States of Jersey

DISCUSSION PAPER ISSUED BY THE MINISTER FOR TREASURY & RESOURCES ON THE PROPOSED SALE OF JERSEY TELECOM

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SECTION 1: BACKGROUND

Until 1 January 2003, the States was the regulator, operator and owner of the only telecommunications provider in Jersey. The Telecommunications (Jersey) Law 2002 completely changed this by splitting the roles of the operator, owner and regulator whereby:

- The operator became the incorporated organisation JT Group Limited governed by an independent board of directors;

- The owner became the Finance & Economics Committee, and subsequently the Minister for Treasury & Resources, acting in the interests of the States as an investor in Jersey Telecom; and

- The regulatory role i.e. the responsibility for protecting the public interest, particularly the need to maintain a robust telecommunications infrastructure and promote consumers' interests, fell to the Jersey Competition Regulatory Authority (JCRA) and the Minister for Economic Development.

The Telecommunications (Jersey) Law 2002 also ended Jersey Telecom's monopoly in the local market by empowering the JCRA to issue licences to new operators where this is in the interests of users.

In the past, the States was involved in the ownership of the operator because telecommunications was seen as a natural monopoly best entrusted to a public sector organisation. This ensured that infrastructure investment took place to provide for such things as a universal service that might not have been provided for by private investment. The industry model has now changed and the separation of operation and regulation, as achieved on 1 January 2003 when the new law came into force, puts in place a regulator to decide on the appropriate level of competition in the marketplace and the controls in place to protect users' interests.

This being the case, the sole remaining reason for the States continuing to own Jersey Telecom is as an investment.

The Minister for Treasury & Resources is of the view that Jersey Telecom should be sold and the sale proceeds placed in the Strategic Reserve where they should be invested in a diversified portfolio of equities and gilts.

This Discussion Paper seeks the views of the public on this proposal and in particular requests responses to a number of questions contained in the report.

SECTION 2: THE COMPANY AND THE MARKET

Jersey Telecom

The National Telephone Company opened the first telephone exchange in Jersey in 1895. The Jersey exchange network was taken over in 1912 by the British General Post Office which was then bought by the States of Jersey in 1923 and named the States Telephone Committee. However, part of the network remained the responsibility of the United Kingdom Minister for Posts and Telecommunications and this was only changed with the introduction of the Telecommunications (Jersey) Law 1972, which vested in the States the exclusive privilege for the provision of all telecommunications on the Island. This model of exclusive privilege was exercised by the States through the Telecommunications Board (made up of members of the States) which was obliged to operate the statutory monopoly.

The process of incorporating the operational activities of the States of Jersey Telecommunications Board into JT Group Limited was completed on 1 January 2003 further to the bringing into force of the Telecommunications (Jersey) Law 2002.

JT Group Limited (which includes the operation of Jersey Telecom in Jersey and Wave Telecom in Guernsey) currently provides a complete range of fixed and mobile services to business and residential customers and for the year ended 31 December 2005 reported an operating profit (before interest and tax) of £14.3m on a turnover of £84.5m. In terms of a return paid by the company, the States was in receipt of £8.5m in dividends and a further £1.95m in taxation[1].

The company has maintained a strong balance sheet which places it in a sound position to fund investment in its Next Generation Network ("NGN") and 3G mobile network rollout, whilst allowing it to support a strategy of addressing competition in the Jersey and Guernsey markets arising from the presence of additional operators.

[1] A copy of Jersey Telecom's Annual Review is available on its website: www.jerseytelecom.com

Trends in the telecommunications market in Jersey

As an international finance centre operating from an Island location, the provision of resilient and reliable telecommunications networks across which world-class services are available is fundamental to the continued success of Jersey. Business and residential consumers alike demand, and have come to expect, the availability of these services, and telecommunications companies in Jersey must invest heavily to ensure that they remain the provider of choice.

Evidence of this required investment is contained in recent announcements from Jersey Telecom that it will be investing a further £12m in upgrading its mobile network to offer 3G (high-speed) services over the next twelve months together with an investment of similar magnitude in its fixed network such that it will be well positioned to further expand its broadband and Voice over Internet Protocol (VoIP) services. Other operators have also announced that they will be investing heavily in order to launch mobile services: £15m in the case of Cable & Wireless Jersey[2] and £20m by Jersey Telenet (a subsidiary of Bharti Global Limited[3]).

