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What is Really Going on with the FCC's Broadcast Incentive Auction?

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If you follow the broadcast or wireless industries, you know that the Federal Communications Commission ("FCC") is conducting the world's first dual-sided spectrum auction. In the auction, television broadcasters participate first in a descending-clock auction to return spectrum to the FCC. Then, wireless carriers bid in a traditional ascending-clock auction to purchase that returned spectrum. Both sides of the auction will close when the money committed to purchasing broadcasters' spectrum is met by wireless carriers' aggregate bids for the recovered spectrum. The first stage of broadcaster bidding started on May 31 and the two sides of the auction are still more than $20B apart. Many are asking why this is happening, and whether the FCC broadcast incentive auction is going to fail.

Broadcasters can only accept the bids they are offered by the FCC

A popular misconception is that broadcasters are unrealistically pushing up prices, thus causing the large gap between the prices broadcasters are willing to accept versus the prices wireless carriers are willing to pay. There are two fallacies here: first, broadcasters have no ability to set auction prices – they either say "yes" or "no" to the price that the FCC offers to pay; and second, the prices never go up in the broadcast auction – they only go down at a rate determined by the FCC.

All broadcaster prices are set by the FCC. Initial auction prices for broadcasters were based on a formula that considered a station's geographic coverage area, population served, and interference potential. The attributes of the FCC's formula were extensively debated by the broadcast and wireless industries and other interested members of the public. In designing the formula, the FCC chose to set prices high so that broadcasters had an incentive to participate – if broadcasters did not agree to participate in the auction, the FCC would have had no spectrum to auction to wireless providers. Because the FCC's formula set the prices high, many broadcasters did participate in the auction and the FCC initially offered 126 MHz of spectrum to the wireless industry, the maximum amount available under the FCC's auction plan.

At the beginning of each new stage of the auction, the FCC sets a desired spectrum "clearing target." Thereafter, the FCC formulates offers to broadcasters that are designed to induce enough broadcasters to exit the auction so that the FCC ends that stage with just enough stations remaining in the auction to reach the pre-set clearing target. To accomplish this, the prices the FCC offers drop in each successive bidding round according to a formula. Broadcasters have no say in how pricing moves forward – they either say "yes" or "no" to the price offered by the FCC. In markets where there are many interested broadcasters, broadcasters, in a sense, bid against each other for the right to return spectrum for payment, with prices going down according to the FCC's formula during each bidding round. Keep in mind, however, that these broadcasters never see the prices being offered to other broadcasters, so this competition is largely theoretical.

Under the FCC's auction system, the constraint that sets broadcaster prices is not the broadcasters who are bidding but rather the broadcasters who are not in the auction – those broadcasters must be "repacked" into the part of the spectrum band that will remain available for broadcasting. Once the broadcast part of the spectrum band is full, the FCC accepts the remaining broadcaster bids (even if a broadcaster might be willing to accept a lower bid) and the broadcast side of the auction is over. For the first stage of broadcaster bidding, the FCC had only 28 channels in which to place repacked broadcasters. Because of this severe channel constraint, the FCC's pre-set pricing formula resulted in a payment to exiting broadcasters of $86.4B to vacate the needed spectrum. In the second stage of broadcaster bidding, the FCC had 30 channels in which to place repacked broadcasters, resulting in an exit cost of $54.6B. In stage three, the FCC had 31 channels with an exit cost of $40.3B. In stage four, which will begin the week of December 12, the FCC will have 35 channels for repacked broadcasters – four more channels than in the previous round which will, in turn, push broadcaster exit prices lower.

While the auction on the broadcast side appears to be going slowly, it actually is proceeding precisely according to the FCC's plan. The idea of this auction is for the FCC to buy from broadcasters as much spectrum as wireless carriers will pay for, with the constraint that remaining broadcasters must have a channel in the post-auction broadcast spectrum band.

Wireless carriers are bidding for uncertain spectrum

There has been significant speculation about why wireless carrier demand for spectrum thus far is not meeting expectations. The FCC's anti-collusion rule, which prohibits communication by bidders concerning their auction strategies and bids, makes it impossible to accurately gauge who is bidding on what in the auction on the wireless side. There could be many reasons for the limited bidding to date, and most of them have been analyzed elsewhere.

