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Larry Downes & Geoffrey A. Manne[1]

I. INTRODUCTION

Some of the most significant transactions singled out recently for intensive federal review involve the communications industry. These include the merger of Comcast and NBCUniversal, the failed merger of AT&T and T-Mobile USA, a multi-billion purchase of spectrum by Verizon from a consortium of cable companies and, just recently, the announced acquisition by T-Mobile USA of rival MetroPCS and Softbank's offer for Sprint.

The predominance of communications transactions is not surprising. With the remarkable boom in mobile devices and applications that took off with the 2007 release of the first Apple iPhone, mobile broadband has emerged as the fastest-growing and most dynamic consumer category in an otherwise sluggish economy. Today, consumers are gobbling up an expanded range of devices and operating systems, downloading billions of apps and moving massive amounts of data—including high-definition video—through the cloud.

Unfortunately, communications providers face serious and potentially fatal problems of supply. Radio spectrum—the chief input and most severe constraint on the ability of carriers to support more users and more data—is essentially unavailable at any price.

That's because the Federal Communications Commission ("FCC"), which oversees the licensing of public airwaves, has run out of usable, unassigned spectrum to license. Moreover, a century-old allocation scheme that earmarks different bandwidths for specific applications makes it difficult for carriers to acquire more capacity from secondary markets, even when doing so would put underutilized frequencies to better and higher use. Reassigning frequencies for different technologies (e.g., satellite to terrestrial), as companies including Dish Network and LightSquared can testify, requires extensive, time-consuming, and politically charged agency rulemaking.

As consumers pull orders of magnitude more data to their smartphones, tablets, and notebook computers, carriers are becoming desperate.[2] Network operators, already experiencing what the FCC warned in 2010 as an imminent "spectrum crunch," have little choice but to acquire spectrum assets from other mobile operators, whose licenses can be put to immediate use once the agency approves the transfer. They have been doing so as quickly as possible, attempting or completing over a dozen major transactions since 2007.

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[2] The other major inputs are cellular infrastructure, including towers, antennae, and pole attachments. In brief, the more infrastructure, the more efficiently carriers can use their existing spectrum licenses. But investments are being artificially constrained by local zoning authorities, a combination of aesthetic and health concerns, incompetence, and corruption. *See* Larry Downes, *Does your iPhone Service Suck? Blame City Hall*, CNET News.com (Sept. 8, 2011).

As the urgency of spectrum-related transactions has increased, the FCC has come to play an increasingly problematic—and largely unstructured—role in the government's review of transactions in the communications industry.

II. MISSION CREEP IN THE FCC'S APPROACH TO LICENSE TRANSFERS

Under the Clayton Act, the Department of Justice ("DOJ") must approve substantial mergers and asset transfers. But only the FCC can approve the transfer of FCC licenses. This has led to the emergence of closely orchestrated but nevertheless duplicative joint reviews of communications industry transactions by the two agencies.

While the Department of Justice reviews transactions under antitrust case law and its published interpretive guidelines, license transfers are evaluated under the FCC's far-squishier "public interest" standard.[3] With little to guide or constrain such reviews, the FCC is easily distracted, with increasingly troubling consequences. In the last few years in particular, the agency has demonstrated a dangerous tendency toward "mission creep" in several directions.

For example, as the scope of proposed transactions expands, reviews take longer, involve messier public records and agency inquiries, and attract more lobbying from Congress and self-styled consumer advocates. Comcast-NBCUniversal was approved after ten months, while AT&T/T-Mobile was rejected after seven months. The Verizon-SpectrumCo deal went through, with significant conditions, in eight months. There is no indication yet of a timetable for T-Mobile/MetroPCS.

Transactions that are approved now come with comically long lists of conditions, including divestitures of some customers and/or spectrum, as well as wildly unrelated remedies. For Comcast-NBCUniversal, the conditions ran to nearly thirty pages, including (i) a requirement that Comcast adhere to net neutrality even if the Open Internet Order is overturned, (ii) rate regulation on Comcast's broadband service, and (iii) specific requirements on what channels Comcast offers in its cable packages.

In effect, the agency now uses transaction reviews to impose the kinds of regulations that would otherwise require a formal rulemaking. In addition to side-stepping notice-and-comment requirements, this regulation-by-merger-condition creates a crazy quilt where different rules apply to different companies, sometimes in different markets. The version of net neutrality Comcast agreed to in the NBCUniversal deal, for example, is dramatically different than the version the agency ultimately passed. Consumers can't be expected to understand why different rules apply to different products and services. Future transactions are needlessly complicated, with the industry experiencing increased regulatory uncertainty.