The significant investment of each operator is indicative of the importance placed on high quality and resilient networks.

Regulation in Jersey's telecommunications market

A robust regulatory framework that protects the interests of consumers whilst allowing operators to invest with confidence is a fundamental prerequisite to the continued development of Jersey's telecommunications market.

The establishment of such a robust framework in Jersey was a key objective when the States agreed to the passing of the Competition Regulatory Authority (Jersey) Law 2001 and the Telecommunications (Jersey) Law 2002. Without such a framework, the sale of Jersey Telecom could not reasonably be considered an option for the States.
The Telecommunications (Jersey) Law 2002 ("the Law") empowers the JCRA to license any operators with respect to telecommunications that concern Jersey. Under

[2] Reference http://www.cw.com/jersey/media_centre/jsy_08122005.html
[3] Reference http://www.bharti.com

the terms of this Law, the JCRA has a primary responsibility to perform its functions in "such manner as it considers is best calculated to ensure that (so far as in its view is reasonably practicable) such telecommunications services are provided, both within Jersey and between Jersey and the rest of the world, as satisfy all current and prospective demands for them, wherever arising."[4]

In so far as it is consistent with this primary duty, the JCRA is obliged to perform its functions in such a manner as is best calculated to:

- Protect and further the short-term and long-term interests of users, wherever appropriate, through the promotion of competition;
- Promote efficiency, economy and effectiveness in commercial activities connected with telecommunications;
- Further the economic interests of Jersey;
- Impose a minimum set of restrictions on those engaged in commercial activities connected with telecommunications;
- Ensure that those engaged in telecommunications activities have sufficient financial and other resources to conduct those activities; and
- Have regard to the special needs of the disabled or those who have limited financial resources or particular needs.

The JCRA meets its obligations through a process of licensing operators that wish to offer regulated telecommunications services on the Island. It controls the abuse of any dominant position in the market through the application of a more stringent set of licence conditions than those which apply to smaller operators or new entrants and ensures that the set of services offered to consumers are sufficient to meet the current and prospective demands for telecommunications services on the Island.

[4] Article 7(1) of the Telecommunications (Jersey) Law 2002

Consumer protection

In fulfilling its duties in respect of consumer protection the JCRA needs to have regard to matters such as accessibility, affordability, high quality and reliability.

The JCRA achieves these objectives in the first instance through the inclusion of a certain set of requirements in the licences that it issues to operators. There is a standard set of Public Service Conditions in the template operating licence and this contains obligations including, amongst others: universal service; public emergency calls; public payphones; and consumer protection.

The Minister for Economic Development also has a role in this connection and, where he considers that it is desirable in the public interest to do so, is authorised under the terms of the Law to give written directions to the JCRA in respect of principles, procedures or policies to be followed in relation to the implementation of any social or environmental policies regarding telecommunications. Having received a written direction from the Minister for Economic Development, the JCRA is obliged to ensure that the obligations set out therein are achieved; how this is done is a matter for the JCRA.

Furthermore, the Minister for Economic Development can change at any time by Regulation the objectives that the JCRA are obliged to have regard to in the carrying out of its duty under Article 7(1) of the Law. These explicitly include the provision of a universal service, social service or cross-subsidised service and the provision of certain tariffs.

The Minister for Treasury & Resources is of the mind that the above represents a more than adequate safeguard for successful regulation of Jersey's telecommunications industry such that the interests of consumers are secured. However, he is keen to hear the views of interested parties on whether the framework is sufficiently robust to allow the government to relinquish control of Jersey Telecom.

Maintenance of essential telecommunications infrastructure

The continued need for investment in essential infrastructure to ensure the provision of all current and prospective demands for high-quality services to residential and business consumers is a key feature of the Telecommunications (Jersey) Law 2002.

The Law provides that if demand for a certain service, in terms of quality or type, is not being met by licensed operators in the industry, the JCRA is legally required to take steps to deal with this issue. To do so, it has the powers to require licensed operators to make or contribute to investment in any infrastructure that is required for the purposes of ensuring that these current and prospective demands for telecommunications services are provided for.

It is therefore the Minister's view that any decision to divest of the States ownership in Jersey Telecom will not impact on the continued provision of essential telecommunications facilities on the Island. Views from interested parties on this opinion, and its basis, would be welcomed.

