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Czech Telecommunications: Financing of Network Expansion and the Choice of a Strategic Partner*

By Richard Seda** and Zdenek Hruby***

Summary

The article examines the sources of financing and the role of the strategic partner in the Development Program of SPT Telecom. It comments upon the results of the selection process for a strategic partner.

1. Introduction

The development of telecommunications in the Czech Republic after the Velvet revolution of 1989¹ has had several phases. Initially, the federal Czechoslovak *postal and telecommunications* operating company was a state enterprise. Clearly, the profitable telecommunications subsidized the inefficient postal operator. Moreover, the low accounting standards and data collection did not allow for an efficient management of the company.

The political development in Czechoslovakia in the years 1991-1992 made it clear that the country aims to separate into two national states: the Czech Republic and Slovakia. Therefore, any coordinated effort in the area of telecommunications was sometimes difficult to achieve, given that at least three Ministries (federal, Czech and Slovak) had to cooperate².

The "First Telecommunication Project" which was drafted by experts of SPT Telecom, Bell Atlantic, US West and the German consulting firm Detecon in 1991 was a success. This plan with its amendments has been the basis for the development of Czech telecommunications since 1992.

Despite the political haggling, the organizational departments of the telecommunications and postal operators were separated on January 1, 1992. On January 1, 1993³, they were also separated financially. Since then, these operators were fully separate economic units. In the Czech Republic the former monopoly-holding telecommunications operator became SPT Telecom, which was a state-owned enterprise.

After another year, on January 1, 1994, SPT Telecom was transformed into a joint-stock company, as a first step towards the Second Wave of Voucher Privatization, which took place during 1994. In its meeting on August 10, 1994, the Czech government accepted "The Main Principals of

the State Telecommunication policy". These principals opened a path for obtaining additional investment capital and know how. It was anticipated that this would be achieved by the entrance of a strategic partner into SPT Telecom. A strategic partner was chosen on June 28, 1995 after a long selection process and some legal wrangling.

The following articles analyses aspects of the aforementioned issues. It commences with Section 2 describing the features of the Czech telecommunications network. Section 3 addresses the financing of network expansion and the allotment of equity in SPT Telecom. Section 4 concentrates on the choice of a strategic partner for SPT Telecom. Finally, Section 5 outlines options for further developments of the Czech telecommunications sector.

2. The network situation

The long-term *systematic*⁴ under-investment and under-development of the telecommunications network

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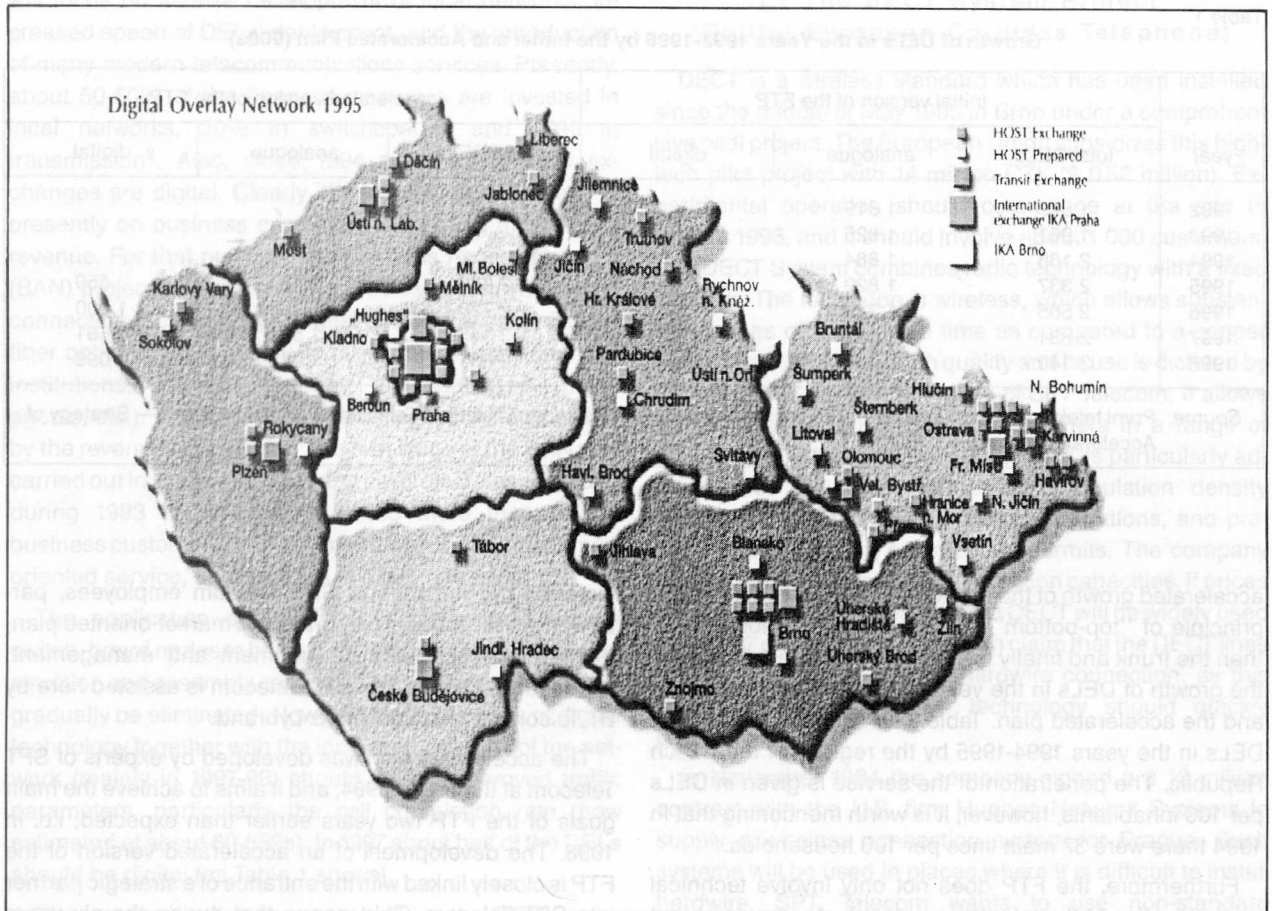
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¹ i.e., after the breakup of communist regime.

