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Getting Risk and Reward Right in the Incentive Auction

by

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Recently, an incentive auction draft order was circulated to the FCC Commissioners, and it is scheduled to be voted on at the May 15 open meeting. The [incentive auction](#) will allow TV broadcasters to volunteer spectrum in exchange for part of the proceeds of a subsequent forward auction among mobile broadband providers. This two-part auction is supposed to be a vital part of the [Obama Administration's original goal](#) of reallocating 500 MHz of spectrum for mobile broadband use.

In response to identified and much discussed risks associated with limiting bidder participation, Chairman Wheeler [has publicly supported](#) the staff, indicating that, “risk is the partner of reward.” Although it is somewhat unfair to jump on only the catchy phrase in public comments, one must ask: what risk and what reward (and whose?) should the government be focusing on?

The risk of the auction failing to achieve sufficient mobile broadband spectrum is borne by the American consumer. The primary reward of the incentive auction should be gaining maximum spectrum for repurposing to give consumers sufficient bandwidth to meet their increasing demands. Reallocating spectrum among individual mobile providers to meet pre-conceived notions of "competition" should not be a goal of the incentive auction. Rather, it should be left to the other fact-based proceedings, preferably conducted by antitrust authorities.

What Risk and What Reward Are the Most Relevant?

As I described more fully [here](#), the incentive auction holds the promise of improving consumer welfare; increasing competition in the broadband market overall (that is, wireless and wireline); meeting specified financial contribution needs, including funding public safety; and addressing the wireless carriers' need for more spectrum. The risk of a faulty auction design is largely borne by consumers, who need enough wireless broadband capacity to satisfy their growing demand for broadband. Associated risks also fall on TV broadcasters, who have to decide whether there will be sufficiently large revenues to justify giving up their spectrum, and wireless broadband providers whose service could deteriorate without sufficient spectrum.

The main reward of the auction's success is again to be achieved by consumers in gaining sufficient capacity for services they want, a reward that TV broadcasters and wireless providers can also share through increased revenues. Thus, consumers bear the brunt of the risk-reward partnership.

Of course, competition among mobile broadband providers is an important FCC policy. The risk of insufficient mobile competition was not the point of the incentive auction when enacted. It is competition among all broadband providers, both wireless and wireline alike, that is even more important according to the FCC's [broadband plan](#), especially since all mobile providers are still playing catch-up to wireline broadband in the marketplace. So fiddling with how much and what type of spectrum individual wireless providers win at a single auction in order to adjust competition among wireless providers should not be a consideration in the incentive auction. So one must ask, what reward is the staff plan seeking and for whom?

The Proposed Auction Design

Although somewhat vague, the staff plan according to [press reports](#) includes the following major characteristics:

Once a yet-to-be-established auction target price is achieved, any bidder with greater than one-third of below 1 GHz spectrum in a market would be prohibited from bidding on up to 30 MHz in that market. The winner of this reserve spectrum would be precluded from selling it for six years. The intention would be to set the reserve price to recover sufficient funds for moving TV broadcasters, relocation of the remaining broadcasters, to pay for first responder spectrum implementation, and meet other government priorities. At the same time the FCC would adopt an order modifying the wireless "screen" used to evaluate whether particular carriers have too much spectrum for competitive reasons. The screen would increase the amount of included spectrum by about 130 MHz, but it would make distinctions based on what percentage of below 1 GHz spectrum the carrier holds.

The industry briefings, including a staff-generated [fact sheet](#), commendably improve the transparency of the Commission's decisionmaking process. But the apparent lack of significant detail adds confusion, which itself detracts from a healthy debate over the merits of the intended

mechanism. And leaving until later some crucial factors which seriously impact private auction decisions makes the entire proposal difficult to evaluate. Some points, however, are already clear as indicated below – and they are problematic.

