

NO. 42304-9-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

FILED
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SPRINT SPECTRUM, L.P.,

Respondent,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellant.

BRIEF OF RESPONDENT

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2/17/12 CASR

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I. INTRODUCTION

Sprint Spectrum L.P. (“Sprint”) sells cell phones and cell phone service. When the customer buys a one or two-year service contract, he or she receives a discount on the telephone. In some cases, the discount reduces the price of the telephone to zero, so the price of the phone is fully discounted. Both the service and the telephone are subject to sales tax. Sprint collects and remits the sales tax on the combined purchase price.

The Department of Revenue (“Department”) assessed use tax on Sprint, claiming that Sprint was using the fully discounted phones as promotional items—free gifts to induce the purchase of service. Sprint appealed to the Board of Tax Appeals (“BTA” or “Board”), arguing that it recovers the discount on the telephone as part of the service package and collects sales tax on the full amount of the combined purchase. The Board agreed with Sprint, framing the question and answer as follows:

3. Under the statutory definitions of “use” and “consumer,” did the Department properly assess use tax on Sprint for the cell phones that Sprint sold to its customers along with one or two-year wireless services contracts that were priced to recover the cost of the phone in addition to the price for the wireless service, and upon which sales tax was collected?

Answer: No, use tax is not payable for the cost of the phone because the phones were resold by Sprint in installments with a zero down payment, upon which sales tax was collected and paid to the Department.

AR 75. The BTA correctly determined that the economic reality of the transactions in issue involved the sale of the cell phones, not the distribution of free phones as a promotion. Substantial evidence supported the BTA's decision. The facts found by the BTA are determinative.¹ The Department's "legal" arguments are dependent on the Department's view of the facts—a view rejected by the BTA.

II. STATEMENT OF FACTS

The Board's factual findings are set forth at pages 4-12 and 24 of its Final Decision, AR 77-85, 97 (¶¶ 4-8). The principal facts include the following:

During the audit period, Sprint transferred some cell phones to customers at discounts equal to the regular price, subject to customers signing service agreements legally binding them to purchase wireless service from Sprint for a term, typically one or two years, either as a new or returning customer.

AR 79, quoting AR 842 ¶ 36.

The purchase of the cell phone and wireless service is one purchase. The customer agrees to service plan, phone activation fee and early termination fee for both their service and their phone.

AR 79, citing AR 1081-84.

¹ The BTA also addressed two additional issues, concerning whether Sprint's service to certain customers qualified as a "residential class of telephone service" exempt from sales tax pursuant to RCW 82.08.0289. The parties have since resolved those issues, and they are not involved in this appeal.

The customer does not entirely pay for the phone and service on the day they obtain the phone and purchase a service plan in the store; there may be an early termination fee due later, and the service fee is collected monthly.

AR 80, citing AR 1084.

Instead of recovering part or all of the wholesale cost of the cell phone from revenue collected at the store, when a phone is sold to a customer at less than its cost, the cost is recovered by the monthly fee, the activation fee, and the early termination fee.

AR 81, citing AR 1091-92.

The price charged for the cell phone takes into consideration the price charged “at the point of sale for the handset” and the “additional revenues” from the service fee, activation fee, and early termination fee.

AR 81, citing AR 1094.

Sprint recoups the subsidy of the phone “through the pricing of its service sold at the same time and in connection with the sale of that handset, as well as the early termination fee and the other fees associated with that.”

AR 81, citing AR 1095.

Sprint offers differing levels of phone discounts in accordance with the length of the service contract (\$75.00 for the one-year commitment and \$150.00 for the two-year commitment) because “Sprint gets a longer life to recoup the cost of that handset subsidy, rather than a shorter [life], and so you’re willing to give a bigger handset subsidy.”

AR 81, citing AR 1098-99.

Sprint “sells a package of phones and services.” The purchase of the device and the plan is related: the fee paid at the store for the device depends on the plan the customer decides to purchase, as well as the asking price of the

particular phone that the customer choose[s]. When a phone is partially or fully discounted, Sprint, in effect, subsidizes the wholesale cost. Sprint must “recoup” as much of that loss as possible through fees agreed to by the customer at the time of the sale, i.e., (1) the activation fee, (2) the plan fee (either the 12-month or 24-month plan), and (3) the early termination fee, which replaces the lost revenue from the plan fee that would have been applied monthly to the cost of the phone but for the early termination of the extended plan.

AR 83; *see* Tr. 12-13, 15, 21, 25-30, 39, 42-45, 53-55, 59-60, 65-68, 73-74.

For customers, the phones are the most important thing, and phones are “very, very important to both Sprint and the customer.” They are typically looking for a phone with certain features, and the phone is either the driver or one of the major drivers for its customers. Sprint may not realize a “net gain” from the sale of cell phones, but it is “integral to the business.” Cell phones are “not used to promote the business.”

AR 84; *see* Tr. 54-59, 67-68.

The prevailing U.S. industry practice is to sell cell phones at a discount (for less than their fair market value or cost of purchase from the cell phone manufacturer) and recoup some or all of the discount back by the monthly service contract (which typically runs one or two years), the activation fee, and, if applicable, the required early termination penalty fee. Sprint refers to the discounted pricing of its cell phones as a “subsidy,” which is reduced by the various fees collected over time (e.g., monthly payments under the service contracts) to recoup the cost of the phone.

AR 84; *see* Tr. 12-13, 15, 21, 25-30, 39, 42-45, 53-55, 59-60, 65-68, 73-74.

Mr. Whalen explains that this is the marketing approach for selling phones in the United States. In Europe and elsewhere, the customer is willing to pay the full retail price for their phone up front. Mr. Whalen explains the different “credit mentality” of the U.S. customer: the U.S. customer is willing to pay for a phone over the course of the contract, which Mr. Whalen terms a “forced financing agreement.”

AR 84; *see* Tr. 39, 54.

Thus, the customer is purchasing the phone over time; the same way a customer might purchase a piece of furniture with zero down and monthly payments for a set period. Sprint states that its customers understand that the cell phone is really not “free” because they cannot receive a fully discounted cell phone without signing a standard one-year or two-year service contract that obligates them to significant monthly payments and an early termination penalty fee.

AR 84-85; *see* Tr. 53.

The cell phones against which the use tax has been assessed are not “free” because the customer is paying or agreeing to pay certain fees. These phones should be more correctly called “zero down payment phones” or “fully discounted phones” than “free phones” because their cost is collected back or recouped via the various fees, including monthly service charges.

AR 85; *see* Tr. 53, 60, 67-68.

Anthony Whalen, Sprint Senior State Tax Counsel (witness on the fully discounted cell phone tax issue) was credible and his testimony uncontested.

AR 97.

Sprint receives money directly from the retail consumer for the “free phones” via its monthly service contract payments and pays retail sales tax on that money.

AR 97.

Sprint is not a consumer of the “free phones,” it is a retailer.

AR 97.

Sprint sells cell phones and service contracts. Sprint’s cell phones and service contracts are interrelated. One cannot be purchased or used without the other. Sprint is a provider of cell phone service; it is not a vendor receiving a commission for its sale of cell phones and service contracts from a cell phone provider.

AR 97.

III. ARGUMENT

The issue in this appeal is whether Sprint “*used*” the fully discounted telephones “*as a consumer.*” RCW 82.12.020(1). There are two ways in which Sprint could have used the telephones as a consumer: *first*, it could have used them other than for resale (RCW 82.04.190(1)(a)); *second*, it could have used them as promotional items (former RCW 82.12.020(5)).

If Sprint sold the fully discounted telephones, clearly the first section would not apply. This is an issue of fact, to which the substantial evidence standard applies.

As to the second section, the Department proposes a broad interpretation of what constitutes promotion that is at odds with its own rule. Once the statute and rule are read properly, the central issue is,

again, whether as a factual matter the fully discounted phones were sold to Sprint customers.

A. The Relevant Statutes

To place in context the BTA's findings that Sprint acquired the phones for resale and not for promotion, we set forth the relevant statutory framework.

Former RCW 82.12.020(1) provides:

(1) there is hereby levied and there shall be collected from every person in this state a tax or excise for the privilege of using within this state *as a consumer*: (a) any article of tangible personal property ***purchased at retail***, or acquired by lease, gift, repossession, or bailment, or extracted or produced or manufactured by the person so using the same, or otherwise furnished to a person engaged in any business taxable under RCW 82.04.280(2) or (7)

(emphasis added).² Whether the use tax applies in this case turns, therefore, on whether Sprint used the phones that it sold in its business “as a consumer.”³

² Prior to June 1, 2002, the terms “use,” “used,” “using,” and “put to use” were defined as follows for purposes of the use tax:

(2) “Use,” “used,” “using,” or “put to use” shall have their ordinary meaning, and shall mean the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (*as a consumer*), and include installation, storage, withdrawal from storage, or any other act preparatory to subsequent actual use or consumption within this state.

RCW 82.12.010 (2001), (emphasis added). The use tax statute did not specifically include “distribution” as a qualifying act of dominion and

Three statutory provisions define the term “consumer,” as applied in this context. The Department relies on two of these: RCW 82.04.190(1)(a) and former RCW 82.12.010(5).⁴

RCW 82.04.190(1)(a) provides, in pertinent part:

any person who purchases . . . Or uses any article of tangible personal property, irrespective of the nature of the person’s business . . . ***Other than for the purpose of (a) resale as tangible personal property in the regular course of business***

(emphasis added). Former RCW 82.12.010(5), in turn, throughout most of the audit period, provided in pertinent part:

(5) . . . “consumer,” in addition to the meaning ascribed to it in chapters 82.04 and 82.08 RCW insofar as applicable, shall also

control preparatory to actual use until June 1, 2002, when that term was added to the statute:

(3) “Use,” “used,” “using,” or “put to use” shall have their ordinary meaning, and shall mean: (a) With respect to tangible personal property, the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (***as a consumer***), and include installation, storage, withdrawal from storage, ***distribution***, or any other act preparatory to subsequent actual use or consumption within this state.

RCW 82.12.010, Laws 2002 Ch. 367 § 3 (emphasis added).

³ The use tax incorporates the meaning ascribed to words and phrases in chapters RCW 82.04 (business & occupation tax) and RCW 82.08 (retail sales tax), insofar as applicable. RCW 82.04.050(1). RCW 82.12.010(6); *Activate, Inc. v. Dept. of Revenue*, 150 Wn. App. 807, 814, 209 P.3d 524 (2009); *Seattle Filmworks, Inc. v. Dept. of Revenue*, 106 Wn. App. 448, 454 n.3, 24 P.3d 460 (2001).