² More on this topic can be found in Hruby 1992.

³ The day before Czechoslovakia ceased to exist, and the two respective national states came into existence.

⁴ See Doyle, Hruby, and Mueller (1993).



which the Czech Republic inherited from the communist regime in the 90s could be best characterized by:

- an extremely low call completion rate (which was even not measured as a parameter of the network performance)
- outdated analogue equipment (some switchboards were even from the 1940s)
- a low service penetration rate of 15.1 DELs per 100 inhabitants in 1989⁵.

It can be concluded that the Czech telecommunications network hindered the economic development of the country.

As mentioned above, the First Telecommunication Project (FTP), developed in 1991, created the base-line for the development of the Czech telecommunication network. The main goal of the FTP is to achieve Western European standards of telephonization (e.g. a 60% penetration of residential dwellings). Also, the FTP was designed to cope with an ever-growing demand for telephone connections, and to bring supply and demand for this service in balance by the year 2000. The old analogue network could not be "patched" forever, the time for a dramatic overhaul had come. Given its character, dimension and investment expenditures, the FTP is one of the largest projects being

undertaken in the Czech Republic. The venture should require about 140 billion CZK⁶ (\$ 5.19 billion) of investment capital.

The realization of the FTP commenced at the beginning of 1992, and so far the project has been successful in achieving its goals. Its main goals are:

- to double the number of DELs, which means to add 1.9 million new DELs, and hence to achieve the density of 38 DELs per 100 inhabitants⁷,
- transformation of 40% of the existing analogue network, i.e. about 700 000 DELs, into a modern digital network,
- to balance supply with demand for telephone services.

The FTP has two phases: in the *first* one (1992-1994) the main goal was the development of a DON (Digital Overlay Network) and in the *second* one (1995-1998)⁸ the goal is an

⁵ See Hruby (1992).

⁶ Czech crowns, the currency of the Czech Republic. The exchange rate used in this article is \$ 1=27 CZK.

⁷ This number varies based on the used update of the accelerated plan.

⁸ Under the accelerated FTP.

Table 1

Growth of DELs in the Years 1992-1998 by the Initial and Accelerated Plan (000s)

year	initial version of the FTP			accelerated version of the FTP		
	total DELs	analogue	digital	total DELs	analogue	digital
1992	1 819	1 819	0			
1993	1 961	1 825	136			
1994	2 138	1 864	274			
1995	2 337	1 829	508	2 388	1 829	559
1996	2 565	1 728	837	2 728	1 728	1 000
1997	2 831	1 584	1 247	3 145	1 584	1 561
1998	3 140	1 465	1 675	3 561	1 465	2 096

Source: Prvni telekomunikacni projekt — Strategie urychleni, SPT Telecom. [The First Telecommunication Project — Strategy of Acceleration]. Prague, 1994.

accelerated growth of the network. The DON is built on the principle of "top-bottom", i.e. first the international level, then the trunk and finally the local level. Table 1 illustrates the growth of DELs in the years 1992-1998 by the original and the accelerated plan. Table 2 illustrates the growth of DELs in the years 1994-1995 by the regions of the Czech Republic. The penetration of the service is given in DELs per 100 inhabitants, however, it is worth mentioning that in 1994 there were 37 main lines per 100 households.

Furthermore, the FTP does not only involve technical modernization of the telephone network. An essential part of it is an advisory and consultancy service called Institutional Development Program (IDP). Its implementation

expands the horizons of SPT Telecom employees, particularly in the fields of corporate and market-oriented planning, human resource development and management, accounting, finance, etc. SPT Telecom is assisted here by BT Telconsult and Coopers & Lybrand.

The accelerated plan was developed by experts of SPT Telecom at the end of 1994, and it aims to achieve the main goals of the FTP two years earlier than expected, i.e. in 1998. The development of an accelerated version of the FTP is closely linked with the entrance of a strategic partner into SPT Telecom. This means that during the six years since the FTP was started, more DELs will be connected in the country than ever before. The second phase of the FTP

Table 2

Growth of DELs in the Years 1994-1995 by Regions of the Czech Republic

	Expected Reality for 1994			Plan for 1995		
	growth of DELs	at 31-12-94	DELs per 100 inh.	growth of DELs	at 31-12-95	DELs per 100 inh.
Central Bohemia	20 005	168 007	15	21 000	189 007	17
South Bohemia	15 000	139 998	20	18 000	157 998	23
West Bohemia	14 600	174 853	20	21 000	195 853	23
North Bohemia	20 352	193 765	16	30 000	223 765	19
East Bohemia	19 987	230 260	19	32 000	262 260	21
South Moravia	34 800	358 773	18	48 000	406 773	20
North Moravia	23 119	280 333	15	36 000	316 333	17
Prague	31 000	594 016	47	45 000	639 016	51
SPT total	178 863	2 140 005	21	251 000	2 391 005	23

