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How the AWS Auction Provides a Teachable Moment on the Nature of Regulation

BY LAWRENCE J. SPIWAK

This January, the Federal Communications Commission concluded its successful auction of AWS-3 spectrum, netting the U.S. Treasury $41 billion in new revenue. Among the winners were two "Designated Entities" (DEs) in which DISH Network Corporation (DISH) had invested—Northstar Wireless and SNR Wireless LicenseCo—which won 702 licenses worth $13.3 billion.[1] However, because these DEs, as "very small businesses," were eligible for bidding credits of 25 percent of the final purchase price ($3.3 billion), accusations that DISH acted improperly came almost immediately from both sides of the aisle.

For example, writing jointly in the WALL STREET JOURNAL, Republican FCC Commissioner Ajit Pai and New Hampshire Sen. Kelly Ayotte (R.) argued that DISH and the two DEs "manipulate[ed] the bidding process."[2] And Democrat FCC Chairman Tom Wheeler stated that he is determined to stop "slick lawyers coming in and taking advantage of a program that was designed for a specific audience and a specific purpose."[3]

These attacks, in my view, are unfair.

First, from all accounts, while DISH may have employed some brilliant lawyering, DISH appeared to follow the Commission's AWS-3 Auction rules[4] to the letter: DISH notified the FCC prior to the auction of its passive investments and its joint bidding agreements with the two DEs[5]; and the FCC found no objection with these investments and approved the two DEs as Qualified Bidders for the auction.[6]

More to the point, we must also recognize that, if and when the FCC grants the licenses to the DEs, DISH will not even hold or control this AWS-3 spectrum: The spectrum will be held and controlled by the DEs. In addition, under the FCC's current rules, these DEs may only lease 25 percent of their spectrum to DISH; if these DEs lease more than 25 percent of their spectrum to DISH, then these DEs will enter into a "attributable material relationship" (AMR) with DISH, which would cause DISH's revenue to be attributed to these DEs. Should that occur, these DEs would exceed the applicable DE revenue cap, and the penalty would be severe: The DEs would be forced to repay their bidding credits (up to $3.3 billion).[7]

Thus, while some may not like the outcome of the FCC's DE rules, due process demands that the FCC honor this outcome nonetheless. If DISH acted within the law (and there is not a shred of evidence to indicate otherwise[8]), then the FCC cannot shift the goalposts on DISH post-auction. Given the robust participation of

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[1] *Auction of Advanced Wireless Services (AWS-3) Licenses Closes - Winning Bidders Announced For Auction 97, Public Notice*, DA 15-131, 30 FCC Rcd 630 (January 30, 2015).

[2] *See* K. Ayotte and A. Pai, *Ending Welfare for Telecom Giants, Wall Street Journal* (February 4, 2015).

[3] *FCC to Tighten Reins on Wireless Licenses*, WALL STREET JOURNAL (March 18, 2015) (available at: http://www.wsj.com/articles/business-watch-news-digest-1426727495).

[4] *In the Matter of Amendment of the Commission's Rules with Regard to Commercial Operations in the 1695-1710 MHz, 1755-1780 MHz, and 2155-2180 MHz Bands*, FCC 14-31, 29 FCC Rcd 4610, REPORT AND ORDER (rel. March 31, 2014) (hereinafter "*AWS-3 Order*").

[5] *See, e.g.*, FCC Form 175, FCC Auction No. 97, Northstar Wireless, LLC, Exhibit C (available at: https://auctionfiling.fcc.gov/form175/search175/attachment_view.htm?searchLevel=B&application_id=8538523&file_num=0006458325&version=2&PStart=1&auction_id=97&attachment_id=19474848).

[6] *Auction of Advanced Wireless Service (AWS-3) Licenses Status of Short-Form Applications to Participate In Auction 97*, Public Notice, 29 FCC Rcd 13465 (October 30, 2014).

[7] *See infra* n. 18.

