ETNO Statement

Surge in inflation requires adjustments in WACC estimates for telco regulation

May 2022

The weighted average cost of capital (WACC) is a key parameter in regulatory cost control procedures and thus for setting prices for legacy services (copper). With surging inflation operators will be faced with increasing interest rates leading to increased cost of capital. However, due to backward looking provisions of the European Commission “WACC-Notice” of 2019, National Regulatory Authorities (NRA) would be forced to decrease their regulatory WACC. We would like to stress that this paper only concerns WACC, but in addition, inflation has an impact on other underlying wholesale costs which are not captured by WACC (e.g. OPEX related costs).

Based on the numbers to be published by the Body of European Regulators for Electronic Communications (BEREC) for 2022, NRAs might have to lower the regulatory WACC in some member states while all indicators point to the opposite direction. Nominal post-tax WACCs could fall below 3% in some countries, although annual inflation is likely to surpass 5% in 2022 in the European Union (International Monetary Fund forecast). This would lead to a negative WACC in real terms. In other words, as the cost of capital can be understood as return on capital which regulators deem appropriate, regulators would deny regulated firms a positive return. This would be particularly the case with copper networks that still require investment and whose assets are not fully amortized, hence requiring operators to suffer a loss in real terms for each invested Euro, against the principle of cost recovery.

ETNO had taken a critical stance on the WACC notice methodology already in the past[1], because the application of the WACC Notice led to regulatory WACCs much below usual market valuations. A recent paper by Communications Chambers[2] did not only show the gap between regulated WACC levels and market estimates but also elaborated on the link between the WACC for legacy networks and the FTTH investments and the detrimental effect of wrongly setting too low WACCs for legacy networks on investments into VHCN.

The European Commission (EC), however, continued to reiterate its position that the Notice would not be amended; a position that is difficult to understand (most recently on a seminar by the Florence School of Regulation and ETNO[3]). In the months since the seminar, economists'

[1] 1) https://etno.eu/library/positionpapers/420:etno-statement-wacc-ec.htmland and 2) https://etno.eu/library/positionpapers/436:etno-statement-on-the-berec-wacc-parameters-report-2021.html.

[2] https://etno.eu/downloads/reports/beyond%20the%20wacc%20january%202022.pdf

[3] https://etno.eu/events/past-events/153:wacc.html

perceptions of inflation have changed from an initial hope for a temporary effect to a more persistent phenomenon. That poses a challenge for the WACC methodology, which is purely backward looking. In the past, this backward-looking feature has led to an underestimation of the equity risk premium. In today's high inflation and rising interest rate context, the major issue can be identified in the estimation of the risk-free rate, which according to the Notice is set as the 5-year average of 10-year government bond yields. A historic 5-year average, however, is strongly in contrast with the current expectation of increasing and much higher rates in the future. While ETNO has been consistently pointing to the pitfalls of the WACC framework set by the EC and BEREC, the historic estimate is simply not appropriate in times of rapid economic changes.

BEREC publishes annually updates on the various input parameters for the WACC formula in accordance with the WACC Notice. The next update is soon to be published. BEREC has to take into account that inflation rates are currently in high single digits and are not foreseen to be only transitory in nature in Europe.

Inflation has recently surged to levels, which have not been seen in more than 20 years. ETNO urges the EC, BEREC and NRAs to stop the mechanical application of a methodology which is unfit for the current economic challenge and to allow NRAs to set regulatory WACCs in such a way that operators can expect a fair return on their investments.