Lessons

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Fast Turnaround for Venezuela's Telephones

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Early results from the privatization of Venezuela's telephone company show that impressive gains are possible in a short time. Even without a fully defined legislative framework, benefits from new investment can be quickly delivered to consumers. In Venezuela's case, within two years of sale 850,000 new and replacement lines had been installed, representing a one-third increase in the installed network. The number of customers increased by nearly half a million, and close to 25,000 public telephones were installed or replaced. This Note reports on the sale that delivered these results.

Prereform
The starting point was a 100% state-owned telecommunications monopoly called CANTV. Telephone services were thin. The country had only 1.6 million lines in service, or 8.2 lines per 100 people, compared with roughly 50 lines per 100 people in industrial countries. While the official waiting list for new telephones was 1 million, real unmet demand was estimated at 3 million, and it often took eight years to get a new telephone. Service quality was poor: only 19% of international calls were completed, and 57% of public telephones were out of service.

Technology was outdated, with only 20% of the network digitalized. Productivity was low, measured at 85 lines per employee, compared with an industry standard of roughly 225. Average revenue per subscriber was only US$275 in 1990, compared with a standard break-even of at least US$500 per subscriber. Telephone rates had not been adjusted to keep pace with inflation, and there was heavy cross-subsidization: local residential rates were very low (US$1 monthly rental charge), while international rates were above economic levels. The company was incurring losses of more than US$100 million annually.

The privatization model
The government's main objective was to rapidly expand and improve basic service, and it believed that this could be achieved only by selling CANTV to a first-class international operator. A major hurdle in the sale process would be CANTV's rate rebalancing. The government felt that this rebalancing should be phased over several years to avoid the risk of political fallout from rate shock. Therefore, it decided that a new operator should have an exclusive franchise for basic local, long-distance, and international service.
service during the rebalancing period. This arrange-
ment would allow the profits from international
service to cross-subsidize local service and finance
the desired network expansion.

The model adopted resembled the recently com-
pleted Mexican and Argentine telecom privatiza-
tions. These companies had been sold with a
monopoly on basic service for a fixed exclusivity
period, but with obligations to expand and improve
basic service. These obligations and a tariff structure
and adjustment mechanism were set out in the con-
cession contract. Among key conditions of the Ven-
ezuelan concession, the new operator would be
granted a nine-year monopoly on “basic wire-line
service,” including local, long-distance national, and
international telephone service (all other services
were open to competition, including cellular, pri-
ivate lines, value-added services, and terminal
equipment), and the operator would be required,
under the concession contract, to carry out an ag-
grressive expansion program (3 million new lines
plus 600,000 replacement lines over nine years, or
400,000 lines annually) and to achieve a number of
service performance targets (which increased annu-
ally). Mexico had given a six-year monopoly on
basic service. The Argentine government had divid-
ed the country into two separate local service con-
cessions, with the two new private operators shar-
ing long-distance operations and revenue. The
monopoly period was seven years, extendible to
ten if performance targets were met.

Pricing and regulatory reform
A price adjustment and rebalancing schedule
was initiated ahead of privatization. Rates were
increased in mid-1991 and again on January 1, 1992
(the expected takeover date for the new operator).
As a result, average revenue per line in service was
expected to increase from US$275 in 1990 to
US$500 in 1992. Rates were grouped into three
baskets, to be regulated on a price cap basis, with
full inflation indexing until end-1996, followed by
partial indexing for the remainder of the exclusivity
period (that is, by end-2000). Phased rebalancing
of local and international rates was to commence
in 1994.

In parallel, a new telecommunications law was intro-
duced in Congress. It set out the legal and regulatory
framework for the development and operation of the
sector, established an autonomous telecom regula-
tory agency (CONATEL), and reduced existing taxes
on CANTV from 5% of gross revenues to 1% (more
consistent with international practice). The legislation
stalled in Congress, though more because of TV and
broadcasting issues than because of the telecom pro-
visions. To provide legal authority for the key regula-
tory features of the proposed privatization in the
absence of a new telecom law, the government en-
acted a series of decrees that established CONATEL
(with less autonomy than would have been possible
under a new law) and defined the regulations for the
various types of service. The competition regime for
the telecommunications sector was specified in
CANTV’s concession contract.

The bidding process
Bidders were initially prequalified on the basis
of six technical and financial criteria, including the
home country number of lines, gross revenue, and
quality-of-service indicators. The criteria were bal-
anced to ensure both bidder quality and a competi-
tive process. Twelve companies expressed interest.
Eight met the prequalification criteria: Ameritech,
Bell Atlantic, Bell Canada, France Telecom, GTE,
Nippon Telephone and Telegraph, Southwestern
Bell, and US West. Those that didn’t qualify were
allowed to join consortia with the prequalified opera-
tors, as long as the prequalified firms held a majority
stake. Draft bidding documents, together with the
information memorandum, were distributed to the
prequalified operators for their comments. The docu-
ments included the concession contract, CANTV
shares sale and purchase agreement, new company
bylaws, the employee shares trust agreement, and
regulations for the various services. After discussion
with the bidders, the government finalized the condi-
tions of sale.

The transaction
The precise terms of the sale were announced. The
operator would purchase 40% of CANTV’s shares,
with the right to appoint five out of nine board mem-
bers, thereby assuring control of the company. The
government would retain 49% of the shares, which it intended to progressively sell on local and international stock exchanges. The government would hold two of nine board seats. The remaining 11% of shares were to be sold to CANTV employees at the same price per share as paid by the winning consortium, but on an installment basis at zero interest. The employees would hold the two remaining board seats. As part of the transaction, the government assumed US$472 million of CANTV external debt.