[8] *See, e.g.*, Walter Piecyk, *Dish Does Not Control The Bidders That Won $10 Billion Of Spectrum*, BTIG RESEARCH (Feb. 2, 2015) ("[W]e believe that there should be little, if any, justification for the FCC to do anything but issue the licenses without delay . . . AT&T and Verizon used the same designated entity structure [in past auctions]"); R. Kaminski, *How Do You Solve a Problem Like Dish? Capital Alpha Partners* (April 7, 2015) ("For now, we believe DISH followed the rules, aiding retention of the ~$3 billion in subsidy, however distasteful it may seem); *FCC Still Looking at Dish Licenses From AWS-3 Auction, But Approves Others, Communications Daily* (April 10, 2015) (According to Craig Moffett, an analyst at MoffettNathanson: "Ultimately, it would be difficult for the Commission to withhold Dish's licenses, or to deny its designated entity discounts, given how carefully Dish followed the rules.").

Northstar Wireless and SNR Wireless in the auction, if the FCC engages in post-auction manipulations, then we would likely need an auction do-over.

Instead, if we are to be angry about the practical effects of the FCC's DE rules, then this anger should be directed towards the root cause of the problem: Congress and the FCC. Indeed, any time Congress and the FCC set up a subsidy program designed to favor one or more political constituencies, it would be highly naîve for anyone to think that profit-maximizing firms will not also seek to avail themselves of those benefits within the full extent of the law. We have seen firms engage in such conduct for decades in the Universal Service and intercarrier compensation space and, the DE program is no exception. As the New York Times recently wrote, aggressive use of the FCC's DE rules "is not a new issue. The 'small firm' exception has been known to be a problem at the FCC for years."[9] Accordingly, rather than pick on DISH for finding a lawful way to comply with the FCC's Designated Entity rules, we should view the AWS-3 auction as a "teachable moment" about the nature of regulation in general—that is, the rules matter, the intentions do not.

A Brief Background of the FCC's DE Rules. For many years, U.S. spectrum licensing policy was a mess. Using both "beauty pageants" and lotteries, spectrum licensing was extremely inefficient. However, recognizing the groundbreaking work of Ronald Coase, the United States in the 1990s moved towards a policy of auctioning spectrum rather than giving it away. The theory supporting this policy was simple and elegant: The firm that values the spectrum most will put the spectrum to its best and most efficient use.

However, as laws are written by politicians, the propensity to stray from the theory in order to cater to political constituencies was irresistible. So, while the Communications Act directs the FCC to auction spectrum via "competitive bidding", the Communications Act also directs the FCC to "disseminat[e[licenses among a wide variety of applicants, including small businesses, rural telephone companies, and businesses owned by minority groups and women."[10] Moreover, to make sure these constituencies can afford to participate in the auctions against established mobile providers, the statute directs that the FCC shall, among other things, "consider alternative payment schedules and methods of calculations, including lump sums or guaranteed installment payments. . . ."[11] In particular, to "ensure that small businesses, rural telephone companies, and businesses owned by minority groups and women are given the opportunity to participate in the provision of spectrum-based services" the FCC shall "consider the use of tax certificates, bidding preferences, and other procedures."[12] Yet, recognizing the potential for abuse of this highly-valuable subsidy, Congress also requires the FCC to promulgate "transfer disclosures and antitrafficking restrictions and payment schedules as may be necessary to prevent unjust enrichment as a result of the methods employed to issue licenses and permits."[13]

For the better part of the last twenty years, the FCC has struggled to find the appropriate balance of promoting Congress's twin goals of establishing spectrum preferences for small businesses and protecting against "unjust enrichment."[14] While a detailed exegesis of the FCC's DE rules would take far too long for this space, let me provide a highly over-simplified overview of the rules applying to the recent AWS-3 auction for purposes of this discussion.