Source: Prvni telekomunikacni projekt — Strategie urychleni SPT Telecom. [The First Telecommunication Project — Strategy of Acceleration]. Prague, 1994; numbers for 1995 are rounded to thousands.

will focus on intense development of local networks, increased speed of DELs' deployment, and the introduction of many modern telecommunications services. Presently, about 50-60% of the financial resources are invested in local networks, 20% in switchboards, and 20% in transmission⁹. Also, since 1994 all newly-installed exchanges are digital. Clearly, the focus of the company is presently on business customers, who bring most of the revenue. For that purpose, the Business Access Network (BAN) project was set up. The BAN uses unconventional connection facilities (e.g., digital microwave or dedicated fiber optic cable) to satisfy its customers (mostly financial institutions, foreign company representatives, travel agents, etc.). The increased cost of this technology is paid by the revenues generated. The pilot stage of the BAN was carried out in Prague in 1992, and the project was extended during 1993 nation-wide. It served more than 10 000 business customers. BAN is a step towards more customer-oriented service, and clearly has a commercial effect.

The application of digital technology causes some switch-board nodes to be unconnected due to a lack of construction and assembly capacity. This lag in connection will gradually be eliminated. However, the application of digital technology together with the increased capacity of the network (mainly in 1997-98) should lead to improved traffic parameters, particularly the call completion rate (now estimated at about 60-65%). In 1997 about half of the DELs should be digital (as Table 1 shows).

The "top-bottom" approach in building the DON can be best seen in the development of the highest network level. In February 1994 the over 500 km long digital backbone highway, which connects Germany via Liberec, Prague, Brno and Breclav to the Slovak Republic, was built. This highway uses fiber optic cables with state of the art SDH (Synchronous Digital Hierarchy) transmission systems. By the end of 1995, the capacity of the international digital exchange in Prague should have been doubled, and in Brno a new international digital exchange should have been introduced.

1995 was the turning point in the development of the Czech telecommunications network. 56 digital HOST exchanges and 327 accessory digital exchanges should be installed. At the end of 1995 there will be 78 digital HOST exchanges and 517 accessory digital exchanges in operation. The results of SPT Telecom for the first quarter of this year prove that the accelerated program of development of the telecommunications network has been fulfilled in every respect. The company's main focus after digitization of trunk and international links changes to local networks, installation of new DELs and increasing the quality of connection. SPT Telecom intends to offer ISDN, and other high-tech data and multimedia services from 1997 on. Today, there is at least one Czech company¹⁰ which has been operating a private ISDN with about 350 lines since February 7, 1994.

2.1 The DECT System Project (Digital European Cordless Telephone)

DECT is a wireless standard which has been installed since the middle of May 1995 in Brno under a comprehensive pilot project. The European Union subsidizes this high-tech pilot project with 14 million CZK (\$ 0.52 million). Experimental operation should commence at the end of August 1995, and it should involve about 1 000 customers. The DECT System combines radio technology with a fixed network. The local loop is wireless, which allows substantial savings of money and time as compared to a copper cable. The system is of high quality and its use is dictated by the ambitious development plan of SPT Telecom. It allows for the wireless connection of customers in a range of 50-100 meters from a DECT base. DECT is particularly advantageous in areas with a high population density because of complicated territorial negotiations, and problems with obtaining construction permits. The company has also limited assembly-construction capacities. If prices are acceptable, it is expected that DECT will be widely used from 1997 on. Some sources even claim that the DECT lines should cost about half of a hardwire connection, as this previously very expensive technology should quickly become cheaper.

In November 1994 the company signed a \$ 12 million contract with the U.S. firm Hughes Network Systems to supply a wireless connection system for Prague. Such systems will be used in places where it is difficult to install hardwire. SPT Telecom wants to use non-standard technologies means, such as DECT and Hughes to connect more than 50 000 DELs. According to Hughes Network Systems' representatives, SPT Telecom is the first to adopt a digital wireless system in Central Europe.

Modern digital radio-relay systems are being applied this year after substantial testing in a pilot project in difficult mountainous terrain and close to large water reservoirs, in places with low population density and in border areas. Simultaneously, the choice of locations is going on, and it can be expected that the number of the DELs connected this way will double.

2.2 The "end" of SPT Telecom's monopoly

It was announced in the middle of June 1995 that SPT Telecom's monopoly will end. The Ministry of Economics has selected sixteen areas where private cable companies could compete with SPT Telecom. The areas were chosen based on a low level of telephonization and outdated network equipment. The Czech Telecommunications Office prepared the conditions of a selection process for the local network operators in these sites. The competitors can either form a joint venture with SPT Telecom or compete on

⁹ Source: Svatopluk Novak, general director of the SPT Telecom.

¹⁰ This company is Svit Zlin.

their own. The selection process for the local operators began on July 20, 1995, and it should end by December 21, 1995. The required experience for this experiment will be gained by two pilot projects by Kabel Plus and Dattel. The beginning of these pilot projects hinged on negotiations with SPT Telecom about interconnection charges. There are attempts from smaller operators to create an atmosphere of "cooperation" with SPT Telecom rather than competition.

