Three's Response to Ofcom's Annual Licence Fees Provisional Decision and Further Consultation.

Non-confidential

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Executive Summary.

Hutchison 3G UK Ltd ('Three') welcomes the opportunity to respond to Ofcom's consultation on the impact of the 90% coverage obligation on the level of Annual Licence Fees for 900MHz and 1800MHz spectrum ('ALFs').

Ofcom has set out its provisional decision on the revised level of ALFs prior to the 90% geographic coverage agreement between Government and MNOs in December 2014. Three understands that Ofcom is no longer consulting on that matter.

Ofcom invites stakeholder views only in relation to the impact of the coverage obligation on future ALFs. Ofcom has provisionally concluded that the obligation is unlikely to impact the market value of 900MHz and 1800MHz spectrum for the purpose of ALFs.

In addition, Ofcom has decided to phase-in ALFs over a one-year period (as in the previous consultation), but it invites further evidence in relation to the appropriate length of that period.

Three disagrees with both conclusions for the following reasons:

- Ofcom has not adopted a correct framework to assessing the impact of the 90% coverage obligation on the market value of ALF spectrum; and

- Ofcom has not addressed windfall profits and losses created by the coverage obligation.

In consequence, Three asks Ofcom to re-consult on its proposed approach to assessing the impact of the 90% coverage obligation on market value, giving stakeholders an opportunity to comment on its revised framework and conclusions. Ofcom should also phase-in Three's ALFs over a period longer than one year, to address the differential financial impact of the 90% coverage obligation on MNOs.

Contents.

1. Ofcom should re-consult in relation to the impact of the 90% coverage obligation on the market value of ALF spectrum.

On 17 December 2014, Three, O2, Vodafone and EE agreed with Government to cover 90% of the UK landmass by 31 December 2017. This commitment has been given effect through a coverage obligation included in MNOs' spectrum licences.

As part of that agreement, Government asked Ofcom to extend its current work "*to revise ALFs in accordance with previous Government directions to Ofcom*". The Government Direction requires Ofcom to revise the fees for 900MHz and 1800MHz spectrum licences to reflect the full market value of those frequencies.

Ofcom has now provisionally concluded that the 90% geographic coverage obligation is unlikely to impact the market value of 900MHz and 1800MHz spectrum for the purpose of ALFs.

Three disagrees with this conclusion. In our view, Ofcom has not adopted a correct approach to assessing the impact of the 90% coverage obligation on the market value of ALF spectrum. In particular:

- Ofcom has only carried out an assessment of market value 'before and after' the 90% geographic coverage obligation;
- However, Ofcom's task is to carry out a forward-looking assessment of market value instead;
- A forward-looking assessment asks whether the marginal operator attaches the same value to encumbered and unencumbered ALF spectrum today;
- Ofcom's conclusions are incorrect because it has asked instead whether the operator values ALF spectrum the same before and after the obligation;
- Furthermore, Ofcom's approach is inconsistent with its (correct) forward-looking assessment in this consultation to estimate the impact on the value of 800MHz of similar coverage and interference obligations.

The rest of this section explains these points in further detail.

Ofcom has only carried out an assessment of market value 'before and after' the 90% coverage obligation.

Pursuant to the 2010 Government Direction, Ofcom must revise the sums payable for 900MHz and 1800MHz licences to reflect the full market value of those frequencies.

Ofcom's approach has been to define full market value *"as the market-clearing price in a well-functioning market, or the forward-looking marginal opportunity cost of the spectrum*".[1] This reflects the value to the highest-value alternative holder of the spectrum, or marginal operator. Ofcom has specifically "*added an explicit reference to the opportunity cost being forward-looking for the avoidance of doubt*".[2]

It follows that the impact of the coverage obligation on market value depends on its impact on the value of ALF spectrum to the marginal operator. Ofcom asks two questions to assess that impact, namely:

- What is the value to the marginal operator of additional ALF spectrum (measured by the change in profits) where it has the coverage obligation, relative to a situation where the operator does not have the obligation (i.e. F – C in Figure 1)?

- Or, in what amounts to the same thing, what is the difference in the incremental cost to the operator of meeting its obligation with and without additional ALF spectrum (G – H in Figure 1)?

