

What Future for the Consortium Model?

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Abstract: As a commercial model, the submarine cable consortium is proving surprisingly resilient even as telecoms markets have liberalized and demand for broadband has multiplied under the influence of the Internet and other revolutionary technologies. Despite the growing prevalence of incorporated submarine ventures, many telecom companies continue to find decisive advantages in multi-party projects based on contracts alone. At the same time, in managing their cable systems the participants must work to overcome the inherent limitations of the consortium format in a variety of areas, such as governance, finance, dispute settlement and sales to international wholesale markets. The paper examines some of these limitations and looks at ways in which they can be overcome, including through adaptations to the traditional model.

1. INTRODUCTION

This paper sets out to discuss the legal and operational reasons for the continued popularity of the consortium model for building and operating international submarine cables.¹ It builds on the writer's personal experience as legal counsel for a major new cable system, and in-house lawyer for the Orange business unit which manages the Group's participation in over a dozen major international cable systems and several maintenance zones. Despite focusing on this area for the past six years, I make no claim to being an expert either in corporate law, broadband markets or cable projects, but I hope to bring an informed viewpoint to a subject that deserves more attention.

2. WHAT IS A CONSORTIUM?

Join the Club

At work one day I was explaining that my paper was about the mystery behind the

enduring popularity of the consortium structure, in an age when the corporation is increasingly the entity of choice for other large business ventures. A colleague immediately replied, "There's no mystery – it's popular because it's a club!" And indeed, consortium cables are often called "club cables".²

It is true that behind the club label lurks the notion of exclusivity³. This connotation is a holdover from the 1950's and 1960's when the first modern submarine cable consortiums began to appear. At the time, most consortium members were telecom operators that held monopolies in their respective countries. This, happily, is largely a phenomenon of the last century. In our era, the principle for building a successful consortium is inclusiveness, not least for reasons of competition law.

Definitions

What my colleague probably had in mind was a different feature of clubs, one that is

found in the original meaning of “consortium” which comes from the Latin word for “fellowship”. Even though members are often competitors and this dimension is never far from the surface, an important trait found in cable consortiums is a genuine culture of fellowship. Parties come together united around common purposes, and over the years strong relationships develop, built on shared values, experiences and professional interests. But while relationships may be the glue, other factors act as the magnet that explains the consortium’s continuing relevance.

Merriam-Webster defines a consortium as “an agreement, combination, or group (as of companies) formed to undertake an enterprise beyond the resources of any one member”.⁴

This definition highlights the co-operative nature of the arrangement: companies associate with one another because it is mutually beneficial, and because they need one another to achieve the objective.

Since the project is typically beyond the resources that any one member can justify investing in terms of its capacity needs, financial cost is a key factor of interdependence. But cost is not the only consideration: regulation and the need for local licenses also make it necessary to involve multiple parties in the project.

A second definition clarifies the concept further:

“A short-term arrangement in which several firms (from the same or different industry sectors or countries) pool their financial and human resources to undertake a large project that benefits all members of the group.”⁵

Lawyers will commonly tell you that a consortium is not a legal entity. This is broadly true, in the sense that a consortium is not a corporation designed to outlast its shareholders, but an “arrangement” created purely by contract, for a limited period of time, to build a specific infrastructure.

Thus, when a consortium enters into a contract with a third party, from a legal perspective the contract is made between the third party and each consortium member. The consortium itself carries on no business activity separate from that of its members.

However, in certain cases, an unincorporated grouping may be treated as a corporation or partnership by tax authorities, if it behaves like a company.⁶

Taxation rules are therefore, as we will see, one important factor in deciding whether to adopt the consortium format, and in circumscribing its activities. The prospect of taxation should never be far from a consortium’s mind, as some tax authorities are only too eager to find grounds for taxing consortia as legal entities.

