EX PARTE OR LATE FILED

DOCKET FILE COPY ORIGINAL

PIPER & MARBURY
1200 NINETEENTH STREET, N.W.
WASHINGTON, D.C. 20036-2430
202-861-3900
FAX: 202-223-2085

BALTIMORE
NEW YORK
PHILADELPHIA
LONDON
EASTON, MD

WRITER'S DIRECT NUMBER
(202) 861-6471

July 5, 1994

RECEIVED
JUL 5 1994
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

HAND DELIVER

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, Room 222
Washington, D.C. 20554

Re: ET Docket No. 93-266
Ex Parte Presentation

Dear Mr. Caton:

This letter is to notify the Commission that a courtesy copy of the attached ex parte letter was sent today to Chairman Reed Hundt, Commissioner James Quello, Commissioner Andrew Barrett, Commissioner Rachelle Chong, Commissioner Susan Ness, Mr. Don Gipps, Deputy Chief of the Commission's Office of Plans and Policy, and Mr. William Kennard, General Counsel of the Commission. In accordance with Section 1.1206(a)(1) of the Commission's rules, attached are two copies of the letter.

Should you have any questions concerning this matter, please do not hesitate to contact the undersigned directly.

Sincerely,

Mark J. O'Connor
Counsel for Omnipoint Corporation

Enclosures

No. of Copies rec'd 0+1
List ABCDE

EX PARTE OR LATE FILED

JULY 5, 1994

RECEIVED

JUL 5 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

HAND DELIVER
WILLIAM F. CATON
ACTING SECRETARY
FEDERAL COMMUNICATIONS COMMISSION
1919 M STREET, N.W., ROOM 202
WASHINGTON, D.C. 20554

RE: EX PARTE PRESENTATION
ET DOCKET 93-266

DEAR MR. CATON

ROYALTIES ARE THE FAIREST AND MOST LOGICAL WAY TO DEAL WITH PAYMENTS BY PIONEERS

In light of recent concerns, the purpose of this letter is to suggest ways that the Commission can continue the pioneers preference program in a manner which obtains fees for the government while offering a true incentive to entrepreneurs to invest in innovation. The letter deals with both the prospective as well as retroactive questions raised by the NPRM last October in Docket 93-266, and as such is a non-restricted proceeding.

Outlined below is a specific royalty proposal set against a minimum. It is also critical that a small business pioneer should have the option to have the minimum established relative to the price actually paid by other small businesses.

The pioneers preference program must also be analyzed in light of the specific auction rules recently adopted. For example, given the defacto 60% discounts proposed for designated entities, charging a pioneer 90% of such a *bid* price would result in an innovator paying *50% more* than the cost to others. Indeed, it could well result in paying 50% more than the true value put on the license by others. Worse, it could also result in a pioneer paying *multiples* of what others actually pay if firms default on payments in later years.

The FCC has shown tremendous creativity in solving the problems facing PCS and the implementation of auctions. The proposed rules in those dockets demonstrate an extraordinary willingness to break out of traditional assumptions about what can and cannot be done. The detailed rules covering designated entities clearly reflect this Commission's ability to understand the details of the problems facing entrepreneurs in a world of auctions. Similar detailed issues concern the pioneers preference program. Similar creative thinking is necessary to solve these issues.

We believe the proposal outlined below offers a true solution to these and the other concerns with "discount" only methods for charging pioneers discussed before.

SIMPLE "DISCOUNT" MECHANISMS DO NOT WORK IN THE CONTEXT OF A PIONEERS PROGRAM

In the letter we sent to Commissioner Ness on June 22, 1994 and copied to the other Commissioners we outlined the problems with using "discounts" for a program intended to incentivize entrepreneurs to invest in highly risky innovations ***before*** a spectrum allocation is made, ***before*** a license is awarded, and ***before*** the results of an auction are known. As noted, there are many problems with "discounts" in a pioneers preference program. A bidding discount defeats the purpose of the program because it in no way assures a license to the pioneer to try the innovation. But the alternative "discount" idea, i.e. assessing a charge on the pioneer's license as a discount to the winning bid on another license is also flawed as an incentive for innovation. The underlying problem with this sort of a "discount" method is that it bases the payments of the pioneer not on what the pioneers business could justify, but instead on what some other business is willing to ***bid*** for a license ***regardless of how speculative the bid price turns out to be*** and regardless of how they will use the license or what unique assets they can exploit.