Competition in Jersey's telecommunications market

Jersey Telecom's licence to operate was issued by the JCRA and became effective upon incorporation on 1 January 2003. Since that date, several other licences have been awarded following a process of application and public consultation undertaken by the JCRA.

Amongst those licensed by the JCRA are a number of significant operators which include Jersey Telenet (a subsidiary of Bharti Global Limited), Newtel Solutions and Cable & Wireless. All of these companies are in the process of developing their presence on the Island. Furthermore, spectrum (radio) licences have been issued that may result in additional entrants to the marketplace over time – an example being COLT Telecom as a possible fourth competitor in the mobile market.

Given the development of a competitive marketplace and the powers currently available to the JCRA, the Minister is unaware of any barrier, in relation to market structure, that should prevent the sale of Jersey Telecom. He would be interested to hear whether respondents also subscribe to this view.

SECTION 3: THE GLOBAL TELECOMMUNICATIONS MARKET

Globally, telecommunications operators are facing two inter-related challenges: increased competition and technological change. The adoption of Internet Protocol (IP) as a standardised technology has further accelerated the pace of change in the already fast moving telecommunications market and the delivery mechanism of services is diversifying to include both fixed and mobile networks. Consequently, these technology changes are often described as “disruptive” to telecommunications operators as traditional revenue sources are eroded.

Technological change is coupled with increased competition amongst service providers. As markets are now widely liberalised, alternative providers (who do not own or operate infrastructure) have been licensed to compete in the same market place as network operators for telecommunications services. Competition is driving telecommunications operators to react in a number of ways that are changing the face of the industry:

- Operators are seeking opportunities to deliver growth and obtain economies of scale through acquisitions. An industry trend towards consolidation is evidenced by large numbers of telecommunication related transactions. This consolidation has seen both the acquisition of similar operations outside of the domestic market, and in response to the convergence challenges, the acquisition of operators in different domestic markets; and

- Operators are investing massively in the introduction of new emerging technologies, including broadband, Voice over IP (VoIP), IP Television, 3G mobile and mobile TV in order to:
  - position themselves as key players in the provision of the next generation of services; and
  - reduce their cost base in order to become more efficient and agile operators.

Maintaining appropriate levels of investment to deliver new products and services for small-scale telecommunications operators is increasingly challenging and is a further factor driving consolidation.

With the liberalisation of the global telecommunications markets, governments have recognised that in a competitive market, public sector management of the state owned telecommunications operator was not ideal. Most importantly the role of government has transformed into that of the regulator of a competitive market landscape rather than the provider of telecommunications services. The response for state-owned telecommunications operators has been full or partial privatisation to achieve this objectivity.

Jersey has successfully achieved the first part of this transformation through the introduction of independent regulation. While this is broadly viewed as having been successful, the question has now progressed to the form of risk attached to the States investment in Jersey Telecom rather than a debate about whether there is a requirement for the States involvement in running an operator for the purposes of providing services that might not otherwise exist.

Jersey Telecom is one of only a few operators of any note that remains fully state-owned[5] and it is interesting to note that the governments of international jurisdictions that are in competition with Jersey are, for the most part, not involved in the operation or ownership of the incumbent operators. Instead they have focused their efforts on ensuring the implementation of an appropriate regulatory framework within which the telecommunications market can effectively function. Examples of such jurisdictions include the Isle of Man, Guernsey and Monaco.

For the most part, European governments have divested all or part of their ownership in former state-owned telecom companies. The success of these privatisations is demonstrated in the size, global footprint and scope of activity and performance of previously state owned companies such as Telefonica, France Telecom and BT, which are now global telecommunications leaders. While some governments have chosen to maintain a partial shareholding in the incumbent operator, for reasons set out in Section 6, this is not the approach being advocated by the Minister in this instance.

Given the pace of technological change and the requirement for economies of scale brought about by the consolidation in the world's telecommunications industry, the Minister is interested to hear whether stakeholders believe that Jersey Telecom would be better equipped to compete successfully if, under independent ownership, it could benefit from access to such scale economies?

[5] The other jurisdictions of interest being Cyprus (where privatisation is underway), the Faroe Islands, Greenland and Luxembourg.

