



Vodafone's response to Ofcom's consultation

"Spectrum Pricing: A framework for setting cost based fees"

December 2013

Non-confidential

Summary and conclusions

Vodafone welcomes the opportunity to respond to this consultation, which relates to the appropriate level of fees to set DTT operators in the relatively short term between 2014 and approximately 2020 during which period Ofcom has determined that only a cost recovery basis is required. Whilst we may agree with the principle that DTT operators should be immediately charged only a cost based fee whilst the long run use of the 700MHz band is still being considered, we are less clear that the sum of £1.1m proposed by Ofcom is necessarily the correct value to use. It may very well not be properly representative of the costs that Ofcom will incur on the 470 - 800MHz spectrum bands for the next few years.

Looking further forward, we are concerned at the inconsistency of the charge per unit of spectrum of the annual fees that Ofcom is currently proposing for mobile and for DTT, once both are being charged on an above cost recovery basis, particularly since Ofcom in its mobile data strategy document published in November 2013 is now suggesting that some, if not all of the DTT spectrum could be better employed in mobile use in due course. In these circumstances, to ensure efficient use of spectrum where alternative uses are proposed, Ofcom should make sure that the spectrum fees of the 900MHz and the 470 – 700MHz spectrum bands are aligned.

The current consultation falls into two parts – a general development of an overall framework for setting cost based fees, and a specific set of proposals for DTT licence fees in particular. These fees should apply for the interim period whilst the future timing of the release of the 700MHz band to mobile is being determined – after this point, significantly higher fees are proposed. Ofcom's current proposal is likely to lead to DTT operators not being charged an appropriate sum to cover Ofcom's actual spectrum management costs over the next few years that relate to the 470 - 800MHz spectrum band. There are also currently no equivalent proposals for immediate revision to other spectrum fees using the data that has been used to suggest the level of DTT fees, even though the data shows that fees for other bands are also apparently significantly out of line with Ofcom's costs. We feel that there is a difficulty with the proposed piecemeal approach to cost based fees, in that deriving the appropriate level of cost recovery for different bands at different times with different datasets is likely to lead to inconsistent results.

The contrast with Ofcom's proposals for mobile spectrum pricing

This consultation is one of several that relate to spectrum fees that are or will be occurring over a relatively short time period in 2013/14 and 2014/15:

- Setting DTT operator fees on a cost recovery basis for a limited period;
- Setting mobile 900MHz and 1800MHz operator fees on a very different basis;
- A short term basis of charge for E-band spectrum licensing;

- The mobile data strategy document that creates a road map for releasing additional spectrum to mobile use in future years;
- The upcoming review of fees for all “fixed link” spectrum bands.

What is most noteworthy from comparison of the proposals for the DTT spectrum fees and for the mobile spectrum fees is the enormous gulf between the two. For DTT, Ofcom is proposing that a payment of £1.1m a year is appropriate for the current holding (excluding 600MHz spectrum¹) of 256MHz. This amounts to only £4,300 per MHz per year. By contrast, Ofcom’s current proposal for the 900MHz mobile band is of an annual payment of £1,990,000 per MHz². It is thus being suggested that mobile will pay 463 times more than DTT per MHz for nearly adjacent spectrum. Surely this cannot be correct?

Moreover, whilst Ofcom plans to increase the mobile fees annually with inflation, there would appear to be no suggestion in the present consultation that DTT fees will be similarly adjusted. So, taking Ofcom’s assumption of 2.5% inflation, then after 6 years the mobile annual rate could be £2,310,000 per MHz of spectrum, whilst DTT would still be paying only £4,300 per MHz. At this point mobile could be paying 537 times more per MHz than DTT. This inconsistency of treatment for adjacent spectrum is extraordinary, particularly since part of the DTT spectrum, the 700MHz band has already been earmarked for release to mobile use in the near future.