First, the FCC set up a schedule of potentially-available bidding credits based upon the revenue of the DE along the following lines:

- Businesses with average gross revenues for the preceding three years not exceeding $15 million are eligible for bidding credits of 25 percent of the license purchase price; and

- Businesses with average gross revenues for the preceding three years not exceeding $40 million are eligible for bidding credits of 15 percent of the license purchase price.[15]

Next, the FCC set up a detailed set of attribution rules to make sure DEs were not, in fact, shill bidders for larger, well-capitalized entities. Under its attribution rules, the FCC will look to determine whether an individual or entity has either *de jure* or *de facto* control of a DE. Identifying *de jure* control is relatively easy, as the FCC will look to see if somebody holds over 50 percent of voting stock or a partnership interest. On the other hand, determining *de facto* control is a bit more challenging. To determine *de facto* control, the FCC will look on a case-by-case basis at the following factors: (1) Does an investor control more than 50 percent of the board of directors or management committee of the DE? (2) Does an investor have the authority to appoint, promote, demote and fire senior executives that control the day-to-day activities of the licensee? And (3) does the investor play an integral role in management decisions?[16]

Finally, given that DEs are able to buy highly-valued spectrum at a discount, DEs are supposed to have some "skin" in the game. For this reason, under the FCC's current rules and policies, these DEs must at some

[9] S.D. Solomon, *How Loopholes Turned Dish into a "Very Small Business," New York Times* (February 24, 2015) (available at: http://www.nytimes.com/2015/02/25/business/dealbook/how-loopholes-transformed-dish-network-into-a-very-small-business.html?_r=0). Indeed, in a paper authored by the Congressional Budget Office in 2005, the CBO specifically found that "the preferences adopted by the FCC in the PCS auctions, particularly those used in the auction for the first large block of spectrum set aside for small businesses, the C block, did not ultimately result in widespread or long-term participation by small businesses in the PCS market. As of 2005, it was a common occurrence that control of a large portion of the PCS spectrum authorized by licenses set aside for small businesses had been sold to large providers; thus, many of the expected benefits of small-business participation were not realized." *Small Bidders in License Auctions for Wireless Personal Communications Services, Congressional Budget Office* (October 2005) at p. 1 (available at: http://www.cbo.gov/sites/default/files/10-24-fcc.pdf).

[10] 47 U.S.C. § 309(j)(3)(B).

[11] 47 U.S.C. § 309(j)(4)(A).

[12] 47 U.S.C. § 309(j)(4)(D).

[13] 47 U.S.C. § 309(j)(4)(E).

[14] *See, e.g., Fresno Mobile Radio, Inc. v. FCC*, 165 F.3d 965, 971 (D.C. Cir. 1999) (when it comes to spectrum policy, the FCC "must balance a number of potentially conflicting objectives"); *accord, Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1103 (D.C. Cir. 2009).

[15] 47 C.F.R. § 1.2110 (f)(1)-(2).

[16] 47 C.F.R. § 1.2110(b)(iii).

point build a network and become facilities-based providers.[17]

But what about preventing ''unjust enrichment''? As noted above, even Congress recognized that the FCC needs meaningful mechanisms to prevent a DE from purchasing highly-valued spectrum at a discount and then immediately ''flipping'' that spectrum at a hefty profit to the spectrum-starved mobile industry.

To deal with the problem of ''unjust enrichment,'' the FCC's primary mechanism of enforcement is a five-year holding rule from which everything else flows. For example, if the DE violates the FCC's extensive financial attribution rules within five years, then it must then pay back all or a portion of its bidding credits. Similarly, if a DE sells its spectrum to a non-DE before the end of the five-year holding period, then it must repay all or a portion of its bidding credits. Finally, and perhaps most draconically, if a DE leases or resells (including under a wholesale agreement) more than 25 percent of the spectrum capacity of any one of its licenses to the same person or party, then that DE enters into an ''attributable material relationship'' (''AMR'') and the DE must repay all or a portion of its bidding credits if those additional attributed revenues cause the DE to exceed the applicable DE revenue limits.[18]

Living in Glass Houses. Given these rules, attempting to use the DE program to obtain spectrum at a discount is harder than one may think. To wit, Ivan Seidenberg, the legendary former CEO of Verizon, once explained to the NEW YORK TIMES exactly how cumbersome it was to use the DE route rather than purchasing spectrum outright. As Mr. Seidenberg bluntly pointed out:

