Vodafone Response to Ofcom Consultation: Review of Annual Licence Fees

1. Introduction

Vodafone welcomes the opportunity to respond to Ofcom's Consultation reviewing the level of Annual Licence Fees (ALFs) for 900MHz, 1800MHz and 2100MHz spectrum. We have appointed Frontier Economics to review Ofcom's proposals and provide their conclusions as Annex A to this response.

As Frontier highlights, it is incumbent on Ofcom to take a conservative approach to setting ALFs. If set too high, then there is a risk that licensees return the spectrum to Ofcom, resulting in inefficiently unused spectrum. Even if the ALF is set at a level so as not to trigger such an action, because ALFs are a regulatory fee they are of the highest priority to licensees when apportioning competing capital demands – so ALFs set too high risk either depriving growth projects of investment (where there is finite capital), or alternatively soaking up sources of low cost capital meaning that growth projects must deliver a higher rate of return to meet their cost of capital. This risks derailing the Government's desire to invest for growth.

We set out below a series of areas, elaborated on by Frontier in Annex A, where we feel that Ofcom has failed to take a suitably conservative approach.

2. Lump Sum Values

900MHz

We are pleased to note that Ofcom has endorsed Vodafone's position that sub-1GHz spectrum bands are largely fungible hence the most appropriate market value benchmark for 900MHz is the 2021 auction of 700MHz spectrum. However, we disagree with Ofcom's assertion that spectrum values will have been stable in real terms since then, hence inflating this lump sum market value by CPI inflation in the intervening period.

As set out by Frontier in Section 4.2 of Annex A, there is substantial economic literature to suggest that the real value of assets is impaired by external shock-driven inflation (as has been the case since 2021). From a more practicable standpoint, examination of MNO returns and share prices shows that an assertion of spectrum having increased in value by 23% since cannot in any way be considered conservative. Inflating the 700MHz auction value by 23% results in baking-in an over-estimate of spectrum value.

We therefore believe that a conservative approach would be to inflate the 2021 value according to Ofcom's long-run view of inflation at 2%/yr (i.e. ~£15M in Sept 2024 prices). This would remove the effect of externally-driven economic shock, more properly reflecting asset values remaining stable in real terms.

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1800MHz, 2100MHz

We group these bands together as being technically interchangeable – hence there is little rationale for suggesting that they are of differing market value on a forward-looking basis. We are therefore disappointed that Ofcom's analysis continues to ascribe differing market values to the bands, and believe that this should be reconsidered.

Section 5.2 of Annex A describes how the distance methodology is creaking at the seams:

- It is far from clear that spectrum value declines monotonically as frequency increases; or that the relationship between valuations of different bands is similar across different markets and stable over time; or that auction data from other countries accurately captures relative values for the country concerned. The only realistic option within the distance method when auction data doesn't match the hypothesis, is to deprioritise (or even outright exclude) that dataset. But is a country's data inconsistent because it is anomalous to market norms, or does it indicate another reason that undermines the thinking behind the distance methodology?
- There is a very small sample of suitable benchmarks that are considered as Tier 1 when applying the methodology, particularly for 1800MHz. For 2100MHz there is a wider set, but with highly inconsistent outcomes. The sample size makes asserting statistical significance to the dataset problematic.
- The analysis dismisses a 1800MHz benchmark (Hungary) which would suggest a lower lump sum value on the basis that it would be below 5 other benchmarks, with little justification other than it would result in a low result – no evidence is presented to disprove an assertion that the UK would best align with that low benchmark. Similarly, for 2100MHz, 2 of 6 benchmarks are excluded (Belgium and Hungary), implying that there is a 33% chance that the chosen lump sum benchmark is higher than actual UK market values.
- Even using 2015 as a guillotine, the analysis relies on auction benchmarks which may not reflect latest thinking. Bidder valuations at the time of auctions could only factor in expected technology developments, and subsequent changes (in a fast-moving industry) may well have impacted upon those values.

Whilst we do not argue that there is sufficient reason to totally abandon the distance methodology, it is incumbent on Ofcom to apply it in an extremely conservative manner. We do not believe that Ofcom has been conservative – conservative benchmarks have been excluded both in the case of 1800MHz and 2100MHz. Given the technical interchangeability of the spectrum, we assert that a conservative approach would be to value both bands at around £10M/MHz.

3. Annualisation rate

Ofcom's approach to annualisation is well-established and understood. However, we assert that the approach set out in the consultation serves to overstate the real discount rate that is appropriate when considering ALFs, i.e. the forward-looking view of input parameters over the period until ALFs are likely next reviewed. Frontier highlights in Section 3.3 of their analysis that:

