

Responses to WACC consultation

This document sets out the substantive comments made in response to the TRA's consultation on WACC, and outlines TRA's responses to these.

Q1	Do you agree that the appropriate base for the regulatory WACC should be the domestic telecommunications services for each company?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel requested avoidance of separate fixed and mobile WACCs, as the use of one integrated WACC would be consistent with industry convergence trends and simpler to implement. • In the case that separate WACCs are implemented, Omantel believes that the fixed WACC should be higher than mobile, as fixed is a riskier investment. • Omantel requested clarification of the term 'international operation' (i.e. operations of subsidiary companies outside of Oman). <p><u>Nawras</u></p> <ul style="list-style-type: none"> • Nawras also requested avoidance of separate fixed and mobile WACCs. • They also argued that new telecommunications services such as data/mobile money more risky than traditional services and that estimates presented are too conservative. 	<ul style="list-style-type: none"> • TRA agree in principle with Omantel and Nawras on the use of one integrated WACC keeping in view the industry trend of convergence and simplicity of implementation.

Q2		Do you agree with the use of the Home Approach?	
No.	Responses to consultation	Our response	
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel agree with the use of the home approach for now, but stated that the TRA should consider changing this basis if the sourcing of capital finance becomes more international in the future. <p><u>Nwaras</u></p> <ul style="list-style-type: none"> • Nwaras agree with the use of the home approach. 	<ul style="list-style-type: none"> • No issues raised as all respondents agree. 	

Q3		Do you agree with the choice of the CAPM methodology?	
No.	Responses to consultation	Our response	
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel agree with use of CAPM approach. • However, they argue that regulatory risk should be explicitly included and that asymmetric risk adjustment should be compensated for in the estimate. <p><u>Nwaras</u></p> <ul style="list-style-type: none"> • Nwaras agree with the use of the CAPM approach. 	<ul style="list-style-type: none"> • No issues raised in regards to the use of CAPM methodology as all respondents agree. • Omantel did not indicate how regulatory risk should be included in the estimates. Given this and the difficulty in estimating a suitable figure for regulatory risk, the draft decision document upholds the proposal to disregard the extreme ends of the estimate range rather than endeavour to calculate an estimate for regulatory risk. 	

Q4	Do you agree with our estimation of the risk-free rate? Where within this range do you think is the most appropriate?					
No.	Responses to consultation	Our response				
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel argue that the time horizon of the yield period of the bonds used is too short and that government bonds used should include Dubai. • They also argue that newer government bond estimates should be used. • Omantel state that the inflation differential seems too low and suggest using higher estimates sourced from EIU. <p><u>Nawras</u></p> <ul style="list-style-type: none"> • Nawras argue that only 10 year bonds should be considered. • Nawras provided the following alternative formula for adding the inflation differential to the US risk free rate. <table border="1" data-bbox="280 1066 791 1160"> <tr> <td data-bbox="280 1066 427 1160">Kc lcy=</td> <td data-bbox="432 1066 791 1115">$(1 + Kc\\$) \times (1 + Ilcy)$</td> </tr> <tr> <td data-bbox="280 1115 427 1160"></td> <td data-bbox="432 1115 791 1160">$(1 + I\\$)$</td> </tr> </table> <ul style="list-style-type: none"> • Nawras also noted that Moody's rates Oman A1 and S&P rates Oman A and that this would give reading of 1.28% as noted and 1.5% for the A rating, flowing Stern's methodology. They recommend an average of 1.39% be taken. • For regional bonds they state that Oman bonds should not be used as the idea is to look at independent benchmarks. They recommend using of q-tar 10 year bond rate and differential from Q-tar default spread. <p><u>Jacob Koshy</u></p> <ul style="list-style-type: none"> • <i>Calculation of risk free rate</i> – Mr Koshy recommends using a 10 year Treasury rate for the calculation. • <i>Inflation adjustment</i> – Mr Koshy suggested that it would be more appropriate to use the market observed inflation rates rather than estimated inflation rates to calculate risk free rates. He also suggested an alternative formula for incorporating the inflation differential, consistently with Nawras's suggestion. 	Kc lcy=	$(1 + Kc\$) \times (1 + Ilcy)$		$(1 + I\$)$	<p><u>Inflation differential</u></p> <ul style="list-style-type: none"> • The adjustment for the inflation deferential has been incorporated using the formula suggested by respondents to the consultation. • The decision document retains the use of forecast. These are more appropriate than the 2008/2009 inflation figures raised by Omantel, as the WACC should be forward-looking. <p><u>Bonds</u></p> <ul style="list-style-type: none"> • The alternative methodology suggested by Nawras is not considered to be more robust that that proposed in the consultation. The suggested alternative methodology (calculation of the risk free rate using Qatar bonds only) incorporates an unsourced and inconsistent estimate of the default spread differential between Oman and Qatar (they use 0.50%, stern gives 0.35%). • As it was not possible to update the bond information, and taking into account the various other concerns raised, these rates have been used as a double check for the calculation based on the US risk free rate only. <p><u>Country risk premium</u></p> <ul style="list-style-type: none"> • An Oman specific risk free rate, and an Oman specific equity risk premium have been calculated using stern market risk premium and the beta estimates. The country specific risk impacts the whole cost of equity figure, not just the equity premium component and therefore should be included in both. <p><u>Risk rating used</u></p> <ul style="list-style-type: none"> • Stern's calculation of the risk premium for Oman, which is based on an A1 rating obtained from Moody, has been employed in the calculation rating. Stern is a respected authority in the calculation of risk premium and it is not appropriate
Kc lcy=	$(1 + Kc\$) \times (1 + Ilcy)$					
	$(1 + I\$)$					

