Dear Mr O'Brien,

Subject: Commission Decision concerning Case IE/2014/1649: Determination of the weighted average cost of capital (WACC) for the purpose of price control obligations in markets 2 to 7 and in the broadcasting transmission market in Ireland

Comments pursuant to Article 7(3) of Directive 2002/21/EC

I. Procedure

On 11 September 2014, the Commission registered a notification from the Irish national regulatory authority, Commission for Communications Regulation (ComReg), concerning the determination of the weighted average cost of capital (WACC) to be applied in the Irish markets 2 to 7 and the markets related to broadcasting transmission (Broadcasting Market A - Wholesale access to national terrestrial broadcast transmission services, and Broadcasting Market B - Wholesale access to DTT multiplexing services).
The national consultation\(^4\) ran from 11 April 2014 to 16 May 2014.

On 23 September 2014, a request for information\(^5\) was sent to ComReg and a response was received on 26 September 2014. A follow-up technical discussion with ComReg was held on 6 October 2014.

Pursuant to Article 7(3) of the Framework Directive, national regulatory authorities (NRAs), the Body of European Regulators for Electronic Communications (BEREC) and the Commission may make comments on notified draft measures to the NRA concerned.

II. DESCRIPTION OF THE DRAFT MEASURE

With the notified draft measures, ComReg is consulting for the first time on the estimation of WACC values for the above mentioned markets.

ComReg proposes that the estimated costs of capital will be used as inputs to price controls in place in markets 2 to 7 of the Recommendation on Relevant Markets as well as two markets for broadcasting, i.e., Broadcasting Market A - wholesale access to national terrestrial broadcast transmission services, and Broadcasting Market B - wholesale access to DTT multiplexing services.

Following the designation of significant market power on undertakings in their respective markets\(^6\), ComReg imposed remedies of price control through cost orientation on the SMP undertakings. The cost of capital is a component of a “cost oriented” price control.\(^7\)

ComReg is proposing nominal pre-tax\(^8\) WACC values of 8.48% for markets 2 to 6, and 8.66% for market 7 of the Recommendation on relevant markets. Broadcasting markets A and B will be subject to a WACC value of 8.68\(^9\):

ComReg has estimated the costs of capital based on the WACC-CAPM (Capital Asset Pricing Model) methodology. ComReg considers that this is the most appropriate method of estimating the cost of capital and notes, in particular, that WACC-CAPM is the standard approach in estimating the cost of capital across regulated industries in Ireland, and for electronic communications services in many countries.

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\(^4\) In accordance with Article 6 of the Framework Directive.

\(^5\) In accordance with Article 5(2) of the Framework Directive.

\(^6\) According to the notified draft measures, with respect to mobile telecommunications the proposed decision will apply to H3GI, Lycamobile, Meteor, Teléfonica, Tesco Mobile and Vodafone. With respect to fixed line telecommunications, the measures will apply to Eircom and other SMP Fixed Service Providers (BT Communications, Colt Technology Services, Magnet Networks, Smart Telecom, UPC Communications and Verizon Ireland). With respect to broadcasting transmissions, the measures will apply to 2rn (for Market A) and RTÉ (for Market B).

\(^7\) In the reply to the request for information, ComReg indicated that the nominal pre-tax WACC value of 10.21\% is currently used in the cost models in markets 2 to 6. In market 7, the tariff is required as an input to the Bottom-Up Long Run Incremental Cost model (BU-LRIC), which is currently being developed. The estimated WACC values for the broadcasting markets are going to be applied retroactively to tariffs from 1 April 2014. As per ComReg Document No. 13/71 a WACC as reported by 2rn/RTÉ’s was applied on an interim basis.

\(^8\) ComReg defines nominal pre-tax WACC as “the Weighted Average Cost of Capital before taxation”.

\(^9\) ComReg's analysis is based inter alia on the results of the national consultation as well as on an expert technical report carried out by external consultants (Europe Economics).
ComReg proposes to “aim-up” the initial pre-tax nominal WACC to reflect the asymmetry of consequences between setting the cost of capital too low and setting it too high. The proposal is based on the consideration that the negative consequences of setting the WACC too low are potentially greater that the negative consequences of setting it too high for investments, innovation and ultimately for consumers in the long term. ComReg reiterates that in this respect it balances short term consumer welfare against consumers’ longer term interests.

In order to justify the proposed approach, making reference to the technical report submitted by the external consultant, ComReg indicated in the reply to the request for information that the principle that there is an asymmetry of consequences between those of setting the cost of capital too low and those of setting it too high has been well-established by regulators over the past decade. In the follow-up technical discussion ComReg pointed out that many regulators aim up WACC parameters implicitly rather than explicitly, which in the present case is done by way of adding one standard deviation systematically to certain WACC parameters (risk-free rate, asset beta and debt premium).

