

Were Auctions a Good Idea?*

I briefly review the effects of the 3G auctions on the telecom industry. (The general question of auctions vs. beauty contests is the topic of section 6.2.)

The wrong culprit for telecom trouble

European telecommunications companies are now worth about \$700bn (£443bn) less than when the UK began the world's first "third generation" (3G) auction in March 2000. These auctions are now routi-

nely blamed for the travails of the telecoms industry and even – by extension – the world economy.

President Jacques Chirac recently protested to the European Union about the 3G auctions, the head of the United Nations telecommunica-



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tions agency claimed that they “helped drive the telecoms industry into its crisis”, and a Finnish minister even called them “the biggest industrial political failure since the second world war”.

The critics assume three things: that the telecoms companies paid more for the licenses than they thought the licenses were worth; that this expenditure has reduced investment in 3G; and that it destroyed the telecoms companies’ market value.

Sustaining these views requires little more than a fallible memory. There has now been so much bad news about the technology and about the lack of consumer interest in 3G services that it is hard to imagine any company voluntarily paid billions of dollars for a 3G license. But volunteer they all did. Not only that but they celebrated their victories. The stock market was happy, and shortly after the UK auction Hutchison even resold part of its license at a profit.

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In retrospect, of course, the licenses look expensive. But in retrospect, shares or houses sometimes look expensive. Like any other market, an auction simply matches willing buyers and willing sellers—it cannot protect them against their own mistakes.

A more subtle complaint is that incumbent operators had to win 3G licenses to protect their existing 2G businesses, so were “forced” to overbid.

But all the main 3G auctions were ascending bid auctions, in which the price stops rising when the losers give up; so the price was set by losers who were new entrants with no existing 2G businesses to protect. Were these entrants – including Hutchison, France Telecom, Telefonica and Sonera – all naively bidding more than the helpless incumbents thought the licenses were worth? It seems unlikely: incumbents, with their established brands and infrastructure, could make much better use of 3G licenses. Entrants would have had to bid a long way north of their valuations before any incumbent could be hurt by matching them. Even if the incumbents did think the entrants were overbidding, they always had the option of dropping out, and buying the entrants later when valuations had settled down.

Furthermore, in the UK, two incumbents, but no entrants, competed to offer £2bn more for a larger license – hardly a sign that the entrants had backed them into a corner. And no one has ever suggested that any incumbent needed a larger rather than a smaller license to protect its 2G business!

Some opponents of the auctions concede the bids were voluntary but argue they were damaging nevertheless: because the licenses were so expensive, investment in 3G is lower and slower than it should be. This is odd: the auction fees are history; they have (almost) all been paid in full, cannot be recouped by cutting investment, and make no difference to its profitability.

It is conceivable that capital markets are so inefficient that obviously highly profitable investment is being forgone because no one wants to fund it. It is more likely that the same bad news that now makes the licenses look overvalued is also making further investment look unwise.

It is even possible that investment may now be too rapid. Two license

winners told the UK government that high license costs would spur investment – perhaps because companies would be keen to prove that they could recoup their license costs. And if high license fees persuade governments to regulate companies more lightly and permit them to raise prices, investment will become attractive for all the wrong reasons. Probably none of these effects is critical. Investment in 3G, as in anything else, is primarily motivated by attractive returns in the future – not by money spent in the past.

Then there is the final claim: that 3G license fees wiped hundreds of billions off the value of European telecoms companies. Before accepting that view too quickly, look across the Atlantic. The United States held no 3G auctions, yet telecoms companies lost just as much: in fact, they lost more. Even setting aside the collapses of Global Crossing and WorldCom, wireless companies such as Nextel and Sprint PCS each lost more than \$50bn in valuation. In the United Kingdom, the most distressed telecoms companies are not the license winners but firms such as NTL – the disappointed runner-up – which has recently been restructured. All in all, it seems a stretch to blame \$700bn of shareholder misery on \$100bn of 3G license fees.

None of the complaints really hold water. Why do we keep hearing them? It is obviously convenient for embarrassed company executives to be able to blame the government. They may even persuade the governments to return the \$100 billion to them – if not in whole and in cash, then at

least in part and by the back door through more lenient regulation. But for governments to do this would be a huge mistake.

There is nothing special about an auction: it is just another market. Buying houses or shares at the peak of a housing or stock-market boom does not entitle anyone to compensation. Why should we make an exception for the phone companies?

If governments wish to subsidize the telecoms or any other industry, that has nothing to do with auctions. Furthermore, governments' past use of public funds to subsidize "key" industries has rarely inspired confidence, and if they do insist on paying subsidies, why pick the telecoms sector (and the telecoms operators within this sector) in particular? Any case for subsidies is completely separate from who paid what for 3G licenses.

The main effect of the license fees was simply to transfer \$100bn from shareholders around the world to certain European governments. This was both equitable, since the companies were buying a public asset that they valued this highly at the time, and efficient, since such a lump sum transfer is much more efficient than most forms of taxation. Efficient, equitable and voluntary government funding is not easy to find: perhaps we should be more enthusiastic about it.

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