Telefonica

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Dear Helen

Annual licence fees for 900 MHz and 180o MHz: methodology to derive a discount rate consistent with CPI inflation

Telefonica UK LTd ("Telefonica") welcomes the opportunity to respond to Ofcom's proposed methodology to derive a discount rate consistent with CPI inflation, in the context of annual licence fees for 900 MHz and 1800 MHz spectrum[1].

Ofcom is keen to emphasis that it has yet to come to a decision about important matters related to, but outside the scope of, this present consultation[2].

The current position, therefore, might be summarised as follows:

- Under its October 2013 proposals, Ofcom proposed to use the real cost of capital (the "weighted cost of capital" or "WACC") as calculated in the March 2011 Mobile Call Termination Statement, as the basis for the discount factor in determining ALFs;
- However, this needs to be updated to reflect the change in the corporate tax rate
- Under the current exercise, Ofcom is consulting on amending another parameter: the RPI inflation rate
- However, Ofcom has not proposed amending other WACC parameters, even though there is evidence available to it now, that didn't exist when Ofcom made the March 2011 Mobile Call Termination Statement, that supports a reappraisal.

Telefonica believes that Ofcom's approach is inconsistent. As a matter of principle, we support the use of up-to-date evidence to determine factors that are relevant to regulatory decision making. Thus, we agree with Ofcom that it is right to change the corporate tax rate parameter in its WACC calculations, to reflect change in the Government's fiscal policy[3]. In addition, we have also argued for a higher RPI assumption[4], again, to reflect evidence that is available now, but was not at the time of the March 2011 Mobile Call Termination Statement.

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[1] Annual licence fees for 900 MHz and 1800 MHz: methodology to derive a discount rate consistent with CPI inflation, 17 April 2014. See: http://stakeholders.ofcom.org.uk/binaries/consultations/900-1800-mhz-fees-cpi/summary/cpi.pdf
[2] See paragraphs 2.5 – 2.8, for example
[3] For the avoidance of doubt, we remain firmly of the view that the the cost of debt is the correct discount rate in relation to annual licence fees
[4] See section 4.5 of our response to the October 2013 consultation.

However, Ofcom does not appear to have adopted the same approach with respect to other WACC parameters. It has conspicuously not considered evidence which has become available to it in the last three years and which has a bearing on other WACC parameters. For example, as we set out in section 4.3 of our response to the October 2013 consultation, more recent evidence supports the use of a significantly lower cost of debt parameter than Ofcom had determined in March 2011. We also note the Economic Insight report attached as Annex C to H3G's response to the October 2013 consultation, which referred to recent evidence on a variety of WACC parameters, including the risk free rate[5].

Ofcom's present position therefore appears to be inconsistent; it recognises that some of the 2011 WACC parameters should be adjusted, but fails even to acknowledge evidence in support of changes to other WACC parameters. Telefonica believes that a decision based on this inconsistent approach would not be capable of withstanding an appeal.

Questions raised in the consultation

Ofcom asked 2 questions in the consultation document:

> *Question 1: Do you agree with this methodology for deriving a real discount rate consistent with the CPI measure of inflation?*
>
> Subject to the above, we have no comment to make on Ofcom's methodological approach.
>
> *Question 2: Do you agree with our approach to deriving estimates of long-run RPI and CPI?*
>
> We agree that the "wedge" between RPI and CPI should be assumed to be greater than 0.5% (ie the difference between an assumed rpi of 2.5% and the Government's cpi target of 2%). In our response to the October 2013 consultation, we argued that expectations of medium and long-run RPI inflation should be at least 3%. Accordingly, we do not object to an assumption of long-run RPI inflation of 3.3%

I hope you find this useful.

Yours sincerely

Lawrence Wardle
Head of Regulatory

[5] See: http://stakeholders.ofcom.org.uk/binaries/consultations/900-1800-mhz-fees/responses/Three.pdf