When the 700MHz spectrum is released to mobile, then Ofcom’s current proposal in the Spectrum Pricing for Terrestrial Broadcasting Statement July 2013 is for AIP based fees to be in place around 2020 for DTT. In the March 2013 consultation that preceded the statement, an indicative level of fees was developed using an opportunity cost view of mobile use of 700MHz (derived from a model by Analysys Mason), of around £40m per multiplex, or £240m for what would from 2020 be 216MHz used for DTT. This amounts to approximately £1.11m per MHz. If mobile operators were at that time to be paying £2.31m per MHz, then mobile would still be paying, and would continue to pay more than twice the level of fees per MHz than DTT³. Such an inconsistent charging basis will not lead to an efficient use of sub1GHz spectrum, particularly since Ofcom has recently suggested in the mobile data strategy document that some or all of the DTT spectrum could in due course be released to mobile use. It follows from this that DTT operators and mobile operators should be charged similar annual fees, to ensure that any boundary between DTT and mobile spectrum allocation is correctly placed. Such consistent charging will also serve to encourage DTT operators to make the most efficient use of their spectrum, using the techniques outlined by Ofcom in section 4 of the March 2013 DTT consultation, in the same way that mobile operators are deploying continuing spectral efficiency improvements.

¹ For the 600MHz spectrum a temporary fee of an even lower rate per MHz per year is employed

² In 2013 prices

³ It is not clear at present whether Ofcom will decide to phase in the increase in DTT fees over 5 years – if it were to choose to do so, then obviously the very large differential in fees per MHz would continue for a longer period.

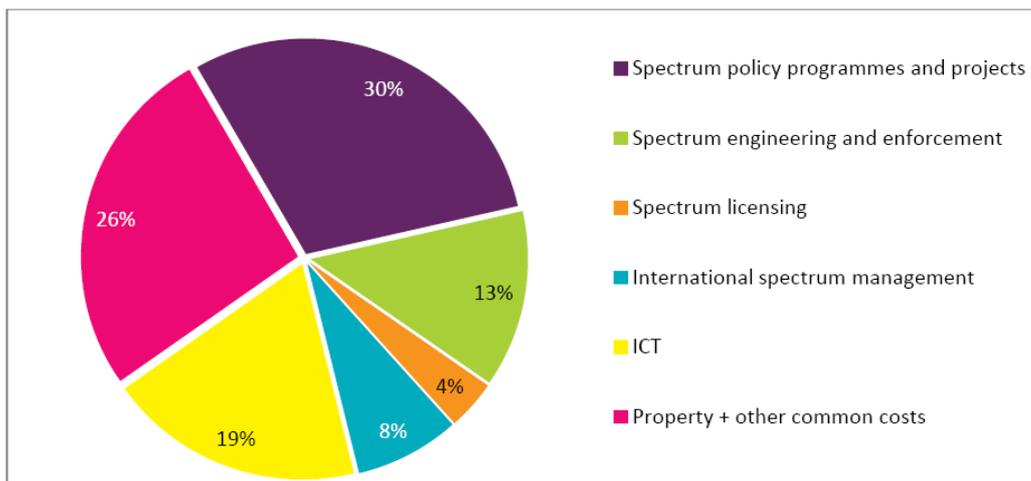
Ofcom's cost allocation and the information it reveals

The information that Ofcom initially provided in the consultation document was insufficient for Vodafone to properly consider the principle and level of fee setting for the DTT sector, given that no analysis of costs into licence classes other than DTT was provided, nor was any pairing of fees received with costs incurred on a licence class basis given. Vodafone sought further information to assist us in responding to this consultation. We thank Ofcom for providing the data contained in the addendum, which matches Ofcom's 2011/12 allocated spectrum management costs with fees invoiced, by licence type and class.

We understand that this level of analysis has only been made possible by the execution by Ofcom of "a significant project to review in considerable detail the costs relating to the management of the UK spectrum". Clearly it is important that Ofcom is aware of how it expends resources, so we welcome the fact that such an exercise has now been conducted. We understand that one significant by-product of this exercise (which was presumably broader in scope than just relating to spectrum management alone) was a view that the then current proportion of IT costs relating to spectrum was lower than assessed in previous years, and thus there was a change in the allocation of Ofcom's overall costs away from spectrum and towards other sectors, such as Networks and Services.

Ofcom presents in figure 1 below the broad cost heads that make up the total of spectrum management costs for 2011/12, reported as £40.1m. It is clear from this analysis that a very significant proportion of these allocated costs are common costs, rather than costs incurred specifically by a particular licence class in that year.

Figure 1: Breakdown of spectrum management costs by type*



Furthermore, many of these common costs are not specific to spectrum, but rather are general property and IT costs of Ofcom, a proportion of which are being allocated to spectrum.