Figure 1: Ofcom's assessment of the impact of the obligation on the value of ALF spectrum to the marginal operator.

	Profit without geographic coverage obligation	Profit with geographic coverage obligation	Incremental cost of geographic coverage obligation
Without additional ALF spectrum	A	D	G = A-D
With additional ALF spectrum	B	E	H = B-E
Market value of ALF spectrum	C = B-A	F = E-D	
Impact of geographic coverage obligation on market value of ALF spectrum[182]			F-C or G-H

Source: Table 6.1 of the Consultation

[1] Paragraphs 1.21 and 6.5 of the Consultation
[2] Paragraph2 2.27-2.28 of the Consultation

Ofcom's starting point is therefore the change in the marginal operator's profit 'without' the obligation (C). This must be the value of spectrum to the operator before it accepted that commitment, because the operator is now bound by the obligation and cannot 'get rid' of it. Ofcom then compares that value with the value of additional spectrum 'with' (i.e. after) the obligation (F).

Ofcom finds that there is no market information available to estimate market value in the presence of the coverage obligation (F),[3] so it assesses the impact of the 90% coverage obligation based on the difference in incremental cost instead (G – H).

As a result, Ofcom recognises that the marginal operator may incur incremental costs to meet the obligation (G) but this is not the relevant consideration in its view. Instead, what matters to Ofcom is the difference in the incremental cost with and without additional ALF spectrum (G – H). The reason is that *"each MNO – and hence the marginal operator – has the geographic coverage obligation regardless of whether or not it acquires additional ALF spectrum*."[4]

On that basis, Ofcom concludes that the 90% coverage obligation is unlikely to have a material effect on the market value of ALF spectrum:

- **If the marginal operator is an MNO**, the incremental cost of the obligation to it would likely be the same with and without additional ALF spectrum – i.e. adding ALF spectrum to their current spectrum portfolio would not materially change the cost of meeting the obligation to each of Three, EE, Vodafone and O2;[5]

- **If the marginal operator is not an MNO**, the impact on market value is zero because the operator does not have to meet the 90% coverage obligation (i.e. C = F).[6]

In Three's view, this conclusion is not robust. Ofcom has only carried out an assessment of market value 'before and after' the 90% coverage obligation, instead of a forward-looking assessment of market value consistent with the Government Direction.

[3] Paragraph 6.13 of the Consultation
[4] Paragraph 6.16 of the Consultation
[5] Paragraphs 6.27 and 6.33 of the Consultation
[6] Footnote 184 of the Consultation

Ofcom's task is to carry out a forward-looking assessment of market value.

As part of the 90% coverage agreement with MNOs, Government has asked Ofcom *"to revise ALFs in accordance with previous Government directions to Ofcom*". Those earlier Directions require Ofcom to revise ALFs to reflect the full market value of 900MHz and 1800MHz licences. The 90% geographic coverage commitment has now been implemented through a coverage obligation included in those licences.

Following the coverage agreement, encumbered and unencumbered ALF licences may be bought and sold on the open market. An MNO is now bound by the 90% coverage obligation but its ALF spectrum can be traded, or it can be sold with other assets and obligations as part of a company purchase.

For instance, an MNO may partition its ALF licence into several frequency blocks, retaining some blocks together with the coverage obligation itself and selling other blocks unencumbered to a second operator – an MNO, a new entrant or a fixed operator wanting to run a mobile business.