> In order to gain control over these assets over time, you have to pay a price. . . . We looked at this. We concluded it makes a lot of sense in the short term to buy the spectrum, get control of it, get out there quickly, not have bureaucracy and not deal with minority owners who don't have an interest other than flipping it.[19]

Despite these concerns, there is precedent for major wireless carriers investing in DEs. Let me provide just four examples:

- In Auction 35 (2001), Cingular Wireless (now AT&T) paid $285 million for an 85 percent stake in a DE called Salmon PCS. Salmon won 79 licenses (many in major metropolitan areas) at a cost of $2.3 billion.[20] According to FCC records, Salmon received nearly $560 million (approximately 25 percent) in bidding credits as a DE.[21]

- Also in Auction 35, AT&T Wireless secured approval to hold up to 79.4 percent in a DE named Alaska Native Wireless (''ANW''). ANW won 44 licenses, some with bidding credits and some licenses that were ''closed'' to bidding by non-DEs, at gross winning bids totaling $2,960,258,000, with bidding credits of $67 million.[22]

- In Auction 58 (2005), Verizon obtained an 85 percent interest in a DE called Vista PCS. Unlike most other auctions, Auction 58 contained both ''open'' licenses (which could be bid on by any bidder in the auction) and ''closed'' licenses (which could only be bid on by certain DEs).[23] In Auction 58, Vista won 37 closed licenses in major cities such as Houston, Seattle and Pittsburgh without having to bid against major carriers.[24]

- In Auction 66 (2006), Leap Wireless had an 85 percent interest in a DE called Denali Spectrum. Denali won licenses in major markets such as Chicago, Minneapolis, and Milwaukee. According to FCC records, Denali's total gross bids in Auction 66 were $365,445,000, with bidding credits of approximately $91 million.[25]

Fixing the Problem? So, notwithstanding the facts that (1) major wireless carriers have invested in DEs for years; and (2) DISH appears to have complied with the FCC's current DE rules in the AWS-3 Auction, FCC Chairman Tom Wheeler nonetheless recently testified at a Senate hearing that ''[w]e are going to fix this'' perceived abuse of the DE program.[26]

Really?

Given the FCC's actions under Chairman Wheeler's leadership to date, it appears that the agency seems more interested in expanding, rather than contracting, the ability of major carriers to invest in DE program participants. Here are just two examples:

Grain Management LLC owns four licenses which it obtained without the benefit of DE bidding credits. Grain Management, however, leases all of the spectrum of these licenses to AT&T and Verizon. Last summer, Grain asked the FCC to waive its AMR rule so that Grain could participate as a DE in future auctions. Much to manys' surprise, the FCC granted Grain's petition, holding that the FCC could address any claims of inappropriate AMR relationships with AT&T and Verizon post-auction in the long-form application stage.[27] In

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[17] *See Implementation of the Commercial Spectrum Enhancement Act and Modernization of the Commission's Competitive Bidding Rules and Procedures, Second Report and Order and Second Further Notice of Proposed Rulemaking*, FCC 06-52, 21 FCC Rcd 4753 at ¶ 21 (2006) (''*CSEA/Part 1 Second Report and Order*''), *modified by erratum*, 21 FCC Rcd 6622 (2006), *clarified by Order on Reconsideration*, 21 FCC Rcd 6703 (2006) (''*CSEA/Part 1 Order on Reconsideration of Second Report and Order*''), *aff'd in pertinent part sub nom. Council Tree Communications, Inc. v. FCC*, 619 F.3d 235 (3d Cir. 2010), *rules amended and petitions for reconsideration dismissed, Implementation of the Commercial Spectrum Enhancement Act & Modernization of the Commission's Competitive Bidding Rules & Procedures*, 27 FCC Rcd 908 (2012).

[18] 47 C.F.R. § 1.2110(b)(iv).