SECTION 4: JERSEY TELECOM AS A STRATEGIC INVESTMENT

Jersey Telecom as a States investment

As referred to previously, the Telecommunications (Jersey) Law 2002 split the role of regulator and operator that was previous the responsibility of the States of Jersey Telecommunications Board. Regulatory responsibilities were transferred to the independent JCRA and the responsibilities for the operational aspects of the Telecommunications Board were incorporated into Jersey Telecom governed by an independent Board of Directors.

In establishing a separation of operation and regulation, the States appointed the Minister for Treasury & Resources as the party responsible for acting in the interests of the States as holder of the security interest in Jersey Telecom.

It should be re-iterated that the responsibility of the Minister for Treasury & Resources under the terms of the Law is “to act in the interests of the States as holder of securities”. As a result, the Minister is legally obliged to maximise the value of the States shareholding in Jersey Telecom and exercise the States interest in the company solely on a commercial footing.

As a result of these obligations on the Minister for Treasury & Resources, the States investment in Jersey Telecom has been operated as a commercial shareholding since it was incorporated on 1 January 2003. A Memorandum of Understanding (MoU) between the Minister and Jersey Telecom establishes the basis for the relationship between the parties. The MoU recognises the independence of the Board of Directors in managing the business, while at the same time identifying the Minister as the shareholder representative with a focus on enhancing the long-term value of that investment.

Consequently, the decision on whether to sell Jersey Telecom must not be about maintaining an interest in a telecommunications operator for the purposes of consumer protection or the meeting of social obligations; it must be a decision on whether the investment strategy of the States of Jersey is best served by either maintaining or divesting of its shareholding in the company.

In other words, this must not be a discussion about “selling the family assets”, but rather, a debate about how to protect and enhance the value and form of those assets.

Investment Strategy of the States of Jersey

On the basis of the previous section which makes clear the obligation of the Minister for Treasury & Resources, it is worth appraising Jersey Telecom purely as an investment within the context of the wider States Investment Strategy.

The aim of the States is to maximise the long-term value of its strategic assets. The investment strategy and policy for the States Strategic Reserve are currently under review by the Minister for Treasury & Resources; however, the current policy which is low risk, and constituted of a diversified portfolio of fixed interest and equity listed investments in entities with high credit ratings, is likely to be confirmed.

The Minister considers the investment in Jersey Telecom, for all intents and purposes, as a component of the Strategic Reserve. If the investment is considered on the basis of the criteria used for the Strategic Reserve though, it falls well outside the current and likely future policy for the following reasons:

- it is not listed on a stock exchange;
- the investment amount is far in excess of that permissible for single investments within the current investment mandates; and
- the risk profile is over and above that considered acceptable.

Against those criteria therefore, this investment would not be included within the Strategic Reserve.

The introduction of competition into the marketplace means that the risk profile of the company, in particular in terms of an investment, has significantly deteriorated from the days when the company was a largely unregulated monopoly. While the Minister has every confidence that the Board of Directors has robust strategies to counter competition within the local market, the competitive pressure will only intensify. As a result, while the level of risk increases, the compensating returns generated for the shareholder are likely to face downward pressure from those enjoyed currently and in recent years.

Also, viewed in the longer-term, perhaps the biggest risk of holding a significant proportion of the States assets in on-Island companies is that in the circumstances when the States might need to realise these assets they might be worth much less. Whilst strategic investments, such as those in Jersey Telecom, provide a buffer if ever the Island were to suffer an economic catastrophe, it would be at such a time that the value of the company would also fall dramatically and it would therefore be difficult to sell. This is the principal argument for disposing of the States holdings in Jersey Telecom and reinvesting the funds in a more diversified international portfolio. It is for similar reasons that Norway, for instance, has a policy that its surplus oil revenues are invested outside the country.

It is therefore the view of the Minister that as the continued ownership of the shareholding in Jersey Telecom represents a risk that is inconsistent with the profile that he wishes to maintain for States investments, the shareholding in the company should be sold with the proceeds placed in the Strategic Reserve to be invested in a balanced portfolio of international equities and gilts. The Minister would welcome views from interested parties on whether they also subscribe to this view.

