Annual licence fees for 900 MHz and 1800 MHz: methodology to derive a discount rate consistent with CPI inflation

EE response to Ofcom's consultation

20 May 2014

Table of contents

Introduction

Ofcom consulted on proposed, revised Annual Licence Fees (ALFs) for 900 and 1800 MHz in October 2013 (the October consultation). Ofcom's proposed methodology for deriving annual licence fees establishes a lump-sum spectrum value, which is then converted to an annual payment using a 20 year annuity formula. The discount rate used in this formula is the real weighted average cost of capital (WACC) for UK mobile network operators as established in the 2011 Mobile Call Termination (MCT) Statement with reference to the Retail Price Index (RPI). Ofcom further proposed that the annual payment would then be increased by RPI every year in order to stay constant in real terms.

Several stakeholders have argued that the WACC is not the appropriate discount rate to apply in Ofcom's methodology, rather it should be the cost of debt or the risk-free rate. In relation to a specific question in Ofcom's consultation document,[1] some stakeholders have expressed concerns that, following the decision by the Office of National Statistics to de-classify the RPI as a national statistic, the RPI may not continue to be available as reference rate.

On 17 April 2014, Ofcom issued a supplementary consultation titled "Annual licence fees for 900 MHz and 1800 MHz: methodology to derive a discount rate consistent with CPI inflation". Though the consultation insists that Ofcom has not yet made a decision on which discount rate to use in its methodology or which inflation index the real discount rate should be derived from, it asks for stakeholders' views on a proposed methodology for re-basing possible real discount rates to the Consumer Price Index (CPI) if Ofcom were to adopt the CPI rather than the RPI. Despite Ofcom's insistence, we interpret the publication of this consultation as a sign that Ofcom is minded to change its methodology to use CPI rather than RPI. If not, there would be no reason to conduct this supplementary consultation.

The choice of inflation index is one of several methodological choices, which have to be evaluated in the round.

As a first observation, we note that the question of inflation index is a material issue for EE. If the basis of the ALF calculation were changed from RPI to CPI, we estimate that, over the next three years, EE would pay approx. £10m per annum (pa) more than the £120m pa estimated based on Ofcom's October 2013 proposal using the 2011 MCT WACC. Whilst we agree that a change to use CPI rather than RPI might be neutral in Net Present Value terms over 20 years, corporate planning and budgets generally look three to five years ahead. A shortfall of £10m pa over the next three years would be a material concern and require cost savings or price increases.[2]

---

[1] Question no. 4

[2] Please refer to section 4 of EE's response to Ofcom's consultation on Annual licence fees for 900 and 1800 MHz, submitted January 2014.

We do not think it is appropriate to consider the inflation index hypothetically or in isolation.

- Under Article 6 of the 2010 Directions,[3] Ofcom is required to revise ALFs for 900MHz and 1800MHz licences so that they "*reflect the full market value of the frequencies in those bands*". Ofcom is also subject to its general duties under ss.3 and 4 Communications Act 2003 and Article 8 Framework Directive,[4] in particular to ensure that the *eventual ALFs imposed*: (i) promote the optimal use for wireless telegraphy of the electro-magnetic spectrum;[5] (ii) promote investment and innovation;[6] (iii) do not distort competition or favour one form of electronic communications network over another;[7] and (iv) are objective, non-discriminatory and proportionate to what they are intended to achieve.[8]
- Each element of Ofcom's methodology in deriving ALFs therefore cannot be considered in isolation, without considering whether the *resulting* ALF both reflects full market value and accords with Ofcom's statutory duties. It would be wrong for Ofcom to adopt a mechanical approach in which, while each step might appear justifiable if viewed in isolation, the overall result is disproportionate.
- The choice of inflation index cannot be divorced from the choice of discount rate or indeed the wider ALF methodology and its implementation. For example, it might be tolerable to use the CPI instead of RPI, if the discount rate used were the cost of debt rather than the WACC because in aggregate the impact of using the CPI rather than the RPI would be offset by the impact of using the cost of debt, not the WACC.
- Moreover, taking a cost of capital figure calculated in 2011 and adjusting it by a measure of inflation expectations calculated three years later cannot simply be assumed to produce an appropriate discount rate. This approach is an artificial construct which introduces the potential for error and hence divergence of the eventual ALF from market value. Further, the cost of capital figure (which, as explained below is now three years out of date) is likely to have assumptions embedded in it which are different from those contained in the inflation expectations.

We remain of the view that Ofcom must demonstrate that its ALF proposal, taking account of all aspects of the methodology, meets the criteria of being a good estimate of market value.

Ofcom is obliged to carry out an impact assessment of its estimate of market value (compared to other possible estimates) and explain how a given estimate promotes its statutory duties: see s.7 Communications Act 2003. Ofcom is also under a duty of transparency under ss.3(3)(a) Communications Act 2003 and Articles 3(3) and 8(5) Framework Directive. The October consultation proposed a punitive ALF and Ofcom did not explain through which mechanism

[3] The Wireless Telegraphy Act 2006 (Directions to OFCOM) Order 2010

[4] Directive 2002/21/EC of the European Parliament and of the Council of March 2002 on a common regulatory framework for electronic communications networks and services

[5] See s.3(2)(a) Communications Act 2003; Article 8(2)(d) Framework Directive.

[6] See s.3(4)(d) Communications Act 2003 and Article 8(5)(d) Framework Directive.