However, one issue that has not gotten much attention is that the product the FCC is offering in this auction is fundamentally different from past auctions. In prior FCC auctions, wireless bidders bid on particular spectrum blocks. If a carrier wanted to aggregate spectrum across the country on uniform spectrum frequencies, it could do so through its bidding. In this auction, in contrast, wireless carriers are bidding on "generic" blocks of spectrum, some of which have interference constraints. Accordingly, after wireless bidding is complete in the clock auction, the FCC will offer wireless carriers the opportunity to bid again – this time for the right to aggregate frequencies across their winning footprint. Under this auction format, if spectrum continuity is important to a wireless carrier, that bidder must reserve funds for the second "assignment" phase of bidding. Notably, when considering whether the wireless industry has tendered sufficient bids to cover the costs of buying broadcast spectrum, any bidding from the second "assignment" phase of the auction is not considered.

The uncertainty of the spectrum product the FCC is offering appears to be having an impact on bidders' behavior. Detailed information about wireless bidding has not been made public, but we do know that, as fewer spectrum blocks have been offered in each bidding stage, wireless bids for the generic individual spectrum blocks have not gone up – as supply has dropped, demand has dropped as well (or at least wireless carriers have not been willing to increase prices in response to the lower supply). Accordingly, in the first stage of bidding, where the FCC generally offered 10 blocks of spectrum in each market, the aggregate wireless industry bid was $23B. When in stage two the FCC generally offered 9 blocks of spectrum in each market, wireless carriers did not respond with higher bids. With less spectrum available at the same prices, the aggregate wireless industry bid dropped to $21.5B. In stage three, with 8 generic spectrum blocks, wireless carriers again did not raise their bids and the aggregate wireless industry bid dropped to $19.7B. We note that this bidding behavior was not anticipated by the FCC. We also note that the net bids in each stage are actually lower than these numbers indicate, as the FCC is offering a variety of spectrum discounts and set-asides that are available only to certain types of bidders, and those discounts and set-asides may also be influencing bids by the major carriers.

Because wireless carriers are not increasing their bids and, as a result, the number of spectrum blocks is falling in each stage of the auction, the total bidding eligibility of the wireless carriers as a group is falling as well. Wireless bidders must currently be active on 95% of their bidding eligibility and by not placing new, higher bids, bidders risk that their eligibility will be reduced as the number of spectrum blocks drops. This requirement, that bidders actively bid to retain their eligibility, could explain why carriers seem to be bidding only in smaller markets – bidding in those markets retains their auction eligibility but does not lead to a second bidding round.

What happens now?

Broadcaster bidding in stage four of the auction will begin the week of December 12. In stage four, broadcasters will retain access to television channels through channel 36 and the clearing target will be 84 MHz. This target would give wireless carriers access to seven blocks of spectrum in most markets. This 84 MHz spectrum clearing target was a clearing target supported early in the auction rulemaking process by many parties, and with much looser channel constraints (i.e. more channels in which to place repacked broadcasters), the expectation is that the final broadcaster exit price will be much lower and could be very close to the current wireless carrier aggregate bid. If the FCC uses the broadcaster bidding schedule it has used in the past, we could know the stage four broadcaster exit price by mid-January or sooner, if the FCC decides to speed up the bidding rounds.

Assuming that the broadcaster exit price at the end of stage four is close to (or less than) the current aggregate

wireless bids, we expect wireless carriers to actually bid again in stage four. Carriers have retained an extra 5% of bidding eligibility, and will be able to move their bids to different markets and change or add the number of spectrum blocks on which they have placed bids. If, however, stage four does not bring the broadcast and wireless industries together, the auction will continue at ever-lower spectrum clearing targets: 78 MHz for stage five; 72 MHz for stage six; 60 MHz for stage seven; 48 MHz for stage eight; and 42 MHz for stage nine. If the auction cannot clear by stage nine, or if declining wireless prices move below the target for total auction proceeds, then the auction will fail.

If the auction is going to close in stage four, we should know in late January or early February 2017 – once wireless bidding exceeds the auction's costs (including broadcaster exit costs), we know that the auction will close once wireless bidding in the stage is completed.

If you have questions on the FCC's auction process, please contact us.

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