

Feature

KEY POINTS

- When sovereigns do not need immediate use of the bid proceeds, instalment payments may present certain advantages.
- Instalment payments can be an effective tool to mitigate a variety of risks.
- Financial and legal advisers should consider adding this tool to the solutions and approaches they recommend to sovereign clients.

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Instalment payments in spectrum auctions and telecom privatisations

REASON FOR AUCTIONS

■ Much has been written in support of auctions for spectrum licensing and privatisations. They are probably the most effective pricing tool for sovereigns to recover full economic rent for private commercial use of public assets. Auctions also impose market discipline on the rationing of scarce spectrum resources in three ways: First, they ensure efficient spectrum use by forcing licensees to pay full market value for what they are assigned whether it is used or not. Secondly, auctions support the goal of ensuring the highest value spectrum use. Thirdly, if properly designed and conducted, auctions are a transparent and efficient selection protocol.

UPFRONT PAYMENTS JUSTIFICATION

Why require upfront payment of bids?

Reducing default risk is one justification. Default risk cannot be eliminated, as it is impractical for bidders to pay or post bonds for the full amount of their bids on auction day, so some risk of default between the auction and the sale closing is inevitable.

Another reason is to provide selling sovereigns with immediate access to funds. For example, a sovereign may need to pay down debt or face other pressing fiscal needs.

A third justification is that transferring unencumbered assets to the winning bidder (after the sovereign has been contemporaneously paid in full) facilitates secured bank financing by enabling lenders to have first priority liens on borrower assets.

Some commentators have suggested that instalment payments also result in speculative bidding, inefficient assignment of licences and other ills. The author has reviewed these criticisms, now quite dated, and believes instalment payments are worth another look.

BENEFITS OF INSTALMENT PAYMENTS

When sovereigns do not need immediate use of bid proceeds, instalment payments may present certain advantages in appropriate cases.

The past decade has seen auctions become the norm for spectrum licensing¹ and telecom privatisations. Weakened capital markets have recently reduced auction activity and bid amounts, potentially creating pent-up demand from sovereigns on the sell side and telecom operators and investors on the buy side. Some auctions allow limited instalment options, but most sovereigns require the full bid price to be paid before granting a spectrum licence or transferring the shares/assets of a privatised telecom operator. See infoDev-ITU, 'One-time Fees and Recurring Fees,' ICT regulation toolkit §4.1.1.1 (2009). Upfront bid payments are often substantial and saddle winning bidders with additional debt/equity requirements. This article suggests that, in some circumstances, instalment payments may benefit selling sovereigns, bidders and stressed capital markets.

First, sovereigns can improve auction results. Lowering upfront capital requirements typically generates more interest and participation in an auction. Net present values of bid amounts are likely to be higher. Fewer auctions are likely to be aborted. Winning bidders obtain, implicitly, sovereign financing for licence fees, reducing capital requirements by shifting licence fees from capital expenditure to operating expense.

Secondly, spreading licence fees over licence terms reduces the temptation for sovereigns to use the 'windfall' from an n-year lease of an asset during the first budget year, which would otherwise deprive future budgets of the benefit of the asset or the income.

Instalment payments are most beneficial for spectrum licences, as opposed to telecom privatisations, because government can simply terminate a spectrum licence in case of payment default without having to repossess other assets.

Although instalment payment mechanisms are less beneficial in privatisations, a blend of upfront and instalment payments may achieve some benefit if part of the bid is allocated to spectrum rights and that portion of the bid is paid in instalments. This option is only available if the privatised telecom operator uses spectrum and the privatised assets include a spectrum licence – as in the case, for example, of the upcoming privatisations of Bahamas Telecommunications Company and the Lebanese mobile operators.

MANAGING THE RISKS

Employing instalment payments impacts a variety of risks that can be addressed by a well-designed auction. Perhaps most significant are (i) default risk to government, (ii) credit risk to capital markets, and (iii) technology and commercial risk. The following discusses ways to manage these risks for spectrum licences (whether auctioned on a stand-alone basis or with a bundle of assets in a privatisation).

Selling sovereigns must mitigate the risk of default in payment of bid instalments. The simplest approach is for the spectrum licence to terminate for payment default, presumably after an appropriate opportunity to cure. However, sovereigns must ensure such termination provisions are bankruptcy/insolvency proof, or at least bankruptcy/insolvency resistant with known and manageable risks. The extent to which this is possible, and the best way to accomplish it, depends on a jurisdiction's bankruptcy/insolvency laws and whether or not its legal/regulatory regime treats spectrum licences. Perhaps the most notable case on bankruptcy risk to a sovereign is the US Supreme Court decision forbidding the FCC's attempted revocation of the broadband PCS spectrum licence previously awarded to NextWave following its Chapter 11 bankruptcy. See *FCC v NextWave Communications, Inc*, 537 US 293 (2003).