A well-drafted Construction and Maintenance Agreement (C&MA) is the first line of defense against this risk. The C&MA usually contains a clause similar to the following:

The relationship between or among the Parties hereto shall not be that of partners or joint ventures and nothing herein contained shall be deemed to constitute a partnership between them. In relation to third parties, the Parties will not act as partners, or as any kind of joint legal entity. Any co-operation among the Parties in Committees, Groups or Subcommittees

is only to facilitate the performance of this Agreement.

Taxation rules are also one of the drivers in the search for new hybrid forms for consortium cable projects (see Section 6).

3. HISTORICAL ROOTS OF THE CONSORTIUM MODEL

The Consortium in other contexts

Cable consortiums are associations of purchasers, whose *raison d'être* is to engage suppliers to design, manufacture and install the infrastructure. But the consortium model is equally popular among manufacturers and construction firms, when they bid together to perform large public works projects⁷ and real estate developments. In all these domains, each party jealously safeguards its commercial independence while contributing its own investment, know-how and skills for the benefit of the group, and sharing some of the risks.

Modernizing The Club Model

To manage its affairs, each consortium has to put rules in place for a variety of subjects, from procurement of the system to governance to capacity management. The C&MA was developed for this purpose, and the template has remained surprisingly stable over several decades, despite the transformations the telecoms sector has witnessed during that time.

The strength of the C&MA is in its flexibility, and therein lies one of the secrets of the consortium's enduring appeal. The parties have broad freedom to allocate rights and powers among themselves with little constraint from regulation other than the general legal framework of contract, competition and tax rules. But this flexibility has its limits as we will see.

As telecoms markets have liberalized and demand for broadband has multiplied, at first glance the original rationale for the 'club' model would seem to have lost much of its relevance. The model developed in a period when most countries had a single telecoms operator, usually government-controlled, and when cables used analogue coaxial technology.

"The [consortium] structure limited the development of a market for international traffic", since the process was complicated⁸ and the conditions onerous⁹ for competitors to lease capacity from cable owners.

As a result, beginning in the U.S. in the early 60's, with the encouragement of the FCC the IRU contract came into use as an innovative way for consortium members to provide competitors outside the 'club' with long-term rights (rather than short-term leases) to capacity on more favorable business terms.¹⁰

Another, more recent, innovation that consortium agreements have embraced is the "aggregate landing" concept. Designating a country as an aggregate landing offers activation rights in that country to more than one operator, instead of the traditional single-member model. This device has two virtues: it enables two or more competing operators to acquire full landing rights in the same country, and to do so at a discounted investment level compared to single party landings, by "aggregating" their investments.

Despite these remodeling efforts, with the emergence of fiber optic technology followed by the spread of telecoms liberalization in the 1990's, the way was open for new players to leave the consortium model behind entirely, and

instead develop private cable systems and sell capacity on international markets.

“Inspired by the early success of private undersea investment in the transatlantic market, throngs of speculative investors pitched undersea cable build-out plans that ultimately resulted in more than \$25 billion worth of new systems being deployed in fewer than four years.”¹¹ Yet in spite of this private investment boom the consortium system persevered, as incumbent telecom operators continued building new cables as alternatives to the newcomers.¹²

“After the [dot-com] bust, some things have gone back to normal: the consortium system made a significant comeback, and there are even some hybrids that have aspects of both consortium and private cables.”¹³

The figures bear out this observation. During the five-year period from 2010 to the end of 2014, “carrier-led and consortium projects accounted for 83% of total investment, with government- and multilateral development bank (MDB)-financed projects accounting for 9% and investor-led projects accounting for 7%.”¹⁴

4. ADVANTAGES OF THE MODEL

In brief, the consortium model offers several widely-acknowledged advantages:

- Sharing of the risk of unanticipated costs and delay linked to the construction and repair of the cable, and of changing market conditions.
- Participative governance based on a committee structure in which each party is represented. Decisions are generally made by consensus and

disputes among the parties or with the suppliers are resolved without resort to litigation.

