

# *Asset Valuation – Some Important Considerations for Caribbean Regulators*



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# Context



- Common background
  - History of monopoly control
  - Common monopolist provider
  - Regulation by political directorate
  - Rate of return regulation
  - Recent liberalisations

# *Major Focus Under Monopoly*



- Compliance with rate of return
- Little concern about cost identification/separation
- Consumer Protection
- Emphasis on retail charges
- Wide scale cross subsidisation

# *Shifting Focus with Liberalisation*



- Cost allocated according to cost causation principle
- Protecting competition
- Protecting Consumers
- Rebalanced tariffs
- Correct market signals (build or buy)

# *Asset valuation becomes even more critical in this context*



- Telecom is highly capital intensive
- Asset values feeds into cost via depreciation and WACC
- Dominant incumbent wholesales to Competitors
- Asset values determine wholesale (interconnection, etc)and retail charges

# *Approaches to Asset Valuation*

- Historical Cost – Assets are kept at original cost and depreciated over their useful life
- Current Cost – Assets are re-valued periodically to take account of changes in inflation and exchange rate
- CCA Accounting the preferred approach
  - Stress benefits of assets to stockholders
  - Focuses on Current as against nominal values
  - Accounts for inflation

# *CCA based on MEA the ideal*

- Modern Equivalent Asset (MEA) – the current value of replacing existing plant with one of the same functionality to be distinguished from reproduction cost i.e. A new version of the same asset

MEA incorporates technological progress

- New functionalities
- Productivity gains (labour & capital)
- Represent the current trend, OFTEL, ACCC, Ireland,

# *Important Issues in Asset Valuation*

- Valuation Method
  - Absolute valuation – best for assets subject to rapid change in technology
  - Indexation – Little technological change
  - Historical values – low value assets
- Allocation Issues – overheads, expensing v. capitalising
- Depreciation – past rates, rates going forward
- Others – loadings, capacity, discounts



# *Jamaica's Experience*

- Similar to experience elsewhere
- CCA valuation but not MEA (prior to liberalisation)
- Values determined by a mix of indexation (C.A. Turner Index , local labour index), absolute valuation, market prices
- Low depreciation rates based on 1988 licence
- A number of defects identified in C&WJ's approach to CCA

# *Jamaica's Experience Continued*

- Indexation resulted in:
  - Failure to capture technological progress such as larger switches with more functions
  - Failure to reflect effects of new material - fibre optics
  - Failure to account for local labour productivity
- The effects of such failings were seen in:
  - Decline in Switching cost slower than market
  - Circuit equipment cost was flat
  - Rising cost for loops without adjustment for increased productivity from use of fibre optics

# *Jamaica Experience Continued*



- Allocation Issues

- Spread of overhead costs (network planning, labour, interest charges, etc) – disparity between allocation to switching and transmission versus outside plant (all plant category saving transmission, switching, satellite & earth station)
- Capitalising versus expensing – future cost versus immediate write-offs
- Reasonableness of overheads and loadings (interest charges, planning expenses, discounts, capacity, etc)

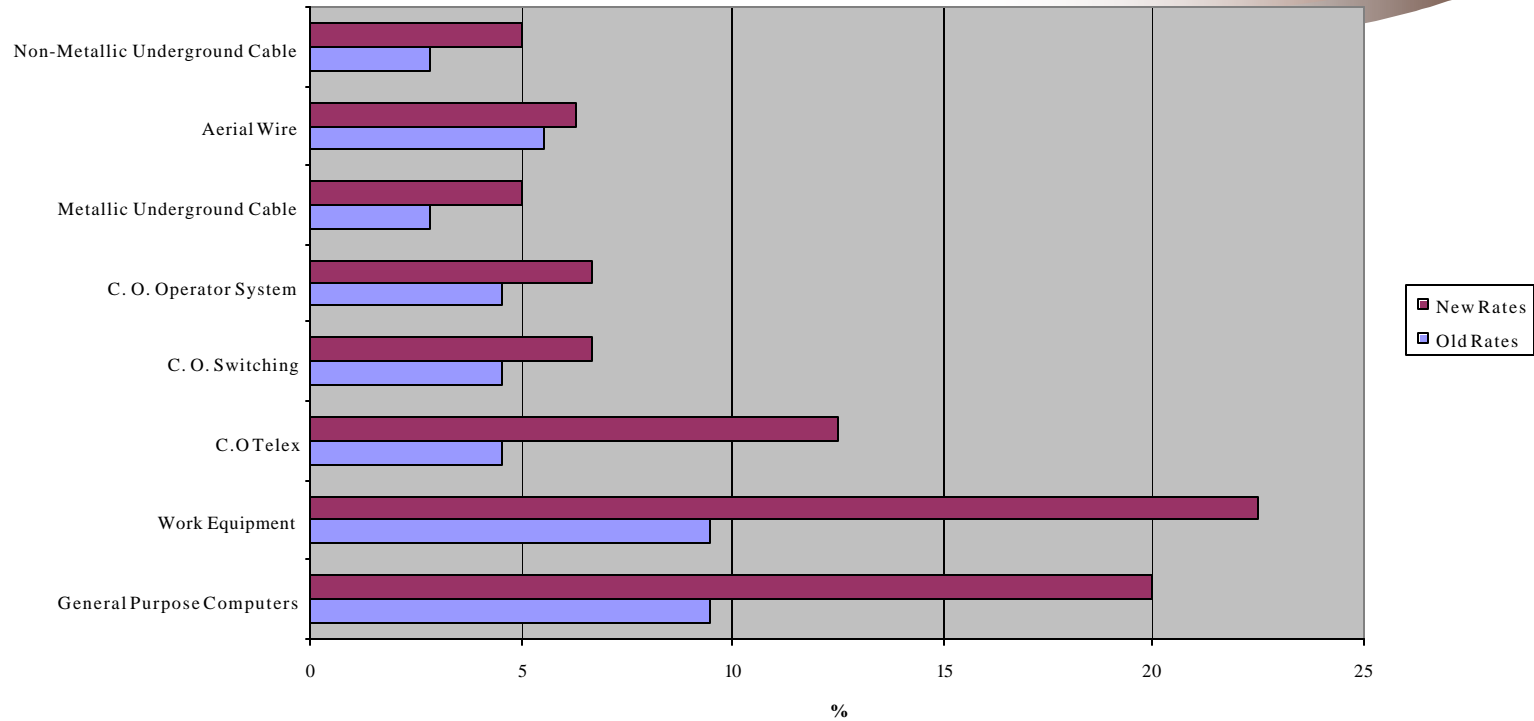
# *Jamaica Experience Continued*



- Depreciation – the economic change in asset value from period to period
- Rising replacement cost lowers depreciation of existing assets
- Falling replacement cost raises depreciation
- C&WJ had comparable low depreciation charges that did not capture technological changes

# Jamaica's Experience Continued

Comparison of C&WJ's Depreciation Rates 1988 & Current



# *Concluding observations*



- Asset valuation critical post liberalization
- Has implications for consumers and competitors
- CCA approach with MEA/its approximation
- Mix of approach is possible
- Allocation and Loadings are critical
- Depreciation should be current