



# **Private Healthcare Remittal**

**Response to  
Assessment of Cost of Capital Working Paper**

**Bupa**

**May 2016**

## 1) INTRODUCTION

- 1.1 On 22 April 2016 the Competition and Markets Authority (“CMA”) released a working paper assessing the appropriate weighted average cost of capital (“WACC”) for a private hospital operator. This submission sets out comments from Bupa on this working paper.
- 1.2 The CMA relies on the WACC when estimating excess profits and the customer detriment resulting from the Adverse Effects on Competition (“AEC”) in Central London. HCA’s estimated excess profits are a key input into the CMA’s Net Present Value (“NPV”) analysis on which the CMA bases its proportionality assessment for the divestment remedies.
- 1.3 In the Remittal Provisional Decision on Remedies (“PDR”) the CMA uses a WACC of 10.0%. The working paper, however, shows that the CMA finds an appropriate WACC range to be “7.6% to 10.5%, with a midpoint of 9.0%”. So the 10.0% point estimate used in the PDR is towards the top end of the range (it is in the top quintile of the range), although there is no evidence presented in the PDR (or working paper) why this point estimate was more appropriate than others levels within the range.
- 1.4 We show in this submission that:
  - i. The CMA does not have strong evidence to support a cost of capital for HCA towards the top end of the range. Using the mid-point would be more logical, and consistent with recent case precedent.
  - ii. The top end of the WACC range is itself likely to be too high on the basis of the evidence in the working paper. Correcting two identified issues with the asset beta and risk free rate would suggest that 10.0% may actually be above, and outside of, the appropriate WACC range.
  - iii. The CMA’s NPV modelling for divestment would become very strongly positive if the CMA used a lower cost of capital, making divestment more likely to be proportionate. For example, if the CMA used the mid-point (9.0%) of its estimated WACC range, we show in the Confidential Annex that the NPV is substantially positive in the base case, *even if* the Cleveland Clinic enters.
- 1.5 This submission should be read in conjunction with our response to the Provisional Decision on Remedies in which we set out twelve errors in the CMA’s NPV modelling. If the CMA addresses these errors, and the ones identified in this submission, the divestment is shown to be proportionate *even if* one believed, which Bupa does not<sup>1</sup>, that the Cleveland Clinic would be a fully effective constraint on HCA by Year 5 (2021/22).
- 1.6 Please note that in the “**Confidential Annex**” of this submission we include analysis prepared by our named economic advisors on the basis of additional information in Confidentiality Ring 1. This shows the effects on the NPV calculation of changing the WACC level. Bupa has **not** had sight of this Confidential Annex and the annex should be redacted in full if the CMA intends to publish this submission.

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<sup>1</sup> Bupa does not believe that the Cleveland Clinic will be a fully effective constraint on HCA by Year 5, as explained in the PDR Response. Further, we note that the published summary of the CMA’s hearing with the Cleveland Clinic from April 2016 strongly confirms that there is **material uncertainty** on the Cleveland Clinic’s entry plans and whether it can constrain HCA effectively. For example, the Cleveland Clinic will not offer Oncology.

## 2) THE MID-POINT OF THE WACC RANGE SHOULD BE USED

- 2.1 The CMA chooses a WACC of 10.0% based on an estimated range of 7.6% to 10.5%.
- 2.2 The CMA presents no evidence in the working paper explaining why it believes a WACC of 10.0% – towards the top end of the CMA’s range (in the top quintile of values in the range) – is appropriate as the preferred ‘point’ estimate. The CMA presents no argument that the range is ‘asymmetric’, with estimates towards the top end being more likely than estimates elsewhere in the range.
- 2.3 If we therefore assume that values in the range each have equal likelihood, then the midpoint of the range would be the best point estimate, as it would be the ‘expected value’ of the distribution. Relaxing the uniformity assumption and simply assuming that the distribution was symmetric (not asymmetric) would also suggest selecting the mid-point as the preferred estimate.
- 2.4 On the basis of the evidence in the working paper, the WACC is therefore *more likely* to be around the midpoint (9.0%) than at the more extreme point estimate of 10.0%.
- 2.5 There are further reasons why using a lower WACC estimate is reasonable:
  - i. We note that in the *Aggregates Inquiry* (2014) the Competition Commission used the mid-point of its WACC range for cement companies when estimating excess profits, customer detriment and ultimately assessing the proportionality of a divestment remedy for the largest cement manufacturer. The Competition Commission decided to order a divestment in that case. This precedent supports using the mid-point of the range in the *Private Healthcare Inquiry*.<sup>2</sup>
  - ii. We explain in section 3 below that the top end of the WACC range is likely to be too high, possibly by more than a percentage point, and so 10.0% may not be in the (correctly) estimated range. This suggests lower WACC estimates are more reasonable, and why a WACC of 9.0% would be more appropriate to use than 10.0%.
- 2.6 In Table 2 in the Confidential Annex we show the impact on the NPV of divestments if the mid-point WACC of 9.0% is used. **It shows that all NPV estimates are substantially positive in the Base Case scenario of ongoing costs**, even before correcting various further errors in the CMA’s original NPV modelling identified in Bupa’s response to the PDR. Divestment is clearly proportionate on a balance of probabilities (even if Cleveland Clinic enters and were fully effective as a constraint by 2021/22).