Biog box

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CREDIT RISK TO CAPITAL MARKETS

The flip side of mitigating government's default risk is avoiding an unacceptable credit risk for lenders. Improperly designed government instalment plans may impair the ability of winning bidders to obtain financing for their remaining capital needs. Sovereigns should, in consultation with bidders, design their default termination provisions to afford secured creditors notice of default and a reasonable opportunity to cure. Sovereigns must recognise that the cure may involve transfer of ownership or control of the licensee/licence by secured creditors. This may require the government to anticipate and permit such eventualities in spectrum licences (subject to regulatory oversight to ensure that the transferee meets minimum licensee qualifications).

TECHNOLOGY AND COMMERCIAL RISK

The most difficult challenge in spectrum auctions is the technology and commercial risk that spectrum will be worth significantly more, or less, than originally anticipated, and the potentially dramatic variation in value over licence terms due to changes in technology and market demand. Some auctions involve spectrum to be used for new technology, while others involve capacity expansion rights for older technology. In both cases, spectrum value is not perfectly predictable or evenly spread over time.

For new technology, anticipated value may be more back-end loaded, and may involve a substantial degree of risk that the new technology will not catch on at all – leaving the licensee with a stranded investment. If licence fees are payable in instalments, a licensee will likely deliberately default in case of a stranded investment, and allow the government to reclaim the relevant spectrum. While this may appear to be an unacceptable result for government, it actually may achieve more economically efficient risk sharing by reducing the bidder's risk of overpaying and allowing re-use of the spectrum (and a second chance for the government to receive compensation for its use) for a more viable technology in due course. In contrast with a sovereign's limited default risk from accepting instalments, licensees that have paid up front for lengthy spectrum licences may have a difficult time recouping their investment

under such circumstances, particularly if licences restrict the purposes for which the spectrum may be used (as is frequently the case).

For older technology, the value of additional spectrum to the licensee may be more predictable, but again not necessarily immediate. Upfront payments burden licensees with significant capital costs that precede commercialisation of new spectrum, and tend to starve existing business lines of cash and reduce product and service innovation and quality. Some European 3G licensing auctions were criticised for this unintended consequence.

For these reasons, instalment payments can be an effective tool to mitigate technology and commercial risks by more closely matching the timing of spectrum value with the timing of licence fees.

SPREADING INSTALMENT PAYMENTS

Sovereigns designing auctions that allow instalment payments must determine the period over which to spread the payments.

As an upper limit, payment term should generally not exceed spectrum licence term, or else the government will face an unacceptable default risk for later payments. Initial licence terms vary considerably. Nearly gone are the days of licences with presumptively infinite terms, and even where these have been granted in the past, regulators are re-taking and re-assigning underutilised spectrum through re-farming programmes. The current approach typically limits spectrum licences to terms of ten, 15, 20 or 25 years based on a variety of factors, and the degree of confidence of regulators (and industry, which frequently has input in the pre-tender consultative process) in the time horizon for existing or anticipated spectrum uses. While shorter licence terms may reduce bid prices, they should not reduce them substantially to the extent they are well-matched to the goal of making the licence co-extensive with future changes in technology and markets. In addition, the net present value of a licence beyond these windows diminishes substantially. Moreover, sovereigns can re-license the spectrum at the end of the shorter terms.

Spreading licence fees over the full licence term has the advantage of almost nearly emulating the useful life of the asset, and so better matches the timing of economic rent

with the licensee's commercial use of spectrum. Licence payments might be even more closely matched by varying the level of payment required during the term. For example, annual fees could be capped at the lesser of a specified percentage of revenues or a stipulated amount – and even the stipulated amount can be varied to front-load, back-load or middle-load the burden to more closely match the anticipated value of the licence to the licensee. Any bid amount deferred by a percentage of revenue cap could then be recouped in later years of the licence term, perhaps by having the percentage of revenue cap increase or expire after an initial period. Limiting instalment payments to percentage of revenue for the entire licence term, however, may undermine the economic rent recovery and rationing goals of auctions because such caps effectively convert the winning bid into a maximum payment rather than a minimum payment.

Shorter payment terms, on the other hand, reduce the default risk to governments, and afford governments access to and use of the licence fees sooner.

CONCLUSIONS

Instalment payment plans for payment of winning bids in spectrum auctions and telecom privatisations are not always good policy, and, even when appropriate, must be designed and managed carefully. However, financial and legal advisers should consider adding this tool to the solutions and approaches they recommend to sovereign clients. In addition, those advising or providing financing to bidders should consider the merits of this approach in pre-tender consultation comments and, in any event, should be prepared when it arises – which the author predicts will happen with increasing frequency. ■

- 1 A spectrum licence entitles the licensee to use a defined block of radio frequencies in a defined geographic area for a specified period of time. Spectrum is used by telecom operators for mobile, broadband and other wireless networks as well as for backhaul communications where fiber optic cable is unavailable. Governments (through their typical telecom regulators or telecom ministries) throughout the world are using the auction process to assign spectrum.