

# Decision on the review of calculation of the cost-of-capital rate of CTT – Correios de Portugal, S. A. for 2011

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September 2012

## **I. Framework**

In the scope of the postal sector's regulatory framework, ICP - Autoridade Nacional das Comunicações (ICP - ANACOM) defined the principles for the development of the cost accounting system (CAS) to be implemented by CTT - Correios de Portugal, S.A. (CTT), aiming for the determination of direct and indirect revenues and costs of each of the reserved and non-reserved services, as well as for the separation between costs associated to the several basic operations integrating the postal services (clearance, sorting, routing and delivery).

In this sense, all costs incurred and revenues obtained with the provision of postal services must be accounted for when determining the cost of products and calculating the respective margin, plus a reasonable remuneration margin. To this remuneration margin corresponds the cost of capital invested in the company.

To calculate its cost-of-capital rate, CTT use the Weighted Average Cost of Capital (WACC) methodology, using the Capital Asset Pricing Model (CAPM) to calculate the cost of equity. Parameters for calculating the referred rate, as well as the associated methodology, are supplied by CTT to ICP - ANACOM, in accordance with obligations concerning the regular reporting of CAS results.

In this context, CTT submitted the CAS results for 2011 by letter 052733, of 29.06.2012.

Without prejudice to conclusions drawn from the audit to these results, ICP - ANACOM notes that CTT have set a value of 21.97% for the cost-of-capital rate, basing their calculations on the following parameters:

**Table 1 – Cost of capital proposed by CTT for 2011**

<b>Parameters</b>	<b>CTT (2011)</b>
Risk-free interest rate	10.13%
Gearing	1.43%
Tax rate	29.00%
Beta	0.89
Risk premium	6.28%
Debt premium	0.50%
Cost of equity	15.72%
<b>Pre-tax CMPC</b>	<b>21.97%</b>

Source: CTT's CAS results (for 2011)

After analysing CTT's calculations of the cost-of-capital rate considered in the CAS results for 2011, ICP - ANACOM adopted a draft decision (DD) establishing for 2011 a cost-of-capital rate of 14.77%, providing CTT with a 15 working-day time limit to assess the issue, under articles 100 and 101 of the Administrative Procedure Code.

Having CTT submitted letter No 053601, on 20.09.2012, expressing their right of reply in relation to the DD adopted by this Authority, the respective prior hearing report was drawn up, integrating this decision.

## **II. Analysis of the cost-of-capital rate proposed by CTT**

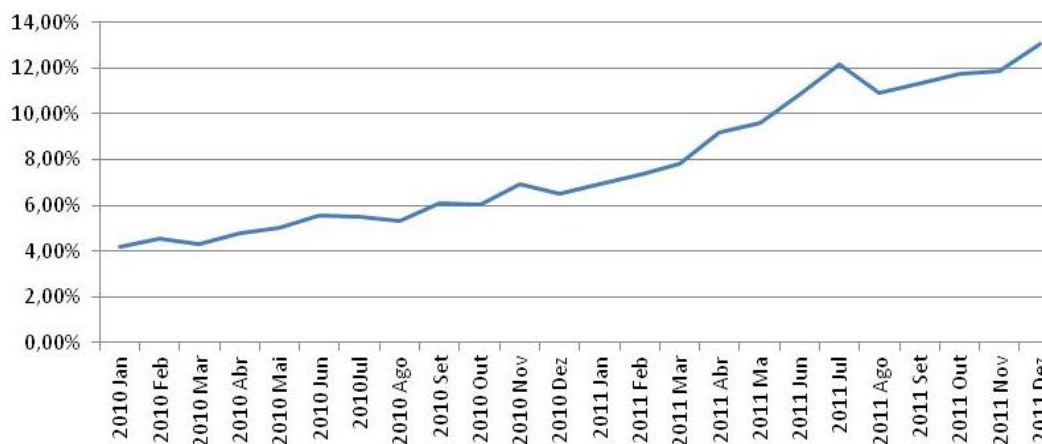
Specifically as regards the calculation of the risk-free interest rate parameter, CTT considered a value of 10.13%, by reference to the average implicit interest rate of 10-year government bonds.

