Strategic Equity Partner (SEP)

Application Analysis

A REPORT TO THE

INDEPENDENT COMMUNICATIONS AUTHORITY

OF SOUTH AFRICA

("ICASA")

SUBMITTED BY

NEXT GENERATION CONSORTIUM

("NG")

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Introduction

Next Generation Consortium ("NG"), a consortium of experts and specialists in a variety of relevant professional categories, was retained by the Independent Communications Authority of South Africa ("ICASA") to advise ICASA on matters relating to the Second Network Operator ("SNO") licensing process.

Important milestones in the process to date include the following:

1 during May 2002 applications were invited for the 19% Black Economic Empowerment ("BEE") stake in South Africa's Second Network Operator. A public process of comment and discussion was carried out by ICASA;

2 on 16 July 2002 NG submitted its report in respect of the BEE application to ICASA;

3 on 30 July 2002 ICASA recommended to the Minister of Communications ("the Minister") that Nexus be appointed the winner of the 19% BEE stake;

4 on 31 October 2002 the Minister announced Nexus the preferred BEE applicant;

5 during 2002 applications were invited for the 51% Second Equity Partner (SEP) stake in South Africa's Second Network Operator to be submitted by close of business on 30 August 2002;

6 on 7 August 2002, the Minister of Communications announced (Gazette No. 23729) that the deadline for SEP applications be extended to 31 October 2002, a postponement of sixty (60) days;

7 on 31 October 2002, two applications were formally received by ICASA. The applications were received before close of business, in the presence of NG's auditing division.

7.1 applications were received from:

7.1.1 Goldleaf Trading (Pty) Ltd; and

7.1.2 Optis Telecommunications (Pty) Ltd.

7.2 ICASA accepted both applications;

7.3 both applicants paid the requisite application fee. Each applicant was provided with time and date registered receipts;

7.4 a late bid was received from Not Just Cheap Talk. However the application was rejected, as it did not comply with the ITA's submission requirements.

8 on 17 January 2003 ICASA recommended to the Minister that neither of the two applicants be awarded the 51% stake in the SNO and that the 51% equity stake be held in reserve for the SEP to be allocated at a future date; and that in the furtherance of the objects of the Act, and in the public interest, the process outlined in section 35A be continued to the next step, which is the creation of the SNO entity and the integration of the SOEs and the 19% BEE stake;

9 on 31 March 2003 the Minister published a second invitation for the expression of interest for the 51% equity interest in the SNO. The Minister did so in terms of section 35A of the Act, read with Notice number 755 of 2002. This invitation is set out in Government Notice 24682 dated 31 March 2003.

10 Two applications were received by ICASA in June 2003.

This document comprises NG's report to ICASA concerning its analysis of the second invitation of applications for the 51% Strategic Equity Partner ("SEP") stake in the SNO.

Methodology

ICASA's authority and responsibility, is set out in phase 3 of Gazette Number 24682 of 31 March 2003.

In particular, ICASA is required to

> "using the process described in the Section 35A Notice consider, and evaluate the applications taking into account the relevant provisions of the Act, with particular reference to Section 2."

ICASA is further required to:

> "consider the applications in accordance with the following evaluation criteria:
>
> 1. technical capabilities
> 2. financial model
> 3. business model
> 4. proposed integration and role of Eskom, Transtel and Nexus."

ICASA's rights and obligations in this regard cannot be delegated.

Following the evaluation procedure, ICASA is required to make its recommendation to the Minister.

NG was retained neither to recommend a preferred applicant nor to evaluate the various applications. Accordingly, NG has neither scored the applicants, rated or ranked the applicants, or compared the applications against one another.

Rather, NG assisted ICASA to ensure that the SNO process was, at every step, open, transparent, fair and lawful, both procedurally and substantively. Further, NG analysed the applications, its analysis in this regard being set out herein.

1 SEP Applications

1.1 Two Applicants

Two submissions were formally received by ICASA. Neither applicant paid an application fee. The receipt of each application was recorded.

These submissions were received from:

1.2.1 Communitel (Pty) Ltd ("Communitel"); and

1.2.2 TWO Consortium (Pty) Ltd ("TWO").

The Communitel submission was labeled an "Expression of Interest" and the TWO submission, labeled a "Best and Final Offer".

1.3 Public scrutiny

Both submissions are available for public scrutiny at ICASA's library. Written comments were received from interested parties and submitted to the applicants for rebuttal and further response. These comments are also available at ICASA's library.

1.4 Public Hearings

Public hearings were held at the Crowne Plaza Holiday Inn on 17th and 18th of July 2003. The hearings were open to the public.

Prior to ICASA commencing the public hearings in respect of each submission, each applicant confirmed that

- all representations appearing in their written submissions were true and correct in all material respects and that they were bound by these representations

- all representations that were to be made in the public hearings, would be true and correct in all material respects and that each would be bound by any representation so made

- each were companies legally constituted within the Republic of South Africa
- each had a duly appointed legal representative acting on behalf of the company
- no employee of the Ministry of Communications, the Authority or any civil servant of the Government of South Africa was party to each application either individually or as part of a legal entity.
- each could provide South African Revenue Service tax clearances in respect of all their shareholders/partners.
- each applicant's written submissions could be regarded as an application as envisaged in sections 1 and 2 of phase 3 of Government Gazette 24682 of 31 March 2003

Each applicant further confirmed and warranted that they accepted the terms and conditions of the Section 35A Invitation, the evaluation procedure, their ability to fulfil the undertakings of their submission, the selection procedure and that the final decision as to the successful party would be binding upon them.

Each applicant was allocated one (1) full day to present their application, to respond to questions from the other applicant, various interested parties, the general public, and the ICASA SNO panel.

Following their respective presentations, each applicant was questioned by the following parties:

1.4.1 The other applicant

1.4.2 Transtel;

1.4.3 Eskom;

1.4.4 Nexus Connection

1.4.5 members of the general public;

1.4.6 the SNO Committee.

The hearings were recorded. A transcript of the proceedings is available at the ICASA library. Extensive media coverage was given to the hearings.

1.5 Submission of Additional Documents and Information

During the hearings, ICASA requested the applicants to provide further information so as to clarify aspects of their original submissions. This authority derives from the original ITA being Government Notice 23460 of 24 May 2002.

Paragraph 13.4 of the ITA states:

> *The Authority reserves the right to request submission of additional information, documents, statements and representations.*

Other relevant paragraphs of the ITA are:

Paragraph 18.1 of the ITA states:

> *Unless otherwise determined by the Authority, the Applicant shall not be entitled to amend its application during the period of binding effect specified in this Invitation*

Further, section 18.3 provides that

> *If the Authority decides to allow amendments to applications, it shall establish the rules, procedures and time frames for submitting such amendments by notice in the Government Gazette.*

Further, Section 19.2 states:

> *In the evaluation of applications the Authority shall, at its sole discretion and with full regard to reasons of fairness, be entitled to request the submission of additional documents or information in order for a more thorough evaluation and analysis of the applications. Applicants shall be notified by the Authority of any such request in writing. Any communication regarding questions and answers between the Authority and the Applicants shall be made in writing. The submission of additional documents shall solely be for the purposes of interpretation and shall not give rise to a right to modify the*

amount of the License fee, the business plan, or any fundamental undertakings in the application.

All additional documentation and information submitted by the applicants, following a request by ICASA in this regard, is available for perusal at the ICASA library.

1.6 Additional information required

ICASA afforded both applicants the opportunity of providing additional detailed information in order to clarify areas of ambiguity. Supplement information contained in their reports; provide additional answers to queries and the like. The questions forwarded by ICASA to the applicants, and their responses, are available at ICASA's library.

2 General Qualification In Terms of the ITA

2.1 Legal Status

The ITA, including the application form (annexure "A" to the ITA) requires the applicants to provide certified evidence of their legal status, management, directors, shareholders agreements and the like. The primary objective for soliciting this information is, inter alia, in order for ICASA to analyse the extent of the applicant's ability to comply with the ITA's strategic equity objectives, to ensure that no precluded persona are in fact directly or indirectly party to any application, and to assess whether the applicant does in fact have a properly constituted legal entity and the requisite authority to act.

Requirements considered by NG included the following issues:

2.1.1 is the application compliant with the Telecommunications Act 103 of 1996 ("the Act"), all statutory enactments and the common law?

2.1.2 in making the application, has any applicant committed any of the following pursuant to Section 101 of the Act:

2.1.2.1 provided false or misleading information?

2.1.2.2 wilfully failed to disclose any information or particulars material to its application?

2.1.2.3 amend its application in any material way, through any subsequent representation?

2.1.2.4 enter into any agreement contrary to the objectives of the Act and the ITA?

2.2 Eligibility

The ITA provides various qualification criteria. The more salient points of each application are recorded hereunder.

2.2.1 Ownership and control

The SNO licensing process seeks to source an acceptable, clearly defined and measured equity partner to the BEE and SOE equity stakeholders. To this end, the BEE partners were required to ensure that there would be no disposal of their shares for a period of at least five years. This necessitated the shares being subject to restrictive transfer covenants. These provisions were not included in the SEP evaluation criteria. It is anticipated that an "equity partner" should in fact be an "equity" partner, and not a "leveraged debt/equity" partner, "consultant", "service provider" or the like.

2.2.2 Communitel

This applicant provided the required ownership and control information envisaged by the ITA. Effectively this consortium is to be controlled by four shareholders.

Their current issued share capital is disclosed to be 40 shares of R1 each. In their submission they indicated that the remaining 60 shares (i.e. 60%) are to be held for future investors.

In their written replies to ICASA's questions they indicated that there are no agreements that relate to contingent direct and indirect ownership and control. However, the majority of the applicant's shares remain unissued and can effectively

be issued to an unknown third party should circumstances require. In view of the limitation of ownership restrictions such a share issue would require compliance with the Telcommunications Act and ICASA's approval. Of particular importance in this regard is the content of Government Gazette No. 23190 of 27 February 2002.

It is not clear what strategic value the inclusion of the MK Military Veterans Association will bring to the consortium. This is notwithstanding the fact that Communitel stated that they would add value because of their ". understanding of the market in South Africa".

The BEE process set out to determine the party that would achieve this most effectively. Indeed, the Minister appointed Nexus for this role. The value of MK Veterans Association should be as an equity partner. In the hearings, the MK Veterans Association indicated that they could readily invest up to R400 million in Communitel. This capability has however not been shown.

2.2.3 TWO

In their submissions TWO indicated that their initial equity investment would be in the region of R221 million. Further, that it will increase this investment to R437 million by the year 2006. It must be presumed that these further investments will only be effected if the SNO proves to be profitable (refer Public hearing transcripts page 195 Mr Broman stated:

> "The issue is the viability of the money. So if there's more equity needed and that equity also is matched by other factors that makes the business plan equally attractive, it is not a major issue. The issues are, if the investment need goes up dramatically but we can't see additional revenues, then we have a problem."

The principal controlling shareholder of TWO would appear (upon the latest information received) to be Industri Kapital through Fanio BV, which holds 10% of the issued share capital of Swedtel AB and 53% of the voting rights. Based upon the equity identified above, Industri Kapital will have effective control of the SNO for an investment of R3, 5 million (Three and one half million Rand). This is an

insubstantial amount, given the value of the infrastructure and revenue contribution by the SOEs.