In its attempts to become a member of the community of telecommunication firms and to throw off the image of the "Big Brother" monopolist, SPT Telecom became a member of the Association of Operators of Cable TV and Telecommunications Networks in April 1995. Similarly, SPT Telecom wishes to become a member of the Association of Local Network Operators (ALNO). This development gives a hint of a positive development in the partially bureaucracy-ridden company. The aim of SPT Telecom is to participate in the ongoing development in Czech telecommunications together with other companies rather than to stay in the "Ivory Tower" based on its monopoly. The dominant position of SPT Telecom in the market gives it a position incomparable with the other operators in the ALNO. However, such a participation is preferable to a SPT Telecom attitude, which hindered the entry of other local operators in the market.

On June 15, 1995 the Ministry of Economy awarded the second telecommunications license to the cable firm Dattel. However, this license is only a local one. Dattel is a limited liability company and wants to transfer its status this year into a joint-stock company. It has 55 employees and an annual turnover of about 60 million CZK (\$ 2.22 million). Dattel plans to connect telephone lines in the area between Wenceslas and Carl Squares in Prague, i.e. the city center. It is expected that other companies shall obtain licenses shortly.

The first clients of Dattel should be connected in July/August 1995. The target number for the end of 1995 is 5 000 customers. Dattel expects to have about 15-20 000 customers at the end of the millennium. Initially, all customers of Dattel will pay charges as high as those of SPT Telecom. Dattel will pay about two thirds of the telephone charges for incoming and outgoing calls to SPT Telecom. Of course, the revenues generated within Dattel's network will not be shared with SPT Telecom.

Another interesting development is the entrance of U.S. West¹¹ into the Czech cable TV market. At the end of May 1995, U.S. West paid about 0.5 billion CZK (\$ 18.5 million) for newly-issued shares in the biggest Czech cable TV company, Kabel Plus. The U.S. company will obtain a 28.5% share in the Czech cable company. The participation of one of the biggest telecommunications companies should strengthen the Czech firm. It is well known that Kabel Plus is a likely candidate for another telephone license in a pilot project to telephonize Liberec (a city in Northern Bohemia). Presently, Kabel Plus has more than 400 000 subscribers.

Kabel Plus is a holding company with the capital of 1.5 billion CZK (\$ 55.6 million). One of its major shareholders is Ceska Pojistovna (Czech Insurance Company).

Crucial questions arise from the above-mentioned situation. The areas destined for local competition are those considered by SPT Telecom as less interesting for investment. Three consequences of this can already be observed:

- a) Local operators are excluded from the most profitable services, long distance and international, through the unfavourable distribution of revenues. Thus, their financial position vis-à-vis SPT Telecom with its monopoly for long-distance and international services and with its strong resources (see paragraph 3) should be considered dubious.
- b) The proposed joint ventures are favourable for the stronger partner, SPT Telecom, which is relieved from the responsibility of developing the local networks in unattractive regions and is able to keep part of the revenue from profitable non-local services.
- c) There are no provisions for the possible bankruptcy of a local operator. Considering all of the above-mentioned facts, the new competition in the local networks should be considered "quasi" rather than fullfledged competition.

3. Financial resources for expansion

3.1 Debt financing of the expansion

Financial resources for the dynamic development of networks were procured in a gradual process. This situation improved with an increased stability of telecommunication policy and a clear definition of the role of SPT Telecom within the system, resulting in its enhanced credibility. In its initial phase in 1992, the implementation of the FTP was negatively affected by a delay in financing which was caused by factors beyond the control of SPT Telecom. Among those, the Czecho-Slovak inter-government wrangling was particularly damaging because it obstructed the procurement of Government guarantees for loans from international banks. In addition, the Government seemed to have other priorities, e.g. guaranteeing loans in the energy sector. Hence, immediately at the start of the FTP, a several months long delay in the introduction of digital technology occurred. These loans were later provided by a consortium of banks (IBRD, EBRD, and EIB), but in the reduced amount of 7 billion CZK (\$ 259.26 million). The money was packaged in the following way: \$ 80 million from IBRD, 65 million ECU from EIB, 68 million DEM and \$ 42 million from EBRD. Furthermore, the above-mentioned loans secured the financing of the FTP between 1994 and the beginning of 1996.

¹¹ US West is already a partner in a joint venture, Atlantic West (together with Bell Atlantic), which owns 49% of the shares of EuroTel, the only cellular mobile telephone operator in the Czech Republic.

According to the audited accounting data¹² from the Annual Report for 1993 SPT Telecom had outstanding debts of 5.095 billion CZK (\$ 188.7 million) at the end of 1993. Total assets were 41.049 billion CZK (\$ 1 520 million) at that time. The SPT Telecom Annual Report for 1994 lists outstanding debts of 8.731 billion CZK (\$ 323.4 million) at the end of 1994. Total assets were then 51.475 billion CZK (\$ 1 906 million)¹³. At the same time SPT Telecom had short-term debts of 1 728 million CZK (\$ 63.98 million), which were financed by large domestic banks (mostly Komerční banka, Česká spořitelna, and Investiční a Poštovní banka).