[19] S. Lobaton and S. Romero, *FCC Auction Hit with Claim of Unfair Bids*, NEW YORK TIMES (February 12, 2001).

[20] *Id.*

[21] http://wireless.fcc.gov/auctions/35/charts/35cls1.pdf.

[22] http://wireless.fcc.gov/auctions/35/charts/35press6.pdf.

[23] *Broadband PCS Spectrum Auction Scheduled For January 12, 2005, Notice and Filing Requirements, Minimum Opening Bids, Upfront Payments and Other Procedures for Auction No. 58, Report No. AUC-04-58-C (Auction No. 58)*, DA 04-3005, PUBLIC NOTICE, 19 FCC Rcd 18190 (September 16, 2004).

[24] *Broadband PCS Spectrum Auction Closes, Winning Bidders Announced for Auction No. 58, Report No. AUC-05-58-H (Auction No. 58)*, DA 05-459, PUBLIC NOTICE, 20 FCC Rcd 3703 (February 18, 2005).

[25] http://wireless.fcc.gov/auctions/66/charts/66cls1.pdf.

[26] WALL STREET JOURNAL, *supra* n. 3.

[27] *In the Matter of Grain Management, LLC's Request for Clarification or Waiver of Section 1.2110(b)(3)(iv)(A) of the Commission's Rules; Implementation of the Commercial Spectrum Enhancement Act and Modernization of the Commission's Competitive Bidding Rules and Procedures; Expanding*

his scathing dissent, FCC Commissioner Ajit Pai went ballistic, observing that:

> the FCC's decision today—that a company can lease every last slice of its spectrum without even *implicating* the purpose underlying the AMR rule and therefore obtain DE benefits—is as unlawful as it is absurd. The decision violates the AMR rule's core purpose of limiting DE benefits to companies that use their spectrum to offer facilities-based service, since Grain offers no such service and its waiver petition evinces no intention whatsoever that it will do so. Indeed, this is the very case for which the AMR rule was *designed*, not one that merits its waiver.[28]

Subsequent to this waiver, it was discovered that Grain Management's founder and managing partner—David Grain—was a major fundraiser for President Obama. As a result, the House Energy and Commerce Committee has launched an inquiry into the whether the FCC acted inappropriately in the granting of Grain's waiver petition.[29]

But as stinky as the Grain Management waiver may smell, it pales in comparison to the FCC's *October 2014 NPRM* and follow-on April 2015 *Public Notice*, in which the agency proposes to ''update'' its DE rules significantly.

And what exactly does the FCC propose?

Among other things, the FCC proposes to weaken the income requirements for bidding credits eligibility and the requirement that a DE be a facilities-based provider. Perhaps most incredulously, the FCC is considering eliminating the AMR rule altogether, thus allowing DEs to license 100 percent of their spectrum. In other words, rather than *constricting* the DE program, the FCC appears more interested in making life a whole lot easier for DEs to get bidding credits and to flip their spectrum via leasing arrangements with wireless carriers without having to invest a dime into network construction and operation. (As a salve, the FCC also seeks comment on lengthening the unjust enrichment period—such as for 10 years or until the license expires—but if a DE can lease 100 percent of its spectrum without having to build its own infrastructure, then all such rule changes would do is close the door after the horse has already left the barn.)[30]

the Economic and Innovation Opportunities of Spectrum Through Incentive Auctions; Amendment of the Commission's Rules with Regard to Commercial Operations in the 1695-1710 MHz, 1755-1780 MHz, and 2155-2180 MHz Bands, FCC 14-103, Order, 29 FCC Rcd 9080 (rel. July 23, 2014) at ¶ 14.

[28] *Id.*, Pai Dissent (emphasis in original).