1. The cost of debt should be estimated over a longer horizon than that used by Ofcom. By using a pre-tax nominal cost of debt estimate which is based only on the last 12 months of data, the annualisation rate will internalise the effect of currently high interest rates, which are extraordinary and reflective of global economic shocks.
   To frame things differently, the ALF calculation needs to be internally consistent – e.g. when bidders valued 700MHz spectrum in 2021, if they had worked based on the now current cost of debt (measured over a 12-month period) a higher discount rate would have been used in establishing the NPV of the spectrum when determining bidding strategies, leading to a lower market/lump sum value. However, Ofcom's proposals take no account of this, instead using lump sum values established against a backdrop of low cost of debt and applying an annualisation rate based on a high cost of debt.
   A robust approach would be to use long-run forward-looking views of the parameters in the annualisation calculation, rather than relying on short-run market values.
2. In establishing the cost of debt for licensees, the proposals err in using an index (*"All Corporates"*) which is not reflective of MNO cost of debt as it is heavily weighted towards financial institutions, rather than following the approach of other sector regulators such as Ofwat and Ofgem and instead selecting indices that exclude financial institutions.
3. Ofcom continues to assume a CPI inflation rate of 2% when converting between nominal and real discount rates. However, forecasts predict CPI remaining above 2% for the foreseeable future (and in turn market debt metrics will be reflective of the market consensus of future CPI, rather than the BoE target of 2%). Whilst there is some rationale that CPI will fall to 2% in the longer term, we have seen no evidence suggesting that CPI will fall below 2% at any time, in order to yield the average 2% number that is used in Ofcom's calculation – even the BoE itself only foresees inflation falling to 2%, not sub-2%.

We believe that the annualisation rate should be recalculated, taking into account these issues.

4. Investment stability

The Government is quite rightly focussed on the creation of a regulatory environment that fosters investment leading to economic growth. After meeting with the heads of regulators, the Chancellor Rachel Reeves commented[1]:

> *"There's no substitute for growth. It's the only way to create more jobs and put more money in people's pockets, which is why it's at the heart of our Plan for Change.*

[1] Chancellor calls on watchdog bosses to tear down regulatory barriers that hold back growth - GOV.UK

Every regulator, no matter what sector, has a part to play by tearing down the regulatory barriers that hold back growth. I want to see this mission woven into the very fabric of our regulators through a cultural shift from excessively focusing on risk to helping drive growth."

In response, Ofcom Chief Executive Dame Melanie Dawes stated[2]:

"Ofcom's central duty – set out in the Communications Act 2003 – is to further the interests of citizens and consumers, where appropriate by promoting competition, and having regard, amongst other things, to encouraging investment and innovation. We believe that this means serving tomorrow's citizens and consumers as well as today's, right across the UK. ***It means we must think about the investment the country needs for the future*** *alongside concerns of fairness and affordability in the present"*

(our emphasis) and

We have also recently consulted on updating our annual licence fees for mobile spectrum, which would reduce costs for operators in some areas.

If Ofcom is to foster an environment encouraging investment that will drive economic growth, it is essential the communication providers are afforded regulatory stability. We are concerned about the proposals in the consultation from two aspects of regulatory stability, as set out below.

2100MHz fees

2100MHz fees were last reviewed in 2021. When BT approached Ofcom to seek a review of spectrum fees in 2024, it was narrowly about the ALFs levied on 1800MHz, with a note that six years after these were last reviewed, they were misaligned with the more-recently set 2100MHz fees[3]. As such, we do not consider that BT (or anyone else) requested a review of 2100MHz fees, and Ofcom did this on its own initiative[4].

Ofcom has repeatedly stated that it favours regulatory stability, a position with which we agree. A proposal to <u>increase</u> 2100MHz fees within four years of the last review is not in keeping with an ethos of regulatory stability and isn't something that licensees could have reasonably expected when determining their investment budgets – a period of at least five years of stability without unexpected price rises is sensible. We therefore consider that a better approach would be to leave the 2100MHz fees unchanged, unless Ofcom were to adopt the proposals we set out in Sections Two and Three of this response and it resulted in a reduction in 2100MHz ALFs.

Annual CPI Indexation

[2] Open letter How Ofcom contributes to UK growth
[3] BT Request for 1800 MHz review
[4] Although the same might be said of 900MHz, it was Vodafone's intention to request that these fees be reviewed in parallel to 1800MHz had Ofcom not decided to do so on its own initiative.

We note the proposals in Ofcom's supplementary consultation on the mechanics of paying ALFs[5] and will respond in due course. However, even with the proposals, licensees will still be exposed to ALFs that increase with CPI inflation each year, resulting in significant exposure to in-year changes in the level of fees after company budgets have already been set. For a company like Vodafone with fees of around £80M/yr, forecast errors in CPI can lead to considerable differences in ALFs in absolute terms. Whilst Ofcom may argue that £1-2M is a small number when compared to industry revenues, it is significant when planned developments need to be paused for budgetary reasons in order to accommodate unexpected rises in ALFs.

We do not oppose that fees increase with CPI inflation in normal economic times but are less comfortable with the situation when spikes in inflation are driven by external economic shocks. As set out by Frontier in Annex A, there is both economic research and empirical evidence that assets (including spectrum) do not maintain their real value in the face of external economic shocks such as the war in the Ukraine.

In order to apply ALFs conservatively, Vodafone therefore believes that Ofcom should introduce guard rails in the application of CPI. We propose that the value of CPI applied should be minimum 0%, maximum 4%, thus stripping out the effect of inflationary pressures driven by external economic shocks rather than implicit changes in the UK economy. This would foster a stable regulatory regime, because when licensees set budgets (including investment plans), they could at least be certain of the maximum ALFs that would be payable. However, we disagree with Ofcom's assertion that limiting CPI in any way should lead to the risk premium in the annualisation calculation being limited – licensees will still be exposed to fluctuations in CPI, just protected from extraordinary changes.

Vodafone UK
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[5] Consultation: Proposals for implementing revised ALFs and notice of proposal to make Regulations