

Milbank

Managed Services Solutions for
Telecom Operators:
Preserving Benefits for Operators and
Minimizing Risk for their Lenders

by

Glenn S. Gerstell, Nicholas A. Smith and Gavin W. McKeon
Milbank, Tweed, Hadley & McCloy LLP

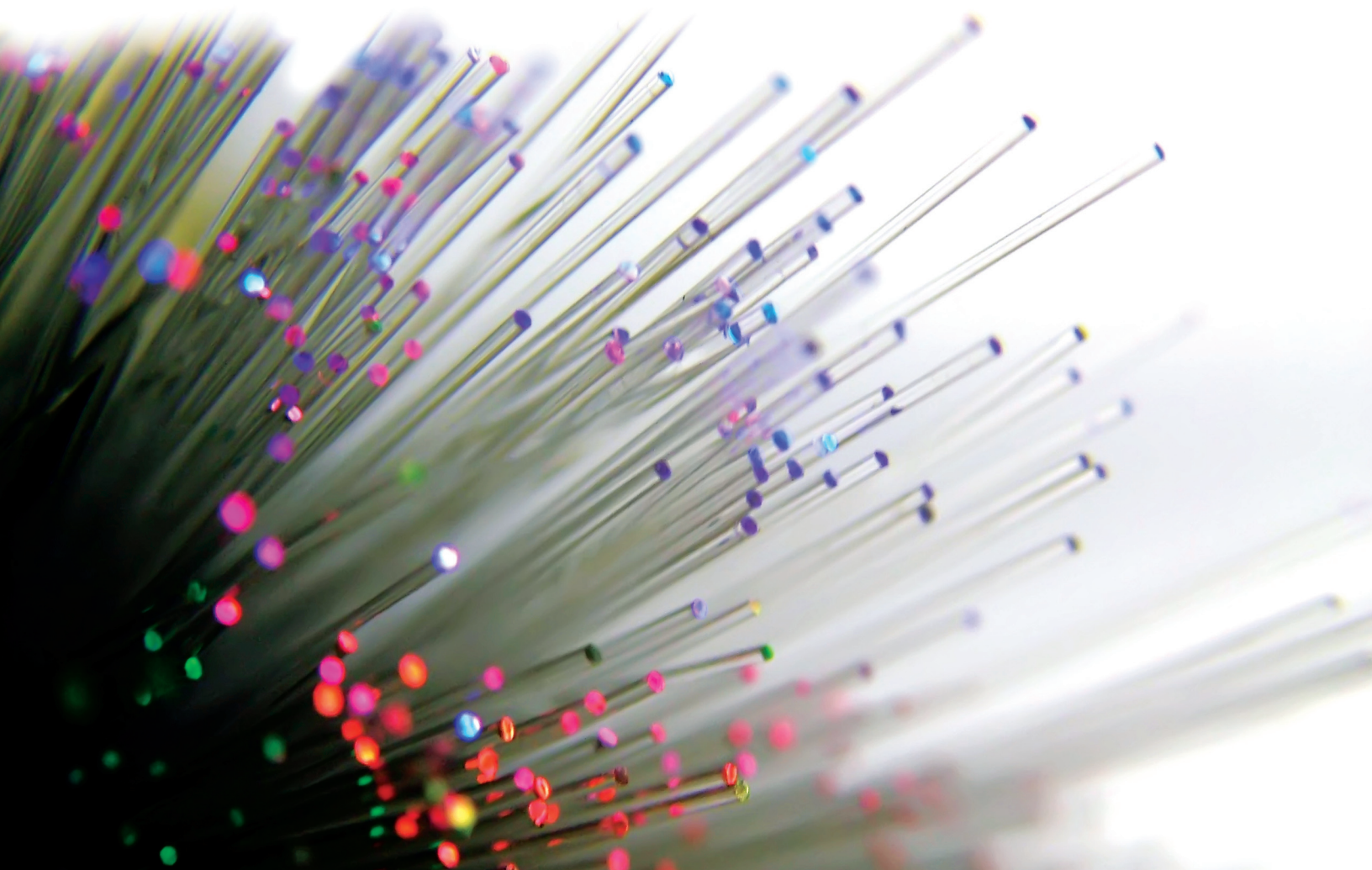
Milbank

Introduction

Facing continued competition and mounting infrastructure costs as technology cycles shorten, telecom operators are under relentless pressure to manage the capital expenditures associated with network deployment and to reduce network operating costs. Telecom operators are increasingly addressing these challenges through adoption of outsourcing solutions.

