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WACC

Same problem, different market conditions

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The European Commission published in 2019 a Notice[2] on the calculation of the weighted average cost of capital (WACC) for telecom legacy assets – copper network among other things. It defines the methodology and concrete steps to be used by national regulatory authorities (NRA) to estimate the WACC when those regulators impose cost control or pricing obligations. The Notice recommends, among others, the use of a 5-year trailing average of 10-year bonds as a proxy for the nominal risk free rate. The equity risk premium (ERP) would be based on historical time series. The WACCs would be estimated in nominal terms. Real WACCs would be derived in a second step using for Eurozone Member states a Euro-wide inflation indicator (in practice, the ECB 5-year inflation forecast).

The Notice tasked the BEREC to publish on a yearly basis a report calculating the various parameters intervening in the WACC calculation. Since then, two reports have already been published and the third one is expected by June 2022. For historical time series for ERP, BEREC has been using, when available, data spanning over more than a century[3]. While legally speaking, this recommendation is non-binding, the EC reviews NRAs WACC decisions against the use of the Notice methodology. Indeed, most regulators' WACC decisions have used the BEREC parameters following the Notice methodology since the adoption of the Notice.

Orange and ETNO[4] have consistently been calling for a change in the methodology applied by regulators to set the WACC since its initial implementation. The notice resulted, in a number of countries, in very low WACCs, significantly below standard, and widely available, market estimates.

Serious concerns have been raised in particular about the backward-looking approach used.

During the sustained period of low inflation, **quantitative easing and resulting depressed interest rates in the EU**, **the cost of equity (sum of the risk-free rate and the ERP)** did not follow the downward trend of the interest rates. **Empirical evidence showed at the contrary that the ERPs departed from historical estimates and increased**. **Using its backward-looking approach and mixing short trailing periods for averaging (5 years) with very long history of ERP data, the methodology failed to capture that increase in the ERP.**

The market circumstances have dramatically changed since, with a steep acceleration in inflation and interest rates. Early signs of a surge in inflation were already visible with world supply chain disruptions due to the Covid-19 crisis. These were compounded with upward pressure on energy prices visible in the second half of 2021 and dramatically accelerated with the War in Ukraine. In this context, central banks (in particular the US Federal Reserve and the ECB) are tightening their monetary stances. The Fed has increased its short-term interest rates while the ECB is reducing its asset-purchasing program, *de facto* putting to a halt its quantitative easing program. Inflation is trending up at a

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[2] Communication 2019/C 375/01 of 6.11.2019

[3] Dimson/Marsh/Staunton (DMS) data when available

[4] https://etno.eu/library/positionpapers/420:etno-statement-wacc-ec.html#_ftnref1

dramatic pace, in particular in the Eurozone**. Nominal long term interest rates have increased significantly since the beginning of 2022, materializing those changing market circumstances, from the previous low inflation and quantitative easing environment to the current high inflation and more restrictive monetary stance.**

Still, the same methodological issues of the EC WACC Notice remain. By estimating the risk-free rate backwards, the Notice fails to capture the changing trend in long term bonds and in the inflation outlook. Most strikingly, applying the backward-looking methodology today would result in nominal risk-free rate estimates that would be even lower than the ones estimated a year ago. **Indeed, the backward-looking 5-year averaging still captures to a large extent nominal interest rates that reflected the past market conditions of very low inflation. The result is, again, an underestimation of the cost of equity, this time through an underestimation of the risk-free rate.**

Ceteris Paribus, **the regulated nominal WACCs computed through the Notice would wrongly fall further and in any case would remain underestimated, while all risk indicators and market estimates point at the contrary to an increase in the WACCs.**

The situation is even worse when one looks at the real interest rates. As the EC points out in its Notice, "*Investors maximise their inflation-adjusted or real returns*". The ECB 5-Year inflation forecast is currently at 2% and captures to a large extent the ECB's inflation target. At the same time, the current inflation in most Euro-zone countries and more widely in the EU, is above that target by several percentage points. **The regulated WACCs real returns for legacy assets are in this context depressed to an unprecedented level through a vicious circle:**

- Nominal WACCs are underestimated and as estimated still reflect the past monetary conditions with low inflation;
- Real WACCs are eroded by the current rise in inflation.

In a number of countries, the resulting real WACCs on legacy assets are turning close to zero or even negative. For the share of non-amortized legacy investments, this outcome is against the principle of cost recovery. It sends an extremely discouraging economic signal to investments.

With the benefit of hindsight, one can reasonably consider that applying mechanically a WACC calculation formula without properly assessing its outcomes compared to market indicators is inappropriate. As it is, the formula might have given accurate outcomes in a theoretical "steady-state" environment of "normal" inflation, nominal interest rates and risk indicators. The real world has been far from this steady state. The formula gave inappropriate outcomes in the period of quantitative easing, depressed interest rates and low inflation. It proves wrong again in the context of increasing inflation and nominal interest rates.

Indeed, the formula today would keep sending a deflationary signal to the telco actors in a world of inflation. It is time to consider a change and to align concrete regulatory actions - as important as setting the WACC - with the broader EU ambitions of the digital decade. This is still important for the "legacy" activities as operators still invest in them. Also, today's investments might become tomorrow's legacy. It is hence urgent that the telco sector earns decent returns on its investments. Otherwise, the sector will fall short to bridge the investment gap that everyone has been highlighting.

Please make our sector profitable again!