

Take my spectrum, please!

The FCC recently announced that it was planning on auctioning new spectrum (the AWS 3 block) for broadband service, but with a catch: you have to give it away. At least some of it.

As part of their ongoing efforts to “bridge the digital divide”, the commission devised the scheme of allowing carriers access to 25 MHz of new nationwide spectrum, provided they provide near universal coverage within ten years, have open network access and provide two way “broadband” service of 768 kbps *for free*. Oh, and by the way they also have to keep it clean, too (i.e. free of “obscene” material).

Which raises the interesting point: Is anybody going to want this stuff?

To help answer this, first let’s consider what this spectrum would be worth without these restrictions. For that, we can look at the recent AWS spectrum results, which imply a valuation of roughly \$3 billion after allowing for a 25% national license discount. However, the proposed service rules also require operators to donate up to 25% of network capacity for the free service. While at first blush this would appear to devalue the spectrum another 25%, the actual effect is probably much worse – because this effectively forces the operators to compete with themselves!! Over time, this may become somewhat mitigated as applications increasingly require additional speed, but with only ~19MHz available to generate revenue, this network will also suffer from a limited capacity to serve high capacity users – which are the only ones it can charge for service. (The rules are unclear whether techniques can be used to maintain QoS [which allows VoIP and streaming video applications] for paying subscribers while denying it to “freeloaders” – a technique that could help mitigate this issue).

So let’s assume a potential bidder looks at all the hair on this spectrum and decides it’s worth \$2 billion with these limitations. Are they going to bid this much? Not so fast, I would counter. We haven’t talked about the deployment requirements yet. While covering the most urban 50% of the U.S. population is probably reasonably cost effective, doing it in four years is a pretty tall order. Consider the case of Clearwire, which is budgeting about \$20 in capex per POP. If we extrapolate this to our prospective new entrant, we’re talking about over \$6 billion in capex, which starts to

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make the potential savings from a lower auction clearing price start to look somewhat piddling.

It gets even better than this, however. Clearwire has over six times as much spectrum (120 MHz)! With that much extra spectrum, they should be in a position to offer much faster service than the spectrum winner, leaving the “winner” in the unenviable position of having to go up against Clearwire on the high end, and against themselves (or, more correctly, their free offering) on the low end. And, there’s also the 4G offerings from Verizon and AT&T, lest we forget them.

And, besides, while we’re tossing around terms like “free broadband” let’s not forget that there is 125 MHz of *free* spectrum available in the unlicensed band for operators to offer service that comes without the service giveaway requirements we’ve discussed.

So what happens if the FCC decides to hold this auction? From my perspective, bids from prospective new entrants are likely to be pretty small – largely reflecting what I expect will be scant willingness on the part of the capital markets to fund this adventure. The funding prospects for any new entrant are likely to be further dimmed by the high profile failures of Earthlink’s and Metrofi’s hybrid free/paid service offerings.

In the hands of a larger operator (think VZ or T), the spectrum is likely to be worth a lot more (since it can be incorporated into large existing spectrum portfolios), but their willingness to cannibalize themselves may keep them away from the auction as well.

So what seems most likely to this writer is that we’ll see relatively low bids emerge, and a winner that uses the auction to effectively purchase a call option on spectrum values. If spectrum rises quickly over the next several years, they’ll deploy substantial service the FCC is loath to turn off, even if the operator is behind on rollout. If spectrum values languish, the auction winner won’t really have that much skin in the game, and will let the option expire.

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