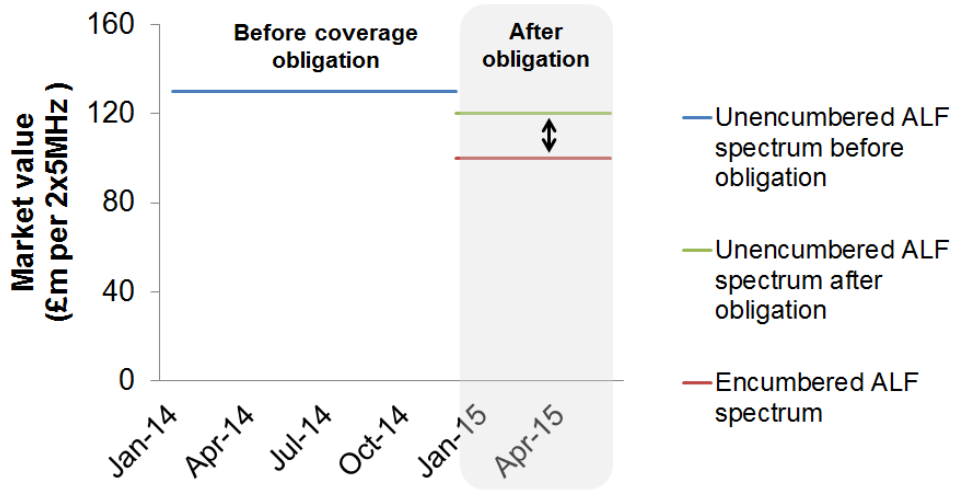
Alternatively, the MNO may sell all of its assets and obligations, including the encumbered ALF licence, to another operator.[7] Ofcom will be aware that O2 and EE have recently agreed to sell their UK businesses, including all assets and obligations, to Three and BT respectively (subject to approval by competition authorities).

Ofcom's task under the Government Direction is therefore to estimate the full market value of encumbered and unencumbered ALF spectrum today, <u>after</u> the 90% coverage agreement. Because Ofcom explicitly defines 'full market value' as the "*forward-looking marginal opportunity cost of spectrum*", Ofcom should estimate the market value of 900MHz and 1800MHz licences on a forward-looking basis.

But Ofcom has not done this. In fact, Ofcom does not appear to estimate the market value of unencumbered ALF spectrum today. Figure 2 illustrates the difference between Ofcom's approach and a forward-looking assessment of market value.

[7] An operator may also transfer its licence (including the 90% coverage obligation) on a concurrent basis, so that both transferor and transferee must meet the obligation. Or it may partition its ALF licence by geography and sell encumbered rights to transmit over parts of the UK, with both operators dependent on each other to meet their respective coverage obligation in the whole of the UK

Figure 2: Forward-looking vs 'before and after' assessment of 1800MHz market value.



Source: Three

Ofcom has estimated the market value of 1800MHz spectrum before the December 2014 coverage agreement as £130m per 2x5MHz block (the blue line in Figure 2). Following the agreement:

- The market value of unencumbered 1800MHz spectrum (in green) may or may not have changed (Figure 2 assumes it is now lower);
- The market value of encumbered 1800MHz spectrum (in red) may be different than the value (in green) of unencumbered 1800MHz spectrum today (Figure 2 assumes it is lower).

Ofcom appears to assess the impact of the 90% coverage obligation by comparing the red and blue lines in the example (F and C in Figure 1) – i.e. the market value of encumbered ALF spectrum today vs the value of unencumbered ALF spectrum before the agreement.[8]

However, a forward-looking assessment should focus on market values today (i.e. the area shaded in grey) and compare the red and green lines, or the difference in value between encumbered and unencumbered ALF spectrum now (the wedge in Figure 2). Ofcom appears to have overlooked the possibility that unencumbered ALF spectrum may be sold following the coverage agreement.

[8] Ofcom never specifies whether the 'additional ALF spectrum' in Figure 1 is assumed to be encumbered or not. Presumably when assessing 'profit with the geographic coverage obligation' in Figure 1 Ofcom assumes that all ALF spectrum is encumbered following the coverage agreement.

A forward-looking assessment asks whether the marginal operator attaches the same value to encumbered and unencumbered ALF spectrum today.

To derive forward-looking market prices Ofcom should focus on the alternative courses of action open to the marginal operator today.

Today, the marginal operator faces a choice between i) not buying ALF spectrum; ii) buying ALF spectrum that is encumbered by the 90% coverage obligation; and iii) buying ALF spectrum that is not encumbered by the obligation. In Ofcom's framework, the operator's willingness to pay for those licences determines their market value

Following the Government Direction, the relevant question for the purposes of determining the impact of the 90% coverage obligation on the market value of ALF spectrum is as follows:

Figure 3: A forward-looking assessment of market value asks:

Is the marginal operator now willing to pay the same amount for an ALF licence that is encumbered with the 90% coverage obligation than for an otherwise identical ALF licence that is not encumbered by it?