A Project Implementation Unit (PIU) was set up. Its task is to coordinate, manage, monitor and evaluate all aspects of the implementation of the FTP. In 1992, the PIU collaborated in the conception of agreements between SPT Telecom and the above-mentioned consortium. PIU contributed to the effectiveness of all credit agreements. In general, the modernization of Czech telecommunications will be financed by the advantageous combination of retained earnings, loans and revenue from the strategic partner.

In the second half of March 1995 SPT Telecom obtained one of the most favourable loans in the Czech Republic. The loan of \$ 150 million is not state-guaranteed, and will be used for development of telecommunications (particularly DON). It is backed by a consortium of twenty-one international leading banks. The interest rate on the loan is 35 basis points + LIBOR p.a. This is the first loan to SPT Telecom, which was provided without state or third party guarantees.

On June 11, 1994 SPT Telecom issued five-year bonds with a total value of 1 billion CZK (\$ 37.04 million). It was the first time SPT Telecom used such a form of financing. The annual interest on the bonds is 12.5%. 100,000 bonds with a nominal value of 10 000 CZK (\$ 370.40) were sold. The issue sold very well and market experts questioned why it was so small. It is clear that the success of this issue brought confidence to potential lenders of SPT Telecom. However, for the next two years SPT Telecom does not plan to issue new bonds or Eurobonds. The reason for this is a relative sufficiency of investment resources that were gained from the strategic partner (see Section 4.1.).

In April 1995, Zivnobanka as a member of a consortium gave two loans totaling 66.8 million DM to SPT Telecom to buy technology from Siemens AG Munich and Siemens Telekomunikace. The loan is segmented into a long-term export loan of 39.2 million DM guaranteed by the German export insurance system Hermes, and a loan of 27.6 million DM.

In June 1995, SPT Telecom borrowed 2 billion CZK (\$ 74.07 million) from Česká spořitelna¹⁴. This was an unsecured five-year loan with better than standard conditions. The loan is aimed at the FTP, mainly for financing construction and assembly work. Most of the money will be directed towards local networks in order to connect a maximum number of new SPT Telecom customers.

Table 3

Survey of Long-Term Loans

Bank	thous. CZK	\$ thousands
Ceska sporitelna	141 000	5 222
Zivnostenska banka	117 000	4 333
Credit Lyonnais I	600 000	22 222
Credit Lyonnais II	215 437	7 979
KfG	1 394 913	51 663
ING Bank	248 755	9 213
Societe Generale	97 356	3 606
Northern Telecom International Finance	120 516	4 464
ABN AMRO	38 228	1 416
Deutsche Bank	91 471	3 388
IBRD	85 759	3 176
EIB	1 904 949	70 554
EBRD	381 913	14 145
BHF	176 906	6 552
Loans of SPT Telecom subsidiaries (total)	352 153	13 043
Total	5 966 356	220 976

Source: SPT Telecom Prospectus, 1995.

A debt is money that must be paid back with interest. "Faster", and from the corporate governance point of view, "softer" ways of financing investments are retained earnings or equity¹⁵. As far as retained earnings are concerned, one of the most important sources of revenues for SPT Telecom are based on tariffs, which are regulated by the state. From April 1, 1995 on, the monthly access charge increased from 52.5 CZK (\$ 1.94) to 70 CZK (\$ 2.59). The price of an impulse went up from 1.60 CZK (\$ 0.06) to 1.90 CZK (\$ 0.07). This price change will affect primarily the digitized local traffic, where each 4 minutes (or 8 minutes in off-peak time) will be counted for an impulse. In the analogue part of the network a local call costs one impulse whatever its length. This will clearly help to avoid cross-subsidization between the long distance and local callers in the digitized part of the network. According to the approved plan, the current tariffs went up from April 1996 to 2 CZK (\$ 0.07) per impulse. Further developments of the tariff level will depend on inflation. SPT Telecom will certainly use its monopoly power in negotiations with the regulators.

¹² Based on International Accounting Standards; same holds for 1994 data.

¹³ For more information, Table 3 contains an overview of long-term debts by 31.3.95.

¹⁴ Czech Savings Bank, the bank with largest assets in the country.

¹⁵ For equity financing see Section 4 and negotiations with the strategic partner.

3.2 SPT Telecom and Voucher Privatization

As mentioned in Section 1, on January 1, 1994 SPT Telecom was transformed into a joint-stock company with a total of 23 512 565 shares. This step was necessary for the company's participation in the Second Wave of Voucher Privatization. By decision of the Government, 26% of the equity (6 113 267 shares) of SPT Telecom were transferred to the public represented by individual investors and Investment Privatization Funds. The shares of SPT Telecom were issued and distributed in 1995 to their respective shareholders. They are traded on the so called "quoted" market of the Prague Stock Exchange since June 22, 1995, and are considered a very good investment. Table 4 contains the percentile division of ownership without and with the strategic partner in the company. As it is well known, the Voucher Privatization does not bring any new money to the equity of the company involved. Thus, SPT Telecom did not earn a penny from its participation in the government privatization scheme. It should be mentioned that the decision for voucher privatization was probably influenced more by political than by economic considerations. Moreover, many (if not most) economists believe that its strengths exceeded its weaknesses.