⁴ The Department does not rely on RCW 82.04.190(2)(a).

mean any person who distributes or displays, or causes to be distributed or displayed, any article of tangible personal property, except newspapers, ***the primary purpose of which is to promote the sale of products or services.***"

(emphasis added).⁵

The phrases "sale at retail" and "retail sale" exclude "[p]urchases for the purpose of resale in the regular course of business without intervening use by [the purchaser]":

(1) ***"sale at retail" or "retail sale" means every sale of tangible personal property*** (including articles produced, fabricated, or imprinted) to all persons irrespective of the nature of their business and including, among others, without limiting the scope hereof, persons who install, repair, clean, alter, improve, construct, or decorate real or personal property of or for consumers *other than a sale to a person* who presents a resale certificate under RCW 82.04.470 and *who: (a) purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person*

RCW 82.04.050(1)(a) (emphasis added).

Use tax is a companion tax to the retail sales tax. As the Department concedes, it is imposed when a seller has not collected the

⁵ On June 1, 2002 this part of the definition of "consumer" was amended as follows:

(6) . . . "Consumer," in addition to the meaning ascribed to it in chapters 82.04 and 82.08 RCW insofar as applicable, shall also mean any person who distributes or displays, or causes to be distributed or displayed, any article of tangible personal property, except newspapers, the primary purpose of which is to promote the sale of products or services. ***With respect to property distributed to persons within this state by a consumer as defined in this subsection (6), the use of the property shall be deemed to be by such consumer.*** RCW 82.12.010(6), Laws, 2002 c. 367 § 3 (emphasis added).

retail sales tax. The intent of use tax is to tax the privilege of using all tangible property within the state on which sales tax has not been paid. Department Br. 36-37 (citations and internal quotation omitted). “An item of tangible personal property may not, however, be subject both to use tax and sales tax.” *Discount Tire Co. of Washington, Inc. v. State*, 121 Wn. App. 513, 521, 85 P.3d 400 (2004).

Thus, the Department must show that the fully discounted phones were not sold but were distributed as promotional items.

B. The BTA Found that the Fully Discounted Telephones Were Sold as Part of a Package. That Finding Is Supported by Substantial Evidence.

The Department concedes that Sprint generally purchases cell phones for the purpose of resale in the regular course of its business, AR 840-41 (¶¶ 30, 34, 35), and the BTA found that “Sprint sells cell phones” Yet the Department attacks the BTA’s findings that, in economic substance, fully discounted phones are sold as part of a package with cell phone service in a single transaction, rather than as two separate transactions. The BTA correctly looked at the economic substance of the transaction; its conclusions were supported by substantial evidence.

1. The Objective Economic Reality of the Transaction, Not its Form, Determines its Tax Status.

It is well settled that in tax matters the “doctrine of substance over form” governs, with the court “look[ing] to the objective economic realities of a transaction rather than to the particular form the parties employed.” *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); accord *First Am. Title Ins. Co. v. Dep’t of Revenue*, 144 Wn.2d 300, 303, 27 P.3d 604 (2001) (“Substance rather than form should be used to assess tax classifications.”); *Washington Interment Ass’n v. Dep’t of Revenue*, 28 Wn. App. 601, 604, 625 P.2d 730 (1981) (“[W]e disregard form for substance, and place our emphasis on the reality of the transaction for taxing purposes”). If, as the BTA found here, the economic reality of the transactions in issue is that Sprint’s customers purchased both telephones and service, then the BTA’s decision must be upheld.

2. The Court is to Uphold the BTA’s Decision if it is Supported by Substantial Evidence.

The principal question raised by the Department’s appeal is whether the BTA’s Findings of Fact, as summarized in the Statement of Facts, are supported by substantial evidence. The Department bears the burden on this issue. *Nordstrom Credit, Inc. v. Dept. of Revenue*, 120 Wn.2d 935, 939-40, 845 P.2d 1331 (1993).

Substantial evidence is “evidence sufficient to persuade a fair-minded person of the declared premise’s truth.” *Skagit Cnty. Public Hosp. Dist. No. 1 v. Dept. of Revenue*, 158 Wn. App. 426, 435, 242 P.3d 909 (2010). “The test for substantial evidence is modest,” *Northwest Pipeline Corp. v. Adams Cnty.*, 132 Wn. App. 470, 475, 131 P.3d 958 (2006), and is “highly deferential to the agency fact finder.” *Chandler v. Office of Ins. Comm’r*, 141 Wn. App. 639, 648, 173 P.3d 275 (2007); accord *Arco Prods. Co. v. Washington Utilities & Transp. Comm’n*, 125 Wn.2d 805, 812, 888 P.2d 728 (1995) (“highly deferential”).

In determining whether substantial evidence exists to support the BTA’s decision, the Court is to view the evidence in the light most favorable to Sprint. *Skagit Cnty.*, 158 Wn. App. at 435; *Pilcher v. Dept. of Revenue*, 112 Wn. App. 428, 435, 49 P.3d 947 (2002); *Dept. of Revenue v. Security Pac. Bank*, 109 Wn. App. 795, 803, 38 P.3d 354 (2002). This standard “necessarily entails acceptance of the factfinder’s views regarding the credibility of witnesses and the weight to be given reasonable but competing inferences.” *University Place v. McGuire*, 144 Wn.2d 640, 652, 30 P.3d 453 (2001); accord *Skagit Cnty.*, 158 Wn. App. at 435; *Pilcher*, 112 Wn. App. at 435.

The substantial-evidence standard also requires that the Court not substitute its judgment for that of the BTA, even if the Court might have

found the facts differently. *Pilcher*, 112 Wn. App at 435; *Security Pac. Bank*, 109 Wn. App. at 803. “[I]t does not matter that a reviewing court would likely have ruled differently had it been the trier of fact. The question, instead, is whether *any* fair-minded person could have ruled as the Board . . . did after considering all of the evidence.” *Callecod v. Washington State Patrol*, 84 Wn. App. 663, 676 n.9, 929 P.2d 510 (1997) (emphasis in original).

3. The BTA’s Findings of Fact Are Sufficient to Permit Review.

The Department begins its argument by complaining that the BTA’s Findings of Fact are “inadequate” because the BTA’s Finding No. 5 stated that “the Board’s finding of facts is set forth in its summary of facts, above, and is adopted by reference,” AR 97, in addition to entering specific numbered findings of fact. Department Br. 23-25. The Department’s argument mistakes the requirements for findings. The statement about which the Department complains is a straightforward one, indicating that the BTA’s summary of the facts, set forth at AR 76-85, constitutes the facts as found by the BTA. The fact that the summary is eight pages long is evidence of its detail, not its inadequacy. Indeed, the “statute does not require that findings and conclusions contain an extensive analysis. . . . Adequacy, not eloquence, is the test.” *U.S. West*

Communications Inc. v. WUTC, 86 Wn. App. 719, 731, 937 P.2d 1326 (1997); accord *NationsCapital Mortg. Corp. v. State*, 133 Wn. App. 723, 751, 137 P.3d 78 (2006). The BTA's reasoning is fairly set forth in its decision, including in the extensive findings quoted in the Statement of Facts above. Nor, contrary to the Department's suggestion, is the BTA required to describe all of the evidence it considered or its reasoning for accepting and rejecting each piece of evidence. See *NationsCapital*, 133 Wn. App. at 752-53.

The BTA's findings are more than sufficient to satisfy RCW 34.05.461(3). They did not leave the Department to guess as to the findings or as to the evidence on which the findings were based.

4. The Finding That Sprint Sold the Cell Phones in Issue is Supported by Substantial Evidence.

The BTA's Finding No. 6, which is the focus of the Department's attack, see Department Br. 25-33, found that "Sprint receives money directly from the retail consumer for the 'free phones' via its monthly service contract payments and pays retail sales tax on that money." AR 97.

The BTA relied in large part on stipulated facts and the deposition and hearing testimony of Sprint representative Anthony Whalen. AR 78-82; Tr. 8-75. The BTA specifically found that Mr. Whalen "was credible

and his testimony was uncontested.” AR 97. *See also* AR 85 (noting that “Mr. Whalen’s testimony is uncontroverted” and that the “Department presented no witnesses.”)

As set forth in the Statement of Facts, the Board provided substantial detail supporting its finding that the fully discounted phones were sold as part of a unitary transaction. These included, for example, the findings that:

- “The purchase of the cell phone and wireless service is one purchase.” AR 79.
- “Instead of recovering part or all of the wholesale cost of the cell phone from revenue collected at the store, . . . the cost is recovered by the monthly fee, the activation fee, and the early termination fee. AR 81.
- Sprint recoups the subsidy of the phone ‘through the pricing of its service sold at the same time and in connection with the sale of that handset, as well as the early termination fee and the other fees associated with that.’” AR 81.
- “For customers, the phones are the most important thing, and phones are a ‘very, very important to both Sprint and the customer.’” AR 84.

- “The prevailing U.S. industry practice is to sell cell phones at a discount . . . and recoup some or all of the discount back by the monthly service contract” AR 84.
- “Thus, the customer is purchasing the phone over time; the same way a customer might purchase a piece of furniture with zero down and monthly payments for a set period.” AR 84.

Each of the factual findings made by the BTA was supported by the record.⁶ As noted, nearly all of the findings were based on stipulated facts or testimony that the BTA specifically found to be credible and uncontroverted.

Moreover, the Department’s own brief concedes the essence of the factual determination made by the BTA, i.e., that the economic reality of

⁶ The Department, while conceding the accuracy of the BTA’s finding that “Sprint’s cell phones and services contracts [are] related,” takes issue with the finding that “one cannot be purchased or used without the other.” Department Br. 30, citing AR 97 ¶ 8. While technically correct that one could purchase a Sprint phone without purchasing Sprint service as well, the telephone *could not be used* if Sprint’s service were not purchased as well. See AR 97, citing AR 841 ¶ 33; Tr. 40-41. And while one could theoretically purchase a new service contract for an old Sprint phone without obtaining a new phone, one would then not “get the benefit of being locked in, which would be cheaper handsets.” Tr. 70. As Mr. Whalen testified, “I’ve never encountered a situation where somebody would sign on for a two-year deal if there was no benefit for them to do it I don’t know why a customer would do it.” Tr. 71. As a practical matter, customers purchase Sprint telephones and service together.

the transactions in issue concerned a combined sale of a phone and service, not the giving away of a “free” phone. For example, the Department concedes that:

The Department has never disputed that Sprint prices its wireless service to cover the expenses Sprint incurs in transferring cell phones to customers at less than its acquisition cost. Thus, the Department agrees that as an ‘economic reality’ the customers ended up paying for the phones they received for ‘free.’