Source: Three

By definition, the 90% coverage obligation will have impacted the market value of ALF spectrum if the marginal operator – the highest value alternative user whose valuation for spectrum determines market value – is unwilling to pay the same amount for those two licences. There should be no presumption that the marginal bidder is already subject to the coverage obligation.

This approach is set out in Table 1.[9]

[9] For the avoidance of doubt, the figures in Table 1 (A, B and C) do not correspond with Ofcom's A, B and C in Figure 1.

Table 1: Three's assessment of the impact of the obligation on the value of spectrum to the marginal operator.

	Profits	Market value
With current spectrum	A	
With additional encumbered ALF spectrum	B	B – A
With additional unencumbered ALF spectrum	C	C – A
Impact of the 90% coverage obligation on market value		B – C

Source: Three

The value of spectrum to the marginal operator (hence, the market value) is the difference in profits with its current spectrum and with additional ALF spectrum. The profit the operator expects to earn with its current spectrum is now given and equal to A.[10] The expected profit with additional ALF spectrum is B if that licence is encumbered by the 90% coverage obligation or C if it is not.

A forward-looking analysis should therefore focus on the costs and receipts (i.e. profits) that will change with the decision to buy additional ALF spectrum. Ofcom's 'before and after' analysis features variables that are now given and which remain unchanged whatever decision is taken. For instance, the level of profit an MNO would have earned 'without' the 90% coverage obligation (A in Figure 1) is irrelevant in a forward-looking assessment. The MNO is already bound by the obligation and cannot 'get rid' of it.

The marginal operator's value of additional ALF spectrum is therefore B – A if it is encumbered or C – A if it is not. In other words, the operator will deduct from its licence valuation any added cost of meeting the obligation to it.

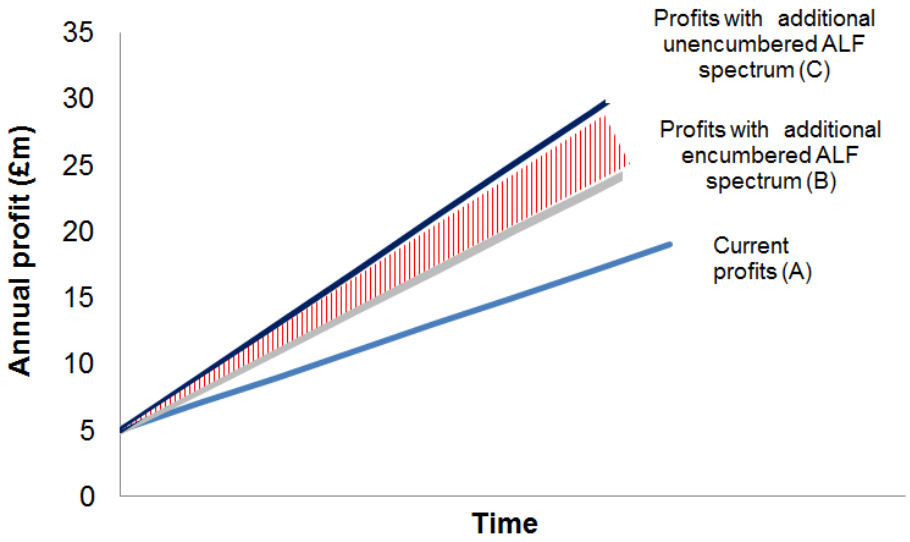
It follows that, on a forward-looking basis, the impact of the 90% coverage obligation on market value is B – C (the difference between the red and green lines in Figure 2).[11] This is the difference in profits to the operator from holding additional encumbered ALF spectrum

[10] The level of current profits A may well depend on whether the operator is already bound by the coverage obligation or not, but for the purposes of a forward-looking analysis those profits are given.
[11] That is, (B-A) – (C-A), which equals B-C.

instead of unencumbered ALF spectrum, or the added cost that holding an encumbered licence imposes on it. In other words, B – C is the incremental cost of the obligation to the marginal operator in a forward-looking assessment, because both licences are assumed identical but for the coverage obligation.[12]

Figure 4 illustrates the value of additional ALF spectrum to the marginal operator on a forward-looking basis. The three lines represent the operator's expected stream of annual profits with its current holdings (A), with additional encumbered ALF spectrum (B) and with additional unencumbered ALF spectrum (C).