TWO has a complicated shareholding arrangement that changes significantly each time a representation is made to ICASA. During the hearings Mr Nahon was unaware of the fact that Swedtel AB's equity investment was effectively R67 million (refer pages 174 to 176). This may possibly have been because of the fluidity of the shareholding structure or merely its complexity.

In the hearings Mr Nahon from TWO advised (page 56):

> "Insofar as funding for the three members of the consortium is concerned, each of the three members has procured their *own* funding based on the business plan and the assumptions contained therein."

In response to Nexus' questioning of Swedtels involvement in the SNO, Ms Xoliswa Kakana stated (page 99):

> "Here we are saying we are investing our own money. I'm saying as a South African in partnership with the Norwegians, investing our own money. With the upside we benefit. With the downside we bleed together with the organisation."

Ms Kakana has subsequently been identified by TWO as a member of Invictus (through ICT-Works (Pty)).

In subsequent questioning by ICASA Mr Nahon advised that (page 161):

> ".the full 51% of Swedtel's equity funding will be provided by Swedtel and will be underwritten by Swedtel."

TWO later confirmed in a written submission (and at the hearings) that Invictus' equity participation was in fact to be funded by Swedtel AB.

There is further suggestion that TMP are financing other persons through Africa Venture Partners (refer below).

The rationale for Swedtel and TMP to select and fund these particular partners is unclear. The implications for further equity calls cannot be ascertained as there are no shareholders agreements to examine. In view of the fact that these shareholders presumably do not have funds to procure their own equity at the moment, they are unlikely to have further funds in the future. The arrangement seems to be in conflict with the concept of "equity" partners and questions about undisclosed voting and control arrangements will remain unanswered until sight is had of the relevant shareholders agreements.

The salient features of the previous and latest representations made to ICASA are as follows:

Founding documentation (but not shareholders agreements) have been provided in respect of the following companies:

Two Telecom Consortium (Pty) Ltd

Swedtel SA (Pty) Ltd

Blue Planet (Pty) Ltd

Telecosm Management Professionals (Pty) Ltd

Telecosm Management Professionals (Pty) Ltd do not appear in any of the disclosed shareholders and the inclusion of their founding documents is confusing.

ICASA requested TWO to provide certified copies of any agreements, verbal or otherwise, between shareholders to the level of the listed companies. TWO provided partial answers as to their various shareholders but failed to provide certified copies of any agreements between the shareholders. Should there be any put options or other control mechanisms, these agreements would be in conflict with the representations made by the representatives of TWO.

The lack of any shareholders agreements (particularly against the background of the fluidity of the various shareholding representations that have been made) is a cause for further query.

As an example, Africa Venture Partners (AVP) is now disclosed in TWO's submission (in response to ICASA's hearings) as a "firm" whose parent company (which has still not been disclosed) is based in Mauritius.

In the Public hearings Mr Erlandsen advised that (page 151)

> "….TMP SA is owned 100% by TMP Norway as far ***as*** the A shares are concerned. As far as the 100% of the B shares it is held by African Venture partners who is *backing financial investors in South Africa*. "

The identity of any party, and the extent and nature of these arrangements remains undisclosed, other than the fact that there is a statement that AVP owns all the "non-voting class B ordinary shares" in TMP SA.

"Non-voting shares" is an unusual arrangement that requires particular attention given the provision of the Companies Act and in particular section 193 thereof.

Despite ICASA having requested details of this arrangement they have not been disclosed nor have the ". financial investors in South Africa". The reason for the arrangement also needs clarity and the ultimate beneficiaries need to be unveiled.

Swedtel AB has indicated that they will support "Invictus … on commercial terms by Swedtel AB's shareholders". There is no copy of any agreement provided to indicate what these terms would be; what consideration Invictus will provide to Swedtel for this arrangement; and why Invictus should receive this favourable treatment.

Similarly in the public hearings Mr Broman advised ICASA that Octavia Telecom

> "..have an option to go in and own shares in the Swedtel Company that will sit on the shares in Swedtel SA."

In their written response to ICASA's questions, TWO stated with regard to Contingent agreements, that

> "Save for what is set out above, in the Best & Final Offer Document and what is set out below, there are no other agreements or arrangements relating to contingent direct or indirect ownership and control interests in

> the Applicant, including, without limitation, voting, financial, governing and management interests".

Clearly these statements are contradictory and require clarity.

TWO have involved a number of South African (and American) IT companies in their bid. The nature of this relationship is unclear however as only two of the members of these IT companies appear to have been involved in the bid preparation; none are directors of TWO; a limited number participated in the public hearings; and none are disclosed in the proposed management structure.

TWO were required to disclose the ultimate shareholders of investors to the level of natural persons. This has not been done in respect of almost all of the companies.

As an example, Yolanda Cuba is identified as a director of Lembede Investment Holdings (Pty) Ltd and as one of the senior directors and managers of Mvelaphanda Strategic Investments (Pty) Ltd, but there is no disclosure as to the shareholders of Lembede Investment Holdings (Pty) Ltd.

Section 4.1 of Government Notice 23460 states that "An individual Applicant or a member of a consortium may not submit or have an interest in more than one application, either individually or as a member of any other consortium".

Nexus' consortium included Nozala Investments (Pty) Limited which is described in page 50 of their application as:

> "The group of founding individuals and BEE groups, who jointly control the group, have set up the Nozala Trust. The Nozala Trust will receive 20% of the dividends attributable to the empowerment group above."

Invictus' shareholders are identified as including The Nozala Trust. It would have been possible to ascertain whether there was an inter relationship if TWO had provided the information requested by ICASA. Their inter relationship and identities are unclear and need to be clarified.

This information will be required before any conclusion can be reached upon the applicants' compliance with various items of legislation.

2.3 Validity

Insofar as validity is concerned, the ITA sets out a number of procedural terms and conditions required before ICASA can accept the applications as being valid. These terms and conditions specifically seek to ensure that:

2.3.1 the applications are prepared in accordance with the structure and numbering order as set out in the application form

2.3.2 the applicants certify the validity of their representations; and

2.3.3 the applicants certify their legal and current litigation status.

Paragraph 19 provides ICASA with the authority to conduct a repeated review of formal compliance and to request the submission of additional documentation at its full discretion.

2.4 Warranties and Certificates

Section 4.4 of the ITA requires applicants to

> *Unconditionally warrant the fulfillment of the undertakings set out in its application and meet the conditions of qualification to apply as set out in the invitation.*

Both applicants have provided unconditional warranties. Notwithstanding the warranties the various submissions indicate that they are conditional upon the applicants obtaining suitable funding and numerous material matters that are intended to be the subject of negotiations.

2.4.1 Communitel

The warranties that have been supplied by Communitel have no value as the applicant is a shelf company with no proven funds and recourse is therefore against an uncapitalised shelf company with no assets. This is of particular significance in the light of the license costing R300 million and the requirement of a performance bond of R50 million for roll out commitments.

Communitel have stated that their business plan and funding is dependent upon discussions with the SOEs, Nexus, ICASA and financial institutions. Should Communitel fail to reach agreement with the SOEs or any financial institution, their application would effectively be withdrawn. This could materially prejudice the SNO project.

2.4.2 TWO

In the case of TWO, their offer is conditional upon the SNO reaching agreement with the SOEs, Nexus and ICASA upon a host of issues. When questioned by ICASA upon what would happen if MTN did not reach agreement with TWO, Mr Allman stated (page 172):

> " ..should an agreement not be able to be reached, there are other options available to the SNO. Cell C is gradually turning on its own network. That is a potential option. Another option is for us to peal away the moving to the mobile environment part of the business plan and just focus on the fixed wireless part of the business plan, and those are substantial revenues in themselves and falling away of the mobile component would not significantly affect the fundability of that plan."

This would appear to be a simplistic assessment of a complex and interdependent situation. Clearly TWO cannot warrant fulfilling their obligations without the guaranteed support of MTN. There are no guaranteed terms of support from MTN. Should the licence be awarded to TWO, MTN will effectively have the SNO's controlling shareholder at their mercy – this could severely prejudice the minority shareholders. The effect of this arrangement could also conceivably fall foul of relevant competition legislation and indeed General Notice 300 of 2002.

In the case of TWO they have subsequent to the hearings indicated that they will provide a guarantee in the amount of R50 million against their failure to capitalise the company. The value of this guarantee is meaningless however as it is only being offered 14 days after the award of the licence. As they presently stand, they are also an uncapitalised shelf company.

TWO have stated that their business plan and funding is dependent upon discussions with the SOEs, Nexus, ICASA and financial institutions. Should TWO fail to reach agreement with the SOEs or any financial institution, their application would effectively be withdrawn. This could materially prejudice the SNO project.

2.5 Procedural Warranties

Applicants were required to provide numerous warranties.

2.5.1 Communitel

Communitel undertook in the hearings to provide the necessary warranties. These were provided in their subsequent submission.

2.5.2 TWO

TWO undertook in the hearings to provide a schedule of the obligations that they believed would be binding and those that they believed would be subject to negotiation.

These undertakings have not been provided in their subsequent submissions.

3 General objectives of the SEP process

The primary objective of the SEP process is to enlist the support of a Strategic Equity partner to compliment the already selected SOE and BEE shareholders.

The SOE shareholders currently hold, (and are expected to introduce), significant assets, experience, infrastructure, personnel and goodwill into the SNO.

The BEE partners are required to introduce a South African commercial experience base, a network of grass roots contacts and extensive experience and research within the South African Telecommunications market. It is unlikely that it was ever anticipated that they would have sufficient equity to match that of the SOEs. BEE leveraged finance was always anticipated to be one of their methods of raising equity for this purpose, and a number of controls were placed upon their funding arrangements.

The Strategic Equity Partner is anticipated to bring resources that are not available to either the SOEs or the BEE. In view of the resources that the SOEs and the BEE have, it must be inferred when reading the application form, that operational cutting edge PSTN experience in other competitive markets and significant cash are the two further resources that the SNO requires. Broadly speaking, Section 2 of the Act seeks to bridge the digital divide and promote competition within the South African Telecommunications market. In the light of the existing incumbent's strength and monopoly within the domestic market, the financial muscle and competitive experience of an SEP are pivotal issues.

An alternative process to the current process could have been to employ consultants to convert and privatize the SOEs with some form of public share offering being effected in the future. The advantage of this arrangement would have been that the consultants would only be required to provide skills where they were lacking in the SOE/BEE consortium, and the significant profit potential of the SNO could be shared by the South African Government and investors. The drawback of such an arrangement is that the consultants would not have a significant share in the downside risk associated with their failure to perform.

Clearly the objective of the process as set out in Government Notice 23460 was not to employ consultants, but rather to find a strategic partner to provide a significantly higher degree of skills, resources and contacts than would ordinarily be available through the employment of consultants. It further anticipated a material inflow of foreign investment into South Africa and it anticipated the SEP sharing in the risk of failure, given the inherent "ownership" requirement.

In summary, the key objectives include:

Strategic input – provide resources and skills *not readily availabl*e from within or obtainable by the SOEs and Nexus;

Equity input – provide long-term financial strength through investing equity *in line with other equity holders*;

introduce *foreign investment* into South Africa;

promote *competition* in the PSTN market;

facilitate the *integration* of various valuable State Owned Enterprises into a commercial entity; and

bridging the Digital divide by bringing broadband communication services to the large sector of the population without any access to telecommunication services.