Maximum Volunteered Spectrum Should Be the Reward Sought

As detailed in my earlier [piece](#), bidder restrictions entail a significant risk of undermining [Congress's](#) and the [FCC's](#) main goal in conducting the auction: to reallocate the maximum amount of spectrum for mobile broadband use. Chairman Wheeler [is defending](#) the staff proposal because in part it would “ensure coverage and competition in rural America,” and increase in-building penetration in urban areas. But, as already indicated, these should not be the goal of this auction.

Because the amount of volunteered spectrum is the most important goal, the FCC should be very concerned with the multiple reports, for example, by George Ford and Lawrence Spiwak [here](#) and Scott Cleland [here](#), that adopting significant bidder restrictions could deter participation and thus reduce potential auction revenues. Some broadcasters [have raised](#) this concern in the past. Reportedly, the agency [now estimates](#) that only 85 MHz of 600 MHz spectrum may be volunteered, a 30 percent decline from the original 120 MHz estimate. A reduction in the potential spectrum yield will certainly occur if significant bidders refuse to participate, as AT&T [has indicated](#) recently that it might do. It is this same concern that prompted almost 80 Democrat House members to sign a [letter](#) urging the FCC to conduct an auction with unrestricted bidding. Consumers are likely to suffer the very real risk of a poor spectrum yield given the number of past auctions that have stumbled or failed because of significant bidder restrictions or other conditions, as I demonstrated elsewhere [in an FSF blog](#).

The dampening effect of lowered potential revenues is reinforced by uncertainty surrounding broadcast licenses. A broadcaster’s decision to volunteer spectrum is a complex one and is accompanied by decades of regulatory baggage concerning the perceived future value of a particular station in a regulatory environment that is viewed as a moving target. The Commission’s years’ long broadcast ownership [review](#), potentially seeking changes to permissible broadcast ownership restrictions, is but one example of that regulatory uncertainty. High retransmission fees, and potential changes to the retransmission regime, might also affect the decision, as Randy May and I suggested in [this FSF Perspective](#). Changing and non-market-based regulatory policies add to the negative effect on a broadcaster's decision to volunteer its spectrum for repurposing to mobile broadband use.

Chairman Wheeler seemed to understand all this when he opined at a recent [post-meeting press conference](#) that the amount of spectrum volunteered and bid at the incentive auction will be a matter of “the free will” of participants as determined by the market. I submit that only unrestricted bidding would be consistent with the free will of the market. Bidder restrictions in an auction represent government-managed competition, which is anathema to free markets. Application of a generally applicable spectrum screen, including all competitive spectrum, in the context of specific transactions is a more neutral, straightforward way of assessing whether a competitor may control too much wireless spectrum in a geographic market.

Overly Complex Procedures Deter Robust Bidding

Complicating even further an already complex auction cannot aid in achieving a maximum spectrum repurposing. Different amounts of spectrum and its location on the frequency band that is volunteered by broadcasters, which likely will vary from market-to-market, already distinguishes the incentive auction from virtually all other auctions to date. Harmonization of volunteered spectrum is still subject to intense [debate](#) surrounding the “band plan.” And brand new rules are [being proposed](#) regarding the geographic market size of licenses, which specifically would favor small bidders. The “reserve spectrum” rules just add further complexity to an already complex situation. Over-complicating the auction rules sucks the life out of certainty, which is essential for maximum volunteered spectrum and robust bidding in the forward auction.

Treating Low Band Spectrum Differently is Not Necessary to Promote Competition

Chairman Wheeler also has stated that the staff plan prevents the current holders of most low band spectrum from exploiting “the auction to keep competitors from accessing the spectrum necessary to provide competition.” Upon careful examination, this concern is not borne out by facts. Although it is certain that below 1 GHz spectrum has different propagation characteristics from other spectrum, Michael Katz, Philip Hale, Mark Israel, and Andres Lerner rightly [point out](#) that there is scant evidence in the record that any carrier has been hindered from effectively competing based on the different propagation characteristics of spectrum it holds. Although T-Mobile urges policymakers to focus on the top two mobile provider’s share of low band spectrum, such focus is irrelevant if, as is the case, the top two providers have gained market share through competition, not spectrum holdings, and the next two providers’ market share is unrestrained by capacity constraints, which is apparently also the case. Relative spectrum holdings did not create or limit current market share, which has been acquired the old-fashioned way, through consumer choice. It is therefore unlikely that spectrum holdings will have anything to do with future market shares.