3.3 Investments into the network

The FTP anticipates that the total investment into the network in the years 1992-2000 (or 1998 under the accelerated version) will amount to 140 billion CZK (\$ 5.19 billion), i.e. 15.6 billion CZK (\$ 576 million) annually [or 20 billion CZK (\$ 741 million) annually under the accelerated version]. This year 6.5 billion CZK (\$ 241 million) should be invested in the local networks, i.e. about twice as much as in the last year. Table 5 below gives a more detailed picture than the above-mentioned averages. However, these aggregate numbers still do not give information about (i) the inflation effects on investment, and (ii) the efficiency of the investment in the FTP.

4. Choice of a strategic partner

In its August 10, 1994 meeting, the Czech government accepted "The Main Principles of the State Telecommunication Policy". These principles provided for the entrance of a strategic partner into SPT Telecom. The selection of a strategic partner was organized by the Ministry of Economics and the final choice was made by the Government. The Minister of Economics, Mr. Dyba, underlined the necessity of international capital for a speedy modernization as shown by previous analyses done by various international consulting firms (e.g., authors of the FTP). It is also clear that an equity injection into SPT Telecom is cheaper for the company than debt financing, although part of the profits escapes abroad. The question of whether a foreign partner is necessary, has been discussed widely in the Czech Republic. The opposition,

led by representatives of the Association of Small Shareholders of SPT Telecom, increased in the months before the final decision¹⁶. The arguments against the involvement of a strategic partner were the following: (i) domestic banks could finance the projected development, (ii) the strategic importance of the sector, (iii) unbalanced distribution of rights in favour of the strategic partner, and (iv) the technological ability of domestic producers. Nevertheless, the final decision was in favour of using a strategic partner. Apart from the need for financial resources and speedy modernization, the following arguments in favour of this solution were expressed: (i) The global trend to multinational alliances is expected to result in further liberalisation of the telecommunication market, (ii) the necessary changes inside SPT Telecom, e.g. the challenge of reforming a giant with a partially socialist work morale into an efficient and productive company¹⁷. Symptomatic for this situation is the high fluctuation of employees of about 25%. Furthermore, their low performance¹⁸ reaches only 1/8 as compared with the one of Deutsche Telecom employees and 1/7 compared with AT&T employees.

Before the official selection process started, the Ministry of Economics drafted a list of companies which were eligible to participate in the competition to become strategic partner in the spring of 1995. The Ministry used some more or less clear criteria, e.g. that the contestant must be a network operator. As a result, Telis, the firm of the enfant terrible of Czech telecommunications, Mr. Karel Berka¹⁹, was not accepted into the contest. Mr. Berka appealed against the decision, but lost the case. Mr. Berka represented the so-called "Czech path"²⁰ of development of the telecommunications network. Minister Dyba claimed that the Ministry has a right to choose the form and criteria for the selection process.

Up to 60 billion CZK (\$ 2.64 billion) of credits could be obtained from domestic sources to finance the FTP²¹. This would be a basis for the so-called "Czech path" which is also promoted by the Association of Small Shareholders, and offered to the Government as an alternative to the involvement of a strategic partner. The loans offered by consortiums of banks, leasing companies, etc. would be available without state guarantees.

Mr. Dyba did not criticize other possibilities of financing network expansion. He indicated that the option of a strategic partner is the most economic and least risky venture. If only domestic financial resources were used, the development would be slower which would have negative

¹⁶ See Telekomunikace strategickeho partnera nepotrebuji , Ekonom 21/1995.

¹⁷ Hospodarske noviny of 03/28/95, p. IV.

¹⁸ Hospodarske noviny of 06/01/95.

¹⁹ Former member of top management SPT Telecom.

²⁰ This development option is based on the use of mainly domestic debt capital, know how, etc.

²¹ Hospodarske noviny 06/23/95: Association of Small Shareholders.

effects in a rapidly developing competitive environment in the European telecommunications market.

The investment funds²² which hold the majority of shares in SPT Telecom which were offered in the Second Wave of Voucher Privatization expressed some discomfort with the planned position of the strategic partner. They argue that the foreign partner should not be given more power, particularly in decision making, than the number of shares held in the company grants. Otherwise, the foreign partner would obtain unusually favorable conditions in advance. Furthermore, it was criticized that according to the considered general agreement, the partner could offer its services to the Czech telecommunications without undergoing a selection process.

The President of the National Property Fund (NPF) claims that the proposed stronger position should give the strategic partner wider independence in management. This would particularly help in fulfilling the demands of the FTP. This arrangement is supposed to be only temporary and will end with the end of the FTP. The strategic partner will be controlled by the NPF which will own 51% of the shares. If the development conditions will not be met, the strategic partner will be subject to a wide range of sanctions (e.g. forced sale of a share of stock for 2 000 CZK (\$ 74.07) - under present and expected market value, financial charges, etc.). The necessity of an international strategic partner is given by the need of the company to change its character, particularly its customer relations. Also, it is expected that the partner will utilize its own experience from network expansion and digitalization. From the financial point of view the participation of a strategic partner will make the whole project about 10% cheaper, according to the President of NPF.

Similarly, the general director of SPT Telecom proposes that the strategic partner should help in the company's reorganization and its orientation towards customer's needs. Without a strategic partner all investment would have to be loan financed. This would not be cheap, because without a strategic partner, SPT Telecom would have a weaker negotiation position.