[7] See s.3(4)(d) and 4(3) Communications Act 2003 and Article 8(2) and 8(5)(c) Framework Directive.

[8] See s.3 Communications Act 2003 and Article 8(5) Framework Directive.

that estimate of market value would work to promote its statutory duties or the objectives of the Direction. In our response to the October consultation, EE explained how an ALF for 1800 MHz at the level proposed would affect our 4G rollout to less populated areas and/or the prices we charge consumers. We feel unable to comment sensibly on Ofcom's assumed proposal to change the inflation index from RPI to CPI or the mechanics of that calculation until we understand Ofcom's revised ALF proposal in full. We note that EU law requires, that where a national regulatory authority intends to take measures in accordance with the Common Regulatory Framework, including when imposing fees for the rights of use of radio frequencies under Article 9 of the Authorisation Directive, it must allow interested parties the opportunity to comment on the draft measure within a reasonable period: see recital 15 and Article 6 of the Framework Directive. That requires consultation on the *whole* measure in order that its impacts may properly be evaluated by consultation respondents, not a partial or piecemeal consultation. We do not believe this current consultation on a methodology for converting the discount rate from RPI to a CPI basis is effective to discharge that obligation.

Cost of capital estimates must be up to date and consistent with other regulatory decisions

Our second observation is that the mobile cost of capital[9] as estimated by Ofcom in 2011 under the MCT review, which Ofcom proposes to adjust based on CPI for the ALF methodology, is now out of date. Ofcom is due to publish a consultation on the MCT for the period 2015-18 in May 2014[10] and this will include proposals for an updated mobile WACC including cost of debt and the risk free rate. We understand that Ofcom may issue a Statement on ALFs in July 2014.

It is of utmost importance that when determined, the ALFs should be based on the most recent and reliable evidence available to Ofcom at that time.

- By its very nature, this is a forward looking decision in that it will set the ALFs for years to come. The legal framework reinforces this point. Article 6 of the Direction states that the licence fees payable must reflect market value: since the licence fees for each year will be payable in the future in respect of that year, that implies that the fees should reflect a best estimate of future market value. Moreover, Ofcom is specifically required to promote efficient use of radio frequencies and to promote "*efficient investment and innovation in new and enhanced infrastructures".*[11] It is therefore essential to ensure that future ALFs are not set at a level which deters or otherwise distorts efficient investment.
- In that context, it is not appropriate to place a great deal of weight on information which is now three or four years out of date. The best estimate

[9] WACC, cost of debt and the risk free rate
[10] with a Statement to be issued in March 2015
[11] See Articles 8(2)(d) and 8(5)(d) Framework Directive; s.3(4)(d) Communications Act 2003.

of future value must be based on the most up-to-date and reliable evidence.

- Whilst Ofcom is required to have regard to the, now historic, prices from the combined award of 800 MHz and 2.6 GHz; it is not obliged to set ALFs at the level of the auction prices or otherwise to have regard to historic information. Indeed Ofcom's publication on 16 May 2014 of further benchmarks from other European auctions that have concluded since the October consultation[12] and that it may take into account when setting ALFs, demonstrate that Ofcom believes estimates of market value can change over time. Of course, the ALFs also have to be reasonably stable over time but if the purpose of the ALFs is to send appropriate signals so as to encourage licensees to use spectrum efficiently and make efficient investment decisions, Ofcom clearly needs to use an up to date measure of the appropriate discount rate in its ALF methodology.

In addition, it is not acceptable to use one estimate of mobile cost of capital for this ALF decision and another for the upcoming MCT decision. According to Article 8(5)(a) of the Framework Directive and section 3.3(a) Communications Act 2003, Ofcom is required to adopt a consistent regulatory approach. That is particularly important when the decisions are being taken closely together in time, and that the ALF decision will affect the mobile operators over the whole of the next MCT charge control period (and after the end of the 2011 MCT charge control). Further, an inconsistency between the two is likely to have a detrimental effect on the mobile operators. Spectrum is in reality an input cost for the provision of mobile call termination, and the cost of mobile call termination is price controlled using a modelling methodology in which spectrum costs are approximated by the additional network costs that would be incurred if incremental spectrum was not held.

The issue of what is the current appropriate cost of capital for the mobile sector is a general one that must be considered in the same way across all relevant Ofcom decisions. It would be wholly unacceptable for Ofcom to consult on an updated mobile cost of capital in May 2014 for MCT and set ALFs on the basis of the 2011 MCT cost of capital in July 2014.

Conclusion

The real issue at stake is what the appropriate cost of capital for the mobile sector is. This must be considered in the round. There are at least two fundamental problems with Ofcom's current approach. First, Ofcom is wrong to consult on the issue of inflation index in isolation. A change of methodology to use CPI rather than RPI is material and must be considered alongside the choice of discount rate with a proper impact analysis of the sum total of Ofcom's proposals to confirm how and why a given estimate of ALFs meet the objectives of the Direction and Ofcom's wider statutory duties. Second, as time passes, the estimate of mobile cost of capital from the 2011 MCT becomes out of date. Ofcom must address the fundamental issue of what is the current cost

[12] Available at http://stakeholders.ofcom.org.uk/consultations/900-1800-mhz-fees/update-note/

of capital for the mobile sector and apply that consistently across its decisions that affect the UK mobile operators.