These arrangements take a variety of forms, including outsourcings in which a telecom operator transfers the operation of its proprietary network to a third-party supplier of greater scale, or in which a telecom operator sells its tower sites and leases back access to the same facilities that are managed by the site purchaser. What unites these outsourcing solutions, though, is that they permit telecom operators to control the capital expenditures associated with asset management and technology upgrades while also benefitting from overall lower operating costs resulting from the synergies produced by a specialist network service provider with greater economies of scale.

This article examines first, how a telecom operator can obtain and preserve the economic gains promised by a managed network outsourcing solution and second, how a lender can control the operational and financial risks created when its telecom operator/borrower avails itself of a managed network outsourcing solution.



Approaches for Network Operators to Preserve Economic Value of Outsourced Relationships

At the core of a network operator's decision to procure managed network services is the determination that the outsourced service creates a predictable economic benefit, not merely in the early years of an outsourcing relationship but also in the later years of an agreement, when industry practices and technology evolution may have altered network management costs in a manner not contemplated by the parties. Given the long transition times at either end of the arrangement, the significant capital expenditures required to deploy a telecommunications network, and the useful life of most network equipment, most managed services contracts will last for many years. While numerous variables will come into play over the relatively long duration of the typical contract, there are at least three areas where change is foreseeable but uncertain: service volumes as subscribers and usage presumably increase, unit prices, which decline over time due to greater efficiencies and market competition, and ineluctable technological improvements. Contract mechanisms and structures to cope with these changes, in a way that accomplishes the goals of both operator and vendor, are the key to a successful outsourcing arrangement.



Ensuring the Value Proposition of Outsourcing: Guaranteed Savings

Managed network services, which include procurement and deployment of network equipment, are often good candidates for a “guaranteed savings” pricing model, in which the vendor’s need for flexibility to reflect changes in service volumes (and thus the vendor’s costs) are balanced against a measure of guaranteed savings for the customer/operator. The starting point, of course, for an operator’s consideration of a guaranteed savings arrangement is its estimate of what it would have to pay for the services if it undertook them directly versus arranging for the vendor to handle them. Both the operator and vendor will typically be able to come to a common understanding of what those savings are at least for a short and predictable period. But the trick is how to measure savings after the first few years of the contract term, when future savings are subject to uncertain assumptions and variables.

Most commonly, guaranteed savings are achieved by limiting the fees payable by the customer to a percentage of an agreed customer cost baseline – an approximation of what the customer would have paid to perform those services on its own in the absence of the planned outsourcing contract. Where an operator has plentiful data regarding its historical costs to operate and maintain its network, this data can be used to formulate a baseline for day one of the outsourcing agreement. Where reliable cost information is lacking, the operator can approximate a baseline through a combination of determining effective cost rates based on the available data and the most attractive rates it can obtain on its own in the marketplace for discrete services and projects.

The validity and relevance of the baseline will obviously decline after the first few years of the outsourcing relationship. Depending on the cost factor, the parties can attempt to modify the baseline over time to reflect changing market practices and pricing, or the fees model for certain aspects of the services can shift once the baseline ceases to be useful (*e.g.*, next generation technology could be purchased under a managed procurement services pricing model rather than a guaranteed savings model).





