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Dear Siew Yoon

We explained in our Consultation response that we support Ofcom's proposed approach for converting a lump-sum market value into annual fees. Whilst true in terms of high-level methodology, we now acknowledge that we should have commented on three aspects of Ofcom's proposed determination of the discount rate (which itself is part of the annualisation rate) that we believe Ofcom must change in its Statement. We discuss our observations on these aspects in turn.

Cost of debt to reflect lower risk involving ALF payments

The cost of debt proposed by Ofcom does not account for the nature of ALF payments. There are two (mutually enforcing) reasons why ALF payments involve less risk than other debt payments (and thus the Government can be more certain to receive ALF payments compared to holders of corporate debt receiving interest and principal). First, ALF payments involve secured loan assets. MNOs have always paid their ALFs but the Government would retrieve and sell spectrum if a MNO were to not pay its ALFs. Secondly, the nature of the counterparty (Government vs corporate) means that MNOs will prioritise paying ALFs over other obligations because of the anticipated implication of non-payment. We call on Ofcom to assess which reduction in cost of debt is appropriate to account for the lower risk level involved.

Cost of capital to exclude liquidity and inflation risk premiums

Ofcom, as per its 900/1800 Statement, removes liquidity and inflation risk premiums in determining the cost of debt (lower polar case). It is not clear to us why Ofcom does not propose similar adjustments in establishing the cost of capital (upper polar case). The Government bears neither inflation risk as ALFs are set to increase with CPI nor liquidity risk as it will not want to sell its right to receive ALF payments. This being the case, Ofcom should make the same adjustments as for the lower case. Doing so would reduce the cost of capital from 3.6% to 3%.

Lower weight to be put on upper polar case

In the 900/1800 Statement, Ofcom concluded that a 25% risk sharing adjustment between lower and upper polar case was appropriate for determining the discount rate. Ofcom now proposes to apply the same 25% weight in establishing discount rate in 2100 ALFs review. We observe that Ofcom has provided no real justification for applying the same adjustment even though forward-looking prospects for 2100 spectrum are very different than they were for 900/1800 at the time, and noting that the rationale for the adjustment is to account for the possibility of future reviews increasing or decreasing ALF payments.

At the time of 900/1800 review, it was known that 700/3.6 spectrum would be auctioned in subsequent years. It was thus well understood that there was a very significant chance that new evidence relevant to 900/1800 market value would become available that could justify a review of 900/1800 ALFs. The situation for 2100 is very different. There is no prospect of any UK spectrum auction to be held over the next ten or more years that can produce evidence relevant to the market value of 2100 spectrum. We recommend that a weight of 0% is put on the upper polar case to account for the much smaller possibility of a future 2100 ALFs review.

Lower discount rate means lower annualisation rate
Accounting for our three points will reduce the discount rate to -1.1% and the annualisation rate to 4.76%. In turn, applying a lower annualisation rate will reduce the ALF per MHz that Ofcom sets.

We trust you can reflect on our observations as part of your review of stakeholder responses and we remain at your disposal if you have questions on either our Consultation response or the above observations.

Regards

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