Legal Innovations

In Submarine Cable Projects

Mike Conradi

Recent years have seen a renewed levels of investment into the submarine cable sector, especially in emerging markets such as Africa and the Asia-Pacific region. Some of these have brought with them some interesting legal and structural innovations. In this article I will aim to discuss, briefly, the innovations that I am aware of, or have been involved in myself. I will end with some legal points concerning the sales of IRUs.

Sale and Leaseback

During 2013, the Brazilian investment bank and asset manager BTG Pactual purchased the Globenet submarine cable network (with its 22,500km of cable infrastructure) from Brazilian telecoms operator Oi. The acquisition was valued in the region of US$ 750m, making it one of the largest ever submarine cable acquisition anywhere in the world.

One of the most interesting innovations that the project included was the central "take or pay" arrangement that involved the supply of capacity by GlobeNet back to Oi and its subsidiaries through a fixed-price long-term contract with volume guarantees. This model is effectively a sale-and-leaseback arrangement taken from project finance deals, and usually used in, for example, large energy projects (or telecoms towers deals). DLA Piper's role was in advising BTG Pactual on this arrangement, and in order to make it work we had to think through a number of completely new issues - such as what guarantees and service levels it would be reasonable for the target company, Globenet, to offer to its former parents in respect of the services which are to be provided. We needed to discuss and agree an appropriate mechanism to ensure that Globenet was not offering a higher standard of service than it used to provide to its parent prior to sale, when there were no arms-length contracts in place, and we needed to agree on mechanisms to deal with cable cuts, pricing changes and demand spikes over an extended period of time.

Insolvency of a Landing Party

Also in 2013, we were involved in a matter for a telecoms operator client that wanted to buy capacity from the landing party of a consortium cable system in an emerging market. The deal was to be structured as an IRU (ie with a significant

[click the arrow below to return to the TOC]

up-front payment) but the customer, our client, was concerned about losing their rights, and their money, in the event of the future insolvency of the seller. The most obvious solution would have been to change the payment terms so as to convert the IRU into a lease but for various reasons this was not feasible.

The issue of the possible insolvency of a landing party has not often been a major concern for submarine cable consortia. This is likely to be because, up until recently, most of the cables connected developed countries and most of the landing parties were, as a result, national incumbent operators with a significant financial asset base and so a low likelihood of insolvency. In this case though, it was a legitimate and real concern. If the landing party became insolvent the purchaser of IRU capacity could be left as an unsecured creditor without either its capacity or a refund of its money.

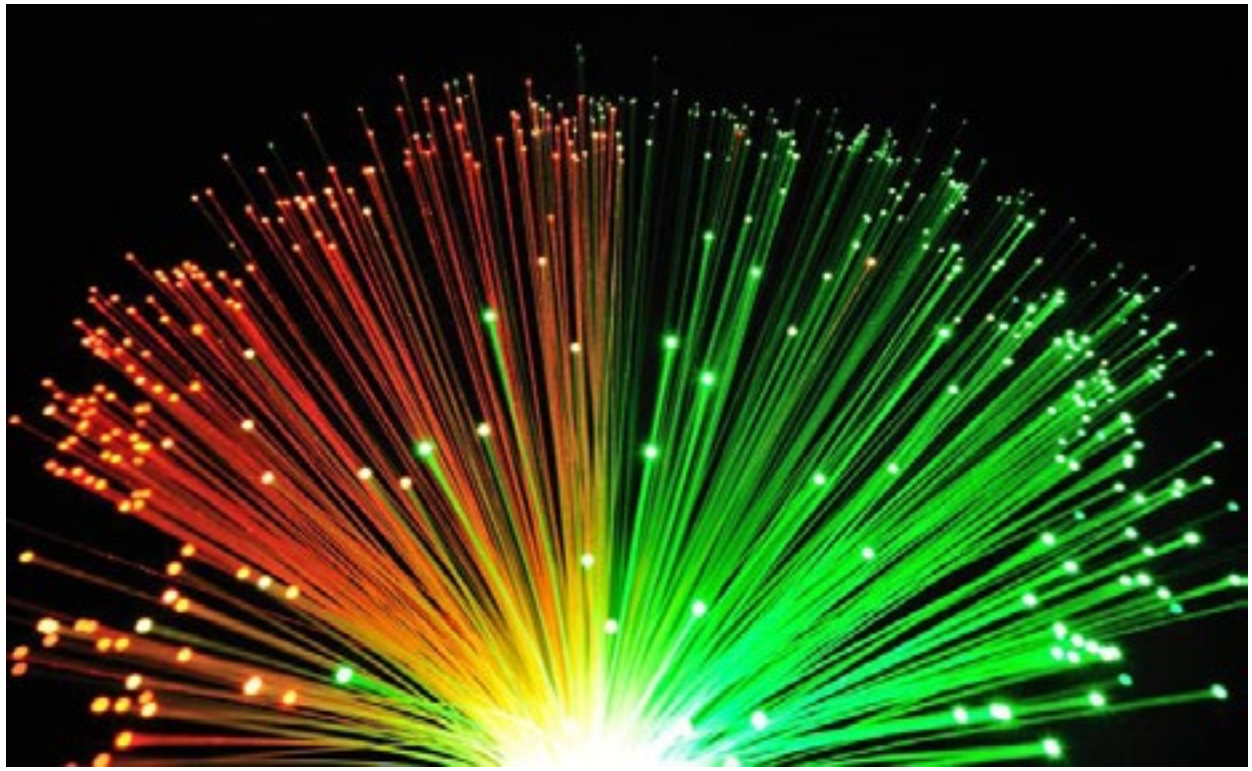
The innovation which we came up with in discussions with our client was to petition the next quarterly meeting of the consortium in order to ask them what sort of protection they might be able to offer. We ended up with a solution whereby the consortium agreed to consider a rule saying that in the event that any of their members is thrown out of the consortium because of insolvency, the consortium would consider, in assessing the suitability of any replacement landing party in the country concerned, whether or not that prospective new party would agree to honour the IRU commitments made by its predecessor to third parties (such as our customer-client). This agreement, together with the good relationship built-up between all the parties as a result of the discussions, meant that although it did not assure the customer that their IRU would be honoured no matter what in a legally binding way, they nevertheless had enough confidence to proceed with the deal.