- Contributing complementary technical skills, and exchanging this know-how among members.
- Overcoming regulatory constraints connected with operating telecoms facilities and providing services in each of the countries. Only a local licensed operator is eligible to install and operate that portion of the system located in national territory.
- Parties are taxed only on their individual revenues. The consortium itself pays no tax as it is not a separate entity from its members, purely an arrangement for sharing project costs and duties, and does not engage in commercial activities with the aim of generating revenues or earning profits.

The first two points are worth examining in more detail.

Limited Financial Risk

The consortium is not the only way to share the costs of a large-scale infrastructure project like building a submarine cable system, but it is the one that involves the least financial risk.

An investor in a company receives shares in return, and the value of those shares will depend on the business success of the company. As we know from the Internet bubble, submarine cables are not always a safe financial investment.

By contrast, operators funding a consortium take less of a financial gamble, since what is involved is procurement of a commodity for the member’s use as an

input to produce its own telecommunications services. In return for its investment, the member remains independent while becoming the owner of an asset which it alone decides how to use, and sets the price, quantity and conditions if it chooses to resell on the wholesale market.

Despite the gradual recovery of submarine cable construction activity over the past decade, there has been “a shift toward a marketplace in which telecommunications operators undertake most investment in new systems themselves. Private, non-telecom investors have faced a challenging financing environment for their projects”.¹⁵

Dispute Resolution Options

There is no doubt that consortiums are reluctant to engage in litigation, especially among members. Fortunately, they have various mechanisms available to settle disputes without going to court or arbitration. Internally, severe sanctions such as suspension of repair services or loss of capacity activation rights are usually effective in resolving late payment issues. As a last resort, contracts usually provide for exclusion from the contract and loss of all rights (including their investment) in cases of serious breach.¹⁶

Apart from the problem of non-payment, disputes can legitimately arise between the consortium and one of its members over responsibility for certain extra costs. An approach that has proved effective (in at least one case the author observed) is internal mediation. A small working group can be formed to receive written and oral submissions and, if the parties still cannot agree, make recommendations to the management committee.

5. LIMITATIONS OF THE MODEL

Despite its undoubted advantages, from a lawyer’s (admittedly narrow) viewpoint the consortium model also suffers from several real weaknesses.

Unlimited Liability

In purely legal terms, the fact that the consortium lacks a separate legal identity from its members can also be seen as a handicap compared to a company. In a contract between a third party and a consortium, the third party can enforce the contract against each of the consortium members, each of which risks its own capital without limitation, unless there is a clause that sets a cap on liability. With a company, the shareholders are considered separate from the company and their liability is limited to their investment in shares, or to the amount of their guarantee (in a company limited by guarantee).

Governance issues

Speed of decision is not one of the virtues readily associated with consortiums of 15, 30 or 50 telecom operators. Face-to-face management meetings are infrequent, and when they do occur they last several days. In between, subcommittees meet to prepare recommendations on specific subjects. As a result, deliberations often extend over months to reach consensus, and even years on contentious issues.

In private cables, decision-making is streamlined. “No longer held up by the diverging opinions of numerous committee members, the timetable for private cable projects became shorter to capitalize on the current market: instead of taking five years or longer, cables could be launched and completed in under two years.”¹⁷

Tax Exposure: Withholding tax on internal consortium charges

In principle, a local entity that makes payments to foreign suppliers for services can be charged withholding tax. The objective of withholding tax is to ensure that the foreign supplier pays income tax on the revenues it receives from the country where the service is delivered.

In the past, consortiums and their members were seldom charged withholding tax. As noted above, the C&MA clearly states – and the reality is – that the parties are not joining together to do commercial business, but to “facilitate” the achievement of a project. The business model is based on cost-sharing, not revenue-earning. As a result, most tax authorities accept the argument that when a consortium issues payment requests to its members (primarily for annual maintenance and repair charges), it is not engaged in providing services, but is merely apportioning costs among the parties in proportion to their ownership stake in the project.