The agency is also reaching further into transactions, again duplicating the DOJ's review and applying its own non-standards. The FCC's authority extends only to license transfers, and Congress intentionally limited the scope of that review. For example, arrangements that do not convey licenses are outside FCC jurisdiction, whether such deals "accompany" a license transfer or not.

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[3] *See*, e.g., 47 U.S.C. § 310(d) (1996).

Yet in the Verizon-SpectrumCo case, the FCC attached competition-related conditions to joint marketing and other commercial agreements that were part of the overall transaction, but which did not include the transfer of licenses. Activists successfully urged the FCC to extend its reach in the SpectrumCo deal on the theory that the commercial agreements could influence the industry's competitive landscape.

Whether ancillary or unrelated agreements in a larger transaction have anticompetitive effects, however, is appropriately the province of the DOJ. Any effect on competition is best measured under the antitrust laws, not by the FCC's vague "public interest" standard.

If, as in the SpectrumCo case, the FCC continues to assert jurisdiction over such agreements as part of its public interest review, its evaluation of license transfers will soon morph into unfettered authority to regulate any aspect of the merged entity's business. This not only duplicates DOJ review, it also does so under a standard that lacks any clear limiting principles or analytical rigor.

The burden of proof is also significantly different under the FCC's antitrust-like review. The DOJ must sue for injunctive relief to block proposed transactions, and has the burden under the Clayton Act of showing they may "substantially lessen competition." But when the FCC rejects the transfer of spectrum licenses, it is up to the parties to demonstrate that the proposed transaction is in the public interest. The shifting of burdens makes it far easier for the agency to extract "voluntary" conditions—too easy.

III. REVISITING THE "SPECTRUM SCREEN"

The scope and timeframe of FCC transaction review, the imposition of merger conditions that effectively apply rulemaking regulations only to some parties in the industry, and "mission creep" in the agency's assertion of unrelated jurisdiction are just some of the more worrisome features of the agency's expanding role in shaping the structure and operation of communications industries. The more outrageous of these encroachments have already attracted unwelcome attention from Congress.[4]

Some at the agency, on the other hand, seem largely unaware of just how unprincipled its reviews have become, or of the unintended consequences its mixed messages have on long-term investments by participants in the communications ecosystem. In a recent filing, for example, the FCC casually describes its *ad hoc* (or "case-by-case") methodology for reviewing license transfer applications thusly:

> Beginning in 2004, the Commission has used a two-part screen to help identify markets where the acquisition of spectrum provides particular reason for further competitive analysis. The Commission does not, however, limit its consideration of potential competitive harms in proposed transactions solely to markets identified by its initial screen….For those markets highlighted by one or both steps in the analysis, the Commission routinely conducts detailed, market-by-market reviews to determine whether the transaction would result in an increased

[4] In March 2012, for example, the House passed The FCC Process Reform Act, which would strictly limit the ability of the agency to attach conditions to license transfers and restrain the agency's tendency to arbitrarily extend the timeframe of its reviews. *See* Andrew Feinberg, *Telecom Industry Applauds Passage of FCC Reform Bill*, THE HILL (March 28, 2012).

> likelihood or ability in those markets for the combined entity to behave in an anticompetitive manner. The case-by-case analysis considers variables that are important in predicting the incentives and ability of service providers to successfully reduce competition on price or non-price terms, and transaction-specific public interest benefits that may mitigate or outweigh any harms arising from the transaction.[5]

This is an unintentionally damning explanation of what happens in FCC transaction reviews, which are filled with pseudo-mathematical calculations, arbitrary adjustments, and catch-all "transaction-specific public interest factors" applied to mask decisions actually made *a priori* on other, unarticulated grounds. It's hard to see any actual rigor—as opposed to the disarmingly misleading appearance of rigor—in the process.

The document just quoted, released days before the announced acquisition of MetroPCS by T-Mobile USA, is a Notice of Proposed Rulemaking ("NPRM") intended to codify some of the more troubling elements of the agency's case-by-case approach. Or maybe not. As Commissioner Pai pointed out in a concurring statement, the NPRM didn't actually propose any new rules—it didn't propose anything at all. It merely sought input from interested parties on whether or not the agency should change its process, and, if so, how.

The NRPM is largely concerned with the so-called "spectrum screen," a significant element in the agency's license transfer analysis and one that is emblematic of mission creep in the FCC's unstructured approach to transaction review. Since it's a feature of the review over which all five of the agency's current Commissioners have expressed concern, it's worth looking at in more detail.

The screen is a bit of agency legerdemain that measures the impact of a proposed transaction on spectrum holdings in each of several hundred local markets. Application of the screen is supposed to simplify the process of approving the transaction. If the merged entity would control less than a third of the usable spectrum allocated to commercial mobile applications in a given market, that market is presumed to be competitive and no further analysis is performed; the transaction is said to pass the screen.