It should be taken into account that 2011 was marked by a high macro-economic instability, with repercussions at the level of implicit interest rates of sovereign debt of European countries in general and Portugal in particular.

In fact, in the course of 2011, the Portuguese State only issued 10-year government bonds once<sup>1</sup>, and in any case, the financing rate resulting from that operation was clearly and substantially lower than the value reached by CTT.

Moreover, still in 2011, the Portuguese State agreed on a program of financial assistance with international organizations<sup>2</sup>, which strongly constrains the representativeness of interest rates of 10-year government bonds, implied in transactions of this debt instrument in the secondary market.

**Table 2 - Evolution of 10-year government bonds (2010-2011)**



Source: European Central Bank

In this sense, ICP - ANACOM takes the view that, in the current macro-economic context, there are no grounds for considering that the value of the risk-free interest rate parameter, used in the calculation of the cost-of-capital rate for regulatory purposes, may be deducted from observations of the interest rate implicit in Portuguese government bonds.

As Portugal is part of a Monetary Union, it could be assumed that the best proxy for the value of the risk-free interest rate could be inferred from sovereign debt bonds of Member States of the Euro Area that are deemed to be the safest.

The following tables show (for 2011) the value of interest rates implicit in 10-year government bonds of the German State and of States holding at the time the highest credit rating (AAA).

<sup>1</sup> Available at: <http://www.icgp.pt/gca/?id=80>

<sup>2</sup> Available at: <http://www.portugal.gov.pt/pt/os-ministerios/primeiro-ministro/secretario-de-estado-adjunto-do-primeiro-ministro/documentos-oficiais/memorandos.aspx>

**Table 3 – Interest rates of 10-year German *Bund* for 2011**

Period	(%)
2011 Jan	3.02%
2011 Feb	3.20%
2011 Mar	3.21%
2011 Apr	3.34%
2011 May	3.06%
2011 Jun	2.89%
2011 Jul	2.74%
2011 Aug	2.21%
2011 Sep	1.83%
2011 Oct	2.00%
2011 Nov	1.87%
2011 Dec	1.93%
<b>Average</b>	<b>2.61%</b>

Source: European Central Bank

**Table 4 - Interest rates of 10-year bonds of Euro-zone countries with the highest credit rating (AAA)**

	Percentage (%)						
	Austria	Germany	Finland	France	Luxemburg	Holland	Average
2011 Jan	3.54	3.02	3.27	3.44	3.30	3.23	3.30
2011 Feb	3.68	3.20	3.41	3.60	3.45	3.41	3.46
2011 Mar	3.68	3.21	3.45	3.61	3.47	3.42	3.47
2011 Apr	3.76	3.34	3.57	3.69	3.58	3.65	3.60
2011 May	3.53	3.06	3.32	3.49	3.29	3.40	3.35
2011 Jun	3.43	2.89	3.29	3.43	3.15	3.28	3.25
2011 Jul	3.35	2.74	3.16	3.40	3.03	3.17	3.14
2011 Aug	2.84	2.21	2.68	2.98	2.59	2.68	2.66
2011 Sep	2.64	1.83	2.35	2.64	2.27	2.34	2.35
2011 Oct	2.92	2.00	2.51	2.99	2.37	2.46	2.54
2011 Nov	3.36	1.87	2.54	3.41	2.31	2.45	2.66
2011 Dec	3.10	1.93	2.52	3.16	2.27	2.38	2.56
<b>Average</b>	<b>3.32</b>	<b>2.61</b>	<b>3.01</b>	<b>3.32</b>	<b>2.92</b>	<b>2.99</b>	<b>3.03</b>

Source: European Central Bank

If CTT's calculation of the risk-free interest rate were to be updated, by replacing only the value of the risk-free interest rate parameter for values resulting from tables 3 and 4 above, all other things being equal, the result of the calculation of the cost-of-capital rate would then

range between 11.43% and 12.02%, which is substantially lower than the 21.97% submitted originally (*vide* table 5).