The SNO licence is anticipated to be issued for a period of 25 years. Once an SEP is selected, it is difficult if not impossible to reverse the process and accordingly it is incumbent upon ICASA to select a long-term partner for the SOEs and the BEE that will achieve the objectives of the Act. There can be no "half" partners or partners who provide consultancy services and then prematurely dispose of their interests.

4 SEP Evaluation Criteria

SEP Evaluation Criteria

As appears from phase 3 of Government Gazette No. 24682 of 31 March 2003, the following evaluation criteria apply to the SEP for the 51% stake in the SNO.

Criteria	**Points**
Financial plan	25
Business plan	25
Technical ability	25
SOE integration	25
TOTAL	100

These criteria are discussed below.

5 Analysis of Evaluation Criteria

5.1. General Observation

The evaluation criteria allocate a maximum of 100 points. The ITA specifically requires (para 13.2) applicants to prepare their applications in accordance with the structure, order and numbering sequence of the application form. Applicants needed to draft their responses with both the requirements of the application form and the evaluation criteria, in mind.

It is relevant to note that the Minister has amended the evaluation criteria that were originally included in Government Notice 23460. The effect of this amendment is that ICASA is no longer required to score applicants in certain categories including the following:

Human Resource Development Policy and practices for training and promotion especially for entry level positions; and

Empowerment of women, disabled persons and youth

The weighting of the Financing and Business plan, (which was originally a combined score of 30 points), was separated into two scoring categories of 25 points each (an effective increase of 20 points). The proposed integration of Nexus and the SOEs was similarly increased from 20 points to 25 points.

The points allocated for Experience in the provision of PSTS, strategic vision, and a demonstration of the Technical feasibility were reduced from 30 points to a combined score of 25 which was simply labelled “Technical capabilities”.

Clearly the Minister requires ICASA to pay more attention to the areas identified in the increased weighting.

The points preponderance has moved to the business plan, the financial plan, the technical plan and the extent to which the applicants will be capable of integrating all stakeholders into the SNO.

When purchasing a business, a significant premium usually attaches to the "cost of control". In the case of the SNO, control is offered to prospective SEPs and has not been offered to either the BEE or the SOEs. In exchange for this "cost of control", the SEPs are obviously expected to provide something more than the BEE and the SOEs can contribute.

5.2 Financial Model (25 points)

It is clear that the applicants must demonstrate and prove that they have sufficient funds available or access to funds that would provide sufficient equity capital to fund the SNO's development and growth.

The ITA requires proof of the applicants' financial ability through the provision of their own Annual Financial Statements and those of their members for the past three years. Neither applicant has adequately complied with this requirement. It is an all encompassing requirement that seeks to explore issues such as whether the applicant has adequately quantified the SNO's capital requirements; vendor financing; the ability of the applicant to approach major capital markets; the credibility of the applicant within the financial markets and various other financial matters

This is important against the background of the fact that the SEP is expected to inject equity finance into the SNO and is required to provide significant warranties. In terms of the draft license agreement (clause 2.1.2), the total funded debt of the licensee shall not exceed two thirds of the total equity of the license.

Both applicants have avoided this constraint through artificial mechanisms. In the case of Communitel they propose "Mezzanine Finance" in the hands of the Communitel consortium. In the case of TWO they propose to treat the SOEs assets as an interest free equity loan. Both of these issues require further consideration.

Beyond this, both Nexus and the SOEs have indicated that they anticipate the funding requirement of the SNO to be in the region of R11 billion to R13 billion. The SOEs are in the position where they have already invested significant funds into the Full Service Network (FSN); they have an established infrastructure in the way of high sites; highly trained personnel; rights of way etcetera and they have an operational and revenue generating Private Telephone Network (PTN).

The contribution of the SOEs has not been evaluated and accordingly we can only provide general comment as to the parameters that may have to be considered in the light of what the SNO licencing process has revealed to date.

Nexus has a detailed and well-researched business plan that clearly sets out an operational approach that meets the financial, strategic and operational objectives of the SNO. They have also demonstrated an ability to employ skilled management, technical and operational personnel. Beyond this they have been required by ICASA to provide proof of equity funding of at least R1 billion in respect of their 19% equity holding. They were further required to prove their ability to raise funding in the amount of a further R1 billion if so required.

If a hypothetical value of R1, 5 billion were applied to the SOEs assets, and these assets were treated as the SOEs' equity, the equity contribution expected from a 51% equity partner would be in the region of R2, 5 billion.

If a hypothetical value of R3 billion were applied to the SOEs' assets, the equity contribution expected from a 51% equity partner would be in the region of R5 billion.

These values represent the minimum and maximum parameters within which an equity partner should probably be expected to participate. These are also the values that the SOEs would in all likelihood consider to be the extremes of acceptability. The values would appear to be consistent with the due diligence work that has been performed by various applicants over the past 18 months.

In evaluating the financial models and the business plans it is important to recognise that the potential SEP has an objective that is diametrically opposed to the interests of the SOEs.

This was emphasised in the hearings when Mr Nahon stated (page 59):

> "I have said that the TMP and Swedtel will negotiate hard insofar as the management agreement is concerned and the returns that they will both earn."

This statement suggests that the management fees (which accumulate to TMP and Swedtel) may be more important than the equity return (which is shared in proportion to equity investment).

5.3 Financial ability

Both applicants anticipate making modest equity investments in the SNO that are probably not consistent with an SEP. In the case of Communitel, they anticipate an investment of R400 million with a further leverage component of R800 million through “Mezzanine Debt”. Other than R100 million, which was stated to be immediately available by Namibia Telecom, there was no evidence of the balance of R300 million but an admission that this amount was still required to be raised. TWO anticipates an investment of R211 million which would be increased slightly over time. They however anticipate Capex being funded from revenues and anticipate receiving performance related management fees that could potentially far exceed this investment.

If the SOEs were to treat their assets as equity and leverage them in the same ratios as Communitel, they would in effect (on the minimum valuation identified above) be able to invest R4, 8 billion. This is twice Communitel’s anticipated equity requirement for the entire SNO.

5.4 State Owned Enterprises

Clearly the SOEs and Nexus have significantly more financial ability/commitment than either of these applicants. In effect they will be required to subordinate and/or dilute their financial strength in favour of a financially weaker partner. This incongruity will probably result in the two shareholder groups having diametrically opposed objectives. The SOEs and Nexus will have the financial ability to pursue an aggressive roll out plan and assault upon the existing incumbent whilst the SEP will be unable (Communitel) or unwilling (TWO) to pursue such an aggressive strategy because of their own equity considerations.

Notwithstanding the fact that the BEE and SOE block may have the ability to pursue a particular strategy (e.g. capital intensive/fast roll out), they will not have the authority as the SEP has the controlling interest in the SNO.

5.4.1 Valuation

The SOEs have invested significant funds in the FSN and PTN's, staff, infrastructure etc. Both applicants have acknowledged this. The Minister has provided in Government Notice 23460 that their capital (equity) contribution may include (amongst other things) cash, rights of way, movable and immovable property, personal rights (goodwill) and other assets including infrastructure, facilities and equipment. Clearly the management of the SOEs have a responsibility to their stakeholders to maximise the value attributed to their assets before they permit their disposal. Disposals at less than fair value, and interest free or subsidised loans will be in conflict with the SOEs corporate governance responsibilities.

On the other hand, the SEP applicants (who will obtain direct financial benefit to themselves as shareholders) will obtain an increasingly high return upon their investment through a low valuation of the SOEs assets. Accordingly their models have to be examined in a manner that tests whether they have ignored potential SOE revenues that would necessitate a higher valuation being placed upon the SOE assets and whether their hypothetical valuations are reasonable.

5.4.2 Staffing

The SOEs have sizable workforces that have a significant vested interest in ensuring a vibrant and correctly sized SNO. Their livelihood depends upon the long-term success of the SNO.

The SEP on the other hand, has to be evaluated upon whether it is providing resources that can be readily purchased upon the open labour market; the quantum of the resource provided; and whether the SNO could in fact procure the resources without the assistance of the SEP. Clearly there is no point in providing the SEP with a controlling equity option if the skills and resources that the SEP provides could be obtained in the open market without the consequent loss of control.

Beyond this, Nexus was chosen as the BEE representative in the SNO and allocated 19% of the equity with the intention of Nexus providing important BEE facilities and services. Blue Planet and Invictus, through the financial assistance of ABSA and Swedtel AB, will have an effective BEE investment in the SNO of 25%. More importantly however, their partners in the SEP will have the power to appoint their members into BEE positions that it was originally anticipated would be filled by the SOEs and Nexus' personnel. It is possible that this arrangement will give rise to conflicts within the SNO.

5.4.3 Comparative ability

The ITA has presumed that an SEP will bring financial muscle and technical expertise that may not be available within the SOEs. In considering any recommendation, ICASA cannot ignore the fact that the SOEs have not been invited to make a presentation upon their own abilities and it is quite possible that they have skills that far exceed those offered by the SEP. Upon the face of the evidence heard to date, the SOEs clearly have significant financial muscle and one must presume that they have considerable technical ability as they have developed, installed and run their own PTNs and FSN. In fact Communitel has acknowledged in their application that the SOEs have done detailed network design, vendor selection and network installation. Communitel are in broad agreement with the technical work done by the SOEs to date. TWO have made no evaluation of the technical work done by the SOEs and accordingly their proposals are constrained by the nature and extent of the limited due diligence work that they have done with the SOEs.

Nexus have made a detailed presentation that affords ICASA the opportunity of comparing whether the SEP applicants bring more expertise than that offered by Nexus. Clearly there is no point in appointing an SEP who dilutes the strengths of the already defined equity partners.

5.5 Communitel

Communitel have indicated that their four major shareholders will each provide R100 million in equity funding. They anticipate procuring a further R800 million in equity funding through a "Mezzanine" financing arrangement from various potential funders

who have provided various expressions of interest. These expressions of interest are all dependent upon a licence award and in all probability there will be conditions that will be imposed by the funders. These conditions will in all likelihood entail some form of encumbrance upon the equity. This has been confirmed in the public hearings where Mr Kahn agreed that the funding would convert from debt to equity should Communitel default upon repayments (see page 73).

Communitel anticipate total equity funding in the SNO of approximately R2, 5 billion. This is in line with the *minimum* funding expectation set out above.

In reality, two major shareholders holding R200 million in direct investment will theoretically control the entire SNO equity investment of R2, 5 billion because of the leveraged funding structure envisaged by this consortium. The management of the company is primarily focused around PCA whose resources would appear to be fully stretched.

PCA and Gateway propose to invest R200 million, their fellow consortium members a further R200 million, whilst a further R800 million is to be invested by potential funders who have a commercial interest and not a vested interest in the telecommunication market (i.e. their core business is investment, not the Telcommunications industry).

This arrangement clearly makes the funding arrangement susceptible to the dictates of the majority funders. Beyond this, one must balance the equitability of a R200 million investor (or even an R800 million funder) being able to control the SOEs assets of R1, 5 billion and Nexus' envisaged equity investment of R400 million (per the Communitel financial model).

It is unlikely that the SOEs and Nexus will condone or support this imbalance when the negotiations surrounding the integration begin. Nexus indicated in its submission to ICASA that it would raise at least R640 million in direct equity investment and the balance of its requirements through leveraged debt.