[29] T. Shields and J.D. Salant, *Obama Campaign Donor Wins FCC Waiver From Auction Rules, Bloomberg Business* (July 23, 2015) (available at: http://www.bloomberg.com/news/articles/2014-07-22/obama-campaign-donor-wins-fcc-waiver-from-auction-rules); A. Schatz, *House Republicans Launch Investigation of FCC Waiver for Obama Donor, Re/Code* (July 31, 2014) (available at: http://recode.net/2014/07/31/house-republicans-launch-investigation-of-fcc-waiver-for-obama-donor); J. Eggerton, *House Republicans Seek Documents on FCC ''Grain'' Waiver, Broadcasting and Cable* (July 31, 2014) (available at: http://www.broadcastingcable.com/news/washington/house-republicans-seek-documents-fcc-grain-waiver/132846).

[30] *See In the Matter of Updating Part 1 Competitive Bidding Rules Expanding the Economic and Innovation Opportunities of Spectrum Through Incentive Auctions; Petition of DIRECTV Group, Inc. and EchoStar LLC for Expedited Rulemaking to Amend Section 1.2105(a)(2)(xi) and 1.2106(a) of the Commission's Rules and/or for Interim Conditional Waiver; Implementation of the Commercial Spectrum Enhancement Act and Modernization of the Commission's Competitive Bidding Rules and Procedures*, FCC 14-146, NOTICE OF PROPOSED RULEMAKING, 29 FCC Rcd 12,426 (rel. October 10, 2014); FCC PUBLIC NOTICE,REQUEST FOR FURTHER COMMENT ON ISSUES RELATED TO COMPETITIVE BIDDING PROCEEDING, WT Docket No. 14-170, FCC 15-49, __ FCC Rcd __ (April 17, 2015).

Conclusion. Many years ago when I got started in the telephone business, I was lucky enough to be mentored by a man named Dennis Gundy. Dennis, in addition to being an avid Corvette car and Harley Davidson motorcycle enthusiast, was the ninth employee of MCI and one of the founders of Sprint. Dennis had a simple credo: ''telecommunications is an easy business: if you know the rules, you can make money.'' Accordingly, if we don't like how the DE rules are being applied, then we should not blame profit-maximizing firms who will always seek to use every lawful means to push the boundaries of these rules for their benefit. (Indeed, firms are never passive recipients of regulation.) Instead, the onus should be on the government to write better rules and to account—to the extent practicable—for the proverbial ''law of unintended consequences.''

Over the last couple of months, a lot of good ideas have come to the fore on how to improve the DE program going forward. These include, among other ideas:

- Strengthening, not weakening as the FCC proposes, the AMR rule;
- Continuing to require, and not eliminating as the FCC proposes, that DEs be ''facilities-based'' providers;
- Extending the ''unjust enrichment'' window from five to ten years as the FCC proposed; and
- Requiring joint bidders to participate at auction as a single entity or prohibiting joint bidders from placing competing bids on the same license.[31]

Regardless of what, if any, reforms the FCC ultimately adopts, it has a very short time in which to act, as the clock is ticking before the FCC's upcoming voluntary incentive auction in which (hopefully) broadcasters will relinquish their spectrum in exchange for a portion of the action proceeds. If the FCC wants to improve the DE program to ensure that small businesses can meaningfully participate in the upcoming incentive auction, then the time to act is now.

But there is more at stake here than just fixing the DE rules. The AWS-3 Auction provides an excellent ''teachable moment'' about the nature of regulation in general. Broad (and perhaps noble) policy objectives—like getting spectrum into the hands of favored political constituencies, putting broadband in schools and libraries, or even promoting an ''Open Internet''—are not, in the end, what matters. The road to hell is paved with good intentions. What matters in reality are the trade-offs Congress incorporates into a statute, how an administrative agency writes rules to implement this statute, how the agency's rules are interpreted and modified by the courts and, most importantly, how these rules influence the behavior of communications providers.

So when firms respond to laws and regulations in a manner undesired by politicians, perhaps a little less indignation and a bit more self-reflection is in order.

[31] *See* J. Marsh, *Lessons from Auction 97 for Future Auctions*, AT&T Blog (February 20, 2015) (available at: http://www.attpublicpolicy.com/fcc/lessons-from-auction-97for-future-auctions).

