile and fixed markets.

	Low Gearing		Medium Gearing		High Gearing	
	Low Estimate	High Estimate	Low Estimate	High Estimate	Low Estimate	High Estimate
Risk free Rate	3.04	4.11	3.04	4.11	3.04	4.11
Equity Risk Premium	5.00	6.00	5.00	6.00	5.00	6.00
Equity Beta	1.07	1.13	1.16	1.22	1.28	1.34
Cost of Equity (post-tax)	8.40	10.86	8.85	11.43	9.43	12.16
Cost of Equity (pre-tax)	12.92	16.71	13.61	17.58	14.50	18.71
Debt Premium	1.00	1.00	2.25	2.25	3.50	3.50
Cost of debt (post-tax)	2.62	3.32	3.44	4.13	4.25	4.94
Cost of debt (pre-tax)	4.04	5.11	5.29	6.36	6.54	7.61
Optimal Gearing	10%	10%	20%	20%	30%	30%
Tax Rate	35%	35%	35%	35%	35%	35%
WACC (pre tax nominal)	12.03	15.55	11.95	15.34	12.11	15.38

Table I – WACC calculation for the Mobile market

Based on the above, the WACC estimate ranges between 12.03% and 15.38% with an average pre-tax WACC rate of 13.73%.

	Low Gearing		Medium Gearing		High Gearing	
	Low Estimate	High Estimate	Low Estimate	High Estimate	Low Estimate	High Estimate
Risk free Rate	3.04	4.11	3.04	4.11	3.04	4.11
Equity Risk Premium	5.00	6.00	5.00	6.00	5.00	6.00
Equity Beta	0.93	1.16	1.02	1.28	1.15	1.43
Cost of Equity (post-tax)	7.69	11.08	8.15	11.78	8.77	12.71
Cost of Equity (pre-tax)	11.82	17.05	12.54	18.12	13.49	19.55
Debt Premium	1.00	1.00	2.25	2.25	3.50	3.50
Cost of debt(post-tax)	2.62	3.32	3.44	4.13	4.25	4.94
Cost of debt(pre-tax)	4.04	5.11	5.29	6.36	6.54	7.61
Optimal Gearing	20%	20%	30%	30%	40%	40%
Tax Rate	35%	35%	35%	35%	35%	35%
WACC pre tax nominal	10.27	14.66	10.36	14.59	10.71	14.77

Table II – WACC calculation for the Fixed market

Based on the above, the WACC estimate ranges between 10.27% and 14.77% with an average pre-tax WACC rate of 12.56%.