However, there seems to be a growing trend to apply withholding taxes to consortium payments, which if it continues will translate into higher operating costs and higher prices for customers.¹⁸

Tax Exposure: VAT Risk

There is a similar risk related to VAT. If the consortium is seen to be using facilities in a given country to offer services, tax authorities could treat it as if it were a company, with a “permanent establishment” in the country concerned, and require it to register for and collect VAT. The risk could arise in several ways including:

- use of the wrong method to finance system elements, based not on cost sharing but on payment for use

(e.g. of landing stations or terrestrial backhaul);

- engaging in commercial sale of surplus capacity.

Consortiums have limited room to resist the application of such taxes, but at the very least they should remain alert not to deviate from the pure cost-sharing business model. Hence the search for “hybrid” structures (see Section 6).

Inability to do commercial business as a group

Thus, for all its ability to adapt to new circumstances, the consortium model is inflexible from a commercial standpoint. Investors may have acquired more capacity than they can use due to high investment thresholds, yet they may not have an outlet for the surplus on international markets. Smaller operators may lack wholesale marketing expertise. In addition, a party’s landing rights in the system may be limited to their home country whereas the demand for capacity on the system is concentrated in other landing points. By contrast, with a private cable investors own shares rather than capacity, and the company can activate circuits for customers between any system landing points. This model makes distribution of capacity to customers much more flexible, and places all shareholders on an equal footing to share in the resulting revenues.

Difficulty of conducting lawsuits

As already mentioned, if a consortium is sued, the members’ liability is unlimited (except for whatever limitations may be found in a contract).

If instead, the consortium has a claim to pursue (against a member or a third party), all the non-defaulting members must agree to participate or at least not object to

bringing the claim.¹⁹ Even then, collective actions tend to be procedurally more complex and thus more costly and protracted. The directors of a company, on the other hand, have the power to launch proceedings whenever they judge it to be in the shareholders' best interests, without the need for unanimity among the owners.

Financial management issues

Occasionally consortium members cease payment of their annual maintenance charges (or more rarely of their committed investment contributions). It is sometimes argued that if consortiums were incorporated, they would be better able to bring lawsuits against defaulting members, for the reasons just noted.

Compliance issues in dealings with banks are another factor that can complicate financial management. Banks are increasingly vigilant when faced with requests from CBP's to open accounts on behalf of consortiums, or to handle fund transfers involving consortium members affected by international trade sanctions. The process of opening an account may be slowed by the need for the bank to perform prior due diligence on each consortium member. Banks may even cease altogether existing account activity for a CBP where they determine that a risk exists in connection with sanctions legislation.

Obstacles to raising finance

One weakness of the consortium model is that the club is not designed to accommodate smaller operators (or even larger operators with smaller needs in a given region), due to a high minimum investment level. Yet without these smaller contributions, there may be insufficient financing to build the system at all.

Reluctance of third party suppliers

Proponents of incorporation argue that some third party service providers may be unwilling to do business with an entity that has no legal personality. This is plausible in theory: it is complicated to contract with multiple parties; consortiums have no credit rating, assets or employees. However, with one exception²⁰ I have found no examples of this in practice.

6. ALTERNATIVE MODELS

As mentioned above, the consortium model is a club with a high entry fee that does not fit the budget of some prospective investors. One solution to this has been to introduce SPVs (special purpose vehicles), which have proven effective for EASSy and ACE in particular. A group of telecom providers form a company, the SPV, in which each takes shares, combining their funds to invest collectively in a consortium. In Africa, SPVs are enabling developing countries, supported by MDB's such as the World Bank, to advance their economic and social development goals. SPVs offer their participants considerable flexibility: some are formed in a single country, while others, notably WIOCC, are regional in scope. In addition, the capacity that SPVs acquire is distributed among the shareholders, or marketed to third parties, in whatever way the SPV investors may decide is best for their circumstances.

Formed in 2007 to invest in EASSy, the WIOCC SPV marked a new departure in the structure of subsea cable joint ventures. First, by its scale – its investment represented 14 operators and nearly 30% of the cost of building EASSy – it proved crucial to enable the project to go ahead. Second, by establishing itself as a commercial company, new share capital could be raised for additional investments in other cables (WACS and EIG), or in terrestrial infrastructure.²¹

In this way the advent of SPV's counteracts a weakness in the pure consortium model, giving the model a new lease on life particularly in Africa, and helping to make possible in recent years the rapid expansion in new cable systems to countries that previously had little or no access to subsea capacity.

