

TELEFÓNICA O2 UK LIMITED RESPONSE TO:

“SRSP: THE REVISED FRAMEWORK FOR SPECTRUM PRICING”

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TELEFÓNICA O2 UK LIMITED RESPONSE – SRSP: THE REVISED FRAMEWORK FOR SPECTRUM PRICING

Introduction

1. Telefónica O2 UK Limited (O2)¹ welcomes the opportunity to respond to Ofcom’s “SRSP: The revised Framework for Spectrum Pricing” (the SRSP Consultation).
2. O2 is a leading communications company for consumers and businesses in the UK, with 21.355 million mobile customers and over 632,400 fixed broadband² customers as at 31 March 2010.
3. As Ofcom has previously recognised: “*UK consumers and citizens already enjoy enormous benefits from the services provided using spectrum in [the 900MHz and 1800 MHz] bands*”³.

Ofcom’s SRSP Consultation

4. We note that the SRSP Consultation is intended to be “*a guide to general principles and practice. As such it does not make detailed fees proposals for individual sectors*” [§1.3] but that rather it “*proposes a framework for spectrum pricing that, subject to consultation, we expect to apply to all future fee rate reviews, but does not propose any specific changes to fee rates.*” [§2.67].
5. Furthermore, Ofcom makes clear that, in relation to existing 900MHz and 1800MHz mobile licences, were the Government’s draft direction⁴ or some other replacement order to be made (requiring Ofcom to revise the level of annual

¹ Telefónica O2 UK Limited (O2) is part of Telefónica Europe plc which is a business division of Telefónica S.A. and which owns O2 in the UK, Ireland, Slovakia, Germany and the Czech Republic, and has 53.9 million customers (at March 2010). Telefónica is the world’s largest integrated telecommunications operator, and the largest in Europe in terms of market capitalisation. Its activities are centred mainly on fixed and mobile telephony, with broadband as the key tool for the development of both.

² And on 1 October 2009, O2 UK entered the business fixed telephony market with the launch of its full communications service to small and large businesses.

³ “Application of spectrum liberalisation and trading in the mobile sector”, Ofcom, February 2009, [§1.2]

⁴ The Wireless Telegraphy Act 2006 (Directions to OFCOM) Order 2010 (laid before the election)

licence fees for this spectrum), then Ofcom would expect to consult, in due course, on its proposed approach to the implementation of the licence fee element of the direction [§2.68]⁵ ⁶.

6. Our comments herein are made, therefore, in preliminary and general terms. We reserve our rights in respect of the specific application of Ofcom's framework of policy principles for spectrum pricing and general methodology for determining the level of fees in relation to 900MHz and 1800MHz. The comments herein are not intended to be an exhaustive set of comments on the general principles and methodology Ofcom sets out in the SRSP Consultation. Rather, we have restricted ourselves to general observations on some of the enhancements Ofcom proposes to its existing pricing principles and methodology for AIP as summarised in the Consultation at §1.19 and §1.20, for example:

- i) The reaffirmation of the purpose of AIP (to secure optimal use of spectrum where it is scarce), generally effective over a "considerable" period (given equipment lifetime) and triggered, in particular, where there is spectrum congestion; and the continued application of the use of "feasible alternative uses" of the spectrum;
- ii) The relevant timeframe which Ofcom would intend to take into account in its analysis;
- iii) An increased focus on relevant market prices when setting fee reference rates;
- iv) Where licences are tradable, to take account of the effectiveness of spectrum trading and other relevant factors when considering the role of AIP;

⁵ And that Ofcom comments: "We propose to apply these principles to all future fee reviews, while recognising that we need to take account of the particular circumstances of the particular frequency bands and licence types under review and those might require us to modify them in particular cases. We will consult on how to take account of the specific circumstances and give reasons for our decisions, when we carry-out future licence sector-specific fee reviews" [§3.3]

⁶ And to this extent, Ofcom's questions in relation to future fee rate reviews and next steps [§1.21] for the spectrum bands are already answered.