Sale of Spectrum (and "virtual spectrum") not capacity

Another recent development in the industry has been the sale not of capacity (for example 40 Gb/s) but of spectrum. The concept is that customers buy the rights to use a particular and allocated range of radiocommunications frequencies and then they can use that

piece of spectrum in whichever way they choose by equipping it with equipment to turn that spectrum into capacity. They might, for example, choose to use the same spectrum cheaply by equipping it for a few wavelengths each of , say, 10 Gb/s or they might instead choose to pay more for the latest generation of 100 Gb/s wavelengths (or, in the future, more). It would be up to the customer to choose when to upgrade without reference to the seller of the cable system or to the other users of the infrastructure, so long as they operate only on "their" spectrum and only.

Since this model was first suggest it seems to have rapidly spread as a concept. Because it is so novel, though, there are as yet no commonly-accepted standards for how the contracts should be structured. At its simplest level, a spectrum sale is just a services contract much like a lease (or IRU - see below) of capacity. This means that the customer is simply given a contractual right to use a certain piece of spectrum. Additional complexity may be introduced though because of the fact that some sections of spectrum on any given fibre-pair will be more useful than others. On one contract which I have been involved with recently the customer's spectrum is "virtual" - they are allocated an amount of spectrum equivalent to a given percentage of the total spectrum on a single fibre-pair, but this could be sub-divided into smaller sections of spectrum across several different fibre-pairs on the same cable.



This then introduces additional concepts - if, for example, there is a problem with one of the fibre-pairs in the cable but not the other, does the customer lose part of their spectrum or does the supplier have an obligation to switch them to the fibre-pair which is still functional?

Private cables becoming consortia

Following on from the previous point, it is not possible to easily split up spectrum into as many different pieces as capacity can be divided into - and so the sellers of spectrum will typically only have a few customers on each fibre-pair in a cable. Each customer, then, is typically being asked for a large amount of money in advance - especially if the sale is by IRU and the contract is a pre-sale for an as-yet-unbuilt system. In these circumstances customers might be concerned about losing their rights in the event of the insolvency of the seller.

[click the arrow below to return to the TOC]

As an aside, I would just add that there is, in my experience, still a large amount of misunderstanding of the nature of an IRU in the submarine cable business. This is a topic I have written about and spoken about before but in brief it is my view that an "IRU" does not convey a property right-it is simply a services contracts. This means that if the seller becomes insolvent then the holders of IRUs are unsecured creditors. There is no meaningful way in which they can be said to own anything physical.

This concern has prompted another innovation in the submarine cable sector. On one deal we were advising-on recently, the seller was a special purpose vehicle (SPV) set up specifically to build a new system. The business model was to sell spectrum, not capacity, to customers by way of pre-sale and to ask them for upfront payments as IRUs. In order to deal with the above-mentioned insolvency concern the deal has been structured with quite a new model. Although the SPV will contract with a Vendor to build the system and will then be the owner of the assets to be constructed initially, each customer buying spectrum will obtain not just a contractual right to "its" spectrum but will also receive a undivided percentage interest in all of the system. At the same time as buying "their" spectrum they will also sign up to a pre-written and pre-agreed consortium agreement which governs how the assets will be jointly managed and dealt-with.

The idea is to have the best of both worlds-the flexibility that comes with a private cable system in terms of being able to make quick decisions and avoid committees, especially in the early stages when it comes to negotiating with the Vendors and making other arrangements, but also the ability to offer customers real ownership of assets in a meaningful and legally effective way.

Restrictions on resale in a submarine cable capacity (or spectrum) pre-sale agreement.

In a pre-sale contract for a new submarine cable system whose construction would impact markets in the European Union, the seller (ie the company wishing the build the new system) often wants to place a restriction on the buyer, which is typically taking a large amount of capacity (or, these days, spectrum) preventing it from reselling all or part of the capacity to other customers, and instead requiring the buyer to use it only for their own internal business purposes.

The issue here is that restrictions of this type risk falling foul of EU competition (anti-trust) laws because they may be said to distort the market. However, the buyer may argue that without this type of restriction in the pre-sale contract it would not be possible, or would be much harder, to make a business case for building the new infrastructure, and that the new cable will ultimately increase competition and so reduce prices in the relevant markets.

If so, then so long as the restriction is drafted narrowly and is limited in time to the minimum necessary to achieve this pro-competitive objective then our view is that the restriction may, in appropriate cases, be justifiable and so lawful.

Mike Conradi is one of the lead telecoms partners at the largest global law firm, DLA Piper and is rated as one of the leading telecoms lawyers in the world by all of the various independent guides. He has a particular focus on submarine cable systems having worked on the legal aspects of more than 20 different systems. He has delivered a "legal masterclass" at ever SubOptic conference since 2004 and was on the SubOptic legal standards working group which published a template system supply contract.

[click the arrow below to return to the TOC]