CABLE AND WIRELESS (JAMAICA) LTD.
REPLY COMMENTS ON

Estimate of Weighted Average Cost of Capital for Telecommunications Carriers

(Consultation Document 2020/TEL/011/CON.002)

11 August 2020

I. INTRODUCTION

1. Cable and Wireless (Jamaica) Ltd. ("**C&WJ**") welcomes the opportunity to respond to comments made on the Office of Utilities Regulation's ("**OUR**") approach to estimating the Weighted Average Cost of Capital ("**WACC**") for fixed line and mobile telecommunications licensees operating in Jamaica.

2. C&WJ would like to use this opportunity to respond to initial comments made by Digicel in this consultation.

3. Please direct any questions you may have on these comments to Charles Douglas at charles.douglas@cwc.com

II. RESPONSE TO DIGICEL'S RECOMMENDATION TO ESTIMATE A SEPARATE WACC FOR FIXED LINE AND MOBILE

3. C&WJ maintains that there is no valid reason to estimate a separate WACC for fixed line and mobile, since there is no longer significant variation in the risk profiles between the two telecoms operators in Jamaica today—C&WJ and Digicel. Both licensees operate fixed line and mobile networks; both offer a similar portfolio of services; and both market and sell their portfolio of fixed and mobile services to a comparable set of customers in Jamaica. Furthermore, market dynamics and trends in technology convergence reinforce the conclusion that a unified measure of WACC is appropriate in the forward-looking framework the OUR relies on.

4. Digicel acknowledges that "there has been some consolidation into multiplay fixed and mobile offerings since the last consultation," but claims (without explanation) that Digicel's "investment profile…remains distinct" from Flow's. Digicel also argues that since there is the "prospect of" or "possibility for separate entry into both markets it would not be appropriate to use a single combined 'telecommunications' WACC."

5. C&WJ objects to Digicel's response. First, we agree that technology convergence is underway in Jamaica today, but is not yet complete. We do not agree, however, that substantial differences remain between the two licensees' operations in Jamaica or, most importantly, that the completion of this convergence process is a necessary or sufficient pre-condition to establishing a unified WACC. To the contrary, the licensees' operations and service offerings in Jamaica are quite similar. In addition, there is an irrefutable trend towards greater convergence, and if this trend is considered within the OUR's forward-looking framework, it becomes clear that technology-based distinctions in estimating WACC are not appropriate. Such distinctions create an artificial variation in licensees' costs that distort economic efficiency and impede the development of telecoms competition in Jamaica.

6. Second, while it may have been a more common practice a decade ago to produce technology-specific WACCs, we do not believe it is best practice today. Reference to the WACC benchmarks presented in the OUR's Consultation Document demonstrate the point that there is no single or "best" approach to estimating WACC. Six of the 12 benchmarks presented in Exhibit 15 (on p. 41) produce a single WACC measure for fixed line and mobile. And of the six benchmarks that produce technology-specific WACCs, in only three cases are the variations between the measures significant (i.e., > 3/5th of a percentage point). This is because almost all the inputs to the WACC calculations are identical for fixed line and mobile. For example, the benchmark inputs used for gearing (Exhibit 2, seven of 12 benchmarks are identical), Beta (Exhibit 9, seven of 12 benchmarks are identical) and cost of equity (Exhibit 12, nine of 12 benchmarks are identical).

7. In light of all the above factors, as well as the further detail provided in C&WJ's initial comments, we encourage the OUR to reject Digicel's arguments for technology-specific WACCs and to apply a single WACC of 9.5% to both mobile and fixed licensees in Jamaica.

III. Response to Digicel's claim that the WACC estimates are underestimated and unreliable due to the uncertainty caused by the COVID-19 pandemic

9. Digicel contends that disruptions caused by the COVID-19 pandemic have created mismeasurement in OUR's WACC calculation. According to Digicel:

> *There is a very significant level of economic uncertainty because of the effects of the pandemic. Regional and sectoral variations in impacts relating to both severity and recovery paths mean that the relevance of past trends or the accuracy of future projections cannot be established.*

10. Digicel identifies three inputs to the WACC calculations that it says are impacted by "the effects of the pandemic": (1) the country-risk premium ("CRP"), which Digicel alleges is **underestimated**; (2) the risk-free rate, which Digicel alleges is **overestimated**; and (3) the inflation rate, which Digicel simply claims is **mismeasured** without opining on the direction (i.e., over or underestimated). Digicel concludes "For the reasons set [sic] above Digicel believes that both the USD WACC estimate [sic] and the JMD WACC estimates are understated." To address this alleged understatement, Digicel seeks to increase the WACC estimates, but fails to opine on the increase that is needed.

11. C&WJ rejects Digicel's superficial arguments. First, Digicel neither quantifies the alleged mismeasurements nor offers any corrective measures. For instance, regarding the CRP input, Digicel contends the error is quite large and "is likely to be a significant underestimate," but offers neither research evidence, nor analysis to support this conclusion. It fails to quantify the effect and explain why the effect is likely to be "significant."