**Table 5 - Determination of the cost-of-capital rate for 2011**

Parameters	CTT's Proposal	Risk-free interest rate (2.61%) (a)	Risk-free interest rate (3.03%) (b)
Risk-free interest rate	10.13%	2.61%	3.03%
Gearing	1.43%	1.43%	1.43%
Tax rate	29,00%	29.00%	29.00%
Beta	0.89	0.89	0.89
Risk premium	6.28%	6.28%	6.28%
Debt premium	0.50%	0.50%	0.50%
Cost of equity	15.72%	8.20%	8.62%
<b>Pre-tax CMPC</b>	<b>21.97%</b>	<b>11.43%</b>	<b>12.02%</b>

(a) – Average of interest rates of 10-year German *Bund* for 2011 - Table 3.

(b) – Average of interest rates of 10-year bonds of Euro-zone countries with the highest credit rating (AAA) – Table 4.

Moreover, ICP - ANACOM takes the view that parameters used in the calculation of CTT's cost-of-capital rate for regulatory purposes may be classified as parameters inherent to the activity and structure of the regulated operator (beta, gearing and debt premium), or as context parameters that are exogenous to the regulated operator (risk premium, risk-free interest rate and tax rate).

As such, and in order to maintain regulatory consistency, ICP - ANACOM is of the opinion that the recent final draft decision on the cost of capital applied to PT Comunicações, S.A. (PTC) and respective draft decision<sup>3</sup> may serve as a basis for determining the values of context parameters (risk premium, risk-free interest rate and tax rate) to be used in the regulation of the postal sector, given that the reference period, context and country of operation are all the same.

<sup>3</sup> <http://www.anacom.pt/render.jsp?contentId=1132426>

If parameters concerning the macro-economic context were replaced for values also used for regulatory purposes in the telecommunications sector, the calculation of CTT's cost of capital would result in a 14.77% rate (*vide* table 6).

**Table 6 – Cost-of-capital rate for 2011**

<b>Parameters</b>	<b>ANACOM Decision</b>
Risk-free interest rate	<b>5,36%</b>
Gearing	1,43%
Tax rate	<b>29,00%</b>
Beta	0,89
Risk premium	<b>5,86%</b>
Debt premium	0,50%
Cost of equity	10,58%
<b>Pre-tax CMPC</b>	<b>14,77%</b>

Source: ICP - ANACOM calculation

It must be stressed that this decision applies only to the 2011 period, as this Authority is preparing a broad methodology review of the cost of capital issue for regulatory purposes, a consultation on this matter being expected to be published soon.

### **III. Decision**

In the light of the above, and without prejudice to conclusions that may be drawn from the audit to CTT's CAS, to be carried out in due course, the Management Board of ICP - ANACOM, in the pursue of powers granted under points b), d), h) and n) of paragraph 1 of article 6 and point b) of article 26, all of its Statutes, approved by Decree-Law No 309/2001, of 7 December, and pursuant to paragraph 2 of article 19 of Law No 102/99 of 26 July, as amended by Decree-Law No 116/2003, of 12 July, and to paragraph 3 of Basis XIII of the Bases of the Universal Postal Service Concession, approved by Decree-Law No 448/99, of 04.11, as amended by Decree-Law No 116/2003, of 12 July, and by Decree-Law No 112/2006, of 09.06, hereby determines:

- (i) that CTT is to adjust its CAS results, and further associated information, for 2011, so that the cost-of-capital rate used in 14.77%;
- (ii) that CTT is to submit to this Authority the CAS results for 2011, adjusted according to the preceding paragraph, within 10 working days at the most.

Annex: List of acronyms and abbreviations

CAPM	Capital Asset Pricing Model
WACC	Weighted Average Cost of Capital
CAS	Cost Accounting System
DD	Draft decision

Annex: List of operators

CTT	CTT – Correios de Portugal, S.A.
PTC	PT Comunicações, S.A.

Annex: List of other bodies/organizations

ICP-ANACOM	ICP- Autoridade Nacional de Comunicações
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