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Telecom sector: Free market or free fall?

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At most discussions on the growth story of India, it is the telecom industry that is cited often as an example.

India is said to be the fastest-growing mobile market with close to 500 million subscribers, which is set to rise to one billion by 2014.

Although addition of new subscribers is driving growth, India has the lowest average revenue per user (Arpu) in any major telecom market in the world. This, along with other factors, is leading to a financial crisis in the industry. While the country's cellular base expanded by 50 per cent to over 450 million users from 2008 to 2009, operators' revenues rose a mere 10.7 per cent.

The primary reason for this is apparent: there is a race to the bottom, caused by the presence of far too many operators. Telecom is staring down the abyss, and faces the prospect of rapidly turning from a sunrise sector to an unviable business proposition. In fact, operators — in response to a recent consultation paper floated by Trai on spectrum and mergers and acquisitions (M&A) policy — have stated that the current crowd of 12-13 players jostling for space is not sustainable. It is also true that the global experience in the telecom sector has shown that no more than five operators are sustainable in any major market.

Regulatory framework: In such a market scenario, the telecom industry faces a prospect of a wave of consolidation. However, the shackles placed on market forces by government regulations are preventing this from happening.

There are a number of restrictions on M&As in the telecom sector. Consolidation is not allowed for three years after the grant of a licence, and there is a lock-in period of three years for the promoters' stake. The combined marketshare of a merged entity cannot exceed 40 per cent in terms of both subscribers and revenues in any circle, and no consolidation will be allowed if it leaves less than four operators in a circle.

Growth is further cramped as no operator can have more than one licence in a single circle, therefore, in practice, there can be no buyout within the same circle. Finally, there is a 10 per cent cross-holding limit for telecom operators within the same circle.

Earlier, the regulatory emphasis was on having a large number of players in the sector to foster growth and competition. This objective has been fulfilled, and given the present state of evolution of the industry, its continued growth requires modifications to the regulatory structure.

The case for consolidation: There is excessive fragmentation of spectrum in the country, with the average spectrum possessed by a GSM operator being just 5.7 Mhz, about a third of global average. This leads to wasteful capital expenditure by operators, and the only people benefiting from this situation are the equipment providers.

Most large markets, such as the US, Japan and Brazil, have a maximum of 4-5 operators. India, in contrast, currently has 14 mobile operators, resulting in duplication of infrastructure and waste of resources when about six operators per circle would be sufficient. The current telecom policy has lowered the entry barrier, while making it difficult to exit due to the three-year lock-in. Inefficient operators are forced to continue operations instead of merging to reach a size that makes commercial sense.

The three-year lock-in for promoter stake was introduced as a knee-jerk reaction, to prevent windfall gains made possible by what some people consider faulty government policy. Former technocrats have openly admitted that the restrictive M&A policy is more a cover up of inefficient handling of the first wave of distribution of spectrum — by adopting a first-come-first-served policy and a narrow subscriber-based criteria. This is far too drastic a measure, and even a tax on windfall gains would be preferable to a clampdown on M&A activity.

The FDI policy also needs a relook, as an Indian partner at present needs to have a minimum stake of 26 per cent, which would amount to about \$5 billion. A few Indian companies that are not already in telecom have that kind of resources, and the few who do, would be unwilling to commit such large sums without getting control of the business in exchange.

The restrictions on M&A pose other challenges as well. Foreign players bidding for 3G licences would have to separately acquire a telecom licence, that would not come bundled with 2G start-up spectrum. Currently, it is close to impossible to acquire fresh 2G spectrum given the large number of pending applications. Also, due

to the M&A restrictions, successful 3G spectrum bidders cannot merge with an operator having 2G spectrum. This makes the entire 3G auction process very unattractive to foreign players, thus discouraging foreign investment.

Fears of consolidation in the sector leading to anti-competitive practices are unfounded. The forming of cartels is highly unlikely in a scenario where there would be at least six major operators. Further, the Trai has sweeping powers to determine tariffs and interconnection charges, allowing it to combat price-fixing. Further, a government operator in the sector can break a cartel. Finally, the Competition Commission of India (CCI) exists to prevent abuse of market dominance.

Outlook: Allowing consolidation would solve many of the problems highlighted here, a fact that has been recognised by the Trai in its ongoing process of amending the regulatory structure. However, policy makers must not lose sight of the prevailing environment that is abound with nervousness about the prospects for the telecom sector, amid increasingly-fierce price wars and sustainability concerns. Consolidation will result in synergies in the areas of infrastructure, human resources, spectrum and other areas. This can bring down costs, improve quality of services due to the availability of sufficient spectrum and increase investment. This would lead to a win-win situation for everyone involved, and ensure that the amazing growth story of Indian telecom remains on track.

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