From Table 2 of the current consultation, it would appear that the principal driver of this cost allocation, into the overall “pot” of spectrum management and then into individual spectrum classes is the internal FTE and external FTE equivalent resources attributed to each class. These levels of resources will be therefore driving for a particular year both the level of costs allocated to each particular spectrum class, and the total of costs allocated to spectrum management. Based on Ofcom’s analysis, it would appear that a relatively small proportion of the total costs of a particular class are direct costs of that spectrum class, with the balance being common costs derived by the allocation process.

There is nothing exceptional in any of this in principle. In practice, providing the overall allocation is robust and that the specific level of effort in each spectrum class is consistent from year to year (and the ratio of overall direct costs inside/outside the spectrum category also remains consistent) then we would expect that a consistent year to year cost for a particular spectrum class can be established. The difficulty we have is knowing whether the results for a single year, that of 2011/12, can be taken as being sufficient of a baseline to be suitable for forming a long-run view of the level of cost of a particular spectrum class.

The additional data that Ofcom has now published relates only to 2011/12, although we did ask for more recent information as well. It is not clear to us why 2012/13 information is not at this stage available – is the derivation of the cost allocation only a very retrospective one-off exercise or a regular capability that has been added to Ofcom’s reporting? The data supplied by Ofcom shows that the TV broadcasting spectrum was allocated £1.1m or 2.8% of Ofcom’s total spectrum management costs in 2011/12. There are good reasons however to expect that the 2011/12 information alone may not be reliable as a long run indicator of the costs of the 470 - 800MHz spectrum class.

1. The total of spectrum management costs for 2011/12 is reported in this consultation as £40.1m. However according to Ofcom’s 2013/14 tariff tables document, the budgeted 2013/14 spectrum management cost is £53.18m, an apparent increase of 33%. How much of that increase relates to the 470 - 800MHz band is not at all clear, but unless a 2013/14 cost split by spectrum class is available (and we assume it is not since no account of any such data is being made use of in this consultation) then prima facie an increase of 33% should be applied to the DTT cost figure from 2011/12 to bring it into line with the latest information.
2. Of the £40.1m total spectrum management cost in 2011/12, the additional data provided at Vodafone’s request shows that £11.1m, or nearly 28% of the total, related to mobile spectrum bands. We can understand that this proportion might be possible in the run up to the recent mobile spectrum auction, but it is not clear that this will necessarily be correct in the long-run, now that the auction is over and once the annual mobile spectrum fee issue has been

concluded. If the proportion allocated to mobile reduces, then, other things being equal, the cost allocated to other licence classes will rise.

3. Whilst there may be a relatively consistent level of resource expended by Ofcom from year to year on the detailed activity of spectrum licencing (in terms of renewals etc.) we can see from table 1 above that this consistent type of activity forms only a very small proportion of Ofcom's spectrum management costs.
4. For other spectrum costs, there is a natural periodicity or variability in Ofcom's reviews of, or work on, a particular sector. For example we know that in this current year, Ofcom is expending resource on evaluating the future level of annual mobile spectrum licence fees – once set these fees may apply for several years with little further attention required by Ofcom. Next year, Ofcom has promised a fee review of fixed wireless, and will clearly devote an increased proportion of its resources to fixed wireless licence classes in 2014/15. This will certainly have the effect of increasing the costs allocated to these classes, but also, given the high proportion of total costs that are common, it is likely to lead to a reduction in the costs allocated to other spectrum classes. But once the review is complete, the level of activity on these licence classes will reduce once more.
5. We know that one of Ofcom's major activities from its current annual plan relates to 700MHz spectrum, to establish the most efficient future use of this band. We would expect therefore that as a result of this upcoming work, the level of the spectrum management costs incurred in 2012/13, 2013/14 and in subsequent years relating to the 470 - 800MHz band to be above that reported for 2011/12.

We understand that at present Ofcom for some internal reason may only have one year's data available, but we do not understand why this needs to continue, particularly in circumstances where it is very unlikely that one year's historic data will remain representative of Ofcom's future costs for any given spectrum class. We appreciate that as discussed in paragraph 4.14 of the consultation Ofcom has undertaken a review of some of the resources applied to the 470-800MHz band over a slightly longer time period than 2011/12, but for the reasons considered above, such a partial exercise is no substitute for a complete cost allocation by spectrum class.