The government set a base price of US$900 million, and bidding was held on November 15, 1991. Two bids were received: the Bell Atlantic/Bell Canada consortium bid US$1.4 billion, and the GTE-led consortium, VenWorld, bid US$1.885 billion. VenWorld, the winning consortium, included three international telephone companies, GTE (51%), Telefonica (16%), and AT&T (5%), and two Venezuelan firms, Electricidad de Caracas (16%) and GIMA (12%). The purchase price represented a market valuation for CANTV of US$4.7 billion (US$3,140 per line in service), roughly double the price per line in service paid for TELMEX. It was the highest price paid for a telecom privatization in Latin America. The consortium took control of the company on December 4, 1991.

**Preliminary results**

**CANTV performance**

CANTV invested US$1.1 billion in the first two years and plans to invest about US$6 billion in total for the nine-year exclusivity period (1992-2000). The early results are impressive. In 1992, CANTV installed 413,000 new and replacement digital lines—more than five times the total number of lines installed over the previous five years—and added 210,000 new clients. This was double its new-line commitment under the concession contract. It installed about 13,500 new public telephones and replaced 5,000 old telephones. The pay phones are computerized card and coin “intelligent” telephones. In addition to replacing and expanding digital exchanges, CANTV is installing a digital microwave long-distance transmission system to expand capacity for long-distance traffic. CANTV plans to install both a long-distance and an international fiber optic cable network. Preliminary results for 1993 indicate that good performance had continued. In the two years since privatization, 850,000 new and replacement digital lines had been installed, and 460,000 new clients had been added.

Quality of service has improved. Call completion rates increased from 19% in 1991 to 38% in 1993 for international calls, and from 30% to nearly 40% for national long-distance calls. Digitalization of the overall network increased from 20% to 36%. The average number of public telephones in operation increased from 43% in 1991 to 87% in 1992. Not surprisingly, customer satisfaction has risen.

Financial results in the first year were much improved. Revenues increased by 104% (55% in constant terms) in 1992, reaching US$1 billion. The revenue increase reflected network decongestion resulting in more traffic per line, higher rates, and new lines and new customers. Operating expenses (excluding one-time 1991 restructuring costs) increased by only 11% (in constant terms), with the result that CANTV reported net profits of US$208 million in 1992 (compared with a US$161 million net loss in 1991). The profit result represents an 11.5% return on total assets and an 18% return on investment (long-term debt plus equity).

**Price regime**

As required by the concession contract, rate increases have been implemented quarterly since January 1, 1992, with one exception. After the February 1992 coup attempt, the government decided to freeze selected prices. CANTV and the government agreed to postpone the scheduled April increase until July, when there would be a double adjustment.

CANTV and CONATEL are generally satisfied with the price cap system. Every quarter CONATEL establishes a maximum weighted tariff increase for each of the three baskets of rates. While CANTV and CONATEL like the flexibility and ease of the price cap system, both agree that quarterly rate filings are burdensome for both the company and the regulator.
Average annual revenue per line (both residential and commercial) more than doubled between 1990 (US$275 per subscriber) and 1992 (US$563) and by 1993 had grown to US$623. Despite the rate adjustments before and since privatization, rates and revenue per subscriber remain below those of other countries in the region, however. Residential rates include the installation charge, the basic monthly rental, and a use charge. Within this structure, the basic monthly rental remains very low—US$3.25 in January 1994—with the result that residential service continues to be cross-subsidized by commercial service, as well as by long-distance and international calls. Under the concession contract, rebalancing should start in 1994 and be phased through the remainder of the exclusivity period.

Sustained rate adjustments are essential for rate rebalancing if full competition is to occur by the end of the exclusivity period. Quarterly rate increases must be approved by the Minister of Transport and Communications, on the recommendation of CONATEL. A draft CONATEL law, which would establish CONATEL as a fully autonomous regulatory agency with final authority on tariff matters, was presented to Congress in early 1993. However, this legislation stalled with the departure of the Perez government. Enactment of this legislation would strengthen CONATEL's autonomy on regulatory matters.

Nonbasic services
In addition to the expansion of the basic network by CANTV, there has been a major expansion in competitive services provided by independent operators. By mid-1993, CONATEL had granted twenty-six concessions to independent operators for a range of services, including cellular telephony (two), private networks (ten), value-added services (five), trunking (eight), and data transmission (two). These companies invested US$350 million in 1992. Combined with CANTV's expansion program, investment in the telecom sector accounted for 1.65% of GDP (compared with 0.25% in 1981-90). Telecommunications was the fastest-growing sector in the economy.

Cellular service is expanding rapidly. The first cellular concession was awarded through competitive bidding in 1991 (before the CANTV privatization) to Telcel, a Bell South-led consortium. It started operating in November 1991 and by mid-1993 had 65,000 subscribers, after the fastest growth by a cellular company ever reported. Telcel invested US$130 million in 1992, in addition to the US$106 million paid to the government for the license. The same amount of investment was planned for 1993, with the objective of reaching 100,000 subscribers by year-end. The privatized CANTV operates the other cellular band through a wholly owned subsidiary (Movilnet) and had 35,000 subscribers by mid-1993. Both Telcel and Movilnet pay CANTV an access charge.

Conclusion
To date, the new owners of CANTV have achieved or exceeded virtually all service targets. To ensure that this momentum continues and that all services are viable at the end of the monopoly period, the tariff rebalancing process must continue. Meanwhile, opening nonbasic services to competition has prompted significant investments by other private sector operators.

Some lessons are starting to emerge. First, in a sector with rapidly changing technology, monopoly provisions will be increasingly difficult to define and enforce. Second, cross-subsidies between local and long-distance services should be eliminated as soon as possible, and the regulator should have the autonomy to set the overall level of tariffs as prescribed by the concession contract. This will give the operator the flexibility to design and charge specific tariffs.

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