

Submission to the ACCC Fixed Line Services Inquiry 2013 regarding discount rates

We are concerned with the ACCC's proposal to use a discount rate of c5.89% as the weighted average cost of capital (WACC, or discount rate), a level close to that offered as secured home loans by well-capitalised, highly-regulated and effectively government-secured banks. It is not an appropriate level for risky, long-dated investments such as fixed line infrastructure and the provision of related fixed line services.

In our estimation none of the companies we cover has a cost of capital close to the level proposed by the ACCC for Telstra's fixed line services. The closest is Telstra. Its ability to evaluate and manage risk, its position in the market, its capital management practices and its experience (learning and response to relevant risks) lead to a low equity beta relative to the market and manage a higher level of debt. This leaves us with a WACC of 8.5% for Telstra.

Other analysts in capital markets use comparable discount rates; none as far as we are aware uses a discount rate comparable to that proposed by the ACCC. Whatever process each analyst may use to assess Telstra's WACC, we think each would appreciate that they are advising institutional investors that face an actual cost of equity and assess a WACC for Telstra well above the 5.89% proposed by the ACCC.

Government Bond Rate is not really the risk free rate facing investors

We think the main difference between the rate proposed by the ACCC and the discount rates considered in capital markets is the risk free rate (RFR) as applied by the Commission. The RFR used by the ACCC is based on the 10 year Commonwealth Bond rate (GBR) which in turn reflects the RBA's reserve cash rate. In periods of relatively stability the GBR may be a good basis on which to set an RFR given payments and redemption are backed by the government's ability to raise taxes and so are relatively assured of being met.

Fundamentally, however, the RFR reflects the time preferences of suppliers of capital on the one hand and productivity expectations of users of capital on the other, where they are confident about future outcomes. Putting aside risk and uncertainty, the interplay between such suppliers and demanders of capital sets a rate at the margin which is the risk free cost of capital.

Typically the establishment of a market based RFR will be the result of the interplay between lots of these agents in capital markets, each "voting with their dollars". The Commonwealth through its bond issuance and the Reserve Bank through its reserve role are players in this market dynamic, albeit with greater potential influence than most other agents.

However, at the peak and trough of the economic cycle the Reserve Bank becomes relatively more influential as an agent influencing interest rates in part because other agents are less active or willing to play a role in capital markets. At such times the Reserve Bank has another role to play through the use of monetary policy to (try to) influence economic activity or inflation targeting. As it plays this role reducing (or increasing) the reserve rate beyond a normal range, the cash rate it sets will less effectively reflect the RFR underlying the cost of investment but rather the monetary policy objectives of the RBA.

We think it is well understood in the capital markets that the RBA cash rate and GBR at such times do not reflect the underlying RFR and more likely reflect higher than usual uncertainty about the future. Low cash rates may reflect less confidence among agents about the future for a range of reasons, and so may reflect a higher natural RFR at such times. To

summarise, it's well-known in capital markets that interest rates are low when uncertainty is high.

RBA Bulletin suggests that low interest rates reflect higher investment risk

In a recent RBA Bulletin note the RBA reflected on why “non-mining business investment has remained subdued” despite historically low interest rates.¹ “Several reasons have been put forward to explain the ongoing weakness in business investment both here and abroad, including weak demand, heightened uncertainty and low business confidence. ... Moreover, many contacts [in the RBA’s business liaison program] have reported that low interest rates do not *directly* encourage investment.” It notes that this reality is in contrast to “economic theory which suggests that the rate of interest affects the cost of capital and should influence investment decisions directly ...” (RBA Bulletin June quarter 2015, p. 1-2).

The RBA note goes on to suggest how low interest rates may discourage investment. “Regardless of whether changes in interest have a *direct* effect on investment decisions, interest rates will still have a powerful *indirect* influence on firms’ investment decisions through other channels, including their effect on aggregate demand.” (RBA Bulletin June quarter 2015, p. 2).

Where the inference in the RBA bulletin note is to aggregate demand in a macroeconomic setting the low RFR/high risk issue is more particularly true in the microeconomic setting of regulated infrastructure. In the infrastructure investment decision making process the Commission’s assessment of cost of capital comes into play not as the discount rate facing investors (they will take their own view on this) but through pricing of access and the flow through to retail pricing (with subsequent effects on volume or usage and market share across players). This affects the numerator in investment decision making, that is expected future cashflow. If this is driven down through access prices reflecting a cost of capital lower than that faced by investors then it will reduce investment returns and so reduce investment against the actual cost of capital faced by investors.

Setting a low discount rate as part of the regulatory process may benefit consumers (or more likely access seekers) in the short term. But the long term effect is to discourage private capital from substantial investment in regulated access infrastructure and this will create long term harm for all players.

Impact of low GBR on cost of equity may be different to that on cost of debt

One of the RBA’s purposes in lowering the cash rate when uncertainty is high is to encourage investment. This most obviously affects the cost of debt through lowering the GBR. In the short term, this affects debt prices or interest rates relatively quickly as the government bond rate sets a reserve rate for key players in debt markets. (That relationship was tested in the global financial crisis with wholesale interest rates decoupling from RBA rates, at least for a period.)