SECTION 5: EMPLOYEE RELATED MATTERS

Jersey Telecom employees

Employees of Jersey Telecom are recognised by the company as the prime reason for its success in the marketplace. This is evidenced by their treatment through the recent incorporation process where great care was taken to ensure a smooth transition, with every term and condition of all contracts of employment and every collective agreement in place pre-incorporation being carried forward to the post-incorporation status without a single change. The importance of this element of the business is also reflected in the Memorandum of Understanding between the company and the Minister for Treasury & Resources, where it confirms an objective that the company should continue to be a good employer.

In its recently published Annual Review, the company recognises that delivering services to the highest standards requires the best employees and this objective is underpinned by a company that prides itself on ensuring a high degree of job satisfaction, good working conditions and good terms and conditions of employment.

The Minister is conscious that any decision to divest of the States shareholding in the company will inevitably impact upon the employees and there are two principal issues on which the views of interested parties would be welcomed:

- pensions; and
- the process of transferring employees.

Pensions

As part of the process of incorporating Jersey Telecom, employees were seamlessly transferred to a ring-fenced element of the Public Employees Contributory Pension Scheme (PECRS) to which Jersey Telecom became an admitted body. The financial statements of Jersey Telecom for the year ended 31 December 2005 show an actuarial deficit of £695,000 on a total pension asset value of £42.2m and it can therefore broadly be considered as fully funded.

An existing obligation of the Law requires that at least 90% of Jersey Telecom employees must participate in PECRS[6]; the Board of Jersey Telecom has made known its dissatisfaction with this obligation and has stated its preference to close the scheme to new members once the above restriction is removed. Although the Board has the commercial freedom to deal with all other aspects of how it runs the company, the obligation in regard to pensions for future employees is considered to be entirely inconsistent. It is noteworthy that States thinking on this issue has progressed with the agreement of the Postal Services (Jersey) Law 2005 which placed no such obligation on an incorporated Jersey Post. Irrespective of responses to this paper, it is the intention of the Minister for Treasury & Resources to come forward shortly with a Regulation to address this development and request that the States removes the existing requirement on Jersey Telecom.

Should Jersey Telecom be sold in any form and thereby pass into private ownership, this will raise the question of whether it could remain as an admitted body to PECRS.

Under one possible scenario, in order to avoid jeopardising the favourable taxation position enjoyed by PECRS as a result of there being no private company participating in the scheme, the Committee of Management may be obliged to require the new company to exit the scheme.

On the other hand, any new company may choose to give notice that, despite closing the availability of the scheme to new employees and establishing a manner of staying within the scheme, it may wish to give notice to leave the PECRS in its entirety.

While the Minister for Treasury & Resources is of the view that pension matters are best dealt with by the company itself, he is cognisant of the concerns that may be raised by respondents on this issue. The Minister is therefore keen to establish whether interested parties feel that any new owner should be obliged to meet the current pension arrangements for existing employees either by way of membership of PECRS as an admitted body (if that is possible), or by replication with an identical scheme should the continued membership of PECRS not be possible.

[6] Article 46(3) of the Telecommunications (Jersey) Law 2002

The Minister is also interested to know whether respondents are satisfied that the sale price would be reduced to reflect the cost of placing such an obligation on any company that expresses an interest in purchasing Jersey Telecom.

<u>Transfer of Undertakings (Protection of Employment) (‘TUPE’) obligations</u>

As a consequence of the process by which employees were passed from the Telecommunications Board to Jersey Telecom without changing their terms and conditions of employment, there were no TUPE issues to be dealt with.

However, the States of Jersey does not have any TUPE type legislation to protect the transfer of employees from one employer to another. Therefore, the manner of transferring any employees would be subject to the particular arrangements agreed with a potential purchaser.

The Minister is interested to hear whether respondents believe that any minimum set of employee-related obligations (over and above those that would normally be expected) should be considered as part of any future negotiations.

Sale Process

Although the Law obliges the Minister for Treasury & Resources “to act in the interests of the States as holder of securities”, the States explicitly retains the power to dispose of the shares in the company or the associated share rights.

Consequently, the Minister for Treasury & Resources would have to obtain the approval of the States to make any changes to the shareholding in Jersey Telecom.

The sale of Jersey Telecom would also be subject to the terms of the Competition (Jersey) Law 2005, and in particular Part 4 of that Law concerning Mergers and Acquisition. This would involve receipt of approval for any transaction from the JCRA before completion.