In markets where the screen fails, more detailed competitive analysis of the proposed transaction is performed. Likely costs to the "public interest" are supposedly weighed against likely benefits, and the scales are tested to see where, on balance, the proposed transfer falls.

The evolving spectrum screen is actually the second part of the review. The first part is the application of the infamous Herfindahl-Hirschman Index ("HHI"), a simplistic calculation that measures market shares and the arithmetic change in market concentration a transaction would yield.

Both are born of the same outdated structural presumption that simply infers anticompetitive effects from high levels of concentration. But in markets characterized by

[5] Federal Communications Commission, *In the Matter of Policies Regarding Mobile Spectrum Holdings*, WT Docket No. 12-269, Notice of Proposed Rulemaking, Sept. 28, 2012.

technological innovation, multidimensional competition, and economies of scale, the reality is that we have no idea what level of concentration is commensurate with optimal outcomes.[6]

While the HHI analysis at least provides a degree of regulatory consistency, the spectrum screen achieves the opposite result. On a market-by-market basis, the FCC regularly updates the amount of total usable spectrum based on changes in technology and previous spectrum reassignments, adjusting the numbers further to take into account the different technical characteristics of different bands, which can be more or less useful for different applications depending on the frequency. The amount of spectrum attributed to different carriers based on partial ownership of subsidiaries is also subject to adjustment.

Different transactions, therefore, are subject to different versions of the screen, adjusted unpredictably at the time of review. The agency is unbound by any concrete formula for its specific adjustments, and no party knows ahead of time—or at the time it submits a request for license transfer—what the screen's key inputs will look like when negotiating an acquisition.

Given the changing dynamics of the mobile marketplace, any spectrum screen would need to be regularly reviewed and clearly articulated, but the FCC continues to make its adjustments more-or-less randomly. There's no actual methodology—or none expressed—as to how adjustment decisions are made. For example, BRS spectrum is included in the spectrum screen in some markets, but not in others, and EBS spectrum is not included in the spectrum screen at all. Because Clearwire's network uses only these two spectrum bands, Sprint's holdings in Clearwire are excluded from the screen.

The screen is so loosely defined that it's proven irresistible to manipulation. Changes seem to be made arbitrarily, often in ways that help the agency reach a preferred outcome. The lack of any real process, in fact, has led to fears that the agency is actually perpetuating another kind of screen: a smoke screen.

Consider how the agency accidentally exposed itself with its thumb pressed down hard on the scale in its review of the AT&T/T-Mobile transaction.

Once it became clear to the parties that the transfers were going to be rejected, the applications were withdrawn. Though un-reviewed and unapproved by the full Commission, FCC Chairman Julius Genachowski was confident the staff's partial analysis made clear why the deal, still pending at the DOJ, was an anticompetitive non-starter. So, contrary to agency protocol and over the objection of the parties, the Chairman released the nearly complete staff report.[7]

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[6] The DOJ now downplays the value of a structural presumption, especially in the broadband ecosystem. According to the DOJ: "We do not find it especially helpful to define some abstract notion of whether or not broadband markets are 'competitive.' Such a dichotomy makes little sense in the presence of large economies of scale, which preclude having many small suppliers and thus often lead to oligopolistic market structures. The operative question in competition policy is whether there are policy levers that can be used to produce superior outcomes, not whether the market resembles the textbook model of perfect competition." Ex Parte Submission of the United States Department of Justice, *In the Matter of Economic Issues in Broadband Competition*, GN Docket 09-51 (Jan, 4, 2010).

[7] John Eggerton, *FCC Chair Defends Release of Draft AT&T-T-Mobile Report*, BROADCASTING & CABLE (Nov. 30, 2011).

The agency was caught flat-footed, however, when the spectrum screen findings in the staff report didn't actually tote up. That's because at the beginning of the review, the staff made a significant adjustment to the screen. Tucked away in a footnote, the report noted that the total amount of SMR spectrum used in the screen was being reduced from 26.5 MHz to 14 MHz.

The adjusted numbers had a significant impact on evaluation of the deal. With the adjustment, the transaction failed the screen in 274 of roughly 700 markets. Without the adjustment, the transaction failed in only 192 markets, a difference of roughly a third. Given so many failures of the screen, the staff seemed inclined to ignore its own process and simply reject the transaction outright rather than conduct the required market-by-market reviews in the affected locations.