How does a small, entrepreneurial company raise money to ***develop*** an innovation if it has to tell potential investors that it has no idea how much it will have to pay for a license to use the innovation or what the value of the "discount" is? The value of the discount on another license will be set by other parties and may not be exploitable by the pioneer. **If the only parties to whom a license is worth, for example, 80-90% of the winning bid for another license are the losing bidders, then the pioneer may end up with nothing; neither the license nor the value of the discount. A discount of unknown dollar value is largely meaningless if the pioneer is simultaneously *unable to justify the price* yet is restricted from selling the license for three years.**

No other industry has this problem of the entrepreneur having no ability to estimate the cost of the shelf space for bringing its product to market. In any other high tech industry start up, the business plan consists of expense estimates which are largely under the control of the entrepreneur. No other business has the risk of funding the development of innovation while having the cost of the shelf space set in an auction by others, which it may never be able to outbid, nor justify the speculative bid amount.

INCENTING RISK CAPITAL FOR INNOVATION IS A SEPARATE PUBLIC POLICY GOAL AND CAN JUSTIFY USING PAYMENT TECHNIQUES TAILORED TO ACHIEVE THAT GOAL

Royalties on gross revenues (or possibly per subscriber user fees based on per subscriber revenues), can be implemented in ways which overcome all of the problems with "discounts". Royalties tie the payments to the success of the pioneers business and not to the speculative bids of other parties. A royalty of 3%-5% on gross revenue over 10 years is equivalent to 50% or more of the profits of any normal competitive business. Royalty payments can also have a minimum cumulative total amount due over 10 years. In the event there is a royalty shortfall relative to this minimum, the remaining amount can be made up for in the tenth year. The minimum can be set as 80% of the national per "pop" average actually paid by the bidders. This evens out the problem of trying to find

"comparables" that don't exist (especially ***prior*** to a spectrum allocation or auction, which is when the pioneers must apply), while still providing an incentive to the entrepreneur.

Royalties Do Not Have Implementation Problems When Applied to Pioneers Licenses

* The Pioneers license is dispositive, thus there is no problem of comparing royalty bids as there would be in an auction

* The number of Pioneers will always be very small, thus auditing is easily manageable

* The royalty can be set on revenue in a way which prevents gaming, or can be set as a per subscriber user fee based on per subscriber revenue

* A minimum cumulative dollar amount for the ten year period can be set relative to a percentage of the national average price paid per "pop"

* A royalty method could be optional for the pioneer, with graduated installment payments resembling expected royalties (based on the minimum defined above) in the form of a step function as an alternative. Thus pioneers that had reasons why a royalty couldn't work could always elect the alternative graduated installment method or even prepay the graduated amounts at any time.

A royalty of 3%-5% of revenue is equivalent to 50% or more of expected profits in any competitive industry. For example, with the advent of six new PCS licenses in addition to two ESMR licenses and the two incumbent cellular operators, profitability in a wireless industry with 7-10 competitors will clearly be driven to normal competitive margins. By having a pioneer pay the equivalent of half its hoped for profits to the government, the pioneer is compensating the public in effect as a partner in return for the government providing the pioneer with the right to the shelf space to bring its innovations to the consumer. The remaining profits are necessary to pay a return on the enormous capital required to build and operate wireless services.

SMALL BUSINESS PIONEER'S PAYMENT MECHANISMS SHOULD BE EVALUATED RELATIVE TO WHAT OTHER SMALL BUSINESSES ACTUALLY PAY

It is critical to the small business pioneer to have the option of any minimum cumulative total amount established by what is actually paid by other small businesses.