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<sup>2</sup> We note that the *Energy Inquiry*, which is yet to conclude, presented analysis of estimated excess profits for the retail supply businesses of the Big 6 in its Provisional Findings Report. The CMA estimated that the WACC range for Retail Supply businesses was in the range of 9.3% to 11.5% (which would give a mid-point of 10.4%). The Provisional Findings Report, however, uses a WACC of 10% in its excessive profits estimates. Therefore, in the *Energy Inquiry*, the CMA appears to be using a WACC **below** the mid-point of its range. This provides further reason why the CMA should use a lower point in its WACC range in the *Private Healthcare Inquiry*.

### 3) THE TOP-END OF THE WACC RANGE IS LIKELY TOO HIGH

- 3.1 The CMA uses Capital Asset Pricing Model to estimate the WACC. We have concerns about the evidence presented for two elements of the CMA's CAPM modelling.

#### **Nominal Risk-Free Rate**

- 3.2 The CMA estimates a nominal risk free rate of 4%. However, the evidence in Figure 2 of the working paper shows that the period average nominal UK government bond yield is below 4% for all maturities. Therefore, 4% is likely to overstate the value, and so inflate the estimated WACC, and the top end of the WACC range should be lower.
- 3.3 The CMA does not conclude on the correct maturity to use for the nominal risk-free rate, but in theory the appropriate maturity of the bond should be in line with the average asset life of hospital assets, in order to reflect the investment horizon of the investor. For hospitals it might be appropriate to use a 10-year asset life to reflect a balance of short and long life assets - if this is the case, the CMA's evidence would point to a much lower nominal risk-free rate of under 3.5% (based on the green line in Figure 2 of the working paper), which would reduce the cost of capital range by around 0.5% (and the top of the range to *at most* 10.0%).

#### **Beta**

- 3.4 The CMA proposes an asset beta range of 0.5 to 0.7. However, the evidence presented in the working paper for comparable companies in Table 4 of the working paper appears to support a much lower asset beta range, in a range of 0.43 to 0.47.
- 3.5 HCA's own beta is calculated as 0.11 to 0.17. The CMA states that it believes that this beta is low largely as a result of HCA's high gearing ratio, but this appears to be an assertion and no substantive evidence is provided as to whether HCA's high gearing in fact leads to a bias in its beta.
- 3.6 Overall, the beta range of 0.5 to 0.7 appears to contain substantial headroom at the top end.<sup>3</sup> We believe that the CMA should have placed more emphasis on the main set of comparable company data presented in Table 4 of the working paper. A more plausible beta range based on the data the CMA present is a range of 0.4-0.5, even allowing for little weight to be placed on HCA's own beta.
- 3.7 A beta of 0.4-0.5 would lead to a pre-tax WACC range that is substantially lower than the WACC range based on a beta range of 0.5-0.7. All else equal, it would lower the WACC range by over a percentage point.
- 3.8 Overall, it seems that the WACC range could be too high as a result of the CMA using an incorrect beta range. The top-end of the range could reasonably be lowered by over 0.5 percentage point (and potentially by substantially more) if a more plausible beta range of 0.4-0.5 was used. Adjusting the beta range in this way would mean that the current WACC rate of 10.0% used in the PDR would be outside the estimated WACC range and unsupported in the evidence.

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<sup>3</sup> The CMA notes: "...we note that the upper end of this range is conservative" (paragraph 48).

#### 4) CONCLUSIONS

- 4.1 Given the substantial impact that the WACC has on the estimates of HCA's excess profitability and so the proportionality of divestments, Bupa believes that the CMA does not have sufficient justification for the current point estimate of 10%. Rather, the mid-point of the WACC range should be used, suggesting an estimate around 9.0% would be more appropriate.
- 4.2 Indeed, even 9.0% could be too high if the range as a whole moves downwards to reflect the issues Bupa has identified above with the risk free rate and beta range.
- 4.3 **Using a 9.0% WACC would result in significant positive NPVs and divestment would be proportionate, even before correcting various errors identified in the CMA's NPV modelling as explained in Bupa's response to the PDR.**

## CONFIDENTIAL ANNEX

[REDACTED]