Clearly Defining the Upper Limit of the Fees the Customer Must Pay

Where the parties can predict the total cost to provide aspects of the network services, or where the parties can formulate an all-in unit rate for components of the network (e.g., an all-in unit rate to deploy or manage a tower site), the parties can formulate a pricing model based on the fixed fees for units of services consumption. This model has several advantages from the operator's point of view, as it: (1) enables the operator to negotiate a single clearly defined rate at a time when it has maximum leverage relative to a vendor vying for the its business; (2) permits the operator to predict and budget costs very accurately, as there will be no unexpected pass-through charges or surcharges unless the operator agrees to them; (3) places the risk of cost overruns squarely on the vendor; and (4) lends itself to benchmarking, which offers the operator the ability to keep its negotiated prices current with marketplace trends benefitting operators.

Fixed fee models can be constructed in all manner of ways while still retaining the overall pricing predictability the operator desires. For example, the parties can agree upon caps on overall project costs while permitting variable pricing for components of the overall project.

The fixed fee model is not right for all situations, though, as it requires the operator to cede considerable amounts of operational control to the vendor. This might be perfectly acceptable to start-up companies or to companies that are shedding themselves of relatively routine operations, but it would not be appropriate for operators who desire a significant amount of insight into and control over the manner in which the supplier goes about performing the contracted services. With their entire business at stake, operators are understandably reluctant to yield total control over a core function, no matter how experienced the outsourcing vendor. For example, the fixed fee model is ideal for the deployment and management of a network using well-understood technology and common industry practices, but is ill-suited to a project entailing custom development of technology or implementation of innovative but unproven operational processes.

Adjusting Fees as Technology Prices Decline and Industry Practices Improve

Given the duration of a managed network services agreement, an operator will insist that the agreement include mechanisms to keep unit prices current with the best prices available in the marketplace. As most outsourcing service providers are unwilling to give “most favored nation” pricing guarantees at all (and since the MFN clauses that some suppliers will agree to are almost always vague and typically afford little more than a baseline for future negotiations), the best option available to outsourcing customers is to include some sort of benchmarking clause in the managed services agreement. In the case of fixed fee models, the customer could engage a third party benchmarking firm to determine whether the customer is overpaying, in which case the fees under the managed services agreement would be adjusted to bring them in line with industry practice. If the fees are equal to or below the industry average, the fees would remain unchanged, and the customer would continue to enjoy the benefit of the good deal it negotiated.

Benchmarking in other types of pricing models often is more complicated and contentious. If there is no qualified benchmarker, or if the nature of the outsourcing transaction is such that there is not enough market data available to conduct a thorough benchmarking evaluation that both parties will accept, the customer will have to resort to more involved but less certain methods, such as auditing and *ad hoc* market tests precisely tailored to reflect the structure and financing of the outsourcing deal. While these methods lack the clear mechanical adjustment of the benchmarking methodology, a well designed fee methodology can incorporate a pragmatic long term view of industry cost structures into the relationship between the parties in a manner that gives the customer leverage even when a true and clear market benchmark is unavailable.

Milbank



What's Good for the Network Operator is Good for Its Lender – or Is It?

Commercial lenders just now recovering from the global recession have instituted tighter credit standards, and those more stringent standards are increasingly being applied to telecom operators who are “asset light” due to divestments of infrastructure in outsourcing arrangements. Even in the traditional model, where telecom operators owned significant capital assets, lenders would grapple with the creditworthiness of non-investment grade operator/borrowers. Those credit challenges are exacerbated, however, when a lender can no longer look to physical assets in the “worst case scenario” but simply to a bundle of outsourcing contract rights possessed by the operator.

While the telecom operator has presumably exercised sound business judgment in negotiating its outsourcing contracts, what may involve acceptable risks and tradeoffs for the operator from a business perspective might not be acceptable to its lender from a credit perspective. Of course, lenders do not want to second-guess management decisions, but the risk appetites of a customer eager for cost savings and a prudent lender looking for comfort in the repayment of its loan will differ. A lender's concern will understandably increase with the criticalness of the outsourcing arrangement to

the operator's business – is it a sale-and-leaseback of a limited number of cell towers or an entire network managed services operation? Where there is a large variance between what the operator has bargained for and what the lender feels comfortable with, there are a range of options open to the lender (assuming it still wishes to proceed with the financing), from accepting the increased risk and addressing it through pricing or tighter covenants, to seeking renegotiation of the contract with the vendor. The prospects for the latter route, needless to say, will be a function of the importance of the operator to that vendor. A vendor that views its contract with a particular operator as a vital source of revenue will be more willing to at least consider the possibility of changes to its contract in order to facilitate a financing that will enable the operator to proceed with the very contract.