A second and equally serious limitation of the consortium is its inability to effectively market the capacity the system generates. With the growth in competition among cables, and the boom both in demand for and supply of fiber capacity, parties in existing consortiums find themselves with surplus capacity but lack the means to bring to it market in a way that is accessible and attractive for customers seeking cross-border, end-to-end services. No single member can reach all countries on a system²² that has a large number of landing points, let alone provide a uniform portfolio of services to multiple countries.

At first glance, the consortium agreement leaves the door open for members to act together to market their capacity. Specifically, the typical C&MA allows "occasional commercial use" of unallocated capacity. However, a closer look at the consortium's legal status demonstrates that the unincorporated association model is poorly designed for commercial capacity sales. Even though the C&MA may envisage some commercial sales²³, the contract as a whole is designed only to share project costs and distribute the production to the individual members. Consortiums would be trading on slippery legal ground if they were to begin selling capacity to third parties on a commercial basis, even in an "occasional" way.

Just as the SPV model has helped resolve the financing gap, it also offers participating operators an outlet for their surplus capacity, and a foothold in the growing pan-African wholesale broadband market (as WIOCC illustrates). In a further step forward, the members of ACE are making creative use of the corporation model to solve the "marketing gap". ACE is designing a separate entity in which all the consortium parties could participate both as shareholders and as suppliers of inputs, preserving the consortium to perform its traditional cable system management role. The new entity, referred to here as 'JVCo', would design product offerings built on capacity obtained from the individual consortium parties. Customers would benefit from a single commercial entry point to the cable, via a single vendor, to obtain capacity to any combination of points on the system. JVCo's sole purpose would be to market and support services built around capacity it purchases from participating consortium parties.

Whereas WIOCC was set up to enable participants to acquire EASSy capacity, JVCo would serve purely as a sales channel for consortium members, who already own their capacity via their previous investment in the consortium. Unlike WIOCC, JVCo would not invest in or own capacity in the system. In addition, whereas WIOCC represents only about half of the EASSy members, it is anticipated that the full roster of ACE members would become co-owners in JVCo.

Table 1 compares in more detail the consequences for a consortium if it were to engage in commercial activities, and illustrates the advantages of using an incorporated company as a sales channel.

Subject	Consortium	Commercial Company (JVCo)
Form of Organization	Unincorporated Entity – additional contract(s) needed among the parties	Incorporated entity: set-up and administration costs
Liability	Members are jointly and severally liable, and risk their own assets.	Liability limited by shares. JVCo alone is liable under customer (or other) contracts, with no additional liability of members (unless they provide guarantees)
Contracts with third parties	Customers face a complex process: contracting with all the parties, with no single entity to hold responsible or sue.	Customers have a single agreement with JVCo, which is fully responsible for service quality
Taxation	Permanent establishment risk: <ul style="list-style-type: none"> - trading profits taxed as if a business entity in one or more countries - obligation to register and account for VAT In some countries, withholding tax on payments to foreign suppliers (including members)	Choice of a low tax jurisdiction prevents heavy tax burden (income, dividends, interest, royalties) Board meetings and major decisions must take place in the country of incorporation.
Governance	Major decisions require unanimity, at times slow and difficult. Meetings and decision making can take place anywhere.	Managers and board of directors make major business decisions (recruitment, pricing, dividends, etc.) and can act quickly.
Assets	Co-ownership of infrastructure and IP rights. Each member is allocated its own capacity.	JVCo may lease or purchase capacity. JVCo holds IP rights (e.g. brand) and other assets, unless otherwise decided.
Licensing Requirements	Each local landing party fulfills local requirements.	Only a few countries require telecom service providers to be licensed for activity limited to sales.
Lawsuits	To bring a lawsuit (especially against a fellow member e.g. for non-payment), unanimity may be lacking.	Directors have a duty to pursue a legitimate cause of action and power to decide in the company's interests.
Staffing and Operation	Signs service contracts with members or consultants for operations (Secretariat, CBP, NA, NOC, etc.) but has no employees.	Recruits own personnel, carries own insurance, operates bank accounts, etc.