12. Second, Digicel's failure to quantity the mismeasurement of the three WACC inputs is compounded by the multi-directional nature of Digicel's assertions. If Digicel wants to argue that one input (CRP) is underestimated, another input (risk-free rate) is overestimated, and a third input (inflation rate) is simply mismeasured in either

direction, then without quantifying these misstatements it is not possible say whether the WACC estimates are understated, overstated or spot on. This ambiguity alone should lead the OUR to reject these Digicel comments as completely unconstructive.

13. Third, we disagree that the pandemic has substantially increased financial risk, or that this increased financial risk has created mismeasurement when estimating the cost of capital. We agree the pandemic has created an immediate and unprecedented disruption to economies worldwide, which has in turn prompted interventions by governments and central banks worldwide that have been unprecedented in scale. Fortunately, there are financial metrics that parse this information and forecast the effects of these countervailing events on financial risk and performance.

14. After considering the significant interventions by governments and central banks worldwide, the evidence to date indicates that there has been no material reduction in investor confidence in both equity and debt markets, relative to pre-pandemic levels. What has changed as a result of the recent economic turmoil is that medical researchers have turned aggressively to developing tests and vaccines for the virus, and central banks have shown a willingness to expand their purchases beyond government bonds into corporate bonds. As a result of these aggressive actions, and their prospects of near-term success, we have observed a reduction in the risk premium (the excess return above the risk-free rate) for both corporate debt and equity. The increased government back-stop has been a major reason for the increased demand for corporate debt and bull stock markets, despite major economic declines globally.

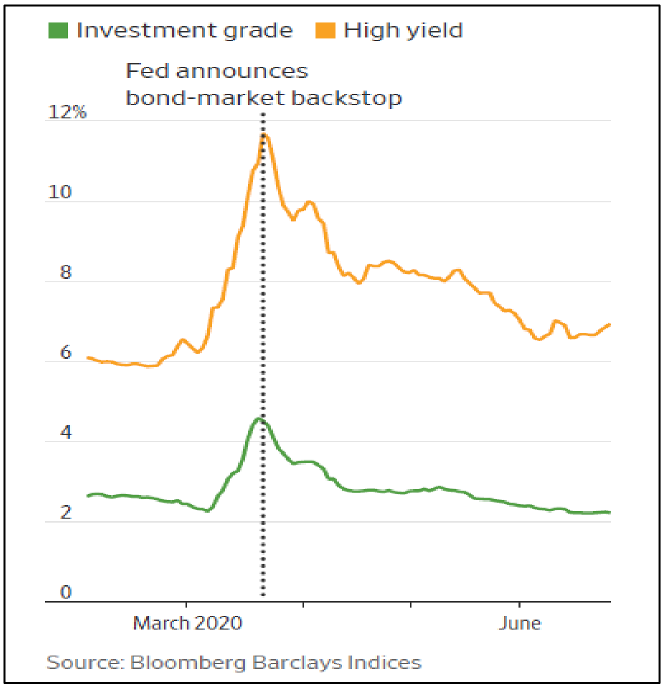
Corporate debt

15. According to a recent article in the *New York Times* (tinyurl.com/y3bnmuwn), the U.S. Central Bank's efforts to stabilize markets have touched off a substantial increase in corporate borrowing:

Through late June, giant U.S. companies had borrowed roughly $850 billion in the bond markets this year, double the pace from last year. Analysts at JPMorgan Chase anticipate that investment-grade companies will borrow roughly $1.6 trillion from investors by the time 2020 is over.

16. While the yield on corporate bonds increased dramatically at the outset of the pandemic, as shown in Figure 1 below, as central banks began their interventions, the yields on corporate debt have since returned to pre-pandemic levels, according to the *Wall Street Journal* (tinyurl.com/y6roma3k).

Figure 1: Yields on U.S. corporate bond indexes



Corporate equity

17. Like corporate debt markets, equity markets also took a substantial hit at the beginning of the pandemic, as shown in Figure 2, but have since rebounded and now exceed their pre-pandemic levels (see, *New York Time*, tinyurl.com/ybq3vude).

Figure 2: Year-to-date return on Nasdaq and S&P 500 Indices

18. There are at least two possible factors driving this recovery in debt and equity markets: (1) investors expect significant increases to future earnings and overall macro performance; and/or (2) investors are discounting (higher) future earnings at a significantly lower rate. Both factors are favorable when it comes to procuring investment and indicate a reduction in the required return necessary to secure investment funding. That is, these outcomes indicate that investors believe markets will eventually (over the medium- to long-term) rebound from the pandemic, and resume growth at rates equal to or greater than pre-pandemic levels.

19. We do not believe that this evidence is consistent with or supports Digicel unsubstantiated assertions that the pandemic has substantially increased investment risk or permanently harmed the prospects of future investment. To the contrary, if

anything, we believe the evidence today indicates an equal or greater confidence by investors in the prospects of equity and debt markets than before the pandemic.

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