



Date: Aug 23rd, 2009

Mr. Alan Horne
General Director
Telecommunications Regulatory Authority
The General Director
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PO Box 10353
Manama
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Email: cost-capital-consultation@tra.org.bh

Dear Mr. Horne,

Subject: Cost of Capital Determination Consultation

Please find enclosed with this letter the response of Zain Bahrain to the public consultation issued by the TRA on the above subject dated 20th July 2009.

Should you require additional information or clarification, please do not hesitate to contact me.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jaffar Abdulla", written over a light blue circular stamp.

Jaffar Abdulla
Manager, Regulatory & Interconnection

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Zain Bahrain Response to the TRA Consultation on the

Cost of Capital Draft Determination

Issued by the Telecommunications Regulatory Authority on 20th July 2009

Ref: MCD/07/09/049

Aug 23rd, 2009

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This response to the consultation is submitted by:

Zain Bahrain

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Response to the Draft Determination on Cost of Capital issued by the TRA on 20th July 2009:

1 Proposed approach to capital structure

Q1

Do you agree with the capital structure proposed by TRA? Please elaborate.

R1

We agree with the 100% equity financed capital structure proposed by the TRA. As Bahrain is a tax-free zone, there are no expected tax benefits from having partially debt financed capital for a company in Bahrain. Even though Zain Bahrain is more leveraged than Batelco, a 100% equity financed capital is a component that gives the highest cost of capital so we do not see any objection to the VTC. However, it is worth noting that if the TRA intends to use a LRIC based model for interconnection costing as would appear to be its intent, the 100% equity

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approach is somewhat in conflict with the LRIC principle which uses the cost variables of a most efficient operator.

Q2

Do you agree with the risk-free rates proposed by TRA under the base-case and alternative scenarios? Please elaborate.

R2

For calculating the cost of capital, risk free rates are often taken based on yields on US Treasury bonds. Gkxgp"vjcv"Dcjtkpøu"ewttgpey is pegged to the US dollar, the estimate of a 3.2% - 3.7% risk-free range based on 2-7 year maturities and a 150 bps country risk premium over US treasuries appears to be appropriate. An alternative to US treasury bonds would be to take the risk-free rate dcugf"qp"vjg"eqwptv{øu"iqxgtpogpv"qt"vtgcuwt{"dqpfu"kh"cxckncdng0" Therefore, the alternative scenario of a range of 3.5-5.8% based on long-term securities issued by the Bahraini Government also appears to be appropriate. In general terms, Zain Bahrain finds this analysis to be acceptable.

3 Proposed country risk premium

Q3

Do you agree with the country risk premium proposed by TRA? Please elaborate.

R3

In calculating the cost of capital, a country risk premium is used in order to take into account the risk of investing in a particular country. In the base-case scenario where the risk free rate is based on US Treasury bond yields, it is necessary (as proposed by the TRA) to add a country risk premium for investment in Bahrain. Zain Bahrain views the uplift of 150bps to be appropriate.

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Regarding the alternative scenario based on Bahraini Government issued securities; it can be assumed that the risk-free rate applied already includes a risk for investing in Bahrain. Therefore, Zain Bahrain is in general agreement with the country risk premium proposed by the TRA.

4 Proposed estimate of the ERP

Q4

Do you agree with the ERP proposed by TRA? Please elaborate.

R4

The ERP range of 5.1% - 6.1%, including a 50bps premium for financial turmoil and 50 bps for illiquidity seems to be well formulated. Our concern is that the ERP could be calculated based on a geometric rather than an arithmetic average which is a 1.2% reduction. The TRA analysis assumed an arithmetic average given the two year tenor of the regulated WACC. The issue is that long-term internationally diversified investors assume a geometric rate of return where ups and downs in the market returns balance out over time. Furthermore, the fixed two year term has an underlying flaw in that since Bahraini operators such as, for example, Batelco and Zain, will be in operation in the Kingdom for the long term and thus, indefinite renewals beyond two years should be assumed.

5 Proposed approach to equity beta

Q5

Do you agree with the equity betas proposed by TRA? Please elaborate.

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R5

This part of the analysis is somewhat subjective since this is an attempt to establish empirically the risk differentials between mobile and fixed line operators. The TRA concludes that the level of systematic risk does not differ between fixed and mobile services but Zain does not fully agree with this conclusion as it does not appear to be in line with international practice. Indeed, using an ERCP decision is not justifiable since it may represent a special case versus international best practice which currently supports differentiation between fixed and mobile. We therefore suggest that the TRA use a neutral equity beta of 1. Equity betas proposed by the TRA which are less than 1, significantly lower the cost of capital. Therefore, in order to avoid any subjectivity, it is better to retain an equity beta of 1 as is done by other regulators (see page 56, paragraph 204).

6 Cost of capital estimates

Q6

Do you agree with the point selection within the range? Please elaborate.

R6

We agree with the point selection within the range but require that equity and asset beta be set to 1 in low and high scenarios to avoid any subjectivity in this generally sound study. With some adjustment to the calculation parameters (e.g., if the beta value is set to 1) and a review of the ERP, the cost of capital seems to be between 11 to 12% rather than the 9% indicated.

Other comments

With the exceptions already highlighted in this response, Zain Bahrain finds that this recent determination employs more thorough empirical analysis to conform with best practices. Therefore,

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with some adjustment to the capital structure estimate and potentially another review of the ERP, it
ku" \ckpøu"qrkpkqp"vjcv"the overall conclusions proposed by the TRA seem sound.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jaffar Abdulla", with a small flourish at the end.

Jaffar Abdulla

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