- v) Making an assessment of the trade-off between the risks of setting AIP too high/ too low compared to the market value on the specific circumstances of the licence class of sector in question (and the extent to which trading is expected to promote optimal use and the risk of underling secondary markets).

Ofcom's duties

- 7. As Ofcom notes, its SRSP must be consistent with its duties (overall and spectrum specific). In its Statement "Policy Evaluation Report: AIP"⁷, Ofcom notes that in setting its principles and pricing methodology, "*Ofcom is required to comply with the legal framework defined in the European Union ("EU") and implemented in UK law, which sets out (i) overarching general duties applying across all [Ofcom's] functions as wells as (ii) specific duties concerning spectrum management.*" [§2.10] And further, "*The policy objectives pursued by Ofcom by means of AIP must comply with this general legal framework*" [§2.16].
- 8. Accordingly the legal framework is an underpinning element in Ofcom's SRSP approach.

Complexity – and regulatory risk

- 9. The framework of policy principles which Ofcom sets out in the SRSP Consultation, along with the general methodology outlined, delivers a complex framework for determining AIP. The determination of AIP is likely to be a significant and complex piece of work for Ofcom and stakeholders. The analysis will need to deal with uncertainty in various forms as well as the balance of regulatory risk that Ofcom will set AIP at too low a level or too high a level. In this latter respect, Ofcom has to date erred on the side of caution.
- 10. Indeed, Ofcom's Policy Evaluation Report notes that:

⁷ http://www.ofcom.org.uk/research/radiocomms/reports/policy_report/ref

“... because of the risks to optimal allocation posed by sustaining AIP above opportunity costs, as well as the difficulties of estimating opportunity costs with confidence ... by adopting a conservative approach Ofcom has sought to minimise the risks of any inefficiency and detriment to citizens and consumers arising from the application of AIP” [§2.22]

11. Furthermore, Ofcom also observes (in the Policy Evaluation Report) that in respect of the original Smith NERA recommendations for cellular (in 1996): *“Even where phasing in of charges was to be undertaken, Government was concerned that the market would receive these rises (at least a doubling of fees in most cases) poorly. Furthermore, Government felt that the rises would unnecessarily burden some sectors of the radio industry” [§4.11].*
12. We are unconvinced that the regulatory risk is any less under the principles and methodology proposed in the SRSP Consultation and, therefore, we believe that Ofcom is required to continue to err on the side of caution in order to comply with its statutory duty to act consistently.

Core pricing policy principles

Role of AIP

13. Ofcom explains that AIP’s role is *“to help secure the optimal use of spectrum by providing a sustained long-term signal of spectrum value to inform users’ investment decisions (both new users and existing users) for spectrum that is scarce.” [§3.10].⁸*

A sustainable long term signal

14. O2 supports Ofcom’s recognition that the time needed to respond to price signals might be lengthy if significant investment is required to upgrade or replace existing systems. And we note that Ofcom explains that AIP is intended,

⁸ Although, Ofcom also notes that there may be reasons why users are unable to respond to AIP in the short or medium term (three broad types of limitations on spectrum users’ ability to change are identified [§3.17]).

therefore, to provide an incentive for longer term investment decisions, recognising that choices may be limited in the short to medium term. Accordingly, Ofcom explains *“The purpose of AIP is to secure the optimal use of spectrum in the long term, so as to allow users to be able to respond to AIP as part of their normal investment cycle”*.

