

**Notice of Ofcom's Proposal to Make Regulations in Connection with the
Award of 2.3 GHz and 3.4 GHz Spectrum**

Telefónica UK Limited Response

NON-CONFIDENTIAL VERSION

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Section 1

I. INTRODUCTION

1. Telefónica UK Limited (“Telefónica”) welcomes the opportunity to respond to Ofcom’s consultation on Notice of a proposal to make regulations in connection with the award of 2.3 GHz and 3.4 GHz Spectrum¹
2. Telefónica has sent a letter before claim to Ofcom in relation to Ofcom's decision of 26 October 2015 regarding the auction (the “Decision”). It is submitting this response strictly without prejudice to Telefónica’s position in relation to any legal challenge made against Ofcom’s Decision and nothing in this response should be construed as any acceptance of the Decision.

II. HIGH-LEVEL COMMENTS

3. [X]
4. [X]
5. [X]
6. [X]

Spectrum caps

7. We believe that Ofcom has made a grave error of judgement in not applying any spectrum caps on bidders in the regulations. We firmly believe that caps are required in order to maintain downstream competition in the short-to-medium term, and as a safeguard against grossly asymmetric spectrum allocation outcomes.
8. We continue to believe that the following spectrum caps are required as a safeguard against anti-competitive behaviour in the auction and to protect against an award outcome detrimental to downstream competition:

¹ <http://stakeholders.ofcom.org.uk/consultations/notice-2.3-3.4-ghz-spectrum/>

- *Auction & trading caps.* There should be two such caps:
 - A 37% cap across all spectrum bands that are designated for mobile use, as was the case in the UK 4G auction
 - A separate 37% cap across mobile bands that are usable in the short-to-medium term (i.e. existing mobile bands plus 2.3 GHz only). This cap, together with Ofcom's broader cap, should be incorporated into the mobile trading regulations (although our additional cap could be time limited to 5 years, in line with anticipated developments in the mobile ecosystem). Without our proposed short-to-medium term cap, Ofcom's position would be inconsistent with its approach at the time of the 4G auction, when it excluded the 2.3 GHz band from consideration because it was 3-5 years away from maturity.
 - *Precautionary auction caps.* Ofcom should also impose an 80 MHz cap across the (closely substitutable) 2.3 GHz and 2.6 GHz bands, and an 80 MHz cap on the 3.4 GHz band. These caps can be limited to the auction only, as they are precautionary only – designed to stop bidders acquiring more spectrum than is obviously useful based on current technology but not to preclude future trading should new uses requiring larger holdings emerge. The 80 MHz caps would act as valuable incremental safeguards if imposed in addition to the 37% caps.
9. Ofcom's proposal to abandon spectrum caps completely for this auction represents a major policy shift but is not supported by any substantive reasoning. Ofcom appears to argue that a cap is prudent for a four-player market but may be unduly restrictive for a three-player market. It therefore concludes that as it is uncertain what the market structure will be, the option that is least likely to lead to an inefficient outcome is to do away with all caps. This makes no sense. It exposes both Ofcom and [X] Telefónica, to huge outcome risk in the event that the market does not move to three players. Even if Ofcom were right that the outcome risk is small (which we dispute), it is reckless to proceed without safeguard caps to prevent such an outcome.
 10. Ofcom argues that its SMRA format makes strategic investment-based bidding risky, as it will tend to drive up prices for the aggressor. While this may be true, an SMRA does not prevent such behaviour. It is not sufficient for Ofcom to rely on its choice of auction format as an incentive for intrinsic value-based bidding.
 11. The strategic bidding risk is particularly acute in the 2.3 GHz band, as there are only 4 lots available [X]. Absent adequate spectrum caps, it is a relatively low risk for a strategic bidder to bid in this band [X].

Bid Increments

12. We believe that Ofcom has made an error in not including some constraints on its ability to set bid increments in the regulations. For governance purposes, bidders require some degree of certainty regarding the potential path of prices over consecutive rounds, and an assurance that prices will not rise too quickly. We welcome Ofcom's comments in Paragraphs 4.8-4.15 that *we think it is unlikely that we will increase prices by more than 10% from one round to the other, and it would not be our intention to do so*", but we believe that Ofcom should have built such high-level guarantees into the regulations. We further request more detailed guidance on how Ofcom may determine bid increments in each band at different price levels.
13. [X].
14. In this regard, we are disappointed that Ofcom rejected our proposal to cap absolute bid increments in each band. It is not our intention in proposing such rules to unduly constrain Ofcom's flexibility, but rather give bidders some confidence that price increases in any given round or on any given day will not move too quickly.
15. We acknowledge that it is not straightforward for Ofcom to identify the appropriate maximum bid increments before an auction, and there is some risk that if it sets the maximum too low, the auction may move too slowly. We also recognise that Ofcom will receive information during the auction about demand which may affect its thinking. Nevertheless, we urge Ofcom not to fall into the trap of blindly setting % increments without paying adequate attention to the absolute increases it is imposing on bidders. In particular, Ofcom should consider having smaller absolute increments in bands where excess demand is approaching zero, as opposed to rising increments as often happens with fixed % increments.
16. As a more general point, our strong preference is that Ofcom keep bid increments low and run many bidding rounds each day, rather than use larger increments and run fewer rounds. With only two bands in this auction, bid decisions in an SMRA should be reasonably straightforward provided that absolute price increases are predictable and not too large. Therefore, round lengths and time gaps between rounds could, if necessary, be quite short.

