

# Digicel

**Digicel's comments**

**to**

**The Office of Utilities Regulation Consultation Document**

**on**

**Estimate of the Weighted Average Cost of Capital for  
Telecommunications Carriers**

## Preliminary Comments

We thank the Office of Utilities Regulation for providing this opportunity for Digicel to comment on the Consultation Document on the Update of the Estimate of the Weighted Average Cost of Capital for Telecommunications Carriers. Digicel is, of course, available and would be happy to discuss our submission further.

The comments as provided herein are not exhaustive and Digicel's decision not to respond to any particular issue(s) raised in the Consultation Document or any particular issue(s) raised by any party relating to the subject matter generally does not necessarily represent agreement, in whole or in part nor does any position taken by Digicel in this document represent a waiver or concession of any sort of Digicel's rights in any way. Digicel expressly reserves all its rights in this matter generally.

Please do not hesitate to refer any questions or remarks that may arise as a result of these comments by Digicel to:

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## **General Comments**

Digicel notes that in its 2016 Determination relating to the estimation of the Weighted Average Cost of Capital (WACC) for the Jamaican Market the Office set out that the estimate of the WACC would be updated every 5 years from the effective date of that Determination which was 28 November 2016.

This means that the WACC is not due to be updated until 28 November 2021.

The Office's indicative timeline for issuing a Determination in respect of this current review of the WACC is to publish this "by November 2020"<sup>1</sup>.

Digicel is of the view that shortening the review period without material reason undermines the regulatory certainty which the Office's previous pronouncements on the review period had given the Industry.

If the proposed new estimate for the WACC is not to become effective until November 2021 as originally advised, then the carrying out the review at this time necessitates the use of inputs that will have "aged" by the time any revised rate becomes effective. This in turn degrades the quality of any forward looking estimate which is based upon them.

This timing issue is all the more relevant in light of the Covid pandemic. 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.

What can be forecast with reasonable certainty is that the economic impacts will be negative. The full extent of duration, depth and distribution of these impacts across countries and sectors cannot be estimated at this time.

Additionally, as Digicel has pointed out in response to other consultations, the use of a pure-LRIC cost standard significantly increases the risk that underestimating either costs or WACC means that operators will be forced into a situation where the mandated MTR will be insufficient to recover the actual cost incurred.

Because of these factors it is Digicel's view that this current review is premature and strongly urges the Office to defer it until Quarter 1, 2021 at the earliest. This would allow time for more informed views to emerge in relation to the impacts of Covid-19.

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<sup>1</sup> Page 6 of the Consultation Document.

### **Question 1 Separate WACC for Fixed and Mobile**

Digicel believes that the use of separate WACCs for fixed and mobile is appropriate. While there has been some consolidation into multiplay fixed and mobile offerings since last consultation the investment profile of both services remains distinct.

The fact that the Office has carried out the exercise of estimating WACC for both fixed and mobile and has arrived at a different answer indicates that the investment parameters are not sufficiently aligned to move to a single sectoral WACC.

Digicel also notes the WACC is to be used in conjunction with separate cost models for fixed and mobile. Given the possibility for separate entry into both markets it would not be appropriate to use a single combined “telecommunications” WACC where there is the prospect of a standalone operator in either the fixed or mobile market.

### **Question 2 – Market Demand**

Digicel notes the Office’s proposed estimates for gearing for both Fixed and Mobile and agrees that based on the chosen comparators these are within the expected range.

### **Question 3 – Risk Free Rate**

Given the Situation with Covid-19 the past trends that the Office has relied on are unlikely to be a reliable basis on which to forecast future levels of risk free rates.

There is significant uncertainty regarding the “risk free” investment in US treasury bonds with the yield in 10 year bonds declining from 1.8% in January 2020 to 0.6% in July 2020. The Office’s cited data source puts the 5 year average risk free rate at 2.1% using data to July 2020.