If Nexus and the SOEs insist that the funding requirement of the SNO be set at R5 billion and not R2, 5 billion, Communitel would probably be unable or unprepared to make such a significant capital investment and they would either withdraw their

application or have to dilute their equity position in favour of the SOEs and Nexus. Against this background one must consider whether the business model has been developed to meet the funding ability of the Communitel shareholders or whether it has been designed to meet the broad based public interest requirements of the ITA.

5.5.1 Proof of funding

ICASA requested Communitel to provide proof of their funding ability. In a written response Communitel referred ICASA to a number of letters of "Financial support". These letters are in fact nothing other than expressions of interest and are all subject to fairly standard provisions. The salient points of these provisions are as follows:

- Financiers approval of an SNO consolidated business plan
- Financiers detailed due diligence
- Financiers credit approval
- Financiers board approval
- No change in financial market conditions
- Subject to the final licensing conditions

One of Communitel's proposed financiers, (the Industrial Development Corporation), in an earlier meeting with NG indicated that it would take them between 9 and 18 months to perform the necessary due diligence upon the SNO. Whilst other financiers may take less time, it is unlikely to be significantly less.

The proposed layered funding structure achieves nothing that the SOEs and Nexus could not achieve in their own right. PCA are in effect consultants who have performed similar work elsewhere in the world. Their envisaged involvement in this proposal is that of fundraisers and implementation consultants.

Ordinarily consultants would be required to report to an independent board of directors who have the ability to measure their performance and terminate their contract. Communitel in effect, for a relatively small investment, entrench themselves in a position where they cannot be terminated as they are shareholders. It could be

argued that their "Mezzanine Financiers" could terminate their services if they were dissatisfied with their performance. This would be a valid argument but goes to the root issue of who is the controlling shareholder?

The fund raising is a function of the licence award and could just as easily be performed by Nexus or the SOEs, both of whom have already raised funding in excess of that envisaged by Communitel. PCA's funding targets included the National Treasury of South Africa – a source that would presumably be more readily available to the SOEs and Nexus.

In effect Communitel's bid is an attempt to "trade" in the value of the SNO's licence with the majority of the potentially significant benefit accruing to the 51% shareholders.

5.5.2 Foreign Investment

If one were to "unlayer" the proposed equity structure; form a company with direct shareholders only; assume that the SOE assets were only worth R1, 6 billion and that they were invested as equity; the effective structure of the company would be:

	Equity	***% of total***	**Debt**	**% of total**
SA funds				
SOEs	1 600	*66,7%*		
Nexus	400	*16,7%*		
MKMVA	100	*4,2%*		
Sub-total	2 100	87,6%	800	100%
Foreign Funds				
Communitel	300	*12,5%*		
Total	2 400	100%	800	100%

The above table is prepared upon the assumption that PCA, Gateway and Telecom Namibia will introduce foreign funding. PCA's expressions of funding interest were all from South African sources though some of the funding would in all likelihood be

sourced from offshore. This analysis clearly shows the limited foreign investment that Communitel introduce into the South African economy.

5.5.4 Financial Layering

What is important in Communitel's structure is that they effectively anticipate:

- borrowing funds from financiers
- warehousing those shares
- with Communitel as the custodians
- with Communitel as the beneficiaries should the SNO be successful

There is no reason for either the BEE or more particularly the SOEs to agree to this arrangement. In effect the SOEs provide the bulk of the assets that create the revenue, that creates the dividend, which allows Communitel (on its own) to take the shares that the SNO built. This is an expensive financial arrangement that the BEE and the SOEs could negotiate themselves on far more favourable terms than Communitel.

The envisaged process will take several months to come to fruition. A significantly quicker process than that envisaged by Communitel would be to issue shares to all participants in proportion to their direct funding ability and to then allow the shareholders to purchase shares from each other through put options.

Communitel's proposal is a convoluted method of controlling a business with limited equity investment from the controlling shareholder.

5.6 TWO

Ordinarily TWO's foreign shareholders would appear to have the ability to raise sufficient equity to fund the SNO if so required. Regrettably their lack of disclosure and the extremely disjointed shareholding arrangements make it difficult to determine what proportion of the disparate shareholders have the necessary funding required to finance the SNO. In all likelihood the real funders will only be Swedtel AB, TMPS (AS), Mvelephanda/ABSA and possibly other "funders".

There have been repeated statements from the consortium to the effect that the shareholders will be investing their own equity. In the public hearings, Mr Nahon when discussing the shareholders investments stated (page 194):

> "It comes in as ordinary share capital. It is not quasi finance. It's not preference shares. It is not mezzanine finance. There is no interest component to it. It is pure equity. "

This approach does not address the real issue, namely "who is putting in what"?

In their original written submission TWO included numerous letters from banks and funds expressing an interest in equity participation and loan finance participation in the Swedtel consortium.

When discussing the assumptions in their financial model Mr Broman stated:

> "I would also like to point out that we have gone through this with our financiers and they were satisfied with all the underlying assumptions".

It is difficult to determine whether or not there are financiers behind this project as there are so many conflicting certified statements.

5.6.1 South African GAAP

The ITA required each applicant to prepare their financial information in accordance with South African GAAP. In the hearings Mr Mc Donald from TWO confirmed that TWO's submission had been prepared in accordance with SA GAAP (page 179). This is not the case and it is therefore not possible to test some of the representations made in TWO's submission.

The effects of inflation and Rand depreciation/appreciation cannot be tested against the statement made in the hearing by Mr Nahon (page 180):

> " … that in our assumptions we assume that with devaluation of the Rand comes inflation. Inflation in turn causes prices to rise, which we anticipate in turn will cause revenues to rise. Similarly international traffic is denominated in US Dollars, so we *hope* to earn proportionately

> more Rand. We believe those two factors within the parameters of our analysis, more than off set the increase in Capex."

TWO have failed to provide the information upon international tariffs as requested and have merely referred ICASA to a detailed commentary.

5.6.2 Self Funding Business

TWO's financial model envisages a self-funding business ("Revenue & Capex matched") and their own capital commitment is limited. In the public hearings, under questioning by ICASA Mr Broman stated

> "… as I tried to explain earlier, it is not the money as such that is the issue. The issue is the viability of the money. So if there's more equity needed and that equity also is matched by other factors that makes the business plan equally attractive, it is not a major issue. The issues are, if the investment need goes up dramatically but we can't see additional revenues, then we have a problem."

Their financial model envisages Industri Kapital investing approximately R3, 5 million as risk capital. In exchange for this minimal investment Industri Kapital obtain control of the SOEs assets (which they have valued at R1, 2 billion though they have indicated in their answering submission that they are prepared to increase this amount) and they anticipate these assets being left in the SNO as an interest free loan for 9 years. At existing interest rates this would equate to a donation from the SOEs to the SNO of approximately R1 billion. If the value of the SOEs assets were in fact closer to R3 billion, this would amount to a donation from the SOEs of approximately R2, 6 billion.

Swedtel's pro-rated benefit of this donation would be (at R1 billion) R167 million. (In TWO's answers provided to ICASA on 30 July 2003 they state that the key assumptions in their Financial Model included the SOE loan being non-interest bearing) They have subsequently stated that the loan should attract interest at 7% "or such amount that may be agreed". Clearly their original was not a Best and Final offer. This offer remains significantly below commercial interest rates and is unlikely to be supported by the SOEs. Should this loan become a commercial interest bearing

loan (as proposed) the licence borrowing restrictions would require a further capital injection from the shareholders.

Beyond this Swedtel's financial model anticipates them receiving attributable post tax income (with no inflation adjustment) of approximately R170 million after only five years. Attributable revenues in the years thereafter would be significantly higher.

5.6.3 Adequacy of Capital

An extrapolation of the information contained in TWO's original submission to ICASA, suggests that their anticipated equity requirement may prove to be significantly higher than they have advised their minority shareholders and ICASA.

The SOEs in their written questions to TWO also highlighted that they believed that TWO's equity requirement was significantly understated. This is a viewpoint with which our own analysis concurs.

Should TWO's projections prove to be correct, the return that they seek to achieve (based upon their own financial information) appears to be disproportionately high in relation to their investment – refer the table below (this table excludes Swedtel's potential management fees of up to R1 billion)

	Investment	Cumulative ***after Tax*** Earnings yield (ignoring inflation)
Year 4	R436	123 %
Year 5		201 %
Year 6		262 %
Year 7		293%
Year 8		312 %
Year 9		327 %

These returns ignore any capital appreciation, which would be significant.

5.6.4 Financial Disclosures

In accordance with the requirements of the ITA TWO were requested to provide "a complete and detailed description of all direct and indirect financial interests in the Applicant, including beneficial interests". In their written response received on 30 July they stated that:

> ".. the only other parties which are likely to have any direct and/or indirect financial interest, beneficial or otherwise, in the applicant are:
>
> - the duly appointed bankers to the Applicant
> - the various financiers and/or funders to the Applicant"

This last statement suggests that there will be further funders. Two have failed to disclose the nature and extent of these funders.

In the public hearings TWO consortium were on several occasions requested to advise whether they would be seeking funding from institutions for the BEE component of their consortium or whether they would be financing their investment from their own cash resources. They advised that they would not be seeking funding from financial institutions.

TWO were further requested to provide proof of bank facilities or other credit facilities. In support of this request the following letters were received:

ABSA in support of Mvelaphanda/Blue Planet in the amount of R500 million (Presumably BEE debt finance)

Swedtel AB to a maximum of R185 million (this amount includes Invictus share capital)

Telenor through Africa Venture Partners *subject to an SNO Board approved business/financial plan* (presumably in the amount of R135 million)

The ABSA support of Blue Planet would appear to be in contradiction of the statements made by Xoliswa Kekana in the public hearings that (page 99):

"Here we are saying we are investing our own money. I'm saying our as a South African in partnership with the Norwegians, investing our own money. With the upside we benefit. With the downside we bleed together with the organisation"

5.6.5 Foreign Investment

Assuming that the SOEs assets are valued at R1, 6 billion and treated as equity, an analysis of TWO's proposed funding structure shows

	Equity	**% of total**	**Debt**	**% of total**
SA funds				
SOEs	130			
SOE loan	1 470	84*%*		
Nexus	82	4,3*%*		
Blue Planet	66	3,*4%*		
Invictus (local)	41	*2,2%*		
Sub-total		*94,0%*		
Foreign Funds				
Swedtel AB	68	3,*6%*		
Telenor	42	*2,2%*		
Invictus (foreign)	4	*0,2%*		
Total	2 360	100%		

The anticipated foreign investment is negligible.

5.6.6 Equity Guarantee

TWO have indicated in their responses to ICASA's questions that they are prepared to offer 2 guarantees to ICASA in the sum total of R100 million. The second guarantee of R50 million may be drawn down by ICASA if TWO fail to subscribe for their anticipated equity investment. This guarantee is meaningless as it is only to be offered 14 days after the award of the licence.

Notwithstanding the proffered guarantee, TWO's investment remains insignificant against the background of the commitments made by the SOEs and Nexus and is significantly worse if Nexus subscribes the R640 million offered in their application. The same can be said about Communitel.

6 Business Plan

It is clear that applicants are to demonstrate their understanding of the telecommunications industry, provide an understanding of the revenue opportunities and asset offerings from the SOEs, and provide a strategy, which will make the SNO a formidable competitor to the incumbent Telkom. It also seeks to establish whether the applicants are already controlling established operations with verifiable operational experience. The business plan should seek to capitalise upon the marketing, financial and technical expertise of an existing operator from a competitive deregulated environment.