The relationship between the RBA cash rate and the cost of equity is much less clear than in the case of debt, and may be inverse as noted in the RBA bulletin note. Where debt may be secured and potentially subsidised by taxpayers, the relationship is not so obvious in the case of equity and RBA rates.

In considering why investment decisions may not react as expected to lower interest rates the RBA noted a “common observation is that the true cost of equity cannot be observed. ... keeping the hurdle rate constant acts as an automatic time-varying risk adjustment: interest

¹ “Firms’ Investment Decisions and Interest Rates”, Kevin Lane and Tom Rosewall, RBA Bulletin, June Quarter 2015. Pp 1-7.

rates tend to be low when uncertainty is high, so the gap between the hurdle rate and the cost of capital should be higher (and vice versa).” (RBA Bulletin June quarter 2015, p. 4).

The article notes firm behaviour consistent with analysts’ use of higher discount rates in advising investors than the rate proposed by the ACCC. “(I)n many instances it appears that firms are using hurdle rates that have not changed in a long time, set at a time when nominal long-term interest rates were far higher than they are today. Whether explicit or not, such behaviour is consistent with a reduced appetite for risk or the possibility that risks have increased.” (RBA Bulletin June quarter 2015, p. 4).

Lowering the equity beta below 0.9 is not fair to equity investors, and undermines capital efficiency

Of the companies we cover, Telstra has the lowest WACC, in part due to an equity beta of 0.9 and bears higher debt. Its ability to evaluate and manage risk, its position in the market, its capital management practices and its experience (learning and response to relevant risks) all contribute to a more stable cash performance allowing it to meet debt and equity payments with relative reliability. These attributes are largely management related and the incentive to develop them, manage and exploit them and reflect them in a lower cost of capital is a key benefit arising from privatisation and its interaction with equity and debt markets.

The Commission moved to an equity beta of 0.7 in the previous FSR (2011-14) when the previous government was bargaining to buy back the fixed access network from Telstra. In contrast other utilities were priced by regulators with higher equity betas through that period. By continuing with such a low equity beta in the current FSR FAD the Commission is taking from shareholders the gains in capital efficiency and efficient capital management that have arisen as result of Telstra’s relationship with capital investors post privatisation (in effect transferring this benefit to access seekers). The effect of keeping this component of the Commission’s WACC decision at such a low level is to penalise relative capital efficiency. The distortion effect from this component is relatively greater in the overall WACC in the case of such a low RFR.

What is the message to capital markets?

In their published review of the NBN Co WACC, Professor Robert Officer and Dr Steven Bishop reviewed regulatory margins of WACC above RFR for Telstra between 2000-01 and the 2011-14 price control period finding that “the primary variable leading to a change in WACC has been the risk free rate.”²

Officer and Bishop didn’t comment on the usefulness of the GBR as an indicator of the RFR, and given the GBR and nominal RFR was around 5-6% through the ten year period of their review the matter is not likely to have arisen. However, they did highlight the risk to investment of setting the WACC too low, including advice from the Productivity Commission “that the long term user of the service may be best served by being conservative in estimating the WACC rather than aggressive, i.e. it is better to err on the side of being ‘too high’ than being ‘too low’.” (Officer and Bishop, p 9.) (It would be interesting to see their views of the efficiency of the WACC with RFR at such low levels.)

In its March 2015 draft decision the ACCC calculate a nominal WACC of 5.43% based on a real RFR of 0.07%. In its June 2015 “further draft decision” the ACCC calculates a nominal WACC of 5.89% based on a real RFR of 0.39%.

² “Report on WACC component of NBN Co’s Special Access Undertaking”, Professor Bob Officer and Dr Steven Bishop, December 2011, p 11.

Given the RFR is the key variable as noted by Officer and Bishop in their review, is the ACCC telling capital markets that they should invest in such infrastructure with a real RFR of 0.329%, or even as low as 0.07%? That is invest with next to no real intertemporal preference?

That seems ludicrous in our view. To go a step further, we have seen examples in other markets where the equivalent government rates are set at zero and in some cases below zero. Would the Commission's advice to investors be that it expects they will invest in such infrastructure at zero or negative real RFR?

As a counter point, the RBA cash reserve rate peaked at over 18% in 1989 and the 10 year GBR has been at comparable levels. Is it credible that the ACCC would take such levels as the RFR at a comparable time in the economic cycle? We don't think so; it would send a dramatically wrong signal to capital markets.

We think discount rates proposed by the Commission for Telstra fixed line services are not based on a sound appreciation of capital market decision making or the cost of capital facing equity investors in the current market circumstances. We think the real RFR faced by those in Australian capital markets is more likely around 3% and no lower than 2.5%.

We urge the Commission to consider further the issue of the appropriate cost of capital in the FSR. We think such low rates and resulting low access prices have a further significant distortionary effect on investment decision making in the sector and capital market responses by investors. We suggest the actual nominal WACC discount rate considered by investors in the case of Telstra should be no lower than 8%.

Ian Martin
Managing Director,
Ian Martin Advisory
537 Malvern Road
Toorak, Vic., 3142