The notion that certain carriers have been unable to acquire below 1 GHz spectrum during past auctions (or in bona fide sales or leasing of that spectrum) is unproven. A [study](#) by Leslie Marx has analyzed previous auctions and concluded that wireless carriers other than AT&T and Verizon could have, but for whatever reason did not, spend sufficient money to acquire low band spectrum when it has been available. The notion that the two largest wireless providers might acquire spectrum to “foreclose” competitors from the market was raised by the DOJ for the first time in the context of the incentive auction. This foreclosure [speculation](#) does not produce fact-based regulation that is so frequently touted by recent Chairmen. In fact, the FCC recently [approved](#) T-Mobile’s acquisition of a significant amount of below 1 GHz spectrum from Verizon.

Basing eligibility for bidding on the perceived value of low band spectrum is speculative at best, and erroneous at worst. Some [have expressed](#) doubts that low band spectrum is more valuable than other types of spectrum. Some [have argued](#) that use of “cost” data is subject to manipulation, is factually questionable, and ignores the value of other spectrum. In fact, the FCC has recognized in a recent [mobile competition report](#) that, as a practical matter, all major

nationwide carriers have a mix of spectrum both above and below 1 GHz that is useful in providing service. FCC competition analysis to date has evaluated spectrum holdings without drawing distinctions based on the type of spectrum held. Weighting certain spectrum differentially, both in the auction and as part of the screen at the behest of carriers with various spectrum holdings, seems like just another way of achieving in another guise T-Mobile's [Dynamic Market Rule](#), which Professors Yeon-Koo Che and Philip Haile [have thoroughly discredited](#). After all, T-Mobile and Sprint could have bid for spectrum in the 700 MHz auction if they had chosen to do so.

Foreign Spectrum Auctions Don't Support U.S. Bidder Restrictions

T-Mobile has more recently [submitted](#) a paper by Peter Cramton which argues that a Canadian 700 MHz auction successfully employed bidder restrictions to promote competition. Analogizing foreign auction design to the U.S.'s different markets and regulatory policies is an unwise basis for domestic policy, as I [have argued](#) in the FSF blog, particularly when the foreign auction's success does not depend on voluntary contribution of spectrum. Regardless, the Canadian auction does not support the theory for which it is advanced. First, even Cramton recognizes that the Canadian market is different from the U.S. market, and any potential benefits from bidder restrictions are somewhat speculative. Second, the Canadian bidding restrictions were very different from what the FCC Chairman and staff apparently are now proposing for the incentive auction. The Canadian restrictions, which applied to all bidders equally with more than a 10 percent share of spectrum in a market, contained a fairly low threshold that would apply to T-Mobile and Sprint in the U.S. Third, Cramton, in fact, recognized that the prices paid by smaller bidders that were guaranteed to win some spectrum were much less than what larger players paid for their spectrum. Fourth, his opinion that the bidding achieved high revenues despite bidder restrictions is only based on a comparison with other auctions; he failed to evaluate whether 700 MHz auction revenues were maximized had there been a level-playing field, the more appropriate inquiry.

Conclusion

Both Congress and the FCC got it right when they originally established that maximum spectrum availability for repurposing should be the main goal of the incentive auction. Thus, the success of the auction, the reward, should be measured by the amount of spectrum volunteered and repurposed, not by whether certain mobile carriers receive a certain type of spectrum in a single auction. If the partner of risk is indeed reward, it's time to establish a partnership that lets the market-based auction work its magic to achieve maximum rewards for the American consumer.

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