Figure 4: Profits to the marginal operator with and without additional ALF spectrum.



Source: Three

Having additional ALF spectrum (encumbered or not) will increase the operator's profit (B and C both exceed A). But the operator will be willing to pay less for encumbered spectrum (i.e. the extra profits between the grey and light blue lines) than for unencumbered spectrum (the profits between the dark and light blue lines) if complying with the coverage obligation imposes an added cost on the operator (the area B – C shaded in red).

[12] This definition is not the same as Ofcom's 'before and after' definition of incremental cost – i.e. the cost to the operator of meeting the obligation with its existing spectrum holdings (G in Figure 1).

On a forward-looking analysis, the impact of the 90% coverage obligation (B – C) on market value can therefore be either:

- **Negative** (as in Figure 4) – if the encumbered ALF licence imposes an added cost on the operator, for instance because the operator is not already bound by the 90% coverage or similar obligation; or

- **Zero** – if encumbered ALF spectrum imposes no extra cost on the operator, for instance because it is already bound by the same (or similar) obligation, or it is planning to achieve 90% coverage for commercial reasons anyway. In that case, the operator will value additional ALF spectrum the same regardless of whether it is encumbered or not (i.e. the B and C lines in Figure 4 become the same).

Ofcom's conclusions are incorrect because it has asked whether the marginal operator values ALF spectrum the same before and after the obligation.

To recap, the relevant question in a forward-looking assessment is whether the marginal operator attaches the same value to encumbered and unencumbered ALF licences today.

Ofcom has addressed a different question – whether the operator values ALF spectrum the same before and after the obligation. Ofcom appears to have lost sight of the Government Direction, perhaps because it has focused narrowly on the question of whether to reduce ALFs from the market value it had estimated prior to the agreement.

In consequence, Ofcom's analysis is incomplete and its conclusions appear incorrect on a forward-looking basis:

- It is the incremental cost of the coverage obligation to the marginal operator on its own (as defined above), and not Ofcom's difference in the incremental cost of the operator with and without additional ALF spectrum, that leads to an impact on market value;[13]

- For the coverage obligation to impact market value all that is required is that the marginal operator places a lower value on encumbered than on unencumbered additional ALF spectrum – i.e. that the obligation imposes an added cost on the operator. It is not

[13] Paragraph 6.16 of the Consultation.

necessary to define market value as the private value to the licensee instead of opportunity cost;[14]

- The marginal operator does not necessarily "*have the geographic coverage obligation regardless of whether or not it acquires additional ALF spectrum*". The coverage obligation attaches to the ALF licence, not necessarily to the marginal operator. If the operator is not an MNO, it will only have the obligation as a result of acquiring additional (encumbered) ALF spectrum;[15]

- Importantly, if the marginal operator is not an MNO the impact of the 90% coverage obligation is unlikely to be zero, because the operator is not bound by the 90% coverage obligation and is unlikely to value encumbered and unencumbered ALF spectrum the same;[16]

- The impact of the coverage obligation on market value cannot be positive – in Figure 4, the marginal operator will not attach greater value to an encumbered ALF licence (area B – A) than to an identical licence that is not so encumbered (C – A).[17]

Furthermore, Ofcom's approach is inconsistent with the (correct) forward-looking assessment it has adopted in this consultation to estimate the impact on the value of 800MHz of similar coverage and interference obligations.

Paradoxically, Ofcom has used a correct forward-looking analysis in the ALF consultation to assess the impact on the market value of 800MHz spectrum of other coverage and interference obligations included in those licences.

Ofcom uses its estimates of 800MHz and 2.6GHz market values from the UK 4G auction, together with relative value benchmarks from other EU auctions, as inputs into the derivation of its 900MHz and 1800MHz UK values.

However, the 800MHz licence won by Telefonica in the UK 4G auction includes a 98% indoor population coverage obligation.[18] Similarly, all

[14] Paragraph 6.18 of the Consultation.
[15] Paragraph 6.7 of the Consultation
[16] Footnote 184 of the Consultation
[17] Paragraph 6.19 of the Consultation
[18] In footnote 183 of the Consultation, Ofcom seeks to distinguish the coverage obligation attached to 800MHz spectrum in the 4G auction from the 90% geographic coverage obligation, on the basis that the latter applies to each MNO regardless of whether or not it acquires additional ALF spectrum. As explained in the previous section, Three does not agree that this is the relevant point of view.