In April 1995, Mr. Dyba received the written statement by SPT Telecom representatives which sees the agreement as utterly asymmetric with an advantage for the strategic partner. Also, there is a conflict that SPT Telecom must remain a Czech-controlled company. The text of the agreement gives the strategic partner more authority than would be derived from its 27% share. In the Executive Committee the strategic partner will have three representatives, while SPT Telecom will have only two. Of course, the Executive Committee is responsible to the Board of Directors and Overseeing Committee. Moreover, the NPF possesses the so-called "Golden Share"²³ which gives NPF the power to veto at the General Meeting of SPT Telecom in many situations. Thus, there is little doubt that SPT Telecom will remain a Czech-controlled company.

There was a delay in the process of selecting a strategic partner caused by the problems associated with the formulation of the tariff policy (cf. the tariff change in April 1995 above). The tariff policy is formulated by the Ministry of Finance and SPT Telecom. A delay of a few months is not considered a major problem, given the size of the transaction, though it certainly affects the financial inflow negatively. The most important aspect is the quality of the selection process.

After the pre-selection was completed by the Ministry of Economics, five companies were invited to bid for a 27% share in SPT Telecom. According to the Ministry of Economics, the five international competitors have shown strong competitiveness and a high level of technological expertise. They proceeded to the next round where they were given more detailed information on SPT Telecom. This enabled them to formulate their final bids. The whole process proceeded based on the rules and criteria of the Ministry of Economics, so that the Government would be less involved in the selection and would only make the final decision. The Government received the recommendations of the selection committee, but was left with enough space for its own decision. There were five contestants: Italian STET, US-German consortium CeTel, Danish operator TeleDanmark, SwissNetherlands consortium TelSource supported by AT&T and French Telfar.

The search for a strategic partner for SPT Telecom began in October 1994 and was considered one of the largest capital transactions in Central Europe. Ten months after the decision to involve a strategic partner was made, the consortium TelSource, consisting of PTT Telecom Netherlands and Swiss Telecom was chosen by the Government on June 28, 1995. The consortium is backed by the U.S. telecommunications giant AT&T. The Government has chosen the candidate, which was pre-selected by the committee at Ministry of Economics. TelSource is ready to pay \$ 1.32 billion (35.64 billion CZK) for the 27% share in SPT Telecom. Moreover, the consortium will provide the Czech company with managerial, software and other services worth \$ 131 million (3.54 billion CZK). This makes the total value of the TelSource offer \$ 1.451 billion (39.18 billion CZK). The transaction is the biggest foreign direct investment in the country so far. It is furthermore the biggest investment in the European telecommunications market at the present time. It is expected that all legal procedures related to the bidding will end in September 1995.

The winning bid was not the highest financial bid, which had been offered by the Italian company STET. Unfortunately for STET, according to Mr. Dyba, the size of the financial bid was only one of the criteria used in the selection process. Due to the fact that this was not simply a sale

²² Expandia, Harvard funds, A-Invest, and IKS KB.

²³ With a nominal value of 1,000 CZK (\$37.04), transferred from a normal share of stock at 2/9/95 by decision of Czech Privatization Ministry.

of a stock in a company, but a search for a strategic partner, more complex criteria were applied, e.g. the commitment of the potential partner to the development goals of SPT Telecom, the ways of achieving them, experiences with network operation and its liberalization and the supply of other services.

The Government did not consider the "Czech path", i.e., network development without a strategic partner in its session on June 28, 1995. TelSource's offer precisely matched the needs of SPT Telecom. In case of unexpected events, two alternate candidates were chosen: Italian STET and TeleDanmark, both having equal rank²⁴.

4.1 TelSource — the strategic partner

TelSource is a consortium of PTT Telecom Netherlands (51%) and Swiss Telecom (49%). According to TelSource representatives, the 51:49 ratio is just a formality, because the Czech government required a majority owner within the strategic partner. In reality, both companies are equal partners. Swiss Telecom is fully owned by its government, while PTT Telecom Netherlands is 70% government-owned — the rest of its shares are publicly traded in Amsterdam. According to the Executive Director of PTT, his company will be less than 50% state-owned, after the second phase of transformation of his company has been completed.

After the transaction documents between the Czech Government and TelSource were signed in July 1995, the financial means were transferred to a restricted account of the Czech National Bank to be used only for SPT Telecom to finance its FTP. Thus, unlike other privatization sales, all money gained from the sale will be fully reinvested in the company and not used by the state. For 1995, SPT Telecom plans to use about 2 billion CZK (\$ 74.1 million) of this money; the rest of the money from the sale should be invested into the FTP in the next two years. Moreover, for some years, all profits of SPT Telecom will be reinvested

into network modernization, so that by 1998 the goal of thirty-six mainlines for 100 inhabitants will be achieved, which means that 60% of households will have a telephone.

In order to merge TelSource and SPT Telecom, TelSource will create a subsidiary with a capital endowment equal to their bid. This subsidiary will then merge into SPT Telecom (see Table 4.). This scheme must be used, because Czech law does not provide for the issuing of new shares in SPT Telecom.

The Czech side argued that after TelSource will become part of the company, there is no need to change the basic strategy of the modernization of Czech telecommunications. TelSource and SPT Telecom will have to fulfill the following requirements:

- in 1995 35% of the requests for lines must be satisfied within one year,
- in the year 2000 already 95% of requests must be fulfilled,
- the call completion rate should go up from today's 60-65% to 97% by 1998.