Table 1: Conditions for Carrying on Commercial Activities

7. CONCLUSION

Twenty-five years is a short lifetime for an organization compared to the unlimited time span of a company²⁴. Indeed, the challenge of closing down a cable consortium is another constraint of the model, but the subject takes us beyond the scope of this paper. However, while it is still too early to say, hybrid models may also have a contribution to make to a smoother retirement process for older consortiums and their replacement by new systems.

8. REFERENCES

¹ The opinions expressed do not necessarily represent those of Orange or of ACE members.

² D. R. Burnett et al, Submarine Cables: The Handbook of Law and Policy (Leiden, Martinus Nijhoff, 2014), p. 46. Chapter 2 "The Submarine Cable Industry: How Does It Work?" by Mick Green, contains a very clear overview of how cable systems are organized and operated.

³ It brings to mind the famous line of Groucho Marx, who claimed that he refused to belong to any club that would accept him as a member.

⁴ Merriam-Webster Dictionary online, www.merriam-webster.com

⁵ Businessdictionary, www.businessdictionary.com

⁶ see section 5, below.

⁷ C-H Chenut, Guide Juridique du Consortium (Paris, Les Editions EFE, 2005), p. 10.

⁸ N. Starosielski, The Undersea Network (Durham, Duke University Press, 2015), p. 42.

⁹ Baker and McKenzie, Etude des caractéristiques de l' »Indefeasible Right of Use » (Study prepared for ARCEP, March 2011), p. 6.

¹⁰ Baker and McKenzie, idem.

¹¹ Terabit Consulting, "Submarine Telecoms Industry Report," Issue 3 (prepared for Submarine Telecoms Forum, 2014), p. 25

¹² Starosielski, p. 51

¹³ Starosielski, p. 54

¹⁴ Starosielski, p. 38

¹⁵ Terabit Consulting, p. 38.

¹⁶ Even where the contract fails to provide for exclusion (e.g. the standard supply contract, unlike the C&MA, has no provision for excluding a non-

paying consortium member as a contracting party), general contract law rules have proven sufficient.

¹⁷ Starosielski, p. 48

¹⁸ Since the service provider may already pay tax in its home country for this revenue, many countries have tax treaties to mitigate the double taxation effects of withholding tax. Unfortunately, not being a legal entity the consortium does not pay income tax and so cannot benefit from the provisions of tax treaties. As a result, either the local consortium party, or the consortium as a whole, must absorb the withholding tax.

¹⁹ The consortium contract generally provides for a designated party (the "maintenance authority") to pursue and settle claims for damages in its own name on behalf of all consenting co-owners, which can reduce the complexity of managing a lawsuit.

²⁰ The exception concerns professional firms and financial institutions dealing with consortiums whose membership includes operators associated with governments that are subject to trade sanctions. In one recent case, an international law firm declined to act for a consortium (none of those cited in this paper) based on a ruling from OFAC (U.S. Office of Foreign Assets Control) that a special license would be required. The law firm explained that had the consortium been a company and the party concerned a shareholder, no clearance would have been needed. However, it is unlikely that incorporation would change the outcome where the party subject to trade sanctions held a significant investment, as opposed to a marginal one as in the case cited.

²¹ S. Ndungu, "Financing Submarine System Infrastructure – the EASSy / WIOCC model". Presentation to Global Telecoms Business CFO Summit, 22 May, 2013.

²² Except for the rare systems that grant to all parties rights to activate full circuits.

²³ In the C&MA the intention appears to be that such use is limited to arrangements with other cable systems.

²⁴ This subject is addressed in another panel at SubOptic 2016: Interim Activity Working Group, Extending the Life of Submarine Cable Systems.