800MHz licences auctioned in the UK include an obligation to mitigate interference into adjacent frequency bands used for Digital Terrestrial TV ('DTT').

To ensure consistency between its 800MHz UK values and 800MHz values from other EU auctions, Ofcom has had to estimate the impact of the 98% indoor coverage obligation and of DTT interference obligations on the market value of 800MHz licences in the UK.

Ofcom calls its 800MHz UK values 'net and gross' of expected DTT co-existence costs and 'with or without' the 800MHz 98% indoor coverage obligation.

Figure 5: Ofcom's assessment of the impact on the market value of 800MHz of other coverage and interference obligations.

	Without coverage obligation	With coverage obligation
Net of expected DTT co-existence costs	£30m	£28.45m
Gross of expected DTT co-existence costs	£33m	£31.45m

Source: Table A6.37 of the Consultation

As shown in Figure 5, Ofcom has found that both the 98% indoor coverage obligation and the DTT interference obligation have depressed the market value of 800MHz spectrum in the UK:

- Ofcom's estimate of the market value of Telefonica's encumbered 800MHz licence is £1.55m/MHz (£31m per 2x10MHz block) lower than the value of the unencumbered 800MHz licences. Ofcom has found that Telefonica's licence *"may impose a cost to fulfil and so may have been sold at a discount to 800 MHz without coverage obligation"*;[19]

- Similarly, Ofcom says that *"where an observed 800MHz auction price is for a licence which includes liability for DTT co-existence costs, we would expect bidders to reflect the expected costs in their*

[19] Paragraphs 2.27 and 2.28 of the August 2014 Consultation and A.6.117 and A.6.186 of the Consultation

bids, potentially leading to a lower observed price".[20] In, consequence, Ofcom finds that the market value of all 800MHz licences is £3m/MHz (£30m per 2x5MHz) lower as a result of DTT co-existence obligations.

In both cases, the level of discount due to the obligation is set by the marginal operator, who will have deducted from its licence valuation any added cost. As Ofcom has found:

- *"Telefonica's own bids suggested the coverage obligation would not cause it to incur any net cost, (as it bid the same … for 800 MHz with, compared to without, the coverage obligation)*".[21] Telefonica's discount was set by Vodafone, the marginal operator for Telefonica's 800MHz spectrum in the auction, for whom the 98% coverage obligation would have imposed an extra cost. The £31m discount is the difference between Vodafone's bids for 800MHz with and without the coverage obligation;[22]

- £30m per 2x5MHz block is the lower value of 800MHz spectrum to EE, the marginal operator for that spectrum in the 4G auction. Ofcom's discussion suggests that EE deducted DTT co-existence costs from its 800MHz bids.[23] £30m is the mandatory cost to all 800MHz winners of establishing and funding an entity to provide information and support to DTT consumers.

Ofcom should review its approach and conclusions in a new consultation and give stakeholders and opportunity to comment on them.

To conclude, Ofcom has promised but not really delivered a forward-looking assessment of the market value of ALF spectrum. As illustrated in Figure 2 Ofcom has only carried out half of the task required from it by the Government Direction – i.e. it appears to have valued encumbered ALF spectrum after the 90% coverage obligation, and then only from the perspective of an MNO.

In our view, in order to complete its assessment Ofcom should revisit its framework and value both encumbered and unencumbered ALF spectrum on a forward-looking basis, taking account of the incremental cost of the obligation to the marginal operator.

[20] Paragraphs A.7.65 of the Consultation
[21] Paragraph2.28 and Footnote 25 of the August 2014 ALF Consultation
[22] Footnote 183 of the Consultation.
[23] Paragraphs 2.184 and A.6.179 of the Consultation.

Ofcom should also bear in mind that the marginal operator – the highest value user that is currently denied access to the relevant increment of ALF spectrum – may be an MNO that is already bound by the 90% coverage obligation, or alternatively it may be a fixed operator such as BT, Sky, TalkTalk or Virgin Media wanting to enter or expand into the mobile market.