Department Br. 49. *See also* Department Br. 26 (“The Department does not question that Sprint probably recoups the expense of providing free cell phones . . . in the pricing of the various fees owed under its wireless service contracts.”), 30 (“The Board correctly stated in Finding of Fact No. 8 that Sprint’s cell phones and service contracts were related.”), 33 (“Sprint provided free phones *only* to customers who qualified by agreeing to purchase wireless services from Sprint for a term of one or two years.”) (emphasis in original).

The Department may not seek to overturn the BTA’s decision simply because it would like to determine the facts differently than the BTA did. If any fair-minded person could have found the facts as the BTA did, then substantial evidence supports the BTA’s decision. *Callecod*, 84 Wn. App. at 676 n.9. In light of the uncontroverted facts and the undisputed economic realities of the transactions, that standard is

satisfied here. Indeed, any other conclusion would ignore the reality of the situation. As Mr. Whalen testified:

[W]hen we use the term free, we put all kinds of stipulations on what they have to do in order to get that phone, quote, free, and I don't think there's any customer out there that thinks that they actually got something free when they agreed to sign on for \$1,400 worth of stuff.

Tr. 68.

5. The BTA's Decision is Consistent With the View of the FCC, Additional Washington Precedent, and the View of Other Taxing Authorities.

The BTA's factual finding that the sale of the telephone and the telephone service is a single transaction is supported by the Federal Communications Commission ("FCC"). When the FCC established a regulatory framework for the licensing and operation of commercial cellular systems in 1981, it permitted cellular service providers to supply the necessary cell phones, but *required* them to be sold "unbundled", or "separate and apart", from the cellular service itself. 86 FCC2d at 497, ¶ 59; *Bundling of Cellular Customer Premises Equipment and Cellular Service*, 7 FCC Rcd 4028 [Appendix A], ¶¶ 2 and 3 (1992) ("1992 Cellular Bundling Order"); *Cellular Communication Systems* 86 FCC2d 469 (1981) ("1981 Cellular Order").

The FCC changed course after a decade of experience. In its 1992 *Cellular Bundling Order*, 7 FCC Rcd 4028 [Appendix A], ¶ 7, the FCC

specifically found that the high price of cell phones represented the greatest barrier to inducing subscriptions to cellular service, and observed that

bundling is an efficient promotional device which reduces barriers to new customers and which can provide new customers with [cell phones] and cellular service more economically than if it were prohibited. Moreover, packaging [cell phones] and service is a common and generally accepted practice in the cellular industry.

Id., at ¶ 19. The subsequent widespread adoption of wireless services demonstrates that the FCC correctly anticipated that bundling cell phones and services would provide new customers a means of economically obtaining cell phones they otherwise could not afford.

The provision of a fully discounted, or “free,” phone with a cellular service contract is similar to a “buy one, get one free” offer in which the purchase of two items is tied together. No one believes that the second item is free; all parties to the transaction understand that the customer is purchasing both items.

The Department and other taxing authorities routinely recognize this in other contexts. For instance, WAC 458-20-124(6) provides:

Persons who sell meals on a “two for one” or similar basis are not giving away a free meal, but rather are selling two meals at a discounted price. Both the retailing B&O and retail sales taxes

should be calculated on the reduced price actually received by the seller.”⁷

Similarly, a hotel that provides its guests with “complimentary” breakfasts each morning and complimentary drinks at receptions each afternoon is selling the food and drink as part of the price of the hotel room, even if these items are advertised as being “free.”⁸

Here, Sprint may advertise fully discounted phones as “free,” but no reasonable person would regard them as such. The BTA’s findings recognized this reality.

In reaching its decision, the BTA noted that the Washington Supreme Court had rejected a claim that part of a package deal was free

⁷ *Accord* City of Seattle Business Tax Rule 5-405(3); *Burger King Corp. v. Director, Division of Taxation*, 9 N.J. Tax 251 (1987), *aff’d*, 541 A.2d 241 (N.J. Super. Ct. App. Div. 1988); Florida Department of Revenue, Sales and Use Tax on Restaurants and Catering (Oct. 2009) (“Meals that are ‘two for the price of one’ are not complimentary food items. . . . There is no use tax applied since the ‘two for one’ charge is a discount or reduced charge covering both meals.”), available at [http://dor/myflorida.com/dor/forms/2009/gt8000035.pdf](http://dor.myflorida.com/dor/forms/2009/gt8000035.pdf); Florida Department of Revenue, Tax Information Publication 03A01-20 (Dec. 17, 2003) (“Sales tax would apply to the actual sales price paid by the customer. Use tax is not applicable to the items sold at no charge.”), available at [http://dor/myflorida.com/dor/tips/tip03a01-20.html](http://dor.myflorida.com/dor/tips/tip03a01-20.html); Iowa Department of Revenue, Iowa Sales Tax on Discounts, Rebates and Coupons, available at <http://www.iowa.gov/tax/educate/78628.html>.

⁸ *See, e.g., Nashville Clubhouse Inn v. Johnson*, 27 S.W.3d 542 (Tenn. Ct. App. 2000); *Drury Supply Co. v. Director of Revenue*, 1996 WL 633387 (Mo. Admin. Hrg. Com. Oct. 8, 1996); and *S&R Hotels v. Fitch*, 634 So. 2d 922 (La. Ct. App. 1994).

in *McDonald v. Irby*, 74 Wn.2d 431, 445 P.2d 192 (1968). See AR 99-101. In *McDonald*, the court held that an airport parking lot operator could not avoid common carrier status by arguing that its customers paid for parking and got a ride to the airport for free. The economic reality of the transaction was that the customer needed and paid for both parking and transportation. 74 Wn.2d at 435-36.

The Department concedes that the economic reality here, like the economic reality in *McDonald*, is that customers are paying for an item described as “free” because the charge for it is not separately identified. Department Br. 49. But the Department contends that “the same could be said for *any* of Sprint’s costs of doing business.” *Id.* (emphasis in original). The Department’s argument confuses three types of items. First, many of the goods purchased by Sprint or other businesses are not passed along to the customer but are instead consumed by the business, *e.g.* Sprint’s transmission equipment. Sprint is the consumer of this equipment and is liable for sales or use tax. Second, of the goods purchased by business and given to customers, some are of little or no value to the customer—advertising materials, samples, etc.—and primarily of value to the business. These are the “promotional materials” as to which the business is considered the consumer and thus liable for use tax, as discussed below. Third, there are goods that businesses purchase for

resale to its customers and which do have real value to the customer. Whether these are sold at a profit or offered for a discount – including a discount of 100% – when other goods or services are purchased with them, the customer is the consumer and pays the sales tax on the discounted price.

The economic reality in *McDonald* was that off-site airport parking would be useless without transportation to the airport. And here, cell phone service would be useless without the phone. The customer is purchasing both together. The economic reality is that there is a single transaction on which Sprint collects sales tax from its customers. To assess Sprint use tax on some of these phones in addition to the sales tax collected is impermissible double taxation.

6. The Department's Objections to the BTA's Findings are Unavailing.

The Department's arguments in opposition to the BTA's finding seek to exalt form over substance. The Department relies, for example, on the fact that a Sprint customer who purchases a fully discounted phone with service receives a cash register receipt that indicates zero payment and the fact that the sale documents do not explicitly state that the customer is paying for the phone over the life of the service contract. *See* Department Br. 25-30. These arguments ignore the economic reality of

the transaction, the law dictating that economic reality governs how the transaction is to be viewed, and the substantial evidence supporting the BTA's findings.

The Department also offers a potpourri of additional reasons why it would reach different factual conclusions than did the BTA. Department Br. 30-33. However, the substantial evidence standard does not permit the Department or a reviewing court to substitute its judgment for that of the BTA, even if they might have found the facts differently. *Pilcher*, 112 Wn. App at 435; *Security Pac. Bank*, 109 Wn. App. at 803. The question, instead, is whether *any* fair-minded person could have ruled as the BTA . . . did after considering all of the evidence." *Callecod*, 84 Wn. App. at 676 n.9 (emphasis in original). Here the Department does not meet this burden.

The Department's response to the BTA's findings is not, in fact, a bona fide argument that the BTA's findings are not supported by substantial evidence. Rather, the import of the Department's argument is that the BTA should have drawn different inferences from the evidence, consistent with the way the Department would like to view the evidence. In particular, the Department believes that the BTA was wrong in finding that the phones were not "free," but were part of a package of goods and services that was already subjected to sales tax. But the substantial

evidence standards set forth above make clear that deference is owed to the BTA's findings and inferences if a fair-minded person could have reached them, even if someone else might have reached different conclusions. And the BTA's conclusions were more than reasonable.

C. The BTA Correctly Rejected the Department's Expansive Interpretation of Promotional Items and Found that Fully Discounted Phones Were Not Promotional.

The Department also contends that Sprint should pay use tax as a "consumer" because "the primary purpose of [distributing the telephones] is to promote the sale of" cell phone service. *See* former RCW 82.12.010(5); Department Br. 33-36, 40-43.⁹ This argument misreads the law and ignores the BTA's factual finding that the phones were sold.

The Department argues it was error for the BTA to find that Sprint is not a consumer of cell phones under RCW 82.12.010(5) because the cell phones are "core merchandise." Department Br. 42. The Department contends that under RCW 82.12.010(5) "*any* article of tangible personal property, except newspapers," can be used to promote sales. However, the Department's own rule, WAC 458-20-17803, clarifies the standard:

⁹ The Department also assigns error to the BTA's statement in the recitation of facts that "Cell phones are not used to promote the business." Department Br. 2, 33. This statement was not labeled a "finding of fact." In the context of this case it is really a conclusion of law that the fully discounted phones were not promotional items "consumed" by Sprint and thus subject to use tax. Even if substantial evidence were necessary to support the BTA's conclusion, there is certainly evidence that the phone is not "free," as discussed above.