	<ul style="list-style-type: none">• <i>Country risk premium</i> – Mr Koshy argued that it is not correct to add the country risk premium to the risk free rate, stating that the country risk premium should be added to the equity risk premium only.	to re-calculate this published and accepted figure.
--	--	---

Q5	Do you agree with our estimation of the Equity Risk Premium?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> Omantel argue that the Stern figure should be the lower bound. They suggest that an initial 1.3% should be added to the upper bound bringing it to 7.58%. <p><u>Nawaras</u></p> <ul style="list-style-type: none"> Nawras agree with the Stern NYU approach when estimating equity risk premium (ERP) but illustrate a calculation which arrives at a figure of 7.58%, which is higher than the latest Stern NYU figure of 6.28%. <p><u>Jacob Koshy</u></p> <ul style="list-style-type: none"> Mr Koshy again raised his concern that using the Oman specific equity risk premium of 6.28% in addition to such adding the country risk premium of 1.28% to the risk free rate may amount to double counting. 	<ul style="list-style-type: none"> Omantel did not provide a calculation to support their revised estimate and it was not possible verify Nawara's re-calculation of Stern's estimate, as they have not provided sources for some of the numbers used. See above (question 4) explanation of the use of country specific risk in both components of the cost of equity.

Q6	Do you agree with our estimation of the beta? Where within this range do you think is the most appropriate?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel argue there should not be large variation in the estimates between Omantel and Nawras because they are operating in the same market with similar licences. • They argue that Nawras has not been operating long enough to estimate a beta and state that Omantel's beta was higher when they first began operations than it is now. • Omantel also suggest that their beta should be higher to account for their service obligations and dividend expectations. <p><u>Nawras</u></p> <ul style="list-style-type: none"> • In general, Nawras agree with the beta estimates put forward by the TRA. However, as they believe that monthly intervals for at least 5 years (at least 60 observations) are needed to assess the beta, they state that as a relatively new telecom company, there is insufficient data for an accurate beta. • On the other hand, they raised concerns that if a sector beta was used as an alternative this might penalize Nawras which has a higher beta owing to its relative youth as a company and investors perception of the higher risk associated with this company. As such, they point out that their market access to funding will not enjoy the same terms as Oman Tel. • They also explained that they would prefer to use adjusted betas to allow for the mean reverting tendency to a market beta of 1. <p><u>Jacob Koshy</u></p> <ul style="list-style-type: none"> • Mr Koshy suggested using the asset betas obtained for Middle East Countries of 0.75 (High) and 0.68 (low) and re – leveraging them to obtain the equity betas for Omantel & Nawras. 	<ul style="list-style-type: none"> • Differences in beta and WACC estimates between regulated companies in the same market are a common occurrence globally and are necessary unless a generic estimate is used for all companies. • Bloomberg have done their own analysis, incorporating the effects of market conditions and the operating environment into their estimates. Therefore, it would be double counting to alter their estimates to take these things into account further. • To obtain an increased number of observations we have used weekly beta estimates. This is most accurate estimate we can obtain currently given Nawras's relatively recent entry into the market. The beta can be re-estimated at a future date when Nawras has been operating longer. • Bloomberg's adjusted beta estimates have already incorporated Marshall Blume's equation to account for the fact that betas revert to 1 over time. Therefore this bias is already corrected. • It is more accurate to use betas calculated for the companies specifically, rather than general region, country or industry betas.

Q7	Do you agree with our inclusion and estimation of the cost of equity issuance? Where within this range do you think is the most appropriate?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel are of the opinion that, since Omantel and Nwaras have already floated their equity issue, the cost of raising equity does not seem relevant unless they recapitalize in the future. <p><u>Nwaras</u></p> <ul style="list-style-type: none"> • Nawras argue that due to the fact that the Omani market is underdeveloped, the cost of raising equity finance would be more to the range of 0.55%-0.8% as noted by Ofgem. • They also state that their recent issue incurred a cost of around 3%. 	<ul style="list-style-type: none"> • The WACC is an annual amount and therefore the allowance for equity issuance is not intended to be covered in its entirety as it does not occur every year. • The Ofgem estimate relates to a study carried out in 2006 for the UK water regulator, and as such should not be considered representative of the Omani market. • The 3% figure stated by Nawras should not be taken as representative of the cost of raising additional finance rather than the cost of an initial public offering. Additionally, Nwaras provides no evidence of their high incurred cost of equity issuance.