Three looks forward to a new consultation where Ofcom reviews its analytical framework and conclusions in light of the above comments. This should set out a revised framework to establish the impact of the coverage obligation on the market value of ALF spectrum, explaining the reasons for its adoption and giving stakeholders an opportunity to comment on those.

2. Ofcom should phase-in Three's ALFs over a longer period to address windfalls profits and losses following the obligation.

As part of the 90% coverage agreement, Government asked Ofcom to afford stakeholders the opportunity to comment on whether the obligation should impact future ALFs, taking account of the associated incremental costs incurred by the MNOs.

Government expected that the introduction of the new ALF regime would be delayed by between 4 and 7 months as a result of the current consultation. Government also raised with Ofcom explicitly the question of the phasing-in of the revised ALFs.

This section explains that:

- The 90% coverage agreement will have a disproportionate financial impact on Three;
- Ofcom has made no assessment of the impact of the coverage obligation on the appropriate length of the phase-in period;
- Ofcom should phase-in Three's ALFs over a period longer than one year, in order to address windfall profits and losses between MNOs created by the 90% coverage obligation.

The 90% coverage agreement will have a disproportionate financial impact on Three.

The 90% coverage agreement will have a very different financial impact on UK MNOs:

- **ALF savings from delay** – due to their much larger spectrum portfolio, EE, Vodafone and O2 will enjoy much greater savings than Three from the 4-7 month delay in the introduction of the new ALFs;
- **Cost of the 90% coverage obligation** – due to their more extensive geographic voice coverage, Vodafone, O2 and EE are also unlikely to incur significant costs to comply with the 90% coverage obligation. [✂]

[✂]

As shown in Table 3, Three expects to incur a [✂] loss (in Net Present Value terms) over a 20-year period, while in our estimate other MNOs will get a large windfall profit ranging from £22m to £26m. The table estimates the benefit to MNOs from a 6-month delay in the introduction of ALFs (accruing in 2015 and 2016), together with Three's estimate of the cost to each MNO of meeting the obligation with its existing spectrum holdings.

Table 2: Financial impact of the 90% coverage obligation to 2034

£m	2015	2016	2017	2018-2034	Total	NPV @ 7%
O2	12.3	12.2	-	-	**24.4**	**22.1**
Vodafone	12.3	12.2	-	-	**24.4**	**22.1**
EE	15.0	13.5	-	-	**28.5**	**25.8**
Three	3.5	4.5	[✂]	[✂]	[✂]	[✂]

Source: Three

Table 3 assumes that Vodafone, O2 and EE are unlikely to incur significant costs to comply with the 90% coverage obligation. By contrast, in order to meet the 90% coverage obligation Three [✂]

Ofcom has made no assessment of the impact of the coverage obligation on the appropriate length of the phase-in period.

Ofcom has concluded that a two-step approach to phasing-in the new ALFs would be appropriate. In its view, this is a fair and reasonable approach that balances two factors: [24]

- On the one hand, the significant period of notice since the Government Direction in 2010; and
- On the other, the fact that the revised ALFs are significantly higher than the current fees.

Ofcom has therefore recognised the financial impact of the new ALFs on MNOs and the need to avoid potential detrimental impacts to spectrum users, consumers and citizens.

[24] Paragraph 7.21 of the Consultation

Against that background, Three is surprised that Ofcom has made no assessment of the financial impact of the coverage obligation on MNOs, or of the appropriate length of the phase-in period in light of that obligation. This is in circumstances where Government has explicitly raised with Ofcom the question of the phasing-in of the revised ALFs.

Ofcom should phase-in Three's ALFs over a period longer than one year to avoid windfall gains and losses between operators.

Three expects that Ofcom will i) recognise the different financial impact of the 90% Coverage Agreement between MNOs; and ii) ensure that the Agreement does not put Three at a financial disadvantage. Ofcom can do so by simply phasing-in Three's ALFs over a longer period than the 1 year currently proposed.[25]

Ofcom has the following legal duties:

- To ensure no distortion or restriction of competition: Directive 2002/21 (as amended) ("Framework Directive"), Article 8(2)(b); Communications Act 2003 ("2003 Act), s. 3(1)(b), 3(4)(b), 4(3)(a); Wireless Telegraphy Act 2006 ("2006 Act"), s. 3(2)(d).