Introduction. Persons who distribute or cause to be distributed any article of tangible personal property, except newspapers, the primary purpose of which is to promote the sale of products or services, are subject to use tax on the value of the property. RCW 82.12.010, 82.12.020, and chapter 367, Laws of 2002. This section explains the use tax reporting responsibilities of consumers when such property is delivered directly to persons other than the consumer from outside Washington. For the purposes of this section, the term ‘promotional material’ is used in describing such property where applicable. . . .

What is promotional material? Promotional material is any article of tangible personal property, except newspapers, *displayed or distributed* in the state of Washington for the primary purpose of promoting the sale of products or services. *Examples of promotional material include, but are not limited to, advertising literature, circulars, catalogs, brochures, inserts (but not newspaper inserts), flyers, applications, order forms, envelopes, folders, posters, coupons, displays, signs, free gifts, or samples (such as carpet or textile samples).*

(emphasis added) Two requirements are evident. First, the materials must be “displayed or distributed” not “sold.” Neither the statute nor the rule includes an item which is sold. Thus, the BTA’s finding that the fully discounted phones were sold is dispositive of this issue as well. As discussed above, that finding is supported by substantial evidence.

Second, although the rule says “any” article may be a promoted item, the examples are all items that are not of the type that are actually sold by the retailer. These items are distinct from discounted merchandise of the sort sold by a retailer in “two for one” or “buy one, get one free”

situations. In those situations, the Department recognizes that the merchandise is actually sold, and is not free. For instance, WAC 458-20-185 deals with the tobacco tax in the case of a two for one promotion:

If a product is purchased or sold at a discount in a promotion characterized as a “2 for 1” or similar sale, the tax is calculated on the actual prorated consideration the buyer paid to the unaffiliated distributor, or a maximum of 67 cents a cigar.

For example:

(i) Duke Distributing (an out-of-state wholesaler) ships tobacco products via common carrier to Lem’s Tobacco Shop (an unaffiliated Washington retailer). . . . The sale includes 200 cigars priced “buy one for \$2 and get one free” . . . Each cigar costs Lem’s Tobacco Shop \$1 (\$200/200 cigars = \$1 per cigar). . . The tax on the cigars is \$100 (200 cigars x \$0.50 = \$100). Total tobacco tax due on the invoice is \$1,075.

See also WAC 458-20-124(6) (“Persons who sell meals on a ‘two for one’ or similar basis are not giving away a free meal, but rather are selling two meals at a discounted price. Both the retailing B&O and retail sales taxes should be calculated on the reduced price actually received by the seller.”)

In fact, the Department treats most sales of Sprint phones consistently with its practice as to other discounted merchandise. When a customer signs a one or two-year service contract, the customer receives a \$75 or \$150 credit on a phone. Large numbers of customers choose more expensive phones and thus pay some amount after the credit is applied. The Department charges sales tax on the discounted price, not the full

price, and does not assert any use tax. These customers get exactly the same discount as the customers getting fully discounted phones. There is no principled way to distinguish the transactions.

Based on these legal arguments, the BTA correctly decided that the fully discounted cell phones were sold, and the sale of cell phones in the regular course of Sprint's business was neither promotional in nature nor consistent with the examples of promotional distributions given in the regulation. AR 90-91, 95. The BTA's decision that the cell phones were not promotional was based on its factual findings that the cell phones were not free and not distributed "primarily for promotional purposes" under RCW 82.12.010(5). Those findings were supported by sufficient evidence. The BTA's decision was not based on an illegally restrictive interpretation limiting the statutory phrase "any article" to those articles enumerated in the regulation.

D. The *Activate* Decision Does Not Save the Department's Argument.

The Department premises much of its argument on *Activate, Inc. v. Dept. of Revenue*, 150 Wn. App. 807, 209 P.3d 524 (2009). The BTA correctly determined, however, that

[T]he facts in this case are materially different than in *Activate . . .*, where *Activate's* argument that it had transferred the phones for valuable consideration was rejected, not because the wireless service agreements were

not “valuable consideration,” but because the trial court had found that there was no “compensation [to Activate] directly from the consumer.”

AR 89. *See also* AR 99 ¶ 3.b.

In *Activate*, the taxpayer “serve[d] as a representative for wireless service provider AT&T Mobility (AT&T) and receive[d] a commission for every extended cellular telephone agreement its customers enter[ed] into with AT&T.” 150 Wn. App. at 809. In contrast to *Sprint*, *Activate* was not a retailer, did not provide wireless service and did not receive compensation from the consumer when it provided a fully discounted phone in exchange for the consumer’s agreement to purchase wireless services from AT&T. Instead, *Activate* received a commission from AT&T. *Id.* at 810, 818. The court of appeals therefore held:

The record establishes that *Activate* did not sell the phones at issue in this case for money directly from the retail consumer. DOR argues that *Activate* has failed to demonstrate that the legislature intended the phrase “valuable consideration” to encompass situations involving transfers of tangible personal property in three-way transactions. Resp’t’s Br. at 31. *Activate* responds that the trial court’s finding that there was “no compensation directly from the consumer” ignores “the inherent value of the executed AT & T service agreement that *Activate* sold along with the cellular telephone, for which [it] received a commission from AT & T.” Appellant’s Br. at 24. *Activate*’s argument is unpersuasive, as it fails to cite to authority in support of its contention that consideration need not come directly from the retail customer or that a customer’s promise to enter into a service agreement with a

third party meets the *statutory* definition of valuable consideration under RCW 82.04.040(1).

Id. at 818 (emphasis in original).

For there to be a “resale” of property such that it is “purchase[d] for the purpose of resale” and not subject to use tax, the alleged resale must constitute a “sale.” RCW 82.04.040 defines “sale” as a transfer “for a valuable consideration”:

“Sale” means any transfer of the ownership of, title to, or possession of property *for a valuable consideration* and includes any activity classified as a “sale at retail” or “retail sale” under RCW 82.04.050.

(emphasis added). Activate argued that it resold the phones by transferring title and possession of the phones for a valuable consideration, in the form of “the inherent value of the executed AT&T service agreement that Activate sold along with the cellular telephone, for which [it] received a commission from AT&T.” *Activate*, 150 Wn. App. at 818.

The court rejected Activate’s argument that the transfer of the phones was a “sale” because Activate “fail[ed] to cite to authority in support of its contention that consideration need not come directly from the retail customer or that a customer’s promise to enter into a service agreement with a third party [AT&T] meets the *statutory* definition of valuable consideration under RCW 82.04.040(1).” *Activate*, 150 Wn. App. at 818 (emphasis in original). The court affirmed the trial court’s

findings that the transfers of the phones were not sales under RCW 82.04.040 because there was “no compensation [to Activate] directly from the consumer.” *Id.*

In contrast, Sprint did receive a valuable consideration *directly* from its retail consumers when they purchased their fully discounted phones. AR 97. These transfers of Sprint phones were “sale[s]”, and “resale[s]”, such that their purchases by Sprint were not “at retail.” As a result, Sprint’s purchases of the phones failed the “purchase at retail” prerequisite to a valid levy of use tax. RCW 82.12.020(1).

It is also notable that the court in *Activate* relied on the definition of “consumer” in RCW 82.04.190(2)(a), a provision that the Department does not rely on in the present case. *See Activate*, 150 Wn. App. at 815. That provision defines “consumer” as including “[a]ny person engaged in any business activity taxable under RCW 82.04.290.” RCW 82.04.190(2)(a). This definition of “consumer” was important to the *Activate* court because, unlike Sprint, Activate only earned commissions, those commissions were not subject to sales tax, and on application of RCW 82.04.190(2)(a) to those facts, Activate was deemed to be a consumer of the fully discounted phones. The court explained:

Activate is a consumer under [RCW 82.04.190(2)(a)] because it engages in a business activity taxable under RCW 82.04.290. RCW 82.04.290(2) provides that a

business is taxable for business and occupation taxes when it engages in any business activity “other than or in addition to an activity taxed explicitly” under another section of chapter 82.04 RCW. As [the Department] explains, because Activate only receives commission income from transactions involving the phones at issue in this case—an activity that is not taxed explicitly under chapter 82.04 RCW—it appears to be taxable under the plain language of RCW 82.04.290(2) and is thus a “consumer” under RCW 82.04.190(2)(a).”

Activate, 150 Wn. App. at 815.¹⁰

In contrast to the facts in *Activate*, all of Sprint’s proceeds from sales of telephones and wireless telephone services in the State are explicitly subject to the tax on retail sales imposed at RCW 82.08.020. If the Department is correct, Sprint would be subject to double taxation, paying both the sales tax and the use tax sought by the Department. *But see Activate*, 150 Wn. App. at 814 (“Use tax is a companion tax imposed when a seller does not collect a retail sales tax.”).

The Department also cites *Mercury Cellular Tel. Co. v. Calcasieu Parish*, 773 So. 2d 914, 918 (La. App. 2000), *superseded by statute as stated in Unwired Telecom Corp. v. Parish of Calcasieu*, 838 So.2d 854

¹⁰ In sustaining the use tax assessment on various grounds, the court also characterized Activate’s role with respect to the fully discounted phones, in part, as follows: “Activate *distributes* articles of tangible personal property (phones) . . .” 150 Wn. App. at 816 (emphasis added). The court did not mention in its decision that the word “distribute” was not added to the use tax statute until June 1, 2002, midway through Activate’s January 1, 2000 to December 31, 2003 audit period.

(La. App. 2003), and a number of out-of state authorities to support its contentions that fully discounted phones are “free” and thus promotional items. Department Br. 41, n 18. *Mercury Cellular* shows the shortcomings of looking to other states. In that case, the local ordinance provided that “sale” included a transfer “for consideration,” and the Louisiana Civil Code defined “sale” as a transfer “for a price in *money*.” *Mercury Cellular*, 773 So.2d at 918 (emphasis added). The court held that the customer had not paid money. *Id.* This contrasts with the case at hand, in which the Board expressly found that Sprint’s customers paid for their phones. AR 97, 99. Moreover, in the wake of the *Mercury Cellular* decision, the Louisiana Legislature passed a law rebuking the court’s decision and clarifying its intent that no use tax should be charged on free phones. See Louisiana Rev. Stat. Ann. § 47:301(10)(v), (13)(g) & (h), (18)(i); 2002 La. Acts No. 85.

