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GUEST COLUMNIST:

SHOULD OLD ACQUAINTANCES BE FORGOT:

WHEN BRASIL'S TELECOMS SECTOR OPENS OFFICIALLY AT MIDNIGHT ON 1 JANUARY 2002, WILL THERE BE A SUFFICIENT LEGAL AND REGULATORY INFRASTRUCTURE IN PLACE TO ENSURE THAT COMPETITION HAS A CHANCE?

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In just three months, Brazil's telecoms market will be officially open for competition at the stroke of midnight on January 1, 2002. However, just because a market may be legally open to competition does not also automatically mean that the market is attractive for new investment. The question at hand, therefore, is exactly what steps does the Brazilian government intend to take between now and January 1 to ensure that the telecoms sector is an attractive investment target for increasingly limited sources of capital.

For those readers not familiar with the intricacies of the telecoms sector, perhaps a brief primer of the business might be helpful at this point. Basically, from an investor standpoint, the key point to understand is that, as a general proposition, telecoms is an extremely expensive business and, as such, entry requires a huge commitment of fixed and sunk costs. Not only does a new firm need to acquire network facilities, but it also has to invest in such things as a sophisticated billing system, back-office facilities, support staff, maintenance staff, and the like. In addition to these investments, an entrant into the telecoms sector must also sink a

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tremendous amount of capital into customer acquisition (advertising) and retention. (Paradoxically, as competition ostensibly takes hold and technology improves, while the cost of providing a telecoms service may decline, the cost of selling the service actually increases exponentially.)

But this is not the end of the investment requirements for the telecoms industry. When you are talking about telecoms, given the monopoly legacy of the industry, new investors must also incur huge incumbent-induced entry costs as well. For example, a new entrant needs to interconnect and collocate with the dominant incumbent's network, but as the incumbent wants to maintain its monopoly position, the incumbent will seek to exercise its market power in every conceivable way to deny, delay and degrade a new entrant's efforts at every step of the way. As demonstrated by the U.S. experience, unfortunately, because new entrants – by definition – bleed red ink, it is a far easier strategy for the incumbent to drag out the competition's limited resources and to force them into bankruptcy than to attempt to innovate and cut costs on its own. (After all, if an incumbent perceives that it will make one dollar, peso, real, bolivar, *etc.* more by deterrence than it can by competition, it will always choose deterrence.)

To mitigate this inevitable anticompetitive conduct, there needs to be an effective legal and regulatory infrastructure in place if competition is ever to take hold and investors are to see a return on their outlay of capital. The big problem with the Brazilian market, however, is that the government has only now issued for public comment some of the requisite steps necessary to establish such a legal and regulatory infrastructure, yet they nonetheless continue to expect that competition will miraculously take off on January 1. By failing to take a comprehensive approach to the problem, therefore, the government's inaction harms – rather than promotes – overall consumer welfare.

For example, if telecoms restructuring is to succeed in Brazil, then the government needs to issue, at minimum:

(1) A standard cost model (compete with a uniform system of accounts) to resolve basic cost allocation issues as competitors utilize bits and pieces of the public network;

(2) A cohesive set of interconnection rules resolving both pricing and access issues;

(3) A cohesive set of collocation rules (again resolving issues of pricing and access);

(4) A cohesive set of unbundling rules;

(5) A standard reference offer of minimum terms and conditions the incumbent monopolist must offer to new entrants;

(6) A code of conduct for dominant firms (*i.e.*, those with market power) including meaningful and timely penalty provisions;

(7) An expeditious and effective dispute resolution mechanism, including detailed arbitration provisions;

(8) A national numbering plan;

(9) Standardized and formalized license application procedures;

(10) An explicit universal serviced plan that does not deter entry (*see, e.g.,* failed U.S. model);

(11) A cohesive paradigm and process for merger review;

(12) A regulatory code of conduct to ensure transparency of decision-making and procedural due process for all stakeholders.

What is of concern about Brazil's current lack of legal and regulatory infrastructure is that it directly undercuts the government's pro-investment policy message it articulated in its 2000 "Perspectives on the Expansion and Modernization of the Telecommunications Sector" or "PASTE" Report, where the government sets forth the truly great potential of the Brazilian telecoms sector. Indeed, in the abstract, what investor wouldn't want to take a first crack at a market with a population of over 165 million potential untapped customers? The big problem, however, is that the complexities of the telecoms industry briefly touched upon above make a "spaghetti on the wall- investment strategy (*a.k.a.* "given the sheer size of the market, if I throw enough money at the wall, something's got to stick") foolhardy at best.

Notwithstanding the above, nothing herein should be construed to suggest that the investor community should demand that the government drop everything and immediately issue this huge set of rules outlined above in just three months. Instead, as sometimes it is better to have things done right then done quickly, the investment community should demand that the Brazilian government demonstrate that it is now going to begin in earnest to approach these complex (and often subtle) issues with the solemnity and analytical rigor they deserve, yet also show that that investment community stands ready to assist the government through this process in any way it can.

There is an old saying that "when you owe the bank a million dollars, you can't sleep at night; but when you owe the bank several hundred million dollars, then they can't sleep at night." As investors become more cautious and capital becomes tight due to the global economic slowdown, it would be a real pity if the lack of cohesive legal and regulatory infrastructure for telecoms were the deciding factors in stymieing Brazil's efforts to bridge the proverbial "Digital Divide" – and, as telecoms is a key input of production in every other industry as well – Brazil's efforts to grow its economy overall.