6.1 Convergence

This report by NG would not be complete if it did not address and highlight the impact of technological convergence. Convergence is described by the ITU as the "technological, market or legal/regulatory capability to integrate across previously separated technologies, markets or politically defined industry structures". Convergence also involves an important international component, as many services and information sources that were traditionally controlled on a domestic level are being controlled on a global basis.

Since the publication of the ITA for the second fixed line operator and the submissions of interest by the applicants, the DOC have indicated that a new Telecommunications policy promoting the convergence of technologies is likely to be announced within the near future. Such a policy will in all likelihood promote further competition within the telecommunications industry and place greater financial strain upon highly geared business models. At the same time, it could offer a multitude of other opportunities for the SNO as a national "infostructure" providing a high-speed communications network that is largely complete by integrating the Esitel and Transtel networks.

Convergence has emerged as a global phenomenon as a result of digitisation, which has allowed traditionally distinct services to be offered across interchangeable platforms. These technological trends have been accelerated by the liberalisation of markets allowing for the development of global digital communication networks offering multiple services across national borders.

It is these technological developments, together with the liberalisation of markets, and the building of national information infrastructures that result in the development of effective modern economies. These networks are characterised by integrated broadband networks offering high-speed access to a multitude of customised services and content to meet a variety of needs across the economy.

For the potential of convergence to be realised and the backbone of an effective digital economy to be developed to take South Africa into a modern networked economy, the information infrastructure of the SOEs needs to be completed by integrating the networks and providing an access network. Low cost wireless technologies have made possible the far more rapid deployment of cheaper networks to compete or compliment existing fixed networks.

It will be the task of the SNO with the leadership and equity financing of the successful SEP to provide this infrastructure to the citizens of South Africa and to reduce the gap between those with access to global information networks and those without access. This has been labelled “bridging the digital divide” and is one of the key tenets underpinning the award of the SNO licence.

It is essential therefore that the applicants illustrated a clear understanding of the implication of technology convergence, with particular appreciation of the opportunities and challenges that will arise when the current market structure is changed from a vertically integrated network, towards a more horizontal market design.

Ultimately a technology-neutral policy environment will lower costs to service providers and consumers. In a converging environment there are no economic or policy reasons to differentiate among services on the fixed network and less reason to distinguish between fixed and mobile.

It is against this backdrop that the award of the equity stake in the SNO should be considered. The benefits associated with convergence and the significant investment in the SOEs network can be optimised by a developing country such as South Africa in order for it to meet national development objectives. The infrastructure has already largely been built by the SOEs. What is now required is the market expertise and investment to complete and integrate the infrastructure and bring the substantial benefits of a new generation network to the nation. The successful applicant should therefore show substantive marketing expertise and have and be prepared to provide sufficient capital to the SNO to fulfil its opportunities and obligations to South Africa.

6.2 Key Performance Indicators

The ITA requires all applicants to complete a number of tables in order that ICASA can fairly evaluate the propositions made by each applicant. These tables are neither voluminous nor complex and are in fact a summary of all key areas of the business and are in many respects an integral component of the expected licensing conditions.

After a written request from ICASA to both applicants, the requisite tables were received. Regrettably TWO failed to complete the documentation, in many cases it was incorrect, and in other cases TWO had amended the information requirement in a manner that made evaluation meaningless and, in many cases, impossible. In some instances cross-references were made to pages of narration when the requirement was to provide statistical information. This may be indicative of an incomplete and superficial business plan. This is more fully dealt with below.

6.3 Communitel

The business plan submissions are detailed and have addressed all of the major issues that one could expect. The model however is in fact very similar to the SNO lite originally proposed by Goldleaf – these similarities are highlighted in the following table:

	Communitel	Goldleaf
Market share	15%	15%

EBIT year 10	R4.6 Billion	R4.7 Billion
Enterprise in profit	Year 3	Year 3
Cum return including payback	Year 7	Year 7
Tax liability	Year 5	Year 5
Peak funding	R4, 9 Billion	R4, 8 Billion
10 year Opex	R40, 7 Billion	R39, 8 Billion

6.3.1 Key Assumptions

Communitel have identified 16 key assumptions upon which they have based their business plan. With the potential deregulation and convergence of telecommunications within South Africa, some of these assumptions may be negatively impacted. Those that may be affected are noted hereunder:

- VANs, other than Telkom and SNO, will not be allowed to carry voice
- Only the PSTS and SMME operators will be allowed to operate VoIP
- Internet telephony will not be legally allowed, other than in SMME operator areas
- SMME operators will have to terminate traffic at their boundary with Telkom or SNO

6.3.2 Board of Directors

It is intended that the Chairman and the Chief Executive Office be nominated (and presumably appointed) by the “Largest shareholder group” which is anticipated to be the Communitel consortium. This arrangement would make sense if the ultimate controlling shareholder was investing 100% equity – in effect the controlling shareholders (four) are only investing R400 million and they are using leveraged debt finance to obtain control of the SNO. In view of the financial strength of the SOEs and Nexus, this would appear to be an incongruous arrangement. Beyond this Communitel’s financiers will probably insist upon some form of Board representation.

It is proposed that the other directors are appointed through consensus and in accordance with the King Commission recommendations. This would appear to be a sound proposal but in reality the lack of a real controlling shareholder will probably result in the SNO board becoming locked in unnecessary disputes and arguments. Similarly there is no equity in a shareholder with a minority (in real terms) investment being allowed to appoint the Chairman and CEO.

In their written responses to questions, Communitel indicated that they envisaged one board appointment for each 10% of equity held in the SNO. This proposal is contrary to the contents of their application (outlined above). Should this in fact be the case, their leveraged finance arrangement allows a minority contributor to exercise greater control over the SNO than a majority contributor. Clearly this arrangement is debatable and may not be easily resolved.

It is proposed that the board retains approval for the 5yr plan, the annual budget and the appointment of the Executive committee.

6.3.3 Management Fees

There do not appear to be any management fees payable by the SNO to Communitel.

6.3.4 Tariffs and Tariff reductions

Communitel have indicated in their written submission that they do not propose a price war with the existing incumbent but intend to promote a more competitive environment.

They anticipate price reductions of approximately 10 percent in local call rates and line rentals, and long distance and International call rate reductions of nearly 20%. Clearly these targets are in compliance with the objective of increasing competition within the market.

6.3.5 Interconnection charges

Communitel's interconnection charges appear to be realistic and well researched. They have performed a detailed analysis that has clearly been tested against various parameters that they are likely to be able to perform against.

6.3.6 Operating costs

Analysis of the expense schedules is difficult without the detail being readily available. Accordingly the expense tables requested from applicants only covered broad groupings thus making broad comparisons possible.

Communitel's employment costs are anticipated to be one third of those of TWO, whilst their personnel compliment is half of TWO's. Communitel have done detailed research as to their staffing structure. Whilst TWO's higher number of employees would ordinarily be in line with their higher turnover, they seem excessive in the light of the number of outsourced services that they are proposing.

Communitel anticipate spending twice as much upon marketing as TWO to achieve only half of TWO's turnover.

6.3.7 Staffing

Communitel anticipate employee attrition but have no specific programme for retirements or retrenchments. This is of course partially a function of their proposal to ring fence the SOEs PTNs.

6.3.8 Roll out

Communitel were requested to provide capital expenditure roll out targets in Rands and also the number of lines that they anticipated installing in each market segment.

In terms of this disclosure Communitel anticipate a conservative roll out which envisages the following cumulative installation achievements by year 6

Business lines 165 000

Residential lines 137 600

Data Internet 15 400

By year six Communitel anticipate achieving inflation adjusted annual revenue of R4, 84 billion on this roll out programme.

Communitel have undertaken to meet the geographical roll out targets of the licence and anticipate installing 12 500-community payphones by year six and 1 450 school Internet laboratories.

6.3.9 Quality of Service Targets (QST)

Communitel's QSTs are significantly higher than those of TWO in terms of faults whilst those of TWO are higher than Communitel's in terms of installation. The representations of the two applicants are scheduled hereunder for their second year of operation (other years are not significantly different).

Indicators	Communitel	TWO
Customer fault reports per 1000 lines p.a.		
Business	2.0	<300
Residential	1.9	<300
Percentage of faults cleared within 48 hours		
Business	95	>88
Residential	93	>86
Serviceability of Public Pay-telephones		
Coin	82	95-98
Card	86	95-98
Customer pipeline – percentage of orders met within specified number of days		
Business 28 days		
90 days	86	>97
Residential 28 days	93	97
90 days	85	>95
	91	98-100

6.3.10 CAPEX

Communitel were required to provide details of their capital expenditure in a particular format, which they have failed to do. Accordingly it is impossible to analyse their investment in the desired manner. However the SOEs have done detailed work on the SNO's capital expenditure programme and Communitel have indicated that they "concur with the general approach". We have also examined the information provided and believe that the SOEs have created an excellent capital equipment and operational base from which to launch the SNO.

It is presumed that the disclosed CAPEX includes the purchase of the SOE FSN. Should this not be the case then their Balance sheet and equity requirements must be understated by at least R1, 6 billion?

6.3.11 Business partners

Communitel have enlisted the support of British Telcom and Deutsche Telcom. These parties have no financial commitment to Communitel and are effectively acting as service suppliers and consultants.

6.3.12 International Call Centres

The concept of International Call Centres is a sound proposal that exceeds the envisaged level of social responsibility and is an excellent quid-pro quo to the South African taxpayers (who effectively facilitate the SNO opportunity).

Communitel further anticipate contracting out various non-core functions.

6.4 TWO

6.4.1 Board of Directors

No detail has been proposed with regard to board appointments and commitments to the King Commission etc. Agreement will be required between the SOEs, Nexus and Swedtel upon potential appointments. In view of the disparate shareholder groupings in Swedtel (most of whose interests should be aligned with other shareholder groups),

there is likely to be considerable instability in the management process unless it is clearly and equitably defined.

6.4.2 Management Fees

In the original written submission TWO included a consortium agreement that indicated that they would be charging the SNO consulting fees. In response to the SOEs written questions they repeatedly indicated that this agreement had in fact been superseded by a subsequent shareholders agreement and inferred that there would be no management fee. In the public hearings they indicated that there would in fact be a management fee but that it would be at the discretion of the SNO and performance related. In the hearing Mr Nahon stated (page 58)

> "The direct cost incurred by the individuals injected into the SNO as well as a performance-based fee has been included in the model."

In the hearings Mr Nahon stated in relation to the management agreement:

> "There is no doubt that TMP and Swedtel will seek to procure the best agreement that they can with the SNO. However, they are an interested party and therefore applying the principles of the King Commission and having regard for South Africa corporate law, they would be precluded from voting in the conclusion of such an agreement."

(It is presumed that Swedtel is in fact Swedtel AB as no other interpretation could be read within this context) It is unlikely that either the SOEs or Nexus would agree to an "equity" partner receiving a "management" or "consulting" fee when their envisaged role is that of risk taking shareholders.

In view of the convoluted Swedtel and TMP funding arrangements with other shareholder parties it is doubtful that any director appointed by Invictus etc could be independent particularly in the light of the fact that there has been no disclosure of any agreement or relationship between these various parties.

