Europe Economics

Response to European Commission Letter

December 2021

Europe Economics
4th Floor
5 Chancery Lane
London
EC4A 1BL

Tel: (0) 20 3862 9252

www.europe-economics.com

Contents

Response to European Commission Letter

This document gives Europe Economics' responses to certain queries raised by Comreg and by the European Commission in response to the European Commission's letter to Comreg of 19 November 2021, reference IE/2021/2345.

We have been asked to comment on the query raised at section 3.1 of that letter, namely what justification there could be for the WACC for fixed line infrastructure in Ireland being materially higher than the WACCs for such infrastructure in France or Spain.

Decomposition of differences

First, in the table below, we decompose the differences in the overall WACCs for France, Spain and Ireland into differences arising from tax, from cost of equity and from cost of debt.

	France	Spain	Ireland
Notified pre-tax WACCs	4.76%	4.84%	5.56%
Tax effect	-0.74%	-0.57%	0
Pre-tax WACCs "at Irish tax rate"	4.02%	4.27%	5.56%
Cost of Equity aligned (after aligned taxes)	1.32%	1.27%	0.00%
WACC at aligned cost of equity & aligned tax	5.35%	5.54%	5.56%

The first line in this table reports the notified pre-tax WACCs for France, Spain and Ireland. Next adjust these notified WACCs to account for differences in the tax rate between France, Spain and Ireland. That then gives us what the pre-tax WACCs would be if France and Spain had the Irish tax rate.

Next we consider how much effect there would be if the costs of equity were aligned, and compare the overall WACCs. We can see that they would be very similar. The vast majority of the difference in the notified WACCs that is not attributable to differences in tax rates is attributable, instead, to differences in the cost of equity. Reflecting this, we shall now explore the differences arising from the cost of equity in more detail.

Cost of equity analysis

In the following table we compare the cost of equity figures for France and Spain with the those obtained under the EC-approach, those obtained under the ComReg 2014 approach, and our final recommendation (which we recall was a blended average between the cost of equity figure obtained under the EC approach, and that obtained under the ComReg 2014 approach).

	France	Spain	Ireland (EC approach)	Ireland (ComReg 2014 approach)	Final recommend -ation
Tax rate	28.41%	25%	12.5%	12.5%	
Risk-free rate (nominal)	0.57%	1.01%	0.824%	3.28%	
ERP	5.30%	5.5%	7.21%	4.90%	
TMR (nominal)	5.87%	6.51%	8.03%	8.18%	
Gearing	40%	39%	40%	40%	
Equity beta	0.81	0.71	0.80	0.71%	
Cost of equity (nominal, post-tax)	**4.86%**	**4.91%**	*6.59%*	*6.75%*	**6.67%**
Cost of equity (nominal pre-tax)	**6.79%**	**6.54%**	*7.53%*	*7.71%*	**7.62%**

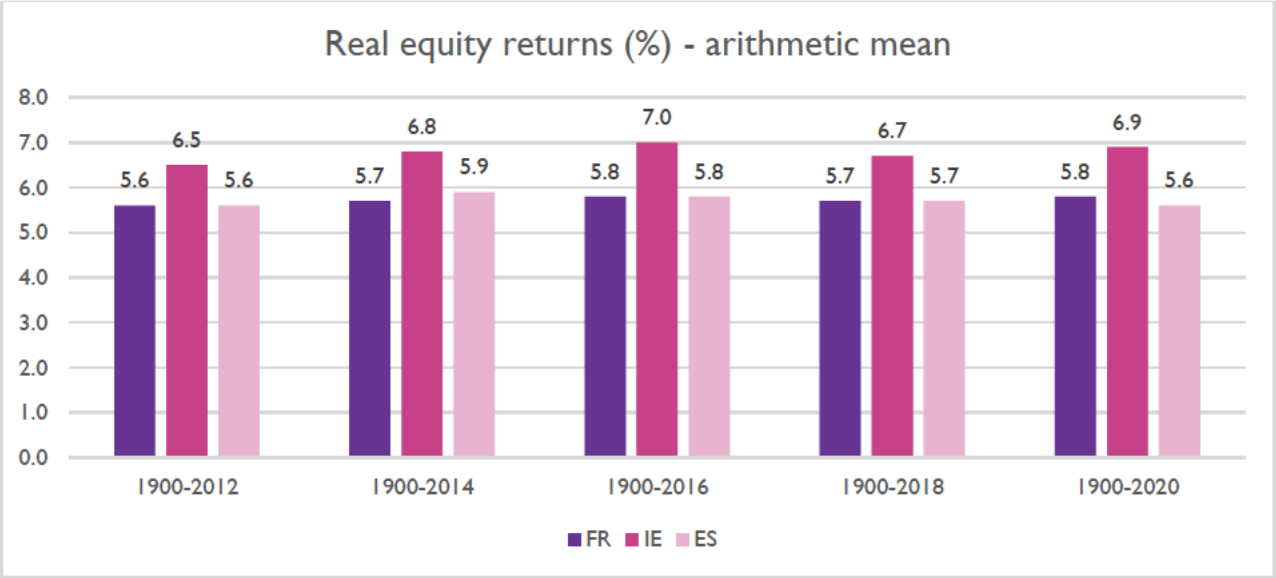
As we can see from the table above, the post-tax nominal cost of equity for France (4.86%) is approximately 180bps lower than our recommended figure (6.67%) for Ireland. However, we note that for France the different can be almost entirely accounted for in terms of the difference in TMR. More specifically, as we can see in the table below, if we replace the nominal TMR figure of 5.87% for France with a nominal TMR figure of 8.03% (i.e. the TMR for Ireland under the EC Approach) the post-tax nominal cost of equity for France rises to 6.61% which is broadly in line with our recommended figure of 6.67%. For Spain the difference is slightly larger. With gearing raised to 40% and the same TMR as in Ireland, the cost of equity, post-tax, is 6.08%. Nonetheless, the considerable majority of the gap is bridged even in the Spanish case.