Further refuting the Department’s argument, the State of New York, Department of Taxation and Finance, in TSB-A-97(84)S, 1997 WL 827339 (N.Y. Dept. Tax. Fin. Dec. 29, 1997) considered a fact pattern similar to the one in this case, in which a company provided “free” cellular telephones in connection with the purchase of phone service. The Department determined that “petitioner’s purchases of cellular telephones are considered to be purchases for resale regardless of whether the

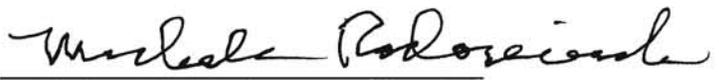
telephones are sold separately or sold in conjunction with the sale of a cellular telephone service, and such purchases are not subject to sales or compensating use tax.” This conclusion is correct and consistent with economic reality.

IV. CONCLUSION

For the reasons stated above, this Court should affirm the decision of the Board of Tax Appeals.

RESPECTFULLY SUBMITTED this 7th day of March, 2012.

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CERTIFICATE OF SERVICE

I hereby certify that I caused the document to which this certificate

is attached to be delivered to the following as indicated:

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Declared under penalty of perjury under the laws of the state of
Washington dated at Seattle, Washington this 7th day of March, 2012.


Elaine Huckabee

APPENDIX A



70 Rad. Reg. 2d (P & F) 1288, 7 F.C.C.R. 4028, 7 FCC Rcd. 4028, 1992 WL 689944 (F.C.C.)

Federal Communications Commission (F.C.C.)

FCC 92-207

***1 IN THE MATTER OF
BUNDLING OF CELLULAR CUSTOMER
PREMISES EQUIPMENT AND CELLULAR
SERVICE**

CC Docket No. 91-34

Adopted: May 14, 1992; Released: June 10, 1992

REPORT AND ORDER

By the Commission: Commissioner Duggan concurring in part and dissenting in part and issuing a statement.

I. INTRODUCTION

1. On March 27, 1991, we released a Notice of Proposed Rule Making (Notice) ^[FN1] seeking comments on whether we should clarify our policy governing bundling of cellular customer premises equipment (CPE) and cellular service. In particular, we sought comments on whether, or on what conditions, we should allow cellular CPE and cellular service to be offered on a bundled basis, provided that service is also offered separately at a nondiscriminatory price. Numerous parties filed comments ^[FN2] and reply comments ^[FN3] in response to our Notice. ^[FN4] Based on our careful analysis of all the comments and issues, ^[FN5] we are clarifying and modifying our policy to allow cellular CPE and cellular service to be offered on a bundled basis, provided that service is also offered separately at a nondiscriminatory basis. Our decision is based on the unique conditions in the cellular market today and on the public interest benefits associated with bundling in that market.

II. BACKGROUND

2. In the Second Computer Inquiry proceeding, the Commission required that common carriers sell or lease CPE separate and apart from the carrier's regulated services, and that new CPE be untariffed. ^[FN6] By requiring common carriers to offer unbundled CPE and transmission services, the Commission wanted to assure that customers have the ability to choose their own CPE and service packages to meet their communication needs ^[FN7] and that they not be forced to buy unwanted carrier-supplied CPE in order to obtain necessary transmission service. The Commission was also concerned that consumers who do not use carrier-provided CPE might find themselves subsidizing consumers who do use carrier-provided equipment, ^[FN8] and that independent CPE vendors might be forced to compete against below-cost, tariffed CPE because part of the CPE costs would be recovered through regulated tariffed service rates.

3. Subsequently, in authorizing commercial cellular service for the first time in 1981, the Commission stated:

Under our Second Computer Inquiry, new terminal equipment is to be deregulated (i.e., unbundled and detariffed) after March [1], 1982. Because cellular service is a new service for which its mobile equipment has never been tariffed, we will require that it be unbundled and detariffed (untariffed) from the start. ^[FN9]

The Commission further indicated in Cellular CPE, 57 RR2d 989, 990 (1990), that the provision of cellular CPE should be left largely to the marketplace, on a competitive, unregulated basis.

4. On December 23, 1988, the National Cellular Resellers Association (NCRA) filed a petition for declaratory ruling requesting that the Commission institute a proceeding to declare that certain practices on the part of facilities-based cellular carriers violate the unbundling policy, citing ITT World Communications, Inc. v. TRT Telecommunications Corp., 51 RR2d 1386 (1982) (ITT World). ^[FN10]

NCRA alleged that the carriers' bundling practices were anticompetitive and unlawful. Cellular carriers and the cellular industry trade associations opposed NCRA's petition, asserting that the allegations of anticompetitive practices were unsubstantiated. In their view, marketing packaged deals is not prohibited bundling because CPE and service are also available separately and cellular service is priced identically to the packaged cellular service.

*2 5. On March 27, 1991, we instituted this Rule Making proceeding to develop a complete record on the status of the bundling policy in the current cellular marketplace. As part of this proceeding, we indicated that NCRA's petition and the comments that were filed in response to NCRA's petition were to be made a part of the record.^[FN11] We also indicated that this proceeding was being initiated to determine whether the cellular bundling policy should be eliminated, modified or clarified.^[FN12]

III. DISCUSSION

6. Our Notice indicated that it was appropriate to reevaluate our bundling policy in light of changes that have occurred in the cellular industry. We indicated generally that bundling might present no problems as long as the markets for the components of the bundle are competitive. Thus, we proposed to look at the competitiveness of the cellular CPE market and the competitiveness of the cellular service market. In view of the Commission's concern that customers have the ability to choose their own CPE and service packages to meet their own communication needs and that they not be forced to buy unwanted carrier-provided CPE in order to obtain necessary service, we also asked whether consumers would be harmed by permitting bundling. In addition, we sought comment on the public interest benefits of permitting bundling.^[FN13] Finally, we tentatively concluded that the current lack of regulation of the cellular industry reflects the competitiveness of the industry, and we asked for comments on the status of federal and state regulation of cellular service.

7. We have analyzed the record before us in light of

the public interest objectives underlying the Commission's cellular bundling policy. This record shows that while the cellular CPE market is competitive, the cellular service is not fully competitive, thus leaving open the possibility that bundling may be used for anticompetitive purposes. Nevertheless, we do not believe that the potential for carriers to engage in anticompetitive conduct provides a basis to prohibit bundling per se. Despite some concerns raised about the status of competition in the cellular service market, the record supports the conclusion that modifying the bundling policy is in the public interest because the public interest benefits of bundling in the cellular market outweigh the potential for competitive harm. See paras. 19-21, *infra*. These benefits include the provision of discounted CPE to customers who otherwise would not subscribe to cellular service and the promotion of efficient spectrum utilization by adding new customers to cellular service. Accordingly, we conclude that it is in the public interest to clarify and modify our policy to allow cellular CPE and cellular service to be offered on a bundled basis, provided that the cellular service is also offered separately on a nondiscriminatory basis.

A. Competition in the Cellular CPE Market

8. In our Notice, we indicated that the cellular CPE market appears to be extremely competitive both locally and nationally and that this competition has resulted in the widespread availability of cellular CPE from a multiplicity of vendors. In order to verify these assumptions, we solicited information on cellular manufacturers, including the number of national and international manufacturers and their market shares, and how cellular CPE is distributed today.

*3 9. The record is uncontroverted that the cellular CPE market is extremely competitive, both locally and nationally, and that this competition has resulted in the widespread availability of cellular CPE. The commenters indicate that there are between 17 and 25 CPE manufacturers who distribute more than 28 brands of cellular telephones under both

primary and secondary brand labels.^[FN14] They note that CPE is manufactured in the United States, Canada, Japan, and Europe. The parties indicate that, because of relatively low barriers to entry, the number of CPE manufacturers continues to grow annually. The information submitted by the commenters shows that no single manufacturer is dominant and none has a market share in excess of 20%. CTIA points out that, as a result of vibrant competition, the average price of cellular telephones has dropped from \$2,500 in 1984 to \$400 today.^[FN15] Moreover, CPE is marketed for sale, rent or lease by facilities-based carriers as well as by agents, resellers, independent outlets, specialty shops, automotive dealers, and department stores. In view of the large number of CPE manufacturers competing in the United States cellular industry and the fact that new manufacturers are continuously entering the market,^[FN16] and given the broad national distribution network for cellular CPE, it appears unlikely that one manufacturer can control the market.^[FN17]

B. Competition in the Cellular Service Market

1. The Competitiveness of the Cellular Service Market

10. The Commission tentatively concluded in the Notice that the cellular service market is sufficiently competitive to prevent bundling from adversely affecting competition in the cellular CPE market. In reaching this conclusion, the Commission indicated that the cellular industry has grown considerably and that facilities-based carriers within each market compete not only against each other, both directly and through agents, but also with numerous resellers. It also indicated that the current duopoly structure of the cellular industry "provides the potential for each facilities-based carrier to possess relatively equal power in the service area and protects the public from the dangers of potential anticompetitive abuse arising from the joint provision of cellular service and CPE."^[FN18] Finally, insofar as bundled offerings of cellular CPE and cellular service require that customers obtain service

from a specified carrier for a fixed term, we asked whether such agreements might be discriminatory or be used to eliminate competition within the cellular market.

11. The record is not conclusive as to whether the service market is fully competitive.^[FN19] In this regard, in the Cellular Report and Order, 86 FCC2d at 474-82, which established the cellular duopoly market structure, the Commission concluded that "even a marginal amount of facilities-based competition will foster public benefits of diversity of technology, service and price." *Id.* at 478. Although the record contains a limited amount of empirical data, it appears that facilities-based carriers are competing on the basis of market share, technology, service offerings, and service price.^[FN20] However, as the FTC staff points out, the current Commission rules allowing no more than two facilities-based carriers per market place an absolute barrier to entry in the provision of wholesale cellular service.^[FN21] Moreover, while resellers may help deter price discrimination, it does not appear that they compete effectively with the two facilities-based carriers in each market. In addition, while it appears that existing services, such as paging, private radio, certain landline services, and possible future services such as personal communications, Mobile Satellite Service, and specialized mobile radio services have the potential to compete with cellular, the record does not support a finding that they currently constrain facilities-based cellular carriers from acting anticompetitively.^[FN22] Therefore, we agree with the DOJ that in the absence of any evidence (such as price and cost data), it is difficult to conclude that the cellular service market is fully competitive.^[FN23]

*4 12. Finally, the record reveals that an integral part of any packaged offering of cellular CPE and service is the mandatory service requirement. As we noted in the Notice, carriers can use the minimum service commitment as a vehicle for predatory pricing or other anticompetitive conduct only if they can eliminate competition and monopolize the

cellular market. See *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986). There is no evidence that this has occurred or is even possible, particularly because the minimum service periods of three months to one year, identified by evidence in the record, are relatively short. Cf. *Comsat*, 5 FCCRcd 4869 (1990), and *RCA Satcom*, 84 FCC2d 353 (1980). (These cases involve regulated domestic satellite services and articulate the Commission's recognition of the benefits that such contracts bring to the carrier-customer relationship).