15. However, it is not clear how in practice Ofcom intends to reflect this in its approach to incentivising users. For example, at §3.64 and §3.67 Ofcom explains that it will *“seek to assess excess demand, congestion and feasible alternative use over a timeframe that reflects the length of existing users investment cycles”*.⁹ And *“signalling our expectation of likely congestion from existing use or demand from alternative use on a similar timescale to users’ investment decisions will tend to give existing users sufficient time to adjust their spectrum use”* [§3.66]. Yet under Ofcom’s approach, excess demand is a trigger for the application of AIP, whereas, as the SRSP consultation notes [3§.15], *“some stakeholders have argued that it is unreasonable to apply AIP if users would find it difficult, in practice, to respond to price signals, particularly where this is as a result of constraints imposed on them ...”*.

16. We would welcome clarification as to how Ofcom will in practice reflect investment cycle constraints in its approach.

The use of auction outcomes or trading prices to inform AIP fees

17. Ofcom proposes to make greater use of observed market valuations in setting AIP in the future (subject to the caveat that, for a number of reasons, care needs to be exercised there under) [§3.101].

18. We believe that Ofcom is right to recognise that caution is required in using auction outcomes and trades to inform AIP setting. As Ofcom points out, auction prices can be affected significantly by the specific circumstances of the award

⁹ In these circumstances, how will Ofcom deal with users on differing investment cycles? Is Ofcom suggesting it will set user specific AIP depending on investment cycles?

[§3.103]¹⁰, which can make it difficult to establish like for like comparisons¹¹ [§3.104]. In addition, linking AIP to auction prices can distort bidding incentives [§3.105]. To Ofcom's non-exhaustive list can also be added factors issues such as the rules of the auction (and any reserve prices¹²) the number of players vs spectrum lots, spectrum coming onto the market in the future, existing holdings of licensees, caps on purchased spectrum, level of substitutability between spectrum blocks, ability to switch between different spectrum types in a multi-band auction, etc ... there is, as Ofcom recognises, a long list.

19. We note that Ofcom remarks that subject to such (in our view significant) considerations, auctions/ trades may provide a reliable indication of market value and that where this is the case, Ofcom "*can estimate the market value with a higher¹³ degree of confidence and there is a lower risk that AIP fees based on this evidence will be either too high or too low*" [§3.114]. We believe Ofcom must exercise caution here. The use of auctions/ trades as benchmarks is likely to involve a significant and complex amount of work, which may not necessarily result in the level of confidence Ofcom suggests. In particular, O2 is strongly of the view that Ofcom must be able to clearly discount the range of factors we identify in paragraph 18 above before it can conclude that any particular reference price (from a trade or an auction) provides evidence of an underlying increase in the value of that spectrum type. Ofcom's duty to act consistently places a burden of proof on Ofcom to clearly explain why these new factors are more relevant to the setting of AIP than the calculated opportunity cost of spectrum.

¹⁰ For example, such as "*how much spectrum is available, and how it is packaged; whether it is adjacent to an incumbent's holding or harmonised; the timing of the award relative to other spectrum market developments (e.g. availability of complementary spectrum elsewhere in Europe); the degree of harmonisation and equipment availability at that frequency; the nature of the technical limitations imposed in the licence, for example to protect incumbents in the same or neighbouring bands; any non-technical conditions, for example on network roll-out.*" [§3.103]

¹¹ Ofcom observes "*from the relatively small number of auctions to date*" [§3.104]. Whilst, of course sample size may be a factor to consider, simply having a larger sample size does not necessarily reduce the margin for error where the circumstances of the auctions in the sample remain varied and are not a like for like comparison. Indeed, given the specificity of any one auction, the likelihood of obtaining sufficient benchmarks may remain slim.

¹² Indeed, ComReg surprisingly chose to use a benchmark exercise by Dotecon to identify indicators of market price, to set the minimum price in the 900MHz Auction in Ireland directly at the benchmarked "market level". Thereby inhibiting the ability of the auction to determine the market price.

¹³ "Higher" than what? It is not clear what level of uncertainty Ofcom is making the comparison.

20. We note that Ofcom explains that where it does not have reliable market evidence of spectrum values, it will estimate the market value by way of an assessment of the opportunity cost of the current use of the spectrum concerned [§3.115].¹⁴ This is something we strongly support.

