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An international forum for the expression of ideas and opinions pertaining to the submarine telecoms industry

Increasing Legal Hurdles

As Subsea Cables Move To The Developing World

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Given the well-known long lead times associated with submarine cable development, it's hard to believe that just a few years ago, industry participants were almost unanimously decrying a glut of overcapacity on subsea networks, industry conferences were sparsely attended and cable-laying ships were being quietly retired.

Despite that recent history and despite the current credit crunch, uncertainty of investment and even the failure of major institutions, 2008 was a surprising year of increased building for the subsea cable industry. Even while the general economy tightens its belt, telecom operators (and some service providers such as Google) are intent on meeting the demands for submarine cable systems engendered in large part by the explosion of web-based video, voice and data and multimedia-centric websites.

Innovations like Facebook, Twitter and Flickr – all just a few years old – have garnered a worldwide audience and placed a high premium on instant accessibility to photos, music and video, as a new generation of 'I-reporters' documents its surroundings, personal interactions, current events and even daily lives through these mechanisms, and through 10 megapixel cameras. All of those applications and photographs, combined with the inexorable increase in web traffic, have generated astonishing demand for intercontinental data connectivity. As the Internet becomes less US-centric, there is a corresponding increase in demand for connectivity throughout the rest of the world.

As a result, many submarine cable projects are currently in full-swing and the focus has now shifted to regional systems in emerging markets and areas that are only now getting significant Internet penetration (principally Africa and parts of Asia). For example, on the east coast of Africa, construction has started on the SEACOM cable that will link Africa with India and Europe with the cable expected to go 'live' in June of 2009. Additionally, Project EASSy is in environmental impact assessment mode and projects to be active in February of 2010. Africa, and to a lesser extent Asia, is witness to a number of announced competing projects – with participants and prospective users all warily eyeing each other in recognition of the simple fact that not all of these projects will indeed 'hit the water.'

Development of a submarine cable system shares a lot in common with infrastructure development generally, but the process entails a number of distinguishing characteristics that have legal ramifications that this article will briefly survey and comment upon. For instance, the geographic scope of a project stretches across thousands of miles, unlike a powerplant or bridge. Sponsors and lenders must be aware of the myriad of legal schemes (some of which may be conflicting) regarding the acquisition of permits and landing rights, the taxing of revenues and environmental regulatory schemes. The overlapping of legal jurisdictions applicable to the cable system is coupled with the high degree of technical specificity and expertise required to build a proper system, starting with the demand surveys and desktop routings to the actual deep-sea cable laying. Furthermore, sponsors must be cognizant of the management of the cable system (including damage due to earthquakes, ships' anchors or inquisitive sharks), the establishment of a network operations center, negotiation of backhaul and interconnection rights, as well as agreeing upon the proper channels for marketing and selling of capacity. So, it is immediately apparent that development of a submarine cable system requires an unusually wide panoply of differing skills and specialties.

This necessity for a variegated 'skill-set' in the creation and operation of a submarine fiber-optic network leads

to two primary consequences. First, it obliges any successful sponsor to be capable of providing (or at least arranging for) disparate inputs (technical, operational, marine, environmental and cross-jurisdictional legal expertise). An obvious solution to this challenge is to introduce a greater number of parties to spread the risk and who can bring their respective proficiencies to the table. However, the need for multiple players inevitably leads to increased costs and complexity. Many commentators have noted that certain projects, (Project EASSy to name one), experienced a long gestation period partly for this very reason. Second, there is no one blueprint for how to proceed in the industry. This is true in regards to financing (equity, debt, developmental financial institutions, private equity), but more so in how the sponsor proceeds to arrange, structure and carry through the project to completion and eventual provision of the service to the end-user. Each project seems unique and is structured differently. This is a novel aspect of the submarine cable industry – as billions have already been spent and yet, fascinatingly, there is still a constant evolution of approaches.

Most sponsors and operators have reacted to the first challenge, as noted above, by adopting the consortium approach. The consortium model originally developed because a telecom operator would rarely have sufficient traffic to warrant construction of its own submarine cable. Moreover, that approach enabled risks and costs to be shared among a number of operators and permitted access to a range of expertise. For decades, the consortium model dominated the industry, in which each participating carrier (historically, a government-owned monopoly operator) would invest an equity share, as co-owner, in exchange for a proportional allocation of bandwidth capacity on the new cable. These equity contributions paid for the construction costs, and the consortium members committed to the future operating and maintenance costs. Today, in most instances, any consortium model will likely be dominated by non-governmental sponsors. Such consortium members can sell capacity to third-party buyers or use it for their member networks.