III.  COMMENTS

The Commission has examined the notification and the additional information provided by ComReg and has the following comments:

Need to provide further justifications in the final measures on the appropriateness of aiming up the WACC estimated values

The Commission notes that ComReg deemed it necessary to "aim up" some parameters (i.e. risk free rates, asset beta, debt premium) of the WACC estimate to reflect the asymmetry of consequences between setting the cost of capital too low and setting it too high.

The Commission takes note of ComReg's assertion that setting too high a cost of capital means that consumers would today pay a little more than would occur in a competitive market, while without fostering innovation and investment consumers tomorrow would miss out on the benefits of investment and innovation that do not occur. ComReg indicates that the latter costs are generally recognised as significantly exceeding the former.

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10 As ComReg states in point 2.26 of the Review of Cost of Capital submitted to public consultation, "the process of aiming up involves estimating the variance of key parameters and aiming up the point estimates of these parameters to confidence intervals that reflect one standard deviation above the mean". The initial pre-tax nominal WACC values were respectively: 8.17% for mobile telecommunications markets, 8% for fixed line telecommunication markets and 8.11% for the broadcasting markets. In the reply to the request for information ComReg stated that they believe it is appropriate to aim-up the WACC values for the broadcasting sector, in a similar manner to the other sectors (even though service providers operating on broadcasting transmission services markets in Ireland are public service corporations), as the asymmetry of consequences of estimating too low a WACC remains relevant due to it being estimated on the basis of an efficient operator operating in a competitive market.

11 ComReg refers, for example, to Ofcom’s approach of estimating the cost of capital, and in particular paragraphs 4.23-4.28 of the relevant consultation document, as published under the following link: (http://stakeholders.ofcom.org.uk/binaries/consultations/cost_capital/summary/cost_capital.pdf).

12 In accordance with Article 7(3) of the Framework Directive.
In view of these considerations, ComReg proposes that the regulatory cost of capital should be set above the central estimate of the market cost of capital, in line, according to ComReg, with common – but often merely implicit - regulatory practices. This would lead to an increase of 6% of the nominal pre-tax WACC point estimate for fixed and mobile markets (resulting in a pre-tax WACC of respectively 8.48% and 8.66%) and of 7% for the broadcasting markets (resulting in a pre-tax WACC of 8.68%).

Since the cost of capital is a component of a cost-oriented price control already imposed on SMP operators in the market at stake, NRAs are bound, pursuant to Article 8 of the Framework Directive and as well Articles 13(1) and (2) of the Access Directive, to impose a cost control obligation that meets the objectives of encouraging investments, including in next generation networks, promoting efficiency and sustainable competition and maximising consumer benefits in terms of choice, price, and quality.

The Commission recognizes that consumers benefit from both lower prices, on the one hand, and innovation and investment, on the other, and that risks with regard to these respective parameters may not be uniform. However, this consideration is not unique to the Irish regulated markets, and the regulatory principles defined in the Framework Directive as well as the provisions of the regulatory framework regarding cost controls and cost recovery should lead to common and predictable outcomes based on shared methodological approaches to common problems. In that regard, while the Commission does not take issue with greater transparency regarding the methodology employed, ComReg's explicit aiming up of its WACC estimate may not be conducive to avoiding discrepancies between NRAs and being consistent with an internal market objective.

The Commission would, therefore, like to invite ComReg to fully substantiate its proposals in the final measures and to provide a detailed reasoning on how both short term and long term consumer benefits as well as the internal market objective are affected by the methodological choice for setting the WACC parameters.

Against this background, the Commission would further like to invite ComReg to cooperate with the relevant BEREC working group and the Commission in order to ensure overall transparency and consistent practice in setting WACC parameters.

Pursuant to Article 7(7) of the Framework Directive, ComReg shall take the utmost account of the comments of other NRAs, BEREC and the Commission and may adopt the resulting draft measure; where it does so, shall communicate it to the Commission.
The Commission’s position on this particular notification is without prejudice to any position it may take vis-à-vis other notified draft measures.

Pursuant to Point 15 of Recommendation 2008/850/EC\textsuperscript{13} the Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. You are invited to inform the Commission\textsuperscript{14} within three working days following receipt whether you consider that, in accordance with EU and national rules on business confidentiality, this document contains confidential information which you wish to have deleted prior to such publication.\textsuperscript{15} You should give reasons for any such request.

Yours sincerely,
For the Commission,
Robert Madelin
Director-General

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