- To avoid discrimination in the treatment of undertakings providing electronic communications networks: Framework Directive, Article 8(5)(b;

- To promote future investment: Framework Directive, Article 8(5)(d); 2003 Act, s.3(4)(d), s.4(8)(aa); 2006 Act, s.3(2)(c);

- To ensure that users derive maximum benefit in terms of choice, price and quality: Framework Directive Article 8(2)(a); 2003 Act s.3(1)(a), s.3(5), s.4(5), s.4(8)(b).

Ofcom has some discretion in the manner in which it requires payment of ALFs. In the first ALF consultation, Ofcom explained that spectrum fees are sometimes phased-in to avoid detrimental impacts on spectrum users, consumers and citizens. Following its Strategic Review of Spectrum Pricing (SRSP), Ofcom considered whether the proposed increase in ALFs would be likely to create detrimental impact absent any phasing-in.[26]

[25] Ofcom proposes that "a fair and reasonable approach" is to phase-in the ALFs over a 1-year period, applied in the same way to each of the MNOs. Paragraphs 6.12-6.14 of the August consultation

[26] Paras 6.17-6.20 http://stakeholders.ofcom.org.uk/binaries/consultations/900-1800-mhz-fees/summary/900-1800-fees.pdf

Ofcom's SRSP sets out two examples were phasing-in of fees would be appropriate:[27]

- where the impact on licensees of increasing fees would be so great that Ofcom would consider phasing-in of fees; and

- where it might be necessary to take account of downstream competition effects, **including the existence of windfall gains** (emphasis added).

Undoubtedly, the 90% Coverage Agreement has created significant windfall gains and losses that Ofcom can mitigate by phasing-in Three's ALFs. Ofcom has previously assessed whether some form of intervention may be justified to prevent windfall gains. For instance, in its assessment of 2G liberalisation Ofcom found that it is good regulatory practice to avoid large asymmetric profit shocks, as they could be disruptive, contribute to perceptions of a less certain regulatory framework and adversely affect incentives to invest in the sector more generally.[28,29]

On the basis of these legal principles set out above and Ofcom's practice, Three believes that Ofcom can phase-in Three's ALFs over a longer period than the 1-year currently proposed. This would avoid competitive distortions, address the burden caused by the Coverage Agreement and mitigate the damage that would be caused to Three by requiring it to pay the revised higher ALFs at the same time as the MNOs.

Even if Three's competitive ability is not undermined, there would certainly be a large asymmetric profit shock which would be disruptive and would adversely affect incentives to invest in the sector more generally. This would be contrary to Ofcom's legal duty to promote future investment: Framework Directive, Article 8(5)(d); 2003 Act, s.3(4)(d), s.4(8)(aa); 2006 Act, s.3(2)(c).

Treating MNOs differently in respect of phasing-in of ALFs would be justified and there would be no unlawful discrimination, because Three is not in the same position as the other MNOs and may legitimately be

[27] 5.141-5.143 http://stakeholders.ofcom.org.uk/binaries/consultations/srsp/statement/srsp-statement.pdf
[28] 5.42. http://stakeholders.ofcom.org.uk/binaries/consultations/spectrumlib/annexes/government-advice.pdf
[29] A 8.107-A8.114. Application of spectrum liberalisation and trading to the mobile sector – A further consultation http://stakeholders.ofcom.org.uk/binaries/consultations/spectrumlib/annexes/annex8.pdf

treated differently.[30] In fact, to treat Three in precisely the same way as the others in this regard is to ignore the important difference between them (i.e. Three's greater burden caused by the Coverage Agreement), and would be discriminatory.

Ofcom must also avoid, by way of its treatment of ALFs, granting a competitive advantage to one MNO or another. To do so may involve grant of State aid under Article 107(1) TFEU. Granting such an advantage is automatically illegal unless it has been notified and cleared in advance by the EU Commission. In examining whether the manner of imposing ALFs amounts to a State aid, EU law looks at the substance and not the form of the advantage.

[30] Unlawful discrimination (contrary to EU law and domestic law) arises where a regulator (without justification) treats like situations differently or different situations alike: Case T-311/94 *BPB de Eendracht v Commission* [1998] ECR II-1129 at §309; *Matadeen v Pointu* [1999] 1 AC 98, 109.