C. Impact of Bundling on Competition in the Cellular CPE Market

13. Even if we were to assume that a facilities-based carrier has the potential to act anticompetitively in its Cellular Geographic Service Area (CGSA), based on the current structural conditions in the cellular service and CPE markets, it appears unlikely that any carrier engaged in bundling would be able to restrict competition in the CPE market. Specifically, the conditions necessary to obtain an anticompetitive outcome do not appear to exist in the cellular industry. First, it does not seem likely that individual cellular companies which operate in local markets possess market power that could impact the numerous CPE manufacturers operating on a national and international basis. According to CTIA, there are 125 facilities-based cellular system operators in this country and more than 6,000 cellular agents.^[FN24] We agree with the FTC Staff that under these conditions, a CPE manufacturer foreclosed by one cellular service company from its CGSA easily could sell its equipment to other cellular carriers operating in many other CGSAs. Furthermore, we agree with the DOJ that cellular carriers do not have the potential to engage in sustained predatory pricing practices in the CPE retail market. As the DOJ points out, even if the two facilities-based carriers in a market cornered the local retail CPE market and began charging high CPE prices, other CPE providers from outside of the local market could supply retailers with affordable

CPE, thus undercutting a carrier's high-priced CPE.^[FN25] Customers, of course, would be able to purchase the lower-priced CPE and obtain cellular service at the same rates as if the customer had bought the CPE from the carrier because cellular service will remain available on an unbundled, nondiscriminatory basis. Under these circumstances, it is unlikely that carriers engaged in bundling could charge supracompetitive prices and still deter retailers from carrying CPE. Thus, we agree with the FTC Staff's conclusion that "[i]f individual cellular service companies do not possess market power in the sale of cellular service on a national level, it is unlikely that foreclosure of the CPE market can be successful."^[FN26] The possibility that one carrier could dominate the CPE market is further diminished by the fact that most carriers do not manufacture CPE and because most cellular service markets are duopolistic rather than monopolistic, a carrier's market power is attenuated.

*5 14. It is also uncontested that there is a robust level of competition that exists in the CPE markets notwithstanding the common marketing practice of packaging CPE and cellular service. This marketing practice of packaging CPE and cellular service has existed for several years and has benefited consumers. Accordingly, we believe that the information submitted in this proceeding reveals that if the Commission clarified its policy to permit bundling, facilities-based carriers engaged in bundling would not be able to adversely affect competition in the cellular CPE market.

15. Finally, two parties allege that facilities-based carriers have entered into exclusive dealing agreements with CPE providers.^[FN27] However, the details of these agreements are not revealed. Therefore, the impact of such arrangements cannot be thoroughly evaluated. Nevertheless, there is no evidence that cellular carriers refuse to provide service to customers that purchase another brand of CPE. Furthermore, although there are general allegations that these exclusive dealing arrangements preclude agents from offering other brands of CPE

to customers, no specific evidence has been raised to support these allegations.

16. ICDMA contends that carriers' exclusive dealing arrangements with CPE manufacturers, coupled with their ability to engage in price packaging, creates the potential for anticompetitive abuse. It therefore proposes several safeguards to reduce this potential. First, it states that if a carrier is the exclusive distributor of a particular manufacturer's CPE, the carrier should not be allowed to create price packaging that includes the cellular CPE unless the carrier makes that CPE available to independent retailers in its service area. Second, it provides that carriers should not be allowed to offer price reductions for CPE included in carriers' price packages offered at the retail level (when compared to the stand-alone CPE retail prices offered by the carrier) that are greater than the highest level of activation commissions paid to independent retailers. Third, it asserts that activation term commitments for subscribers purchasing carrier provided retail price packages should be for the same period of time as the term commitments made by subscribers purchasing their service through independent retailers, which thereby earn activation commissions for those retailers.

17. We find that ICDMA's safeguards are not warranted because there is no evidence in the record before us revealing that the anticompetitive abuses which ICDMA is addressing are presently occurring. If such evidence were presented, however, we would consider adopting safeguards similar to those proposed by ICDMA. The record is also void of any evidence showing that these existing exclusive dealing arrangements will potentially have an anticompetitive impact on competition in the CPE market.^[FN28] Accordingly, we do not here adopt ICDMA's safeguard proposals.

18. Furthermore, the record does not demonstrate a reason to be concerned about future exclusive dealing arrangements. First, it appears that carriers are primarily motivated to sell more service and are not particularly interested in entering into such agree-

ments with CPE providers because, as Century has pointed out, their customers demand that they carry the widest variety of CPE possible.^[FN29] Second, if one carrier managed to eliminate all agents and only offered a bundle of service and one CPE manufacturer's CPE, a customer could always go elsewhere or to another carrier to get CPE. Third, current nondiscrimination requirements preclude a cellular carrier from refusing to provide service to a customer on the basis of what CPE the customer owns.^[FN30] Fourth, because cellular service is offered in local markets, exclusive dealing arrangements would not eliminate international and national CPE providers in the absence of a nationwide conspiracy by cellular carriers to eliminate CPE manufacturers. Therefore, it is highly unlikely, even theoretically, that a future exclusive dealing arrangement could be successful in eliminating a CPE manufacturer. Nevertheless, if in the future, it comes to our attention that carriers' exclusive distribution agreements with CPE manufacturers are resulting in anticompetitive abuse, we will not hesitate to revisit this area.

*6 D. The Public Interest Benefits of Bundling Cellular Service & CPE

19. Notwithstanding the state of competition in the cellular service industry, there appear to be significant public interest benefits associated with the bundling of cellular CPE and service.^[FN31] In this regard, the record supports a finding that the high price of CPE represents the greatest barrier to inducing subscription to cellular service.^[FN32] Thus, as several of the commenters, including the DOJ, have pointed out, bundling is an efficient promotional device which reduces barriers to new customers and which can provide new customers with CPE and cellular service more economically than if it were prohibited.^[FN33] Moreover, packaging cellular CPE and service is a common and generally accepted practice in the cellular industry. Finally, the FTC Staff explains that a decision to prohibit introductory discounts "may cause the companies to replace these discounts with promotional expendit-

ures that are more costly and less likely to be directly appropriated by the customer.” [FN34]

20. Moreover, with the influx of new subscribers due to the bundling of cellular CPE and service, the fixed costs of providing cellular service are spread over a larger population of users, achieving economies of scale and lowering the cost of providing service to each subscriber. [FN35] Rapid growth of the subscriber base also promotes the efficient use of the spectrum. In addition, clarifying our policy to allow the bundling of cellular CPE and cellular service furthers the Commission's goal of universal availability and affordability of cellular service and thus promotes the continued growth of the cellular industry. [FN36] We also find that bundling can assist in the conversion to digital. As the DOJ and the FTC Staff point out, initially, digital deployment will require the use of dual-mode telephones, which will, most likely, be slightly larger, heavier and more expensive than analog models. A prime means of marketing these phones will be through attractively priced packages of service and new equipment.

21. Finally, bundling may be used by carriers as an efficient distribution mechanism. Here, the FTC Staff point out that because a decision as to how to distribute one's product may have a significant impact on the type of service or the quality of the product provided, “interference in these relationships should be approached with caution.” [FN37]

E. Other Considerations

1. Impact on Cellular Service Prices by Permitting Bundling

22. The Commission tentatively concluded in the Notice that consumers are not likely to be harmed by permitting bundling. The Commission stated that modifying the bundling policy probably will not affect cellular service prices. The Commission also indicated that discounted CPE appears to be the result of agents using their commissions to offset or hold down the price of CPE. If CPE discounts

are eliminated, it continued, carriers probably will continue to pay their agents commissions because such payments are market driven, and it is unlikely that the cellular service prices would decrease. Because it appears that agents are using their carrier-paid commissions to hold down the prices they charge their customers, the Notice requested comments on whether this is the type of cross-subsidy that public policy should prevent and whether a modification of the bundling policy would adversely affect cellular service prices.

*7 23. Based on the record before us, it appears that subscribers may be benefiting from the current cellular industry practice of bundling cellular CPE and cellular service. As a result of the lower prices for cellular CPE, [FN38] individuals who would otherwise decline cellular service are becoming subscribers, thereby spreading the cost of providing cellular service. Moreover, there is no evidence that bundling cellular CPE and service has led to an increase in service prices. [FN39] Nor has evidence been submitted to support the claim that bundling leads to discriminatory cellular service rates. The industry practice is that cellular service is offered separately from CPE on a nondiscriminatory basis.

24. The record is also inconclusive as to whether carriers are using their service revenues to subsidize their bundling practices. As we pointed out in the Notice, discounted CPE appears to be the result of agents using their commissions to offset the original cost of CPE. Thus, even if cellular CPE discounts were eliminated, there is no indication that carriers would not continue to pay their agents commissions because these commissions appear to be market driven. Nevertheless, as the DOJ and the FTC Staff agreed, it is unlikely that any profit maximizing firm would set its service rates based on the size of the commissions paid to agents. [FN40] Moreover, there is no convincing evidence that if these packaging practices were eliminated, cellular service prices would decline. In any event, the potential anticompetitive impact from this type of bundling is outweighed by the public interest bene-

fits associated with the bundling of cellular service and CPE. Finally, we agree with the DOJ that even if the elimination of bundling led to a reduction in the commissions carriers paid their agents, there would likely be a negligible effect on the marginal cost of cellular service and, therefore, no discernible impact on service rates.

25. In the Notice we tentatively concluded that the lack of state regulation of the cellular industry reflects the competitiveness of the industry and a decreasing concern that carriers are using largely unregulated cellular service to act anticompetitively in the unregulated CPE market, i.e., by raising cellular service prices to subsidize low cost CPE. The record reveals that cellular service is unregulated at the federal level and largely unregulated at the state level.^[FN41] Moreover, it appears that most of those states that do regulate cellular service do not exercise rate-of-return regulation. While the non-regulation of cellular service does not in itself demonstrate that the cellular service market is competitive, it does suggest that state PUCs have chosen not to regulate cellular service because they do not consider it a monopoly service. In addition, the lack of regulation based on rate-of-return principles, combined with the absence of monopoly status for cellular carriers, significantly reduces one important motive for carriers to bundle—to build unregulated CPE costs into the service rate base and cross-subsidize at the expense of the subscriber. As the DOJ notes, “absent a guaranteed return on their cellular service investments, carriers cannot expect to recover CPE discounts by including it [the amount of the CPE discounts] in their rate base.”^[FN42] We agree with this conclusion.