Section 2

III. DETAILED COMMENTS ON THE REGULATIONS

17. Telefónica continues to support Ofcom's choice of the SMRA as the appropriate format for this award. Although the approach to identifying standing high bids and managing price increments for generic lots is novel, the format appears to us to be well thought out and to be an effective way of dealing with a situation where all lots within a band are de facto perfect substitutes.
18. We have carefully reviewed the detailed regulations and have identified some further issues where changes or clarifications may be appropriate. Our comments and suggestions on specific aspects of the rules are set out below.

Identification of standing high bidders

19. Ofcom's approach to identifying standing high bidders does not seem to allow for gradual reduction of demand in response to price increases. Specifically, Paragraph 32 (1) implies that a bidder, who was assigned as standing high bidder for n lots in the previous round, cannot bid for fewer than n lots in the current round, in the case where the price has increased.
20. This rule constrains the flexibility of bidders to gradually reduce demand in response to price increments. For example, a bidder that was assigned standing high bidder status for 10 lots after the previous round cannot reduce demand to 9 lots in the current round. Instead, the bidder will have to wait until the next round in which he is outbid, at which point the bidder may only want to bid for 8 lots in response to a further price increment. This bidder never has the chance to bid for 9 lots.
21. We are not convinced that this is the most sensible way to run the auction. As an alternative to changing the rules, we note that the adoption of moderate price increments would minimise risks for bidders. If Ofcom continues with this regulation, we urge it to provide appropriate guidance that it will consider our concerns over flexibility when determining the appropriate bid increment.
22. In addition, we ask Ofcom to clarify the following two points:
 - Paragraphs 27-28 appears to suggest that the ranking of bidders is determined every round, such that the rank order of two bidders who have standing high bids from a previous round could change, and this may in turn affect who loses

standing high bidder status. We ask Ofcom to clarify if this interpretation is correct.

- Ofcom does not specify what method of random selection will be applied in Paragraphs 63 (4) and 69 (3). We ask Ofcom to clarify what method it will use and how it will ensure that the method is fully random.

Possibility of unsold lots

23. Paragraph 30 (2) considers the case where a bidder with a minimum requirement after the final round is assigned fewer standing high bids than specified by the minimum requirement. In such a case, the standing high bids will not become winning principal stage bids, and a different bidder will not become winner of such lots either. In other words, such lots will remain unsold.
24. We ask Ofcom to clarify our interpretation that no more than 3 lots can remain unsold, assuming (i) demand for 3.4 GHz lots was at least equal to supply at some point during the auction; and (ii) there are no withdrawals from the band.

Price determination

25. One remaining concern we have with the detailed rules for bidding is that bidders are exposed to paying different base prices for identical lots.
26. Paragraph 31 states that each winning principal stage bid will be equal to the round price at which that bid was made. Since winning bids can be made in different rounds (at different prices) winners of identical generic lots can pay different base prices.
27. We again suggest that Ofcom consider an alternative pricing methodology that is better suited to an auction with generic lots, i.e. all lots in a category should have a common base price, which could be set at the lowest price of any winning bidder in that band. We do not think that Ofcom has given adequate weight to the potential for unfairness, with random chance dictating that some winning bidders may pay less than others. The effect is potentially bigger than a specific lot SMRA as bidders may be buying many lots and will pay the same price for all those lots. For example, if one were to apply the level of absolute bid increments applied at the end of the 4G auction for unpaired 2.6 GHz lots, the potential payment difference between two bidders could be substantial (and unlike in a CCA, with one of the bidders paying more than opportunity cost).

28. As a second best solution without changing the regulations, Ofcom should provide guidance that differences in base prices (per lot) should be kept at a minimum by using small price increments in the auction. This is especially important under these rules when excess demand is low and competition for a band may be approaching a conclusion. In this case, absolute increments should ideally be reduced to minimize payment risk. If Ofcom does not do this, it will increase incentives at the margins for demand reduction.

29. In addition, we ask Ofcom to clarify the following point:

- Paragraph 62 (4) (a) relates to the case where a bidder has not made a valid assignment bid for the 2.3 GHz band. We believe the word "valid" should be inserted before "2.3 GHz assignment stage bid", such that zero bids are considered for winner determination under Paragraph 63. The same applies to Paragraph 68 (4) (a) in relation to the 3.4 GHz band. Failure to treat zero bids (as a result of submitting an invalid bid) is inconsistent with other paragraphs, e.g. Paragraph 77 (3).

Assignment stage

30. The rules on assignment stage bid options are presumably designed to avoid assignment outcomes that are sub-optimal. Yet, Paragraphs 67 (1-3) suggests it is a possibility that a bidder may be assigned 3.4 GHz spectrum in two blocks, if so, one of which could be a single 5MHz isolated lot. Such an outcome would clearly be undesirable and a bidder would be at risk of having overpaid in expectation of having a single block.

31. Specifically, Paragraph 67 (2) addresses the case where a bidder has won at least 8 lots, in which case assignment will be such that no block of lots will contain less than 4 lots. However, Paragraph 67 (3) applies to the case where the assignment options specified by Paragraph 67 (2) are not feasible, which suggests there is a case where a bidder may be assigned 5MHz isolated lots. We ask Ofcom to clarify whether there is a risk of being assigned such isolated lots. If this is the case, we believe that Ofcom should include further regulations to rule out obviously inefficient ways of splitting up 3.4 GHz spectrum.

Deposits

32. Paragraph 82 (1) explores a case where the deposit a bidder has in place after the assignment stage is not enough to cover a bidder's total fees. However, it is not clear how this case is possible given the deposit requirements specified in Paragraph 77. Paragraph 77 specifies that each bidder must have sufficient deposit in place (before submitting assignment stage bids) to cover base prices, withdrawal liability and highest bid amounts in the assignment stage. We ask Ofcom to clarify under which circumstances Paragraph 82 (1) could apply.