As Sarah Sideman of the Commission's staff stated in the June 29, 1994 FCC Open Meeting:

> **"We do not believe that bidding credits would be especially meaningful [to small businesses] in an uninsulated block, especially in the 30MHz MTAs. Indeed, a number of commenters have stated that extraordinarily large credits even on the order of 50% or more would be ineffective in this particular service."**

The New York Times in their June 30, 1994 article stated that, "FCC officials estimated that the combined package of preferences added up to an effective discount of more than 60%."

The creation of an Entrepreneurs Band in PCS is the first step in recognizing that small businesses cannot possibly match bids with large businesses. This will be equally true in other dockets in the future. For the same reasons stated above, the small business pioneer should be compared to the per "pop" amounts paid by other small businesses, not to the bids of the giant companies. This is true even if the small business pioneer's license is not within an Entrepreneurs Band. The two purposes should not be put into conflict with one another.

Further, because there is no guarantee that the designated entity rules might not be gamed by some large entities, especially through non-ownership based contractual relationships, 80% of national average should be used to set the pioneer's minimum.

Perhaps most importantly, because some parties may overbid and then default, it is important to set the floor relative to what is *actually paid* by others over the ten year period. It is critical that the minimum be set by what is actually paid, or else the pioneers would be exposed to artificially inflated bids which turned out to be non-existent payments.

Note that this same problem applies to large business pioneers in a different form -- namely, that a bidder may later discover that it overpaid and thus never initiates service, or goes bankrupt. Despite the initial euphoria and free licenses, 5 of the 7 PCS operators in the UK went bankrupt. By having all pioneers pay with a royalty mechanism over 10 years, the total amounts actually paid by other surviving competitors will be known.

With respect to discussions of retroactive application of payment mechanisms to existing pioneers, the problems with simple discount mechanisms are brought into even greater relief. A 10%-20% discount relative to what others bid for another license not only has all the problems noted above and in our prior submissions, but it results in acting as a fine on the pioneers. There is absolutely no way of correlating the value of a *prospective* 10%-20% "discount" on the amount bid on another license with what a pioneer has ***already spent*** under a program when there was no intention of charging pioneers. The auctions haven't even been held yet. Any estimate of the theoretical value of a "discount" is purely speculative, especially considering the licenses cannot be transfered for three years.

Without commenting on the merits of Omnipoint's final award of a pioneer's preference, we can state that nearly $30 million has now been invested in the innovations which resulted in the award. Nearly $45 million is targeted to be spent by the estimated time of the auctions. How can any party know that a 10%-20% "discount" relative to another's bid will provide breakeven let alone a return on this investment?

All pioneers must make their investments when it is riskiest. The expected rate of return on venture capital is enormous relative to the discount rates used to evaluate operating businesses. Dr. Robert Pepper stated during the Question and Answer period after the June 29, 1994 FCC Open Meeting that **equity capital for small businesses bidding in an auction (where they don't have to spend the money unless they win) would normally command *20%-40% expected rates of return*. But existing pioneers already had to offer these rates of return because the investments had to be made made *before* knowing the outcome of any decision to award a license, any auction, indeed even *before* any spectrum allocation was made.**

We have heard no one propose that the pioneers be reimbursed if the "discount" falls short. How can anyone know that a 10%-20% "discount" to the *bid* on another license is the right balance?

Hopefully, the rationale for a royalty scheme as outlined above is clear. It ties the payments to the actual business of the pioneer. We urge the Commission to adopt this to preserve the original intent of the pioneers program.

Sincerely,

Douglas G. Smith

Douglas G. Smith
President, Omnipoint Corporation

cc: Honorable Reed Hundt
Honorable James Quello
Honorable Andrew Barrett
Honorable Rachelle Chong
Honorable Susan Ness
Mr. Don Gips
Mr. William Kennard