Key Provisions for Lenders in Outsourcing Contracts

At a minimum, the credit investigation or “due diligence” of the lender prior to making the loan should focus on two areas in the outsourcing arrangements: termination rights and the presence of unusually onerous provisions, either in the form of customer duties and or vendor rights. Ideally, a lender might like to have the vendor waive any right of termin for convenience and impose a covenant in its loan documentation that the operator will not exercise any such right in order to give the lender comfort that a key component of the operators operations will not be put in jeopardy. A lender might be more worried about breaches giving rise to termination than the operator (who might be more sanguine about its ability to surmount any operational problems or to find a replacement vendor), and therefore demand that the operator be afforded expanded rights to cure such breaches. In any case, a lender would typically seek a broad event of default under the loan documentation giving it the right to accelerate upon almost any kind of termination. Equally, an operator/borrower will resist such a broad provision, arguing in part that it limits its flexibility to manage relations with its suppliers and indeed might embolden a supplier to be more difficult knowing that an operator would be loathe to invoke termination and run the risk that its loans would be accelerated.

Other contract areas where a lender might want to confirm that it was comfortable with the operator’s judgment include liquidated damages clauses, overreaching customer indemnities, warranties and guarantees, unusual exclusions for vendor liability, overly generous vendor cure rights and restrictive covenants. In any event, a prudent lender would also include notice covenants in the financing documents that would require the operator to keep the lender apprised of all material developments under the contract.



Doomsday Scenario: How Realizable is your Collateral?