Even if the Office was to rely on past trends the fact the current rates are significantly below the rates used in the average means that the average risk free rate will be overstated. This is an even greater issue if one considers that the Office is relying on a data sequence which ends at best in mid 2020 to estimate a rate which is not due to change until November 2021.

### **Question 4 – Country Risk Premium**

The historical trends on which the Office’s estimate of Country risk premium are based cannot be relied upon to project forward. The trends were based on stable economic conditions with improvements in Jamaica’s economy and GDP/Debt ratio.

The medium to long term impacts of contractions in global manufacturing and in global travel patterns due to the Covid-19 pandemic means that these past trends cannot be reliably used to infer future values.

Digicel believes that the estimate for CRP proposed by the Office is likely to be a significant underestimate of the actual position over the period in which the proposed WACC will apply.

### **Question 5 – Debt Premium**

Digicel notes that the Office decided on the criteria of comparators for determining the benchmark. i.e. that they were recent regulatory decision which assessed the debt premium. Having decided on this criteria the Office then arbitrarily excluded the highest value comparator from assessing the average because it was an outlier.<sup>2</sup>

The Office has offered no analysis that this value is invalid or in some other way is not an appropriate comparator.

Either the criteria for selecting the comparators are appropriate or they are not. Excluding comparators which otherwise meet the criteria for inclusion simply because they do not conform to the Office's expectations raises the issue of pre-judgement.

Digicel notes that the Office only excluded one outlier from the other averages which use this pool of comparators and that was on the basis of a specific objective reason where the excluded comparator did not conform to the parameter being assessed<sup>3</sup>.

Even after the exclusion of the SUTEL estimate of Debt Premium the Office appears to accept as valid 2 estimates of 1.9%. The Office offers no justification why the value in Jamaica would be lower than this. Digicel would again point out the risk of forcing below cost selling if the costs estimates or the WACC are set too low and having accepted that the risk premium could legitimately be as high as 1.9%, the Office offers no objective justification for determining that the rate that pertains in Jamaica is less than this other than the fact that the average of other markets is lower than this.

### **Question – 6 Beta**

Digicel notes the Office's proposed estimates for Beta for both Fixed and Mobile and agrees that based on the chosen comparators these are within the expected range.

### **Question 7 – Market Risk Premium**

Digicel notes that the methodology proposed is the same as that used in the previous Determination and that there have been no developments since the last consultation which would require a change in this approach.

### **Question 8 – Inflation**

Much of the progress in controlling inflation rates in Jamaica has been attributable to the strong fiscal policies together with economic growth. It is clear that much of the economic progress of the past number of years will be unwound due to the impact of Covid-19. The ability of the Government of Jamaica to continue its fiscal program in the light of reduced tax receipts and the need for borrowing to meet requirements for economic supports in respect of Covid and to support economic recovery is not clear.

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<sup>2</sup> Footnote 10 on page 25 of the Consultation Document

<sup>3</sup> Footnote 8 on page 21 of the Consultation Document

International experience is indicating extended periods where Covid related social distancing and other measures will be required. These are likely to increase cost for businesses feeding through into higher retail prices. While this dynamic will also be present in the United States it is not clear if the underlying cost increases will be proportionately higher in Jamaica.

Overall it is premature to form a clear forward view of likely inflation trends in either the United States or Jamaica. The only thing that can be said with a degree of confidence is that the projections used by the Office in the Consultation are unlikely to be accurate.

#### **Question 9 – Estimate of WACC**

Digicel notes that the values quoted in the consultation question are the pre-tax WACC estimates in USD.

For the reasons set above Digicel believes that both the USD WACC estimate and the JMD WACC estimates are understated.

This will lead to under recovery of investment and adversely affect investment decisions in the Jamaican telecommunications market.

These underestimates are exacerbated by the premature carrying out to the WACC review and reliance on historical trends which are not reliable inputs to future forecasts because of the uncertainty caused by the Covid-19 pandemic.

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