

POLICY RESEARCH