	France	Spain	Ireland (EC approach)	Ireland (ComReg 2014 approach)	Final recommend -ation
Tax rate	28.41%	25%	12.5%	12.5%	
Risk-free rate (nominal)	0.57%	1.01%	0.824%	3.28%	
ERP	***7.46%***	***7.02%***	7.21%	4.90%	
TMR (nominal)	***8.03%***	***8.03%***	8.03%	8.18%	
Gearing	40%	40%	40%	40%	
Equity beta	0.81	0.72	0.80	0.71%	
Cost of equity (nominal, post-tax)	**6.61%**	**6.08%**	*6.59%*	*6.75%*	**6.67%**

Therefore, we believe that the key point of contention here is whether it is indeed justifiable to use a higher TMR figure for Ireland than for France or Spain.

Comparative TMR analysis

In the following chart we show the evolution of real TMR estimates (sourced from the Credit Suisse Global Investment Returns Yearbook) for France, Ireland and Spain over the last decade.[1] As we can see the TMR for Ireland has been consistently higher (around 100bps) than that of France and Spain. This suggests it could be justified to have a materially higher TMR assumption for Ireland than for France and Spain.



We observe that whilst the figure we used, in our ComReg Fixed Line WACC reports, for the real TMRs for Ireland, under our two approaches, at 6.65% and 6.35% are a little lower than the TMRs in the chart above (where as we can see Ireland's most recent number is 6.9%), the implied real TMRs for France and Spain in their Decisions are much lower than those in the chart. We do not have access to the precise inflation rates assumed by France and Spain in their Decisions, but to be conservative we assume they lie between 1% and 2%. (If their assumed inflation rate is higher than 2%, that will make our point stronger.) Taking the French TMR of 5.87% and the Spanish TMR of 6.51%, if we deflated them at 1% they would be equivalent to real TMRs of 4.82 and 5.46%. In that case we can see that the French TMR in the decision would be about 1% below the historic norm, whilst the Spanish value would be only a little below (roughly equivalent to the amount by which our Irish TMR assumptions are below the historic norm). At 2% inflation the figures would be 3.79% for France (two percentage points below the historic norm) and 4.42% for Spain (well over a percentage point down on the historic norm).

Thus a further factor is that, as well as there being a materially higher TMR in Ireland than in France and Spain over time, the analysis of the French risk-free rate and ERP underpinning the French and Spanish decisions appear to have concluded for a greater reduction in TMR, relative to the historical data, than the reduction we concluded for for Ireland. If that is so, it might not be inappropriate given that Ireland's economic growth in recent years has been much more rapid than that in France or Spain and the relative growth of Ireland, compared with the historical period, has been stronger – so one might expect that the Irish TMR would have fallen by less, relative to its historic norm, than those of France or Spain.

[1] We use real TMRs, rather than nominal TMRs, in this chart because investors will be interested in their expected real returns. So when we are drawing lessons from historical data on what returns investors might be anticipating in the future, it is the past real return that is most relevant not the past nominal return.

Overall comparison of WACCs "on Irish basis"

In the table below we consider the impacts on the notified WACCs if France and Spain had used Ireland's tax rate and the TMR embodied in Ireland's WACC decision, and if Spain had used a 40 per cent gearing level.

	France	Spain	Ireland
Notified	4.76%	4.84%	5.56%
Pre-tax cost of equity at aligned TMR & aligned tax, at 40% gearing	7.80%	7.16%	7.70%
Cost of debt	1.81%	2.16%	2.35%
WACC "on Irish basis"	5.41%	5.16%	5.56%

We can see that with these adjustments the French WACC becomes very similar to that in Ireland. The Spanish WACC is 0.4% below that for Ireland, but the considerable majority of the gap has been bridged.

We note that there is no obligation, as we understand it, for Ireland's WACC to be identical to that in other countries. But we were asked to consider why the Irish WACC might be higher than that in France or Spain. The answer we have provided here is quite straightforward. The WACC is higher mainly because the cost of equity is higher, and a higher cost of equity for Ireland is precisely what one should expect, other things being equal.