High representatives of TelSource think that their consortium won because of their project's quality. They claim that their offer to SPT Telecom is based on the principle of equal partnership, and does not imply a dominant position — despite the fact that they will have a 3:2 majority on the board of SPT Telecom. They consider their offer perfect for SPT Telecom because of similarities in market size and culture between the countries of origin of TelSource and the Czech Republic. The representatives of TelSource are convinced that their participation in the development of Czech telecommunications will initiate a period of fast growth. The Executive Director of PTT Telecom Netherlands confirmed that they plan to build two million new mainlines within the next five years. AT&T will work in the area of the Human Resource Development, which is one of the most underdeveloped parts of SPT Telecom's business operations.

TelSource plans to modernize the telecommunications infrastructure as fast as possible, e.g. the swift elimination of telephone shortages, and the creation of a new image of SPT Telecom as a customer-oriented company. In order to keep multinational customers, international tariffs are planned to be cut, and local tariffs increased, of course, in consideration of the inflation targets of the Czech government. All these changes should be completed within five years.

According to TelSource, the main reason for a strategic partnership is the opportunity to participate in international telecommunications trade. The winning firms already operate a regional network in Hungary and are active in the Ukraine. In the near future, thanks to the liberalization, the

²⁴ The consortium TelFar declassified itself because of its relatively low financial bid and the consortium CeTel misjudged the needs of SPT Telecom.

Table 4

Breakdown of Shareholders Position in SPT Telecom

	w/o strategic partner	w/ strategic partner
CR National Property Fund	70.00 %	51.10 %
TelSource (strategic partner)	0.00 %	27.00 %
Investment and Share Funds	22.00 %	16.06 %
Individual Owners	4.00 %	2.92 %
Restitution Investment Fund	3.00 %	2.19 %
Endowment Investment Fund	1.00 %	0.73 %

Source: The Preliminary 1994 Balance Report and authors' computations.

Table 5

Structure of Investments in the Years 1993-1997

	1993	1994	1995	1996	1997
Communications	2 327	2 615	4 691	4 905	6 133
Technology Transmission	820	1 481	2 103	2 553	2 410
Technology Buildings	501	743	1 127	1 037	997
Subscribers' Network	1 408	3 938	6 594	9 707	12 385
Other	1 436	1 450	2 392	2 226	1 767
Reserve	0	0	487	500	500
Total	6 491	10 226	17 394	20 928	24 192

Source: SPT Telecom and SPT Telecom Prospectus. Actual data is presented for the years 1993 and 1994; information for the year 1995-1997 is derived from financial projection. Data in the table fields are rounded, thus the totals may not add up. All data in million CZK.

situation in the European market will be similar to the American one. The number of operators will decrease to a few giants which profitably operate long-distance and international calls and data transfers. Then there will be small local network operators which are less profitable. Middle size firms will either merge with the long distance giants or die.

The Executive Director of PTT Telecom Netherlands holds that TelSource was the only competing consortium which existed already before the announcement of the tender for the strategic partner of SPT Telecom. TelSource has operating experience in the advanced telecommunications markets of Switzerland and the Netherlands, and is familiar with the cooperation agreement resulting from its partnership with the Swedish firm Telia and the Spanish firm Telefónica in the European alliance Unisource. Together with AT&T they created a consortium called Uniworld, which provides telecommunications services to the largest global and multinational companies. They also work on the fast development of the information superhighway.

SPT Telecom should also profit from the international activities of the TelSource, where it should take an important position. TelSource sees the Czech Republic as a switching center for potential Central Europe. It also intends to offer SPT Telecom immediate participation in its multinational alliances. It is particularly the membership in the European alliance Unisource, for which the Czech operator could work as an international interconnecting center. This way, the Czech operator could make money on international services, without need of costly investment.

5. Conclusion

It is clear from the material presented above that the development of the FTP and Czech telecommunications is

well-financed until the end of the century. However, not only financial resources were the decisive reason for the option of a strategic partner. The connection to global alliances, strengthening of the competitiveness of SPT Telecom with respect to the increased competition within the framework of the expected liberalization of the European telecommunication market, know-how transfer, as well as managerial influence on the behavior of the company are also important.

TelSource as a strategic partner is a new kid on the block of the Czech telecommunications market. There are many indices that the partnership was necessary, e.g. (i) fiercer competition in the European telecommunication markets will put pressure on the operator, (ii) the general public and businesses depending on telephone services would not keep their mouths shut.

The authors believe that there is a small risk that the SPT Telecom deal might later resemble the deals of Skoda MB — Volkswagen or even Czechoslovak Airlines²⁵. However, there is no reason for the Czech state to keep 51% of the equity in SPT Telecom. There are recent indications that the Government will change its mind. Such an option causes worries about the state's ability to influence telecommunications with respect to the strategic importance of the sector. Thus, the next development requires at least a very exact definition and assuring of the "golden share" rights, together with improving and stating more precisely the regulation network.

²⁵ Here the foreign partner did not fully satisfy the initial expectations and fulfilled all agreements. In the case of the Czechoslovak Airlines this even led to a full forced resale of Air France shares to the Czech Government. It is worth mentioning that the Air France Chairman at that time was Mr. Attali.

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Zusammenfassung

Telekommunikation in der Tschechischen Republik: Die Finanzierung der Netzerweiterung und die Wahl eines strategischen Partners

Dieses Papier untersucht die Finanzierungsquellen und die Rolle eines „strategischen Partners“ im Entwicklungsprogramm für SPT Telecom.