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Telecommunications Reform— How to Succeed

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Today, more than sixty emerging economies—twenty-five in Sub-Saharan Africa alone—are at some stage of transformation from state telecommunications monopolies to private-led, competitive markets. When well done, this reform can be a positive-sum game in which all stakeholders gain—customers, existing and new operators, employees, domestic and foreign investors, and the government. Faster growth, better and new services, lower costs, and, eventually, lower prices follow. This Note outlines the key ingredients of successful reform.

Get support at the top

Reform is most likely to succeed if it is led at the highest level of political authority. This is usually the head of government, who then allocates responsibility for the reform to a single person with direct access to senior government officials, freedom to cut red tape, and resources to assemble a small support team and hire the necessary experts. Such was the case in the privatization of Mexico's telecommunications company, TELMEX. The president announced the reform in August 1989, appointed the minister of finance chairman of the board and gave him overall responsibility for the privatization, and handed over the chief executive's job to an experienced public administrator with a clear reform mandate. Privatization was completed in December 1990. By contrast, Brazil's attempts at reform from the early 1980s did not muster the necessary political muscle. Not until 1997 has real progress been made.

Sort out conflicting objectives early

The primary purpose of reform is to get consumers more, better, new, and less costly services. Pressures from interest groups—incumbents who want ongoing protection, new entrants seeking special deals, treasury officials

expecting to use sale revenues to reduce budget deficits, financial advisers earning success fees tied to transaction prices—can steer reform off this track. In particular, sale strategies that drive up the prices paid for existing companies or new licenses can hold down growth, reduce the funding available to invest in these companies, or result in high tariffs.

For example, convinced that the six-year long-distance monopoly granted to TELMEX in 1990 had led to high consumer prices and slower growth than would have happened under competition, the government in 1996 chose to forgo the high fees it could have obtained by tendering one or two new licenses and instead opted for unrestricted entry. In India, exorbitant prices bid for second fixed operator licenses in 1996 combined with modest revenue projections (from an overall low-income population) is making it difficult to raise debt financing for investment. In Brazil, the consortium that won the cellular license in São Paulo in 1997 with a US\$2.5 billion bid—four times the government's asking price and 60 percent more than the second-highest bid—is likely to pass on the cost to customers through much higher tariffs than those proposed by rival bidders. By contrast, the government of Bolivia privatized ENTEL in 1996 by issuing new shares for which the winning





bidder paid US\$600 million, immediately available for investment in the company.

Sale strategies that place less emphasis on cash up front can, moreover, yield substantially more cash to the government later. For example, awarding a cellular license to the bidder that offers the largest build-out plan—rather than the one offering the highest license fee—can increase tax revenue for years to come by creating more business. And initially selling only the minimum number of government shares needed for effective transfer of control of the state company to the new owners (usually 20 to 30 percent) allows the government to float the balance later and obtain much higher prices, once the company appreciates under private management. In the privatization of TELMEX, for example, the government initially sold 20 percent of the shares to a strategic investor in 1990 for US\$1.8 billion, then sold 31 percent more through public offerings in 1991 and 1992 for US\$4.5 billion—70 percent more per share.

Set clear policies and procedures

The business offered to investors must be clearly defined in the laws, regulations, and main transaction documents (licenses, contracts of sale). The most critical policy issues relate to pricing, competition, and interconnection. In pricing, governments must bite the bullet early and rebalance tariffs. The price an operator is allowed to charge its customers is the most important determinant of profitability and ability to finance growth. Existing tariffs are often way out of line with costs. Including rebalancing plans in the licenses or contracts has tended to delay further reforms, as the new owners avoid the public fallout from raising some prices yet later expect the licensing of competitors to be delayed because tariffs remain unbalanced. To set new tariff structures, though, calculating the actual costs of each operator is seldom a viable method. Rather, tariffs observed in competitive markets probably offer the best guidance on efficient prices. Although some cost elements (labor, land, taxes) vary considerably among countries, the

main costs (equipment, capital) are determined in global markets and thus international benchmarks are relevant. As the market becomes more competitive, pricing can be increasingly left to the operators.

The interconnection obligation of the dominant operators, the principles under which terms of interconnection will be negotiated, and the process and timetable for a regulatory decision if the parties fail to reach agreement must be clearly spelled out. A new operator's ability to reach (and be reached by) customers of the existing operator and to use parts of existing networks under reasonable technical and price terms rather than building complete new facilities plays a big part in determining not only its own viability but also the economic efficiency of the sector overall. In Poland, failure to sort out interconnection with the incumbent meant that of some 200 licenses issued to independent operators since 1990, only about twelve were in use in 1996. Licensees cited the main impediments as unfavorable terms for sharing revenues with the dominant state operator, limited access to its network, slow negotiation of interconnection agreements, and a prohibition on setting up their own transmission facilities.

Reforms should follow clearly defined processes that are open to participation and review by all interested parties. The public should be kept informed. Market mechanisms, not individual negotiations, should be used to select partners and determine the right sale prices. And the award of licenses and contracts should strictly adhere to the evaluation criteria announced at the outset. Once a window of political opportunity for reform opens, time is of the essence—but should not be used as an excuse to cut corners or strike deals behind closed doors.

Clear rules and processes must also apply to the regulatory function. The locus and functions of regulatory authority as well as the basic procedures that will govern its relationships with operators and customers must be defined, preferably by law. That does not mean that a full regulatory capability must be in place before

major reform steps can be undertaken. Initial regulatory decisions can be written into licenses and contracts of sale. A core decisionmaking capability in the form of a commission, say, and a secretariat with processing capability, supported by outsourcing of expertise, can deal with whatever is essential in the first two or three years, such as issuing licenses, managing conflicting demands on the radio spectrum, and resolving interconnection disagreements. Other areas of competence can be gradually developed as needed. Chances are that successive problems will arise, peak, and then decline to a low simmer so that a permanent, comprehensive in-house capability may never be needed. Moreover, in most emerging economies, anything beyond a minimalistic regulatory institution is not feasible.