*8 2. Impact on Resellers

26. In our Notice, we requested comments on the extent to which the elimination or substantial modification of the cellular CPE bundling policy would affect resellers, and the extent to which this impact should be taken into account in formulating our bundling policy.

27. The record is inconclusive as to what extent resellers would be affected if facilities-based carriers were allowed to bundle cellular CPE and cellular service. On the one hand, many of the parties argue that resellers have not submitted specific evidence demonstrating that the current carrier practice of packaging cellular CPE and cellular service has had an adverse impact on resellers. On the other hand, other commenters, such as NCRA and NACA, argue that the anticompetitive effects of bundling are driving resellers out of business because they are unable to compete for new cellular subscribers. They argue that, unlike facilities-based carriers, resellers do not have service revenues that subsidize bundling practices. NCRA also claims that the number of resellers in existence today that are not affiliated with a facilities-based carrier is small and is declining.^[FN43]

28. As the FTC Staff points out, in a case such as this where resellers are alleging that carriers are engaging in predatory pricing practices, (i.e., offering wholesale cellular service to resellers at an inflated non-cost based price and at the same time reducing the retail price charged by their retail arms through commissions or other incentive payments), it is difficult to differentiate between such predatory practices and intense retail competition that includes the use of an efficient distribution system.^[FN44] We agree with the FTC Staff and the DOJ that the most efficient government policy is to allow firms the ability to choose how to distribute their own products.^[FN45] Thus, to the extent that elimination of the bundling prohibition allows facilities-based carriers to utilize their preferred distribution systems more intensively, and to the extent that resellers are not part of the facilities-based cellular carriers' preferred retail distribution systems, resellers may not benefit from the elimination of the bundling prohibition.^[FN46] Nevertheless, the possibility that one type of retailer may be harmed “does not provide a basis for a rule that limits the use of a potentially efficient contract or retail distribution system.”^[FN47] This is especially the case here where the resellers primary concern appears to

stem from the rate structure that they are held to by the carriers and not the carriers' practices of offering cellular CPE and service on a bundled basis.^[FN48] Moreover, the DOJ further explains that since resellers will remain able to obtain CPE to offer their customers together with service, the sole effect of allowing carriers to bundle will be to put the resellers in the same position that any distributor faces when its supplier engages in dual distribution.^[FN49] We agree with the DOJ that "[s]uch dual distribution does not, in itself, raise anticompetitive effects." Finally, we note that the record shows that resellers also offer promotional packages of cellular CPE and transmission service.^[FN50]

IV. CONCLUSION

*9 29. As we noted in the Notice, packaged offerings are commonplace in a variety of industries in which customers can purchase an array of products in a package at a lower price than the individual products could be purchased separately.^[FN51] However, the Commission's prohibition of bundled offerings in the Second Computer Inquiry was based on the concern that subscribers have the ability to choose their own CPE and service packages and that they not be forced to buy unwanted carrier-supplied CPE in order to obtain transmission service. Based on our analysis of the cellular industry, we have found that while the cellular CPE industry is competitive, we are unable to conclude that the cellular service market is fully competitive.

30. Nevertheless, we do not believe that the potential for cellular carriers to engage in anticompetitive conduct provides a strong reason to prohibit bundling per se. Despite our concerns about the status of competition in the cellular service market, the records supports the conclusion that clarifying the current bundling policy to allow facilities-based carriers to bundle cellular CPE and service would not have an adverse impact on the cellular CPE market. Moreover, the theoretical potential for this or other anticompetitive behavior is outweighed by the public interest benefits of permitting bundling.

These benefits allow customers to obtain a wide assortment of combined CPE and service from numerous sources, including the carriers and their agents. Accordingly, we will adopt our initial proposal and allow cellular CPE and cellular service to be offered on a bundled basis, provided that the service is also offered separately at a nondiscriminatory price.^[FN52] This policy will ensure that facilities-based carriers who provide cellular CPE and cellular service on a packaged basis will continue to be required to offer cellular service to agents, resellers and other customers at a nondiscriminatory rate.^[FN53] We wish to emphasize that our responsibility is to assure that the public interest, including maintaining a level playing field and fostering competition, maximizes benefits to subscribers.^[FN54]

31. While we recognize the customer benefits of CPE discounting as a part of the sale of cellular service, we intend to monitor the bundling of cellular service and cellular CPE. Our continuing interest is based on our intention that bundling not be used anticompetitively. If parties can demonstrate that carriers' incentive offerings lead to anticompetitive abuses, the Commission will be open to further action.

32. Finally, the parties generally agree with our position in the Notice that there is no reason to institute a federal bundling policy that preempts state action in this area. Accordingly, while we modify our current cellular bundling policy, we will not preempt state regulatory action even if it is more restrictive.

V. ORDERING CLAUSES

33. Authority for the changes to the bundling policy adopted herein is contained in Sections 1, 4(i), 4(j) and 303(r) of the Communications Act of 1934, as amended, 47 U.S.C. Sections 151, 154(i), 154(j) and 303(r).

*10 34. Accordingly, IT IS ORDERED that the Commission's cellular bundling policy is clarified and modified as set forth above.

35. IT IS FURTHER ORDERED that the changes made herein WILL BECOME EFFECTIVE (30) days after publication in the Federal Register.

36. IT IS FURTHER ORDERED that this proceeding is HEREBY TERMINATED.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy

Secretary

FN1. Bundling of Cellular Customer Premises Equipment and Cellular Service, 6 FCCRcd 1732 (1991), appeal dismissed, *National Cellular Resellers Association v. FCC*, No. 91-1269 (D.C.Cir. April 2, 1992).

FN2. See Appendix A for list of commenters. Late-filed pleadings were filed by David A. Wolber, Don Philpott, John Webb and David M. Block. We will accept these comments in the interest of obtaining a complete record upon which to base our decisions in this proceeding. On May 10, 1991, the National Association of Cellular Agents (NACA) requested a 90 day extension of time to file comments. By Order, Mimeo No. 13260 (May 28, 1991), the Common Carrier Bureau denied the request, finding that NACA had failed to show good cause for the requested 90 day extension of time.

FN3. Reply comments were originally scheduled to be filed on June 4, 1991. On May 28, 1991, in response to a request from Telocator, the deadline for filing reply comments was extended to June 19, 1991. See Order, 6 FCCRcd 3374 (1991).

FN4. Ex parte comments were filed by several parties and, in accordance with Section 1.1206 of our rules, have been made part of the record in this proceeding.

FN5. We have analyzed all of the arguments contained in the comments before resolving this rule-making proceeding. However, not all of the points raised in the comments are discussed in the Report

and Order for reasons of brevity.

FN6. Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Final Decision, 77 FCC2d 384; modified on recon., 84 FCC2d 50 (1980); further modified 88 FCC2d 512 (1981), aff'd sub nom., *Computer and Communications Industry Ass'n v. FCC*, 693 F.2d 198 (D.C.Cir.1982), cert. denied, 461 U.S. 938 (1983), aff'd on second further recon., FCC 84-190, (released May 4, 1984).

FN7. Id. at 443-43, para. 149.

FN8. Id. at 444-45, para. 154.

FN9. Cellular Communications Systems (Cellular Report and Order), 86 FCC2d 469, 497 (1981) modified, 89 FCC2d (Reconsideration Order), further modified, 90 FCC2d 571 (1982) (Further Reconsideration Order) appeal dismissed sub nom. *U.S. v. FCC*, No. 82-1526 (D.C.Cir. March 3, 1983).

FN10. NCRA indicated in its petition that it had filed pleadings in another proceeding concerning the Commission's cellular resale policies and that those pleadings referenced the Commission's unbundling policy. See Petitions for Rule Making Concerning Proposed Changes to the Commission's Cellular Resale Policies, 6 FCCRcd 1719 (1991). NCRA requested that the pleading filed in the resale proceeding be incorporated in its petition dealing with bundling.

FN11. Accordingly, we declined NCRA's request to act formally on its petition for declaratory ruling at that time.

FN12. On June 3, 1991, NCRA filed a petition for review in the United States Court of Appeals for the District of Columbia Circuit of the Commission's decision in Bundling of Cellular Customer Premises Equipment and Cellular Service. *National Cellular Resellers Association v. FCC*, D.C.Circuit No. 91-1269. That proceeding was dismissed on April 2, 1992. See note 1, supra.

FN13. We also requested comment on the relative importance of the factors incorporated into our analysis and on any other factors that we did not address. CTIA asserts that in analyzing the effects of packaging on consumer welfare, the Commission should utilize the Sherman Act antitrust standard applied in *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984). Under that standard, tying arrangements are per se illegal. CTIA argues that illegal tying arrangements do not exist in the cellular industry because consumers are not being forced to purchase CPE. We decline to adopt CTIA's narrow standard which focuses exclusively on anticompetitive effects because, as the Commission has noted in the past, the public interest standard encompasses matters that go beyond the promotion of competition. Cellular Report and Order, 86 FCC2d at 486.

FN14. See, e.g., Herschel Shosteck Associates, Ltd., *Advance Data Flash Cellular Brand Sales*, Vol. 6, No. 2, Quarterly Survey (September 1991).

FN15. CTIA Comments at 13.

FN16. See e.g., Rhonda L. Wickham, *Plenty of Portables*, Cellular Business, Vol. 8, June 1991.

FN17. For its part, the North American Telecommunications Association (NATA) argues that a finding now that the CPE market is competitive does not justify a reversal of the unbundling requirement, because the Commission in the Cellular Report and Order relied on the existence of CPE competition when it mandated the unbundling of cellular CPE. NATA Comments at 12. We agree with NATA that it would be insufficient to permit bundling based solely on a finding that the CPE market is competitive. Nevertheless, the competitiveness of the CPE market is an important factor for purposes of determining whether to modify the cellular bundling policy. The Commission in the Second Computer Inquiry stated that:

If the markets for the components of the commodity bundle are workably competitive, bundling may present no major societal problems as

long as the consumer is not deceived concerning the content of the bundle.

Second Computer Inquiry, 77 FCC2d at 443 n. 52. Moreover, as discussed below, in addition to considering any concerns that flow from the status of competition in the relevant markets, we have also examined the public interest benefits of permitting bundling.