In the hearings TWO undertook to provide the quantum of the management fee that they had included in their business model to ICASA. This information has not been received.

6.43 Tariffs and Tariff reductions

The applicants were required to complete a number of schedules which recorded important information such as their anticipated tariff reductions in each market segment, the make up of their costs etc.

In respect of tariff reductions TWO applied a uniform percentage across all market segments whilst inferring in its written submission that it would in fact have a number of different discount policies for different market segments. The percentage applied in the schedules was on a sliding scale, with a 12% reduction in year 2 that decreased to 4% at the end of year 6. This would constitute a 36% reduction over 5 years. Whilst this is consistent with the "promotion of competition" objectives of the Act, it does not tie in with the applicant's financial model. The financial model shows their margins improving over time and not decreasing, as one would expect if there was 36% price erosion.

No information was provided in respect of residential rental, though it was provided in respect of residential volume growth but in an amended format.

Details in respect of the revenue model were not provided and ICASA was merely referred to a detailed explanation of TWO's financial model contained in their 30 July responses.

6.4.4 Interconnection charges

A major concern displayed in the public hearings (with regard to TWO's financial model), was the calculation of their interconnection costs and revenue (page 64). Again TWO failed to provide the requisite information and ICASA was again merely referred to a detailed explanation of TWO's financial model. TWO have indicated that their interconnection costs will only be 14% primarily because of revenues being set off against expenses. (This accounting treatment is not in accordance with South African GAAP).

In the hearings Communitel asked questions around the determination of these interconnection costs.

In the hearings Mr Batek stated:

> "We have identified that a large number of, or a large portion of the residential traffic actually stays within the same underserved area. In other words, the originated and terminated calls are made within the same geographical suburban area and that skews the calculations as presented by CommuniTel".

We have the same concerns as expressed by Communitel, but because of the lack of information provided by TWO we are unable to clarify the matter. The foregoing statement infers that the bulk of TWO's residential traffic will be through the MTN mobile network. This is in conflict with their subsequent statement to ICASA on 30 July 2003 where they state " … very little revenues will accrue to MTN for their participation in the residential roll out". This statement is made despite the fact that there is no agreement with MTN.

6.4.5 Operating costs

The schedule of operating expenses does not agree with the summary income statement and therefore cannot be properly evaluated. A major difference between the Business plans of Nexus, Communitel and TWO is the fact that TWO anticipate significantly lower operating costs than either Nexus or Communitel. In their schedules they were required to separate various expenses for comparative purposes but they disclosed some and merely lumped others into other cost categories thus making detailed evaluations impossible (Again this is not in compliance with South African GAAP). In the light of the numerous financial commitments recorded in the application, the expenditure appears to be very low.

It is important to note however that upon a full years trading TWO's salary bill, is twice as high as Communitel's; Traditional network opex is half of Communitel's; Administrative costs are twice as high as Communitel's; whilst their marketing costs are 60% of Communitel's. Their interconnect cost is unknown and inferred to be close to zero but was identified as 14% in the hearings (refer above). (Communitel's interconnection cost by comparison is 26% of opex – Telkom's are at a similar level).

Whilst no detailed inferences can be drawn, because of the issues surrounding the interconnection charges it is quite possible that TWO's expenses have been significantly understated.

Although TWO have not disclosed the extent of their provision for a management fee the original consortium agreement included a performance bonus in favour of Swedtel of up to 3%. This equates to an uninflated amount of R770 million in the first six years (with inflation this is more likely to be closer to R1 Billion).

As noted above, TWO have indicated that this amount has been included in their Financial Model. The exclusion of this amount from the already low expenditure would make TWO's representations even less plausible.

If TWO are capable of operating at such remarkably low expense levels, one would like to have seen a greater proportion of these savings being passed on to consumers.

6.4.6 Staffing

With regard to employees, TWO anticipate no retirements, nor natural attrition and no voluntary retirements. This appears to be an unrealistic assumption. The retrenchment of SOE personnel is however avoided by virtue of their proposal to selectively employ SOE personnel and to ring fence the Service Organisation personnel into an SPV.

They disclose on their schedule that salaries will decrease over 6 years from an average salary per employee of R427 136 p.a. (year 1) to an average salary per employee of R344 269 p.a. (year 6).

Based upon the information supplied, if TWO's Technical operations personnel, customer care personnel and marketing personnel received an average annual salary of R180 000 per annum, their Middle Management received an average annual salary of R400 000 per annum, this would result in the Senior Management receiving an average annual salary of R8, 3 million. Clearly this is a theoretical figure but it is an exercise that we have performed to determine the reasonability of the employment costs disclosed in their submissions.

6.4.7 Roll out

TWO were requested to provide capital expenditure roll out targets in Rands and also the number of lines that they anticipated installing in each market segment.

In terms of this disclosure TWO anticipate an extremely aggressive roll out which envisages the following cumulative installation achievements by year 6 (Communitel's roll out in brackets).

Business lines	658 000	(165 000)
Residential lines	2 294 000	(137 600)
Data Internet	150 000	(15 400)

Notwithstanding the fact that TWO have an enormously higher expectation of their number of installed lines, they anticipate a percentage market share that is almost in line with the expectations of Communitel and they anticipate spending significantly less on marketing. In their written application, TWO quoted a table from Telkom SA (page 2-7) in which the number of Fixed Access lines as at September 2002 was identified as being 4,895 million (this includes data lines). Whilst it is accepted that TWO's model is a convergent model that relies upon Cellular structures, their anticipated number of lines appears to be inordinately high in comparison to the size of the market and the anticipated competition.

Communitel anticipate achieving inflation adjusted annual revenue of R4, 84 billion whilst TWO anticipate unadjusted revenue of R7, 2 billion with a significantly higher investment in installations.

In their written submission TWO have included a Market Revenue forecast (page 2-6) that shows the total fixed line market to be R35, 4 billion by the year 2008. Their 7,2 billion revenue forecast would represent 20% of this number. This again seems to be an inordinately high market share after only six years.

In their submission subsequent to the hearings, TWO indicated that they would anticipate negotiating an amendment to the licensing condition with regard to the percentage of geographical coverage. They seek to have the licence condition amended from having to cover 80% of South Africa geographically to having to cover 80% of the South African population. This proposed amendment would in effect promote further urbanisation and is unlikely to be acceptable to the authority.

6.4.8 Quality of Service Targets

These targets are scheduled in the analysis of Communitel above.

6.4.9 CAPEX

An analysis of TWO's capital expenditure (per their schedule) shows that they do not anticipate any replacement or updating of technology in the first 6 years and that they have no provision for any Network Management expenditure or facilities leasing costs.

They also state in their written responses on 30 July 2003 that they will build their own GSM infrastructure at a cost of R3, 5 billion over 5 years in high population environs such as Hillbrow (residential). Their accompanying Capex schedules show a total 5 year residential Capex of only R1, 9 billion for this period.

There does not appear to be any provision for the purchase and capitalisation of any of the SOE FSN (unless this is included in the lump sum number of R1 500 million anticipated for the Business Network roll out). Should this be the case then their Balance sheet and equity requirements will be understated by at least R1, 2 billion.

Within their written submission they have indicated that they anticipate utilising MTN's network management system. They have also stated (page 2-54) that they require a state of the art Network Management System and on page 6-3 they say that:

> " … the incremental cost to MTN of securing the additional functionality .. is likely to be considerably lower than the cost for the SNO to procure its own IN platform".

This implies that no assessment has yet been made as to what cost is required in respect of the IN platform, who will pay for it and whether it should be included as part of the facilities leasing costs. This may also explain why the required information has not been furnished in the application schedules.

TWO's technology, financial and business plan is highly dependent upon MTN's resources and is in effect a theoretical document with no agreements in place, no guarantee that they will be in place and absolutely no confirmation as to whether

agreements (if concluded) will actually agree with the assumptions that may have been included in TWO's models. This position was confirmed in the public hearings when Mr Batek made the following statements (page 166)

> "there *will be* a revenue sharing agreement with MTN. We *envisage* a revenue sharing agreement with MTN as far as the mobile revenues generated by the SNO customers, once they leave their home zone. That revenue sharing agreement *hasn't been finalised* because we envisage *a whole lot of other strategic partnership issues being negotiated* at the same time. My colleague Ross Macdonald mentioned one of the things that we also discussed a *possibility* of site sharing agreements with MTN. We've also discussed a *possibility* of the SNO providing the backbone service for MTN to connect their own base stations for their own purposes. So, there are a whole variety of commercial issues, which *will have to be negotiated* at one point in time."

These strategic partnership issues may have particular significance to the licensing conditions and must be agreed and clarified before any licence can be considered.

In the public hearings Mr Batek stated (page 190):

> "We have absolutely assumed using the relevant high sites from the SOEs in our plans as well. However, we've been prudent in including costs of leasing those sites because the ownerships issues are not clear at this stage."

and

> " …in our financial plans, we have included operational costs for leasing space on those sites."

In TWO's subsequent submission in response to ICASA's questions they noted that Facilities Leasing costs were "not applicable" to them.

It is again difficult to understand which representations are correct as there is no detail (as required) to determine which statement is correct though an examination of their expenditure table suggests that they have not been taken into account.

7 Technology

The ITA required applicants and their shareholders to provide details of their technical and business experience in the provision of telecommunications services.

Applicants were required to provide an overview of their proposed technology, a description of the operation of the system; detailed information upon the frequency requirements and evidence that the proposed technology has been proven internationally.

They were also required to provide detailed proposals upon topics such as air interfaces, network security, service quality, equipment use, interconnection, domestic and international roaming etc.

The inclusion of this section was intended to establish whether the applicants understood the technological challenges facing the SNO. These particularly include the issues surrounding the opportunity of a DCS 1800 Mghz and 3G license, which would ordinarily have provided a significant advantage to an SNO. The license fee of R300 million over 10 years is materially lower than the 3G licenses paid for and issued elsewhere in the world.

The technical evaluation section was also included to establish whether the applicants clearly understand and have an appreciation of the networks and technology that the SOEs will bring to bear. It is necessary for an SEP to establish which network elements and assets of the SOEs can be utilized to form a large integrated network providing a level of universal service anticipated in the ITA.

Both applicants have members who have extensive experience in the provision of PSTN services and these are more fully analysed below.

7.1 Communitel

The management and shareholders of Communitel clearly have experience as employees of BT where they have enjoyed the operational advantage of working under BT's goodwill and muscle. They have also had experience as consultants, particularly within Africa.

They have an agreement with BT in terms of which BT have been granted various rights of first refusal. The agreement may be binding upon Communitel but is certainly not binding upon the SNO. Against these circumstances Communitel will be unable to act objectively in any SNO decision with regard to BT.

A similar agreement is in place with both Microsoft and Accenture.

The Communitel application shows an understanding of new technologies such as "optical transmission systems employing DWDM technology …offering infinite band width". They are familiar with the SOE networks including the backbone fiber optical network (FSN) and the network-operating center (NOC). They also displayed an appreciation of the key technical issues, which will affect the success, and viability of the SNO.

They have been provided with a letter from BT affirming their capabilities thought their strengths would appear to be primarily as consultants.

