

WACC Review - 2010

Statement on revised WACC rates

April 2010

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Table of Contents

| | |
|--|----------|
| INTRODUCTION | 2 |
| RESPONSES RECEIVED..... | 2 |
| MCA APPROACH AND DECISION | 3 |
| WAY FORWARD..... | 4 |
| APPENDIX 1 | 5 |
| APPRNDIX 2..... | 6 |

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 operators 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 two mobile operators and one fixed operator³. The MCA reviewed the submissions to confirm 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 has 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

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

³ Although Melita Mobile Limited was found to have SMP in mobile termination, it is only required to prepare interim unaudited accounts for the first accounting year ending on or after 1st January 2010. Further details are given in the November 2009 Decision Notice entitled Wholesale Voice Call Termination on Individual Mobile Networks – Identification and Analysis of Markets, Determination of Market Power and Setting of SMP Conditions

- Debt premium

In its review, the MCA sought to verify that SMP operators applied these set parameters consistently. One of the submissions did not conform to the MCA's set methodology only in the approach to establish the risk free rate.

3 MCA APPROACH AND DECISION

As stated in the statement on revised WACC rates published in April 2009, 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 uncertainties were impacting on the risk free rate.

In its approach to determine the risk free rate, the MCA made reference to the 2014 and 2019 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.

Compared to 2008, monthly fluctuations in the current yield to maturity in 2009 followed a smoother pattern. Average current yields of 2014 bonds decreased gradually from 3.93% as at the end of January 09 to 3.45% as at the end of December 09. Average current yields of 2019 bonds decreased gradually from 4.68% as at the end of January 09 to 4.5% as at the end of December 09.

In arriving at the WACC rates established in the statement published in April 2009, 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 08, June 08, September 08 and December 08). This was done to mitigate against the effect of short term cyclical variations.

In view of the continuing financial climate, 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 2009 was taken (i.e. March 09, June 09, September 09 and December 09). The resulting WACC calculations of both the Fixed and Mobile markets are presented in Appendix 2. The MCA hereby mandates that WACC rates are revised to these new rates (i.e. Fixed Market – 13.25%, Mobile Market – 14.44%). These revised WACC rates shall be applied to regulatory accounting periods ending on or after 31st December 2009.

4 WAY FORWARD

Calculations from SMP operators⁴ for the next review of the WACC rates will fall due by end of February 2011. 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.

⁴ Including newly designated SMP operators that are due to prepare unaudited accounts for periods ending on or after 1st January 2010.

APPENDIX 1 – Illustrative results of risk free rate calculation

| Listed Malta Government Securities - YTM | | | | |
|---|---------------|---------------|---------------|---------------|
| | Mar-09 | Jun-09 | Sep-09 | Dec-09 |

| | | | | |
|---------------------|-------------|-------------|-------------|--------------------|
| 6.60% 2014 I | 3.58 | 3.72 | 3.44 | 3.29 |
| 6.45% 2014 II | 3.77 | 3.90 | 3.61 | 3.53 |
| 5.10% 2014 III | 3.66 | 3.81 | 3.53 | 3.41 |
| 7.00% 2014 IV | 3.80 | 3.92 | 3.63 | 3.56 |
| Average | 3.70 | 3.84 | 3.55 | 3.45 |
| Low Estimate | | | | <u>3.64</u> |

| | | | | |
|----------------------|-------------|-------------|-------------|--------------------|
| 6.60% 2019 I | 4.52 | 4.61 | 4.38 | 4.48 |
| 7.00% 2019 II | | 4.62 | 4.42 | 4.52 |
| Average | 4.52 | 4.62 | 4.40 | 4.50 |
| High Estimate | | | | <u>4.51</u> |

APPENDIX 2 – Illustrative results of WACC estimation

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

| | Low Gearing | | Medium Gearing | | High Gearing | |
|----------------------------------|--------------|---------------|----------------|---------------|--------------|---------------|
| | Low Estimate | High Estimate | Low Estimate | High Estimate | Low Estimate | High Estimate |
| Risk free Rate | 3.64 | 4.51 | 3.64 | 4.51 | 3.64 | 4.51 |
| 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) | 8.29 | 11.49 | 8.75 | 12.18 | 9.37 | 13.11 |
| Cost of Equity (pre-tax) | 12.75 | 17.67 | 13.46 | 18.74 | 14.41 | 20.17 |
| Debt Premium | 1.00 | 1.00 | 2.25 | 2.25 | 3.50 | 3.50 |
| Cost of debt(post-tax) | 3.01 | 3.69 | 4.34 | 4.50 | 5.15 | 5.31 |
| Cost of debt(pre-tax) | 4.64 | 5.51 | 5.89 | 6.76 | 7.14 | 8.01 |
| Optimal Gearing | 20% | 20% | 30% | 30% | 40% | 40% |
| Tax Rate | 35% | 35% | 35% | 35% | 35% | 35% |
| WACC pre tax nominal | 11.12 | 15.24 | 11.19 | 15.15 | 11.50 | 15.31 |

Table I – WACC calculation for the Fixed market

Based on the above, the WACC estimate ranges between 11.12% and 15.31% with an average pre-tax WACC rate of 13.25%.

| | Low Gearing | | Medium Gearing | | High Gearing | |
|----------------------------------|--------------|---------------|----------------|---------------|--------------|---------------|
| | Low Estimate | High Estimate | Low Estimate | High Estimate | Low Estimate | High Estimate |
| Risk free Rate | 3.64 | 4.51 | 3.64 | 4.51 | 3.64 | 4.51 |
| 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) | 9.00 | 11.27 | 9.45 | 11.83 | 10.03 | 12.57 |
| Cost of Equity (pre-tax) | 13.84 | 17.33 | 14.53 | 18.21 | 15.43 | 19.33 |
| Debt Premium | 1.00 | 1.00 | 2.25 | 2.25 | 3.50 | 3.50 |
| Cost of debt (post-tax) | 3.01 | 3.69 | 4.34 | 4.50 | 5.15 | 5.31 |
| Cost of debt (pre-tax) | 4.64 | 5.51 | 5.89 | 6.76 | 7.14 | 8.01 |
| Optimal Gearing | 10% | 10% | 20% | 20% | 30% | 30% |
| Tax Rate | 35% | 35% | 35% | 35% | 35% | 35% |
| WACC (pre tax nominal) | 12.92 | 16.15 | 12.80 | 15.92 | 12.94 | 15.93 |

Table II – WACC calculation for the Mobile market

Based on the above, the WACC estimate ranges between 12.8% and 16.15% with an average pre-tax WACC rate of 14.44%.