In line with the second challenge above, the consortium model has undergone many permutations in recent years and each consortium of sponsors will face differing sets of issues depending on the specifics of the submarine cable project. Due diligence has also taken on a more prominent role as undersea cable projects have shifted to the developing world, causing many sponsors to exert more time and effort in order to understand unfamiliar, and often nascent and incomplete, legal and regulatory schemes. Environmental regulations and permitting rights are important in any submarine cable project, but, especially in the developing world, a sponsor must make sure it has staff or advisors that are well-equipped to understand the intricacies of these regulatory frameworks. The issues are often further complicated given the interweaving of multiple jurisdictions, especially in current African subsea projects, where as many as ten developing countries could be implicated at a time. Multiple jurisdictions means sponsors must maintain counsel in each affected jurisdiction and this leads to burgeoning costs, a premium on executive coordination time and inevitable delays for the project.

Local tax schemes will have a strong bearing upon what sort of entity sponsors decide to form, since sponsors will naturally try to minimize taxes whenever possible, customarily by having the principal cable owner sited in a tax haven. Many developing nations insist, however, that cable landing rights and other relevant licenses be granted to only domiciliaries of that nation – and consequently the requirements for local participants and owners lead to a complicated web of multiple corporate entities. Additionally, the very nature of these projects means that from a tax perspective, they are capable of earning revenues in many places. Many sponsors will have the different aspects of the submarine cable system (marketing, contracts, maintenance) conducted by separate subsidiaries in distinct locales. It is thus crucial to understand the tax burdens associated with the corporate structure and also ensure transparency so that any potential lenders will be able to monitor cashflows and dividend streams. The shift to developing countries also has an associated impact on drafting the governing contract. Along with the problems that accompany any contract

(including which law shall govern and remedies in the case of breach), sponsors must pay particular attention to dispute resolution procedures and query whether it is realistic to achieve the judicial or arbitral relief they require in the jurisdiction selected. In short, developing cable systems in the Third World means dealing with inchoate legal systems and judicial and licensing systems that, to put it charitably, may not always be predictable. Prudent sponsors will often seek to balance nationalistic desires against the need for governing law and dispute resolution procedures that are familiar and established.

Newer consortia tend not to follow the path of large operators with lavish resources. In the past, a strong sponsor with high technical proficiency, a strong debt/equity position and numerous staff at its disposal could conduct its own internal market-demand analysis and assume some of the role of general contractor during the construction of the cable system. However, as we move into an age of smaller regional projects in the emerging markets with a multitude of parties who may not have this large staff and expertise, the solution becomes a turn-key construction contract. This is a somewhat more expensive, but perhaps unavoidable, solution. Moreover, while the major fiber-optic system vendors are reputable and proficient at their tasks, this approach puts a premium on the sponsor being responsible for overseeing the vendor and making sure it gets the utmost out of the team employed to the end that all work proceeds in the manner that the sponsor sees fit. Often, sponsors will engage separate consultants to undertake this supervising role, and lenders to such a project will invariably engage their own engineers and other advisors to vet everything from the marketing studies to the projected 'ready for service' date.

In any consortium, whether it be in the developing or developed markets, it is critical for the sponsors to craft a cohesive and well-structured contract to govern the rights amongst themselves. Given the amounts of money involved, it is sometimes surprising to see that parties have proposed a contract that is a product of cobbling together disparate pieces of a cable maintenance contract, a shareholders' agreement and

a capacity sale document. Important areas to address include when and on what terms equity contributions are required, the responsibilities for cost-overruns, when the project can be abandoned, when upgrades are necessitated and who is entitled to decide on them, how maintenance responsibility is apportioned and how marketing for the selling of capacity will be conducted. All of these and other elements need to be considered in conjunction with each other. As in any negotiation, there will be sponsors with higher degrees of bargaining power and the ultimate deal reached will reflect these nuances. Differences in creditworthiness also become relevant when lenders enter the stage to provide some type of financing to complement the equity. Lenders to a project will be concerned with how they will hold each sponsor liable (jointly and severally liable for the full amount or merely severally liable for each's share of the debt) and how to deal with sponsors in the consortium with lesser creditworthiness. Lenders will also need to decide what entity they will lend to – directly to the sponsors to fund their respective equity contributions, or to some newly created joint venture of sponsors whose creditworthiness reflects the sponsors' combined strengths. Ideally, from the lenders' viewpoint, the loan could be made directly to the project company. This approach has the benefit of lending to where the assets and cashflow are located and the ability to obtain liens on or pledges of the assets. Sponsors will typically also be asked to give a pledge of their shares in the project company in these instances to ensure appropriate security and remedies to the lenders.

So, there is optimism – albeit somewhat tempered by these bleak economic times – for submarine cable projects, both for systems currently being constructed and for future build-outs and upgrades. There are various ways for sponsors to structure the ultimate project even within the consortium model, but one must keep in mind that 'no one size fits all.' No submarine cable project is a foregone conclusion of success and a sponsor must be cautious and not lead to overzealous action by market allure. Especially in the context of developing markets, sponsors must analyze and conduct their due diligence, company formation,

contract drafting, construction and operations with explicit focus on legal frameworks, the expertise their team provides and market realities.

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