7.2 Two

Swedtel AB and Telenor have indicated that they have had extensive experience as a second operator in a number of markets around the world. It is important to note that in all of the examples cited this experience is upon a contractual basis and not necessarily as a strategic equity partner. In analysing the information presented in TWO's submission, it appears that Telia have always been the equity partner in Telecommunications ventures whilst Swedtel have been the consulting partners. Telia are identified as the equity partner in the following ventures:

> MTC Namibia, MTN Uganda, TESS in Brazil, Suntel in Sri Lanka, Telia Norway, Telia Denmark, Telia Finland.

In their application document Swedtel identify themselves as the "… first operator-owned consulting company." and Swedtel's experience base is clearly shown to be that of a consultant and not an investor.

Examples cited include:

- MTC in Namibia where Telia have a *minority* stake in a mobile operator

- MTN Uganda where Telia partnered MTN South Africa and Swedtel was *contracted* to provide technical management
- Suntel in Sri Lanka where Swedtel was responsible for the start up of the Telia owned Suntel

During the hearings ICASA requested TWO to advise who was responsible for the compilation of their bid. They identified the following individuals:

Individual	**Experience (extracted from CV's)**
Michael Nahon	*Management Consultant*
Ross Mac Donald	*Management Consultant*
Eero Tarjanne	*Independent Consultant*
O Jansson	Senior Director Business Development
J Batek	*Independent telecommunications consultant*
John Broderick	Swedtel AB – *Responsible for financial bids for consultancy services*
Mac Allman	*Senior Advisor/consultant*
Y Cuba	Corporate Finance Executive Mvelaphanda Holdings (Pty) Ltd
X Kakana	Managing Director – ICT Works
M von Schack	Responsible for new Telecomms projects in Africa

Although the foregoing is a selective extraction of information from the CV's submitted subsequent to the hearings, a detailed reading of the CV's shows no long term operational experience in an entity such as the envisaged SNO. Furthermore the

CV's clearly show that the representations made by TWO (as regards the involvement of consultants) in the hearings were incorrect.

On the surface it is difficult to understand why Swedtel would act as equity partners when they have no experience in this aspect of an operator. However when one analyses the extent of their equity participation; the high degree of company layering; the minimal value of their equity participation; and the potential management fees that they may derive, it may be possible to draw another conclusion from their involvement. The management fees (after ex patriate costs) are expected to be in the region of R1 Billion over six years whilst their equity investment will be only R144 million. This equity investment will be further reduced by the SNO's subsequent profits. Their after tax share of profits (on their own forecasts) is anticipated to be R728 over six years.

In their documentation they emphasise their ability to manage and implement operations. There is however no evidence as to the extent of their market research and marketing abilities (i.e. their pre-management/operation abilities).

In the public hearings TWO were provided an opportunity to display their financial and technical skills and their understanding of the market. Instead they allowed three potential strategic partners to make presentations on their behalf. These partners have no commitment or contractual relationship with TWO and failed to provide any evidence of TWO's ability to meet any of their indicated objectives.

In the hearings Communitel commented that TWO's presentations were primarily made by consultants. This was denied by Mr. Allman (page 99) who stated

> "…it was stated by our competitors that the majority of presenters are consultants, each and every single one of the presenters this morning is either employed and/or has an equity stake in a member of the Consortium who was not one single consultant presenter standing up this morning. Thank you."

Clearly MTN, Didata and Virgin are neither employees nor equity stake holders (unless there are agreements that have not yet been disclosed).

Beyond this Mr. Ross Mac Donald (who made the presentation on behalf of TWO) was asked by the Chairman of ICASA (page 155):

> " ..but do you confirm that at present you are an employee?" *(of Swedtel)*

Mr. Ross replied:

> "I confirm"

Subsequent to the public hearings Swedtel have submitted Mr. Ross's CV which shows that he is Joint Managing Director of Octavo UK Ltd and not an employee of Swedtel. Mr. Mahon who was also integral in the TWO presentation is now disclosed as the other Joint Managing Director of Octavo UK Ltd. In addition Mr Eero Tarjanne, Mr. J Batek and Mr. Mac Allman have identified themselves on their CV's as management consultants.

TWO's proposed solution of utilizing MTN's facilities is a theoretically sound and expedient solution. It is however an extremely risky and dangerous approach if there has been no research or inadequate research, and if any of the pivotal underlying assumptions are incorrect, and if there are no long term qualified personnel.

As an example TWO have stated that it is their intention to deploy cutting edge technology (page 2-33 written submission). In their business plan presentation they have indicated that they will invest Capex in year one of:

Residential fixed wireless	R398 million
Residential data	R 45 million
Business	R1, 5 billion

Network management, International & satellite, Facilities leasing – Zero.

This Capex structure is based upon the assumption that MTN have available capacity that will be available to the SNO at a facilities leasing cost of Rand "zero". TWO Consortium have made it clear throughout their various presentations that they have not had adequate time to research numerous aspects of the business and one presumes that the SOE asset base has been included in the business Capex.

Two's technology strategy is highly dependant upon MTN yet there has been no evaluation as to the appropriateness of the SOEs technology in relation to MTN. Their submission document identifies the following areas where they are relying upon MTN:

High sites - TWO indicate that they require approximately 1900 high sites; that MTN have approximately 4000. They seem to have failed to identify that the SOEs have approximately 6 000 already available.

Prepaid Billing System - Although TWO have identified the ability of this resource they have no contractual arrangement and presumably no idea of any cost implications (Work has already been done and halted by the SOEs)

Interconnection system - TWO propose to utilize MTN's facilities until it can develop its own. Again there is no contractual arrangement and no detailed or adequate reference to any cost implications.

Switching centers - TWO suggest that a number of MTN's centers could be re-organised to create spare capacity which could be leased to the SNO. Again there is no contractual arrangement and presumably no idea of any cost implications and the adequacy of the potentially available capacity.

Intelligent Network Platform - TWO suggest that the incremental cost of MTN obtaining additional functionality is likely to be significantly lower than the SNO procuring its own IN platform. Again there is no contractual arrangement and presumably no adequate reference to any cost implications.

TWO also envisage an opportunity to use MTN's marketing channels, Radio planning resources and their ISP capabilities.

Whilst MTN clearly have capabilities within these areas, ICASA cannot make an assessment upon any of them, as there are no firm offers or statements to evaluate. TWO are in effect requesting ICASA to presume that MTN have the technical

abilities and to presume that they can be modified to meet the requirements of a fixed line operator and to presume that MTN and the SNO will reach a commercial agreement upon their utilisation.

TWO's technical ability has not been disclosed though it can be presumed that Swedtel, MTN and Didata probably have sufficient technical ability. TWO appear to overstate the nature of the "support relationships" with MTN and Didata. There are no agreements with any of these entities that are prepared to subvert their loyalty to any party who is the licence holder.

MTN's support is fully dependent upon, and subject to, the negotiation of an agreement of acceptable commercial terms. Yet, nowhere is there any indication that MTN and TWO have defined what these acceptable commercial terms might be. Furthermore, no line item in the financials estimates the cost for MTN's support.

Indeed, the "agreement" is only an agreement to negotiate. Often, attempts to establish such support arrangements fail. The applicant's future ability to deliver against its commitments is at risk if MTN and the SNO do not come to a commercially acceptable agreement.

8 Integration

This section of the ITA seeks to ascertain the extent to which an SEP would acknowledge the skills and resources that could be sourced through the 19% BEE shareholder and the 30% SOEs. It would ordinarily necessitate an evaluation of the business processes that could be assumed by the BEE and the SOEs, which could easily have covered marketing, SMME opportunities, human resource development, local procurement etcetera. It is important to note that the entire SNO process anticipated the broad based participation of historically disadvantaged groups and skills transfer.

Beyond this the SOEs have loyal and capable personnel who have played a major role in developing the SOEs telecommunications infrastructure. "Take overs" are frequently characterized by the personal feelings of a select oligarchy determining the future of many long serving and capable personnel. In an environment such as South Africa these issues are extremely important and require delicate attention. Neither

applicant has suggested the use of a third party Organisational Change Consultant (or similar), and it is unlikely that either of the applicants will succeed in the SOE integration without the assistance of such an independent facilitator.

Many of the assets controlled by the SOEs are strategically important to the economy of the whole of South Africa. Transtel controls the communications infrastructure of the airways, the ports and the railways, whilst Esitel effectively controls the national power grid. In view of the strategic and economic importance of these assets (and the implications of these assets failing through incorrect or incompetent management), the integrity, financial and technical ability of any applicant must be of the highest order.

Accordingly the applicants were required to show that they fully understood the implications of any integration and that their plans would not unnecessarily jeopardize the ongoing operation and viability of the SOEs businesses. The SOEs have done enormous time consuming and detailed preparation, and they have made significant investments that cannot be discounted without a thorough and objective evaluation.

Furthermore applicants needed to take cognisance of the executive and managerial skills and resources available through the BEE and the SOEs.

8.1 Communitel

Communitel anticipate negotiating the valuation of assets, the use of facilities and the transfer of personnel with the SOEs. Communitel have done significant detailed research into the assets, skills and personnel of the SOEs and they appear to have a sound understanding of all the broader implications of the SOE integration.

Notwithstanding this, they anticipate a direct negotiation with the SOEs upon numerous issues. The threat to SOE personnel will not make these negotiations easy and the use of an Organisational Change Consultant would significantly assist in a controlled and impartial integration of the various equity partners. They have advocated a participative management integration process with their own skilled personnel withdrawing after approximately two years.

Whilst the majority of Communitel's management are not "South African", they have extensive successful "hands on" experience derived from their operations from within the country and other areas within Africa. Beyond this, many of Communitel's personnel were part of the Goldleaf SEP application, and accordingly they have had the opportunity of making significant valuable additions to the information and experience that they derived in that previous SEP process.

8.1.1 PTNs

Communitel anticipate taking control of the PTNs at a relatively early stage, ring fencing them and then "stream lining" them over a period of 18 to 24 months. This arrangement affords Communitel the opportunity of avoiding some of the costs and legal implications of retrenchment etc. and effectively defers the payment of the purchase consideration to the SOEs.

8.1.2 Technology choice

The SOEs' technology choice is consistent with Communitel's technology choice. Communitel acknowledge that the SOEs have prepared detailed designs for the Network and have chosen vendors for the equipment all of with whom they are happy.

8.2 TWO

TWO has conducted a limited due diligence, due by their own admission to imposed time constraints, but despite this appears to have a good understanding of the facilities and resources under the control of the SOEs. In their answers to the written questions from Communitel and the SOEs, they have made the following statements:

> "All areas of the SOEs operations were reviewed … TWO is confident that the number of man hours spent was fully sufficient for the purpose of the B&FO"

and

> "The TWO consortiums due diligence team spent considerable man hours in Transtel's Data Room as well as with executive and senior

> management. Two Consortium's perception of that business was not supposed to be definitive"

The depth of understanding displayed by TWO with regard to the SOEs is a cause for some concern that is re-enforced by these contradictory statements. However, the plan put forward by TWO enables TWO to minimise its reliance on the SOEs by involving the network infrastructures of MTN and Internet Solutions. In their written responses to questions they stated

> "Swedtel will satisfy itself as to the acceptability of, inter alia, the terms and conditions of the license, the terms of the interconnect with Telkom, the terms of the agreement with the SOEs and the terms of the agreement with MTN hereafter the subscription will be effected".