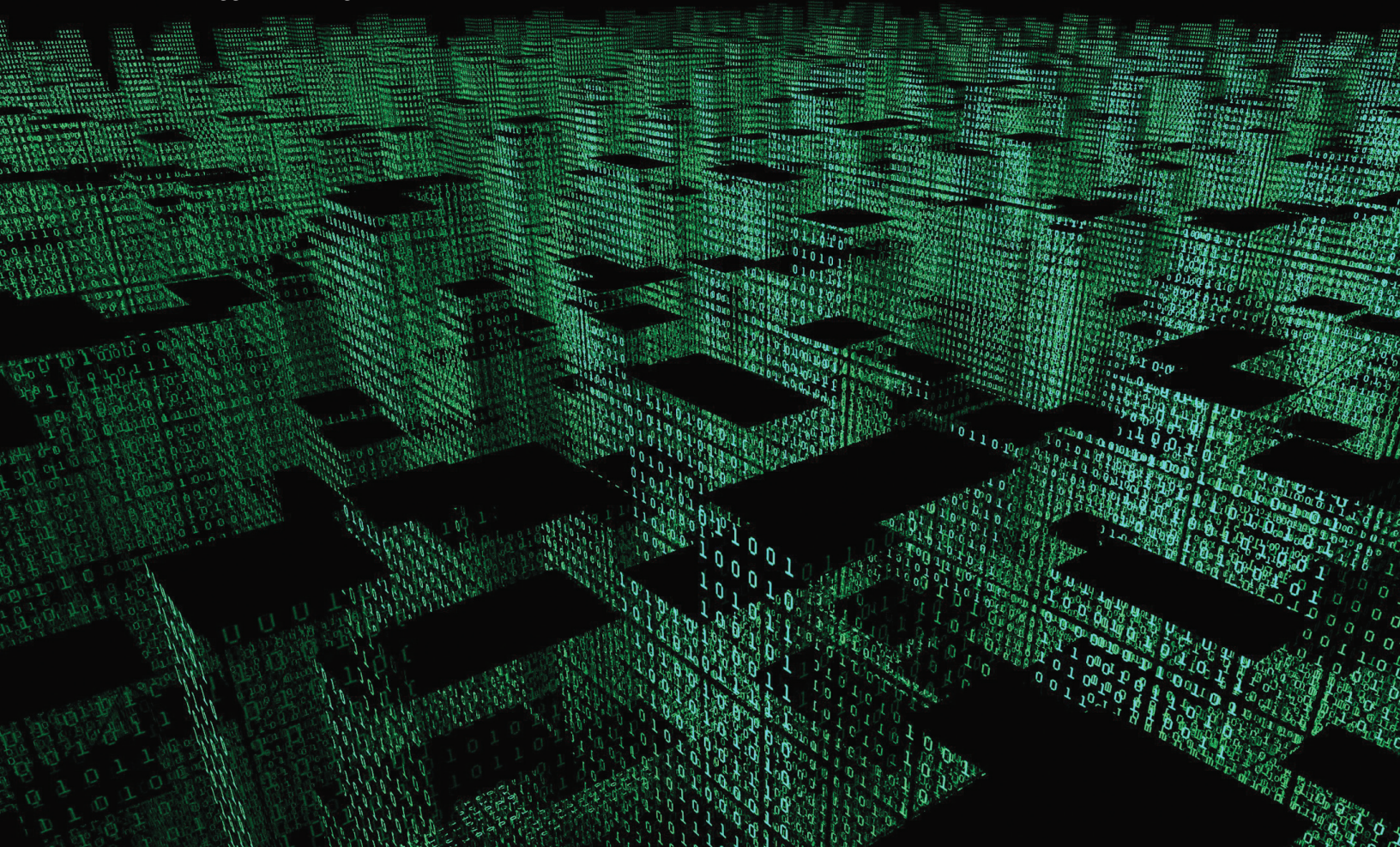
A lender's satisfaction with its borrower's management and their contract decisions does not of course avert the need to consider the worst-case possibility: a default under the loan documents or bankruptcy whereby the lender would be forced to realize asset value in order to repay its debt. For operators of less robust credit quality, this inevitably means that a lender will demand a pledge of the borrower's rights under the outsourcing arrangement and perhaps additional collateral security as a condition to making the loan.

As a first step, the lender must be assured that the operator can grant a lien on the outsourcing contract, which is often negotiated without thought of a subsequent financing. Thus, the assignment provisions of these contracts restrict the granting of a lien or the assignment to a third party. If possible, the lender should obtain a consent from the vendor allowing the granting of a lien and the enforcement thereof by the lender, and if appropriate, agreeing that the lender or its designee can be a permitted transferee. As a second step, the lender should ensure that any enforcement upon collateral (for example, upon the pledge of shares of the operator) will not trigger a "change of control" default under the

outsourcing contract permitting the vendor to terminate it precisely at a time when the lender most wants the continuity of the outsourcing arrangement.

A lender could go beyond a simple consent or acknowledgement from a vendor and seek a promise of future cooperation from a vendor in enforcement. If anything, a vendor will at most usually be reluctant to do more than agree not to frustrate or intentionally adversely affect the lender's enforcement rights. If the lender and its borrower have more bargaining leverage, the vendor might be willing to agree that it would facilitate a transfer of the contract to new owners (or enter into a new contract) following an enforcement.

Infrastructure outsourcing arrangements offer potentially significant benefits to network operators – usually only if they can assure themselves of the very cost savings that underlie the outsourcing decision; and these same arrangements can present risks to lenders that have to be carefully examined and addressed through balanced negotiations with operator/borrowers and at least in certain cases, their vendors as well.





Glenn S. Gerstell



Nicholas A. Smith



Gavin W. McKeon

**Glenn S. Gerstell is a partner and head of the global telecoms practice, and
Nicholas A. Smith and Gavin W. McKeon are senior associates,
at Milbank, Tweed, Hadley & McCloy LLP.**

They can be reached at:

gerstell@milbank.com (Washington, DC) | nsmith@milbank.com (New York) | gmckeon@milbank.com (Washington, DC)

Milbank

www.milbank.com