FN18. Notice at para. 13.

FN19. NCRA argues that, in analyzing whether the cellular market is fully competitive, the Commission in the Notice should have utilized the same standards used to evaluate market conditions in the interexchange markets, citing *Interexchange Market Regulation Order*, 5 FCCRcd 2627, 2639-40 (1990). It asserts that the application of different standards is arbitrary and capricious unless the Commission can offer a reasonable explanation. As discussed below, our decision in this proceeding is not dependent on a conclusion that cellular service markets are fully competitive. Accordingly, we need not address NCRA's concerns regarding the market analysis suggested in the Notice.

FN20. Several parties argue that in some markets, the cellular service prices are similar, but there is no indication that anticompetitive conduct is occurring. As we stated in the Cellular Resale Notice of Proposed Rule Making and Order, 6 FCCRcd 1719 (1991), "similarity in price without more may equally indicate vigorous price competition between facilities-based carriers in the same market." *Id.* at 1725, citing *Turner, The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusal to Deal*, 75 Harv.L.Rev. 655 663-73 (1962).

FN21. According to the FTC Staff, the Herfindahl-Hirschman Index, which is used to measure the extent of market concentration, indicates that the cellular service market would be 5000, well above the highly concentrated threshold contained in the Department of Justice Merger Guidelines. FTC Staff Comments at 11-12.

FN22. NCRA and Tandy point out that the Commission in Competitive Carrier Rule Making, 98 FCC2d 1191, 1204 n. 41 (1984), classified facilities-based carriers as "dominant carriers," a classification which suggests that both carriers in each market jointly possess market power and are capable of engaging in anticompetitive conduct. NCRA asserts that the Commission has not reclassified facilities-based carriers as non-dominant and that eliminating or modifying the bundling policy requires a demonstration that cellular service carriers do not exercise market power. Therefore, it asserts that the Commission's tentative conclusion that the cellular service market is sufficiently competitive so that bundling would not affect competition in the cellular CPE market is unsupported. NCRA Comments at 9 n. 9. We do not agree that the Competitive Common Carrier Rule Making requires that carriers must be found non-dominant before the bundling policy is modified. The Commission's classification of carriers as dominant or nondominant in the Competitive Common Carrier Rule Making does not, without further analysis, determine whether carriers should be allowed to bundle cellular CPE and transmission services. We must take into account other factors, including the impact on competition in the cellular CPE market and the public interest benefits of bundling. To the extent that NCRA and Tandy challenge the Commission's conclusion that bundling would not affect competition in the cellular CPE market, see discussion in paras. 13-18, *infra*.

FN23. The DOJ Comments at 5.

FN24. CTIA Comments at 14.

FN25. The DOJ Comments at 8-9.

FN26. FTC Staff Comments at 23.

FN27. Cellnet, a reseller in the Detroit area, maintains that it has been foreclosed from marketing certain brands of CPE by virtue of exclusive arrangements between particular manufacturers and one of the facilities-based carriers in the Detroit

market. Cellnet Comments at 11. In addition, Cellular Marketing, Inc., an independent agent and reseller in the Houston area, also contends that such exclusive arrangements between one of the facilities-based carriers in the Houston area and certain cellular CPE suppliers have prevented its agents from buying CPE at the lowest cost. Cellular Marketing Comments at 5. No more specific details are provided.

FN28. We indicated in the Notice that exclusionary conduct reducing the likelihood of price decreases should be considered a form of monopoly or market power because such conduct can delay or prevent prices from falling by preventing the entry of or raising the costs of more efficient competitors. See Krattenmaker, Lande, and Salop, Monopoly Power and Market Power in Antitrust Law, 76 Georgetown L.J. 241, 259 (1987). In this regard, there is no evidence in the record to show that, in those instances where cellular carriers have entered into exclusive distribution agreements with CPE manufacturers, CPE prices have increased or that CPE competition has diminished.

FN29. Century Comments at 4.

FN30. Several parties, such as NCRA, NACA and Tandy, argue that, in the long run, allowing duopolists with market power to bundle cellular CPE and service drives out independent CPE competition, reduces the number of CPE/service choices to two, and eventually leads to higher service prices. This worst case scenario is unlikely to occur for the reasons stated above. For there to be only two CPE offerings nationwide would require a conspiracy of cellular carriers to eliminate CPE manufacturers. Such anticompetitive conduct could be prevented through application of the state and federal antitrust laws.

FN31. As we pointed out in the Notice, packaged offerings are commonplace in a variety of industries in which customers can purchase a number of goods in a package at a lower price than the individual goods could be purchased separately.

Moreover, under the federal antitrust laws, packaged offerings are legal unless they constitute an illegal tie-in or represent an unlawful exercise of monopoly power. See *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984); *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1955); and *Hunt-Wesson Foods, Inc., v. Ragu Foods, Inc.*, 627 F.2d 919, 924 (9th Cir.1980).

FN32. The majority of the commenters believe that the increasing rate of cellular subscribership in the United States is, in large part, due to the sharp price reductions of cellular telephones. See e.g., CTIA Comments at 5-6; Cellular Communications Comments at 13; and New Vector Reply Comments at 2.

FN33. NCRA maintains that unless evidence has been submitted showing that the joint provisioning of cellular service and CPE yields some production efficiency, the cost of bundled service and CPE can never be appreciably lower than the sum of the cost of each component. NCRA Comments at 17. However, as the FTC Staff has pointed out, packaged offerings can be used to reduce transaction and information costs as well as to lower the cost of distributing the products. FTC Staff at 16-17.

FN34. FTC Staff Comments at 17-18.

FN35. CTIA points out that in January 1985, the capital investment per subscriber was \$3872.93; in January 1988, it was \$1951.11; and in January 1991, it was \$1189.01. CTIA Comments at 19.

FN36. Centel Comments at 3-4.

FN37. FTC Staff Comments at 14.

FN38. For example, Century notes that in 1988, the average price of a cellular telephone was \$1,000, while in 1990 the average price was \$400. Century Comments at 2.

FN39. According to NCRA, cellular is a declining-cost industry; each carrier's ratio of fixed-to-total costs is very high; original plant has been substantially depreciated; and consumer demand grows at

tremendous rates each year. NCRA contends that under these conditions, rates should be falling. NCRA Comments at 10-11. However, McCaw cites industry studies showing that from 1987 to 1991, cellular service prices declined in absolute terms in one third of the top 30 markets and in additional markets when adjustments for inflation are considered. McCaw Reply Comments at 9.

FN40. In this regard, NCRA and Tandy argue that bundling causes existing cellular subscribers to subsidize CPE purchases from new users. NCRA Comments at 18-19; Tandy Comments at 19-20. We reject this argument. As DOJ has observed, this argument presumes that carriers set their rates on the basis of their average costs. However, in the short run, profit-maximizing carriers will set their rates based on variable costs, i.e. the costs they can control by increasing or decreasing output. DOJ states that demand requires a carrier to try to maximize the difference between revenue and total variable cost. Once the carrier has signed up a new customer, the commission it paid its agent is a sunk cost that has no unique impact on the variable cost of providing cellular service. Thus, the service rate charged would not vary with the size of commissions paid to agents. DOJ Comments at 10-11. In short, the CPE expenses are treated as any other cost of securing a subscriber, e.g., advertising.

FN41. CTIA submits data showing that 12 states fully regulate cellular service, 12 are partially regulated and the remaining states impose no regulations. According to CTIA, a state which regulates cellular service requires a Certificate of Public Convenience and Necessity (CPCN) and tariffs, for both wholesale and retail offerings. A state which partially regulates typically requires a CPCN and tariffs at the wholesale level but not at the retail (subscriber) level. A state that is not regulated does not require cellular carriers to obtain CPCN's or file tariffs. CTIA Comments at Attachment D.

FN42. The DOJ Comments at 29.

FN43. NCRA Comments at 14.

FN44. FTC Comments at 13-14.

FN45. *Id.* at 15.

FN46. See FTC Staff Comments at 15.

FN47. *Id.* at 15.

FN48. Any restrictions on resellers' ability to buy packages of CPE and service on the same basis as other customer would be unlawful. See Petitions for Rule Making Concerning Proposed Changes to the Commission's Resale Policies, (Cellular Resale NPRM/Order), 6 FCCRcd 1719 (1991). Resellers also appear to be concerned that service prices may be subsidizing CPE prices in packaged offerings. NCRA Comments at 3. In this regard, see para. 24, *supra* and note 53, *infra*.

FN49. The DOJ Comments at 12.

FN50. NYNEX states that resellers have offered promotional packages where the facilities-based carriers or its retail affiliate do not offer such packages. NYNEX Comments at 10. See also Southwestern Bell Comments at 14.

FN51. See Notice, 6 FCCRcd at 1737, n. 21.

FN52. In addition, we note that cellular carriers will still have to comply with all applicable state and federal antitrust laws. See, e.g., Section 3 of the Clayton Act, 15 U.S.C. Section 14.

FN53. In its petition for declaratory ruling filed on December 23, 1988, NCRA contended that carriers' bundling or packaging practices are inconsistent with our decision in AT & T Opportunity Calling, ENF-84-36, E-84-28 (released April 4, 1985) (Opportunity Calling). NCRA maintained that carriers' offerings patently discriminate in favor of new customers who receive a discount or rebate and against customers who do not receive such a discount or rebate. We disagree with NCRA that the Common Carrier Bureau's (Bureau) decision in Opportunity Calling provides a basis for finding that cellular carriers' bundling or packaging practices

are impermissible. In Opportunity Calling the Bureau indicated (in dictum) that circumstances could arise in which rate preferences for new customers might be unlawful. As indicated earlier, however, cellular service is not subject to cost based rate-of-return regulation and there is no conclusive evidence here that cellular carriers use their cellular service revenues to subsidize their bundling practices. Hence, the record does not support a finding that new cellular customers are receiving rate preferences for cellular service through cross-subsidization. Moreover, as discussed in paras. 19-21, *supra*, bundling is an efficient promotional device which appears to create benefits for all cellular customers.

FN54. In view of our determination that such bundling activities are not precluded under our new policy, we reaffirm our dismissal of NCRA's petition for declaratory ruling filed on December 23, 1988. As noted above, the record before us does not support NCRA's petition.

70 Rad. Reg. 2d (P & F) 1288, 7 F.C.C.R. 4028, 7 FCC Rcd. 4028, 1992 WL 689944 (F.C.C.)

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