Accounting for uncertainty in market values when setting fees

21. Ofcom rightly recognises that in setting AIP fees it needs to take account of the risk that its estimates of market value are either too high or too low relative to the actual market value of the spectrum [§3.112]. And that this will have implications for citizens/ consumers and users.

22. Indeed, to date, Ofcom's policy has been to (rightly in our view) "*err on the side of caution when setting AIP fees. In practice, this means that [Ofcom has] generally set AIP fees below [Ofcom's] estimates of spectrum value*" [§3.113].

23. However, Ofcom notes that it could refine its "cautious" approach in specific circumstances¹⁵ by being less conservative and setting AIP fees to encourage spectrum to migrate towards higher value users or uses in a timely manner (or where there was a case for quicker re-allocation, Ofcom might intervene to clear the band sooner than by using AIP as the incentive)¹⁶. We think Ofcom is right to consider the balance of risk. Indeed, as Ofcom observed in its Policy Evaluation Report, a key question is: "*How close to expected 'full opportunity cost' levels to set conservative AIP rates, given the fluctuations and uncertainties in market rates and the attendant risks of regulatory failure.*" [§9.8]

24. Furthermore, as Ofcom also recognises, there may be no certainty that feasible alternative uses will materialise and hence that it may continue to give proportionately more weight to the loss of current benefits than to delays in potential future benefits from alternative uses being realised [§3.125].

¹⁴ This suggests that any assessment will commence with a significant and complex review of market evidence (which may not necessarily provide robust benchmarks. Given the complexity of such work and the risk of it not delivering robust benchmarks, we recommend that there is some "go/ no go" decision built into the process before any significant piece of work is undertaken.

¹⁵ Where the value of feasible alternative use is much higher than the value of current use, then the potential loss from setting fees too low is more likely to be higher than the potential loss from setting fees too high.

¹⁶ As discussed in "Aeronautical and Maritime Spectrum Pricing", Ofcom, 2007, page 6 and 59-65.

25. Accordingly, we believe Ofcom should exercise caution in its ambition to rely/ focus increasingly on market benchmarks.

Role of AIP when licences are tradable

26. We remain of the view that any role for AIP falls away with the introduction of liberalisation and trading because both AIP and trading have the same objective – the efficient use of spectrum. Indeed, as Ofcom remarks: “*We believe that objective [the optimal use of the spectrum] is, as a general rule [17], more likely to be achieved if detailed decisions on how spectrum is used are left to those directly engaged in its use rather than dictated centrally by the regulator.*” [§1.8]

Methodology for setting levels of spectrum fees

General

27. Ofcom discusses the general methodology for determining the level of fees. We believe this is helpful. However, we also believe experience suggests that the deployment of the methodology will remain a complex and significant piece of work. As Ofcom will recall, there have been significant differences in the outputs of models over the years in relation to 2G. As such, the regulatory risk of error and distortion remains and cannot be discounted.

Least Cost Alternative

28. We note that Ofcom intends to continue with the Least Cost Alternative methodology. O2 remains generally supportive of the least cost alternative method. However, as has previously been found, LCA modelling is sensitive to input assumptions and hence the regulatory risk of error is ever present, which in reality, is likely to be asymmetric for spectrum users.

¹⁷ Although, we note that Ofcom concludes that “*Trading alone may not provide sufficient incentives towards efficient spectrum use in individual markets in two main circumstances: if it is limited by barriers like transaction costs, co-ordination problems and/ or lack of price information; [and] if licensees are more responsive to AIP than to trading.*” [A6.51].

Phasing

29. We agree with Ofcom that there may be circumstances in which it will need to consider phasing in any increases in fees (for example, where such changes may be disruptive to existing users).

Concluding remarks

30. We would be pleased to discuss our comments with Ofcom.

Telefónica O2 UK Limited

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