Whilst TWO have given superficial consideration to various issues such as the Labour Relations Act and the HR implications of any integration, they do not appear to have made any detailed skills audit or included any possible retrenchment costs in their plan. These appear to have been left for the SOEs to address.

TWO do not envisage the use of an Organisational Change Consultant and anticipate negotiating the numerous issues directly with the SOEs. In view of the numerous areas of divergence, the imbalance of personnel and the numerous conflicts of interest already highlighted, there is unlikely to be a rapid conjoining of the minds of the three potential partners.

TWO plan to build a New Generation (3G) Network, which will be totally reliant on the MTN infrastructure for the first two years. There will be minimal reliance on Telkom's infrastructure. The access network will be primarily through the MTN infrastructure utilizing fixed mobile technology. The extensive network of Internet Solutions, which would presumably have voice over IP capability and allow TWO to provide "voice" directly to a large existing client base, would supplement this network. The immediate additional revenues that would be available to the SNO are significant and it is estimated that the SNO could benefit materially from diverting the revenue stream, which currently accrue to Telkom. This would be in addition to the revenue stream from the SOEs. There would also be material cost savings to MTN and IS who both currently have to pay large interconnection fees to Telkom.

TWO require an early integration of the Fiber Optic Network into the SNO in order to provide long haul capacity from commencement date. It has however indicated that the FSN (which it estimates to have a value of R1, 2 billion) should be included in the SNO and the purchase consideration should be treated as an interest free loan (less any equity consideration that it may agree with the SOEs). In their written questions the SOEs have made it clear that they will not grant an interest free loan. This has significant negative implications for TWO's funding and profitability.

It has further acknowledged that the SOEs have the following infrastructure advantages:

Rights of way and servitudes

Interconnect sites and ducts with Telkom

Spare capacity in the PTNs

The Network Operations and Management Centre

Existing High sites

Existing transport, access, switching and routing infrastructure

Facilities and resources e.g. equipment, buildings and depots nationwide

Engineering teams

Operator expertise and capability

A satellite based international gateway in Roodepoort

These assets are considerable; they provide a rapid route to market and they carry a considerable goodwill value that may be as high as R1 or R2 billion. A fair value payment for these assets will also negatively impact upon TWO's financial model and equity requirements.

In their submission, TWO state that the valuation of the SOEs businesses is likely to be high and unaffordable and they also suggest that the SOEs may encumber the SNO with businesses that the SNO can ill afford and that the SOEs should therefore provide an interest free loan in the amount of approximately R900 million. (The same argument could just as easily be applied to the proposed management fee in favour of Swedtel)

In their various presentations, TWO have indicated that the SOEs integration will take between 12 to 24 months. Their proposals are characterised by a process of selective employment and selective acquisition. Their presentations envisage a small grouping of personnel (approximately 20 ex patriate personnel) "taking over" existing operational businesses and streamlining them. We would suggest that this "Top Down" approach is in all likelihood a recipe for failure. An approach that is more likely to succeed would entail empowering the existing infrastructure to "merge" the SEP into their own operations. A bottom up approach is probably the only method that will succeed in view of the imbalance of resources and "South African" experience.

The business and technical plan of TWO is innovative and makes optimal use of existing infrastructure and new technologies to provide a cost effective solution which should meet the requirements of the ITA.

9 Summary

Both submissions are highly contingent on a number of issues, which therefore makes them non-binding offers.

There appears to be a non-acceptance of the draft licence conditions and both applications are contingent on negotiations.

The valuation and the use of the SOE assets remains a major and contentious issue, which needs resolution prior to the award of the licence.

Both applicants have ignored the provision of the Draft Licence that the debt equity ratio should not exceed two thirds.

Both applications are financially deficient.

Integration with the SOEs and Nexus may require ICASA or third party mediation.

9.1 TWO

1. the application is deficient in terms of its disclosure of shareholders; their inter-dependencies; their rights; and their obligations;

2 their effective control of the SNO (whether it be through Swedtel AB, Worldtel Ltd, Fanio BV or Industri Kapital) seems to be disproportionate to their real equity investment;

3 the net foreign investment into South Africa is initially minimal, and heavily negative in later years;

4 the extent of their equity participation appears to waiver and their participation appears to be subject to various escape clauses;

5 the returns leveraged out of the SOEs interest free equity loan and potential management fees are disproportionately high in relation to their investment;

6 the interest free equity loan avoids the borrowing restrictions imposed by the licensing condition. Conversion of the loan into a non-equity loan necessitates the shareholders significantly increasing their equity injection;

7 they anticipate the SOEs diluting their financial strength in favour of their own commercial considerations;

8 Consultants and business partners did TWO's presentations. They have failed to evidence the ability of a capable management team though the size of their organisation would suggest that they should be able to source such personnel. Their normal role appears to be as consultants and not as long term PSTN operators;

9 the applicant is a shelf company with no trading assets or record to underpin their commitments though warranties in the amount of R100 million have been proffered to ICASA;

10 the application is (by their own admission) highly dependent upon MTN with whom they have no written agreement and whose allegiances are available to any partner;

11 the business plan provided insufficient information to make meaningful evaluations, particularly with regard to the research performed by the applicant and the reasonability of the assumptions upon which it depended;

12 there is every indication that the equity requirements have been significantly understated but insufficient information has been provided to validate this

13 because of minimal due diligence the applicant has a limited understanding of the nature and import of the SOEs businesses and the work that they have performed in developing their own networks;

14 their time to market is dependent upon a due diligence, negotiations with the SOEs and ICASA and then the investment approval of their ultimate controlling shareholder;

15 their offer is highly conditional and depends on acceptable terms and conditions of licence and acceptable service level agreements with Telkom regarding interconnection fees, the value of the SOEs assets, and an agreement with MTN to utilise their infrastructure;

16 their offer is essentially a merger with MTN and while reducing competition, could provide a competitor of substance to compete with Telkom;

17 their business plan is innovative and fully recognises the opportunities prevalent in the SNO and the impact of convergence. They have put together a plan that will be quick to market, cost effective and will generate substantial revenue;

18 they have provided a plan where their main strategic partners are not equity partners. This raises the question of network and operational vulnerability;

19 their financial model shows profits being directed to shareholders and not being used to significantly lower prices and promote competition in the market.

20 their involvement with MTN may be positive for competition within the Telcom market, but may have difficulties in terms of the Competition Act.

9.2 Communitel

1. Communitel anticipate raising equity through a highly geared mezzanine-funding instrument. Their shareholder funds are limited to R400 million whilst their other SEP partners have significantly more financial ability than they do. Their envisaged role is inconsistent with that of an equity partner;

2. their model anticipates a funder warehousing the excess SNO equity in a manner that allows their consortium to acquire this equity at a future date from their share of the SNO's dividends;

3. the mezzanine financing arrangement avoids the borrowing restraints imposed in the draft licence;

4. the net foreign investment into South Africa is minimal and could be potentially heavily negative in subsequent years;

5. their management and shareholders are primarily consultants and not long term major telecommunications operators;

6. their business plan though not aggressive, is sound, well researched and displays an understanding of the South African market;

7. their financial plan is sound and assimilates well with their business plan;

8. they have a sound grasp of the SOEs abilities and appear to be sensitive to the integration opportunities and problems;

9. their time to market is dependent upon due diligence and their ability to raise funds;

10. the applicant is a shelf company with no trading assets or record to underpin the warranties required by the ITA;

11. much of Communitel's stated experience in running SNO's is unsubstantiated;

12. they have conducted an extensive due diligence and have a good understanding of the SOEs' network;

13 they have an innovative concept to introduce international call centres;

14 their telecommunications operator partner Namibia Telecom operates in a monopolistic environment and therefore has minimal marketing and competition experience;

15 Namibia Telecom may offer a significant advantage by enabling the SNO to have direct access to the SAT3 submarine cable infrastructure for international traffic;

16 their plan is a slow to market model;

17 their strategic partners have a minimal network in South Africa;

18 they have not provided proof of funding;

19 there is a potential BEE conflict with Nexus;

20 their financial model shows profits being directed to shareholders and not being used to significantly lower prices and promote competition in the market.

9.3 State Owned Enterprises

1 the SOEs have to date not been required to effect a presentation;

2 Communitel have identified that an extremely large amount of excellent network design, construction and implementation has already been effected by the SOEs;

3 they have strong balance sheets that could readily be used to raise equity capital in the region of R3 to R4 billion;

4 they have highly trained worked forces that are enormous in relation to the workforces on offer from the applicants;

5 they are existing operational and revenue generating businesses;

6 their existing revenue base and cost of infrastructure may well exceed the valuations determined by the applicants by a material amount;

7 the applicant's primary interest is in the SOEs' FSN. There is only a secondary interest in the PTN which are an important component of the SOEs' sale asset;

8 the integration of Transtel and Easitel is an enormous unconsidered project on its own. The two units currently operate as two separate entities.

Appendix 1: Summary of General Qualifications

QUALIFICATION CRITERIA	Communitel	TWO
Is the applicant a South African entity? (Section 1.3.5)	Yes	Yes
Was the application submitted by only natural and legal persona persons and a consortium so formed? (Section 4.1)	Yes	Yes
Did the applicant provide an original copy of the consortium agreement certified by a notary public or commissioner of oaths? (Section 4.1)	Yes was provided	No
The applicant may have no employees of Ministry, ICASA or civil servant of government of RSA. (Section 4.2.1)	Compliant	Unknown. Insufficient information provided
Did the applicant provide evidence that at least one member of its consortium has a customer base exceeding 500,000 fixed	Yes	Yes

line subscribers? (Section 4.3)		
Did the applicant warrant unconditionally the fulfilment of undertakings set out in its application and unconditionally meet the qualifications to apply? (Section 4.4)	Yes	Yes
Was the application in English? (Section 13.1)	Yes	Yes
Did any member of the applicant's consortium have an interest in more than one application? (Section 4.1)	No	Probably yes
Did the applicant acknowledge when the application was submitted that all information in its application was in the public domain? (Section 11.2)	Yes	Yes
Was the application prepared in accordance with the required form, structure and numbering? (Section 13.2)	Yes	Yes
Did the applicant make	Yes.	Yes

the certifications with regard to clause 4 of the ITA (13.3.1)		
Did the applicant warrant that there is no cause for disqualification or curtailment? (Section 13.3.2)	Yes	Yes
Did the applicant warrant that no company with an interest exceeding 5% in the applicant is in liquidation or bankruptcy? (Section 13.3.3)	Yes	Yes
Did the applicant certify that the applicant has no tax liabilities due in excess of one year, providing certificates from the tax authority to this effect? (Section 13.3.4)	Yes	Yes
Has the applicant disclosed any obligations with respect to any civil, criminal or competition offences, current or within past three (3) years? (Section 13.3.5)	Yes	Yes
Has the applicant disclosed any obligations with respect to judicial and/or collection procedures, current or within past three	Yes	Yes

years? (Section 13.3.6)		
Did the applicant disclose any obligations with respect to any current civil law suit? (Section 13.3.7)	Yes	Yes
Did the applicant acknowledge that the Authority has the right to use the information in the application on a non-exclusive basis? (Section 15.1)	Yes	Yes
Did the application exceed 200 pages (excluding attachments)? (Section 16.1)	No	No
Was the application signed on each page by an authorised representative of the applicant? (Section 16.1.2)	Yes	Yes
Did the applicant submit the required number of copies and CD? (Section 16.1.3)	Yes	Yes