In order to obtain the best outcome for the States, particularly in terms of best value, the Minister needs to be able to determine the exact timing of the sale dependent on market conditions. Prospective purchasers also need certainty in their dealings with the Minister, particularly as they will be committing substantial sums of money in progressing the purchase.

The Minister recognises the significance of the transaction that he is contemplating but, as already stated, considers that the absolute requirement is to ensure that the States receives full value for it shareholding. A sale process which is contingent on the outcome of a future States debate would almost certainly be prejudicial to the value of an eventual transaction.

It is therefore the Minister’s intention to bring a proposition to the States seeking the authority to enter into a binding agreement for the sale of Jersey Telecom on behalf of the States. The proposition will include clear principles and parameters within which the sale must progress. The Minister will also appoint high quality, expert advisors to manage the sale process.

The Minister's view is that best value will be obtained by the States authorising him to enter into binding agreements for the sale of Jersey Telecom through a transparent sale process and clear criteria agreed by the States. He is keen to hear the views of interested parties on this point.

<u>Form of sale</u>

There are two elements to any decision on the form of sale that must be considered. The first element relates to the method by which the States may choose to divest its shareholding and the second relates to the whether any sale would involve the full (100%) or partial sale of the States shareholding in the company.

In regard to the first element, the principle options available to the Minister include:

- a process by which shares in the company would be offered to the public (referred to as an Initial Public Offering ("IPO")); or
- a sale to a purely financial investor (referred to as Private Equity); or
- a sale to a telecommunications operator (referred to as a Trade Sale).

The Minister's view, at this stage, is that an IPO would not be likely to achieve the best value for the States investment. An IPO is a costly exercise with no guarantee of success and in order to ensure sufficient demand for shares, a discount on the overall value of the company would be necessary. It would also not result in the company benefiting from economies of scale or access to new technologies or expertise.

The Private Equity option could ensure that additional financing is available to the company. Private Equity, however, is normally considered as a short-term ownership solution whereby the new investors have an objective of increasing the value of its holding prior to exiting the business.

A Trade Sale, on the other hand, would be likely be a long-term outcome that would allow Jersey Telecom access to economies of scale that it does not currently enjoy. It would also allow the company the space to grow within the context of a larger operator rather than continue operating as a small independent provider within an increasingly competitive marketplace.

On the above basis, the Minister's current preference is for a Trade Sale but he would be interested to hear opinions on this view.

Moving on to the second element of the decision, in general terms, the Minister views that there are two critical themes that need to be considered in connection with a decision on the matter for a full or partial sale of the company: control, and value.

In terms of control, the States could maintain partial ownership, or a "golden share" through which it would exert its power on certain items deemed to be of importance, such as employee or investment matters. However, the use of such shares would potentially come under scrutiny from the JCRA if it leads to an imbalance in the operation of the marketplace and would undoubtedly reduce the value of the enterprise.

On the subject of value, while some jurisdictions have chosen to transfer their wholly-owned incumbent to full private ownership in a staged fashion, this is normally only considered to be effective if the government were to take advantage of a subsequent improvement in value. However, there is no substantial restructuring required in Jersey Telecom that is likely to lead to a significant increase in value over time. In the main, the company has been operating as though it were in private ownership since incorporation on 1 January 2003 and the local market, from which its principle value obtains, is coming under increasing competitive pressure as a result of new entrants and developing technologies.

A further disadvantage of a staged sale is that it requires the development of a complex exit strategy with some duplication of the initial cost of sale.

Accordingly it is the Minister's view that a full sale is the preferred option as it will maximise the value that can be obtained from the disposal of Jersey Telecom and involves a clear and transparent way forward on the part of the States. Any opinions on whether this is the best course of action would be welcomed.

SECTION 7: NEXT STEPS

This consultation period will run from 13 July 2006 until 8 September 2006.

During that period, the Minister for Treasury & Resources would welcome any comments on the matters set out in this Discussion Paper and these can be forwarded in writing to:

Jersey Telecom Consultation
Treasury & Resources Department
Cyril Le Marquand House
The Parade
St Helier
Jersey
JE4 8PF

or via e-mail to: jtconsultation@gov.je

The intention is to bring a proposition to the States on the sale of Jersey Telecom for debate during October 2006.