The footnote explained that the change to the spectrum screen had been approved in a related proceeding involving spectrum licenses that AT&T was acquiring from Qualcomm. But when the final order in the Qualcomm transaction was published, it made no mention of any adjustment. Apparently the draft report on the AT&T/T-Mobile deal was referring to a proposed adjustment that, in the end, wasn't made. But the staff's eagerness to make use of a pending change, and to assume it would actually make it into the Qualcomm order, betrayed a desire, certainly communicated from the Chairman, to make the AT&T/T-Mobile transaction look as bad as possible.

IV. TAKING A BREATH, AND A GIANT STEP BACK

The Qualcomm scandal badly damaged the supposed objectivity of the spectrum screen, leading in part to the recently released NPRM. The FCC is now seeking comment "on retaining or modifying the current case-by-case analysis," as well as whether it should implement the "bright-line limits advocated by some providers and public interest groups." To this end, it is asking interested parties whether the agency should formalize the screen into a rulemaking, and, if so, what it should actually look like.

By "bright-line limits," the NPRM means returning to the days prior to 2003 of a fixed cap on the amount of spectrum a carrier can control in each local market. Reinstating a cap would represent a big step backward, one that elevates form over substance and ossifies the unsupportable structural presumption. As Commissioner McDowell points out in his concurrence to the NPRM, the cap was eliminated "after determining that spectrum aggregation limits were no longer necessary due to meaningful competition among providers of telecommunications services."

As far as the screen is concerned, there's no evidence that a carrier that controls more than a third of the usable spectrum in a market has the ability to inflict harm on consumers. And there's certainly not the kind of data that would justify a fixed cap in a market as dynamic as today's mobile ecosystem.

The need to make frequent and unscientific adjustments to the screen on a regular basis, instead, makes clear that it was an unmanageable proxy in the first place; more obviously so the more the staff tries heroically to keep it relevant. And while a fixed cap would provide administrative relief, it would severely hamstring the continued evolution of this dynamic market.

So instead, we'd like the FCC to consider a different course: Do away with the screen, caps, and reliance on the HHI calculation altogether, and place the burden on the agency to demonstrate likely harm to consumers before imposing limits on license transfers under the "public interest" balancing test. The reasons are simple. There is no basis for the presumptions that animate the screens; there is no intelligible or articulated basis for the precise triggers they employ; and their unpredictable application and politicized interpretation lead to significant and costly regulatory uncertainty.

Meanwhile, there is plenty of direct evidence of competitive conditions in these markets—including prices, broadband speeds, number of users, churn, advertising expenditure, innovation, infrastructure investment, and more—more than enough for the agency to perform a far more reliable and realistic, data-driven analysis of the costs and benefits to the public interest of proposed transfers in the future.

The FCC already collects most of the data needed for that kind of evaluation as part of its regular reports on mobile competition, broadband deployment, and video competition.[8] Indeed, that data is the basis on which the agency, by its own rules, is already supposed to weigh the costs and benefits of requested license transfers. But meaningful, data-driven analysis has given way to increased deference to a mechanical formula without meaning or objectivity, masking the absence of real analysis or cynically justifying a conclusion already reached.

V. CONCLUSION

The misguided reliance on the spectrum screen, as the FCC itself now recognizes, has potentially and unnecessarily made more hostile an already difficult business environment for communications companies. Together with other defects in the agency's unstructured transaction review—including manipulation of the review calendar, extending the scope of reviews to include ancillary agreements, and unprincipled use of conditions to achieve unrelated regulatory and political goals—it has damaged the FCC's reputation as an independent agency. In many cases, the agency has almost certainly exceeded its legal powers, and in ways that are practically or procedurally non-reviewable.

The agency's expanding presence, ironically, is an indirect result of its own errors and inefficiency in providing spectrum sufficient to meet voracious demand. Thanks to the FCC's mismanagement of the airwaves, we can expect more, not fewer, mergers among carriers—necessitating more, not fewer, agency reviews. Even as T-Mobile USA announced its acquisition of MetroPCS, for example, news reports surfaced that Sprint was considering its own, perhaps hostile, takeover of the smaller carrier, reports that were soon followed by Softbank's offer to acquire70% of Sprint. The stage is set for more charged and politicized battles over spectrum—the outcome of which may be determined by the FCC's ungrounded and unpredictable review process.

Rather than expanding the FCC's unstructured approach to transaction reviews, we should be reining it in. In particular, we should wherever possible leave to the Department of Justice's experts the task of evaluating the competitive consequences of proposed transactions.

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[8] *See*, e.g., Larry Downes & Geoffrey A. Manne, *FCC Mobile Competition Report is One Green Light for AT&T/T-Mobile Deal*, BNA DAILY REPORT FOR EXECUTIVES, 132 DER B-1 (July 11, 2011).

That, at least, would be the better way to serve the "public interest."