Q8	Do you agree with our calculation of the cost of debt? Where within this range do you think is the most appropriate?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <ul style="list-style-type: none"> • Omantel argue that the gearing ratio for Nawras seems wrong compared to their company financials (which they estimate provides a gearing ratio of 25%). • Omantel also question why the corporate ratings for AA corporates used as a benchmark have a lower cost than AAA rated companies. <p><u>Nawras</u></p> <ul style="list-style-type: none"> • Nawras agree with the method of calculating cost of debt but suggest using 10 year bonds only. <p><u>Jacob Koshy</u></p> <ul style="list-style-type: none"> • Mr Koshy is concerned that the debt premium for A rated corporate debt has been applied both for Omantel and Nawras without regard to the gearing of the companies. They argue that it may be proper to give an A rating to Omantel as it is debt free company majority owned by the Government but that for other companies, a synthetic rating should be estimated based on the interest coverage and the debt premium should be based on that rating. 	<ul style="list-style-type: none"> • The values used in the consultation were derived from Bloomberg's estimates. The figure for Nawras was checked using Nawras market capitalisation as listed on the Muscat Securities Market and the net debt (Interest bearing borrowings minus cash position) listed in their financial accounts. Results were found to be consistent with Bloomberg's figure. Therefore, the 5.3% gearing estimate has been retained for the decision document. • An appropriate bond period should be linked to the regulatory period, and therefore continues to use 5 year bonds as lower case and 10 as higher case, as in the consultation. • The gearing of both companies is extremely low. Therefore, the difference in gearing ratios between the companies is unlikely to impact their relative risk. The use of A rated companies as a benchmark has been retained for both companies. • A review of the reported numbers found that the estimates for Corporate AAA bonds had not been updated in the source since 2009. Therefore these have been removed from decision paper. However, since the methodology employed uses only Corporate A bonds, there is no change from the consultation.

Q9	Do you believe that we should set the gearing at the company-specific level or international optimum level?	
No.	Responses to consultation	Our response
	<p>Omantel</p> <ul style="list-style-type: none"> Omantel agrees that the gearing should be at company specific level. <p>Nawras</p> <ul style="list-style-type: none"> Nawras agrees that the gearing should be at company specific level. 	<ul style="list-style-type: none"> No issues raised as all respondents agree.

Q10	Do you agree, in general, with our calculation of WACC for Omantal, Nawras and a generic operator? Where within these given ranges do you think is the most appropriate?	
No.	Responses to consultation	Our response
	<p>Omantel</p> <ul style="list-style-type: none"> Omantel questioned why the tax rate varies between companies. Omantel also suggests that the Nawras forecast beta estimate used is more volatile in than the current beta level. <p>Nwaras</p> <ul style="list-style-type: none"> Nawras believes the WACC calculations shown in the report to be too conservative. They state that employing their suggested changes would result in WACC estimates of 14.43% to 17%. <p><u>Jacob Koshy</u></p> <ul style="list-style-type: none"> Mr Koshy pointed out that the after tax cost of debt has been inadvertently calculated by dividing the pretax cost of debt by 1- tax rate instead of by multiplying the pre tax cost by 1- tax rate as described in the consultation. He suggested this be corrected. 	<ul style="list-style-type: none"> It is appropriate to use the effective tax rate rather than jurisdictional corporate tax level. The data considered from Bloomberg indicates that Nawras's long-term beta is forecast to be less volatile than the current level not more as suggested by Omantel. The calculation of post tax debt has been corrected.

Q11	Do you have any additional comments about our proposed methodology?	
No.	Responses to consultation	Our response
	<p><u>Omantel</u></p> <p><i>Frequency</i> – Omantel recommend that the TRA review WACC annually, and that the time period should be agreed by an industry forum.</p> <p><i>Variations in WACC</i> – Omantel argue that separate estimates between firms and between fixed and mobile cause confusion/complications, especially as there are a number of other telecoms companies in Oman other than the main two.</p> <p><i>Accounting separation legislation</i> – Omantel have asked for confirmation that, regardless of the WACC estimate for regulatory purposes, that their WACC calculation in the preparation of statutory accounts should comply with the provisions of the Accounting separation regulation.</p> <p><u>Nawras</u></p> <p><i>Frequency</i> – Nawras believe that the cost of capital needs to be more stable and long-term in nature in order to allow for more accurate business planning. A short-term focus will lead to volatility and hinder development.</p> <p><i>Risk of low estimate</i> – They argue that due to the current stressed market conditions, the market is now in the process of deleveraging. Therefore, they caution against underestimating costs of capital as they will most probably push higher over time.</p>	<p>These issues are possibly outside of the scope the draft decision document.</p> <ul style="list-style-type: none"> • The TRA believes that there is an argument to be made for both longer-term and shorter-term estimates. Since WACC is to be used for regulatory purposes, the TRA believes it is appropriate to set WACC over the appropriate regulatory period. This may mean that the WACC will be reviewed at the start of major regulatory periods and held constant over that period. • The TRA has calculated a generic WACC which can be applied to other operators in the industry, to the extent that any regulation of these operators is necessary. • The TRA considers that this regulatory WACC should be considered outside the scope of the statutory accounts.