The arguments above suggest that the £1.1m extracted from a single and historic year's data is unlikely to remain an appropriate level that is representative of Ofcom's actually incurred costs for the 470 - 800MHz band for the next few years. A superior approach would be to use an average of Ofcom costs for the 470 - 800MHz band from a more extended period, using full cost allocation data from 2012/2013 and 2013/14, and paying some attention to forward looking forecasts of activity. If Ofcom is unable to extend its cost allocation analysis in this way, then Vodafone would suggest that the rate charged to DTT operators needs to be adjusted for the change between the total

spectrum management costs in 2011/12 and those in 2013/14 or the 2014/15 budget or whatever the latest benchmark of total spectrum management costs that Ofcom has available. We note that Ofcom is not proposing to charge DTT operators for spectrum until the end of 2014, so the use of data that by then will be more than two years out of date is questionable.

Ofcom identifies from paragraphs 5.8 onward a roadmap for other cost based fee review exercises where the fees are out of alignment with the current view of Ofcom's costs. While the issue of DTT fees are slightly different, in that for historic reasons no fees are currently charged at all, the view provided by the additional information Ofcom released at Vodafone's request shows fees recovered of £3,865k against underlying costs of £5,156m. Removing radio broadcasting which seems to be the licence class best aligned between fees and costs from consideration gives fees recovered of £356k against underlying costs of £2,308k. It would appear that the fees are some distance apart from Ofcom's underlying costs. Whilst the total of this difference is relatively small, these are sums that could otherwise be passed on to the UK treasury – the under-recovery of Ofcom's costs in these bands is effectively being subsidised by those spectrum bands where the fees are set above cost. There is a good case therefore, once a more satisfactory baseline of say three years has been established, for reviewing all of those cost based classes those that have not been addressed in the upcoming fixed fee review on a simultaneous basis.

There is a further point that if the cost allocation data used for setting cost based fees for these particular bands is different from those that Ofcom has used for the 470 – 800MHz band then there is a potential for inconsistency in charging on a band by band basis. At the very least the later analysis will produce data that is more current, as well as being able to draw on a longer baseline that may provide a more representative view of costs. Accordingly Vodafone believes that Ofcom should use any improved or enlarged dataset of costs by band to consider whether the 470 – 800MHz fees need a further adjustment at that point. Vodafone is not advocating a perpetual annual revision, but merely a consistent approach to the basis of cost based charging across all relevant licence classes.

Responses to Ofcom's specific questions

Question 1: Do you have any comments on our cost allocation methodology and proposed approach for setting cost based fees?

Vodafone response - as per the discussion above, we have no criticisms of the methodology per se but do have a concern that one year's data from 2011/12 is insufficient to be able to form a view of the forward looking long run average Ofcom costs for a particular licence class, particularly when charging is only commencing at the end of 2014. We do not understand why Ofcom cannot draw on 2012/13 data and its expectation of the 2013/14 outcome as well.

Question 2: Do you have any comments on our proposed licence fee for national DTT multiplex operators?

Vodafone response - it is not clear that the cost derived of £1.1m for the licence class is representative of Ofcom's likely annual costs for the 470 - 800MHz band for the next few years. If Ofcom is unable to draw on additional years of data on a licence class basis to extend the baseline, we suggest as a minimum that Ofcom applies the historic 2011/12 470-800MHz band proportion of total spectrum management costs to its best view of the future total spectrum management costs, be it 2013/14 or 2014/15 actuals or forecasts, to provide a more robust outcome.

Question 3: Do you have any comments on our proposed licence fee for the local TV multiplex operator?

Vodafone response - not specifically, but the general level of this fee should be adjusted by the mechanisms suggested in our response to question 2.

Question 4: Do you have any comments on our proposed licence fee for the Northern Ireland DTT multiplex?

Vodafone response – as question 3

Question 5: Do you have any general comments on our approach for implementing the proposed licence fees?

Vodafone response – given the size of the proposed fees, the small differences in timing of the proposed implementation of the charges between multiplexes is relatively trivial. In the future however Ofcom will be charging a significantly higher AIP based fee for the DTT multiplexes. In paragraph 5.11 of the March 2013 consultation on spectrum pricing for terrestrial broadcasting, annual fees of £40m per multiplex were provisionally suggested. Here the anniversary based timing differences laid out in table 3 of the present consultation could lead to significant cost differences between multiplexes during the period of fee change implementation. To avoid this problem we would suggest synchronising the implementation date of the cost based fees now and then continuing the use of a common date for multiplex fee revisions into the future.

Vodafone Limited
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