Open all markets to competition

Without competition, the benefits from increased private participation will not be fully realized. In Latin America, for example, countries that granted monopoly privileges of six to ten years to the privatized state enterprises saw connections grow at 1.5 times the rate achieved under state monopolies but only half the rate in Chile, where the government retained the right to issue competing licenses at any time (table 1). Rural areas, too, can become an attractive business under liberal entry and pricing policies. In Chile, government subsidies equivalent to less than 0.5 percent of total telecommunications revenue, allocated through competitive bidding in 1995, mobilized twenty times as much private investment to extend basic telephone access to rural areas. The program brought service to about a third of the rural population lacking it.

Contrary to views often expressed by financial advisers, investors are not opposed to competition—as long as they are not also burdened with regulatory uncertainty, unrealistic service obligations, and rigid tariffs and employment rules. This is true even in small, low-income markets. Ghana Telecom was successfully privatized in late 1996 at the same time that a license was awarded for a second full-service

TABLE 1 FASTER GROWTH IN OPEN, PRIVATIZED MARKETS
Annual percentage growth in main telephone lines

	1984–89	1989–94
Brazil, Colombia, Ecuador, Peru, Uruguay	7.0	7.8
Argentina, Mexico, Venezuela	6.7	11.3
Chile	6.6	20.5

state monopolies
 privatized monopolies
 privatized open markets

Source: Pyramid Research (1996) and World Bank.

national operator and three other cellular companies were already in place—and the price per line was similar to that paid for the monopoly in neighboring Côte d'Ivoire. But lack of clarity regarding competition policy does drive investors away. Partial privatization in 1996 of Svyazinvest, the Russian holding of 85 regional telecommunications companies, failed shortly before closing when the winning bidder realized the government did not intend to grant Svyazinvest a license to build its own long-distance network.

Enhance credibility and stability

Even if a government gets all the policies, rules, and procedures right, operators and investors will come and stay only if they believe that the government will stay the course. Governments can do several things to enhance credibility and stability. To safeguard reforms against political changes, governments should develop them with the support of major stakeholders—various branches of government, public and private sector users, chambers of commerce, consumer groups, large enterprises (including state-owned firms) that could become alternative network providers, local investors and banks, and the staff and management of existing operating companies.

In emerging economies, most with strong growth potential, the concerns of labor can in fact be readily accommodated. Most workers



stand to gain from higher salaries, improved career prospects, and new opportunities as employees or entrepreneurs in a rapidly expanding market. Growth allows major gains in labor productivity with little reduction in personnel. As Ghana Telecom prepared to privatize in 1996, some 500 workers (14 percent of the combined telecommunications and postal workforce) agreed to leave with severance packages that cost the government less than 3 percent of the initial proceeds from privatization. After privatization, potential labor problems largely disappeared following management commitment that there would be no forced redundancies, introduction of training programs, and expected growth. By contrast, labor unions whose concerns—and political clout—had been ignored brought to a halt Sri Lanka's reform program in the mid-1980s. In the restructuring of state telecommunications enterprises in Latin America, an additional enticement has been offered—employee stock option plans that transfer about 5 percent of shares to employees on favorable terms.

Essential for reducing investor risk is limiting the opportunity for discretionary government or regulatory intervention in business, especially in the early years. In Uganda, initial decisions on tariffs, service obligations, and default interconnection terms are being written into licenses and contracts (as was also done in Ghana). Numbers that will remain firm for, say, five years—subject if necessary to automatic adjustment, based on simple formulas, for inflation, foreign exchange, or other factors—are more effective at reducing risk than are rules for calculating these numbers.

Telecommunications reforms gain credibility when coupled with broader programs in which the government has a large stake. The privatization of ENTel in Argentina was the flagship of President Menem's multisectoral public enterprise reform program in the early 1990s, and everyone knew that a failure by the government to stick to the rules it had set for telecommunications would have undermined the whole program.

Investors, operators, and customers will be reassured by a telecommunications law that establishes broad principles and rules governing the sector. A law with a narrower objective, however, such as establishing a regulatory authority, may suffice. The timing of amending or replacing a dated law must weigh the potential delays and political cost.

Anchoring key elements of reform in international frameworks also adds credibility. World Trade Organization (WTO) member countries that subscribe to the telecommunications agreement of 1997 enter a binding international commitment to implement aspects of their own reform targets, abide by a common set of regulatory principles, and recognize the WTO as an instance of intergovernmental appeal. All this is likely to provide comfort to investors worried about regulatory risk. Similarly, loans, credits, and guarantees from multilateral agencies such as the World Bank Group involve government obligations that can be tailored to help offset risks such as failure of the government to abide by the terms of licenses (on pricing, for example) or ensure access to foreign exchange for debt service or dividend payments. A US\$90 million investment by the International Finance Corporation and the European Bank for Reconstruction and Development in 1993 in the Hungarian state telecommunications company mobilized US\$1.2 billion in foreign funds at the time of privatization.

Conclusion

Major transactions such as a privatization or the issuance of new licenses tend to drive the reform agenda, but change continues well beyond these transactions. Following the rules and honoring commitments helps consolidate an environment for sustainable growth. Also critical is to build a regulatory capability to suit changing needs, take every opportunity to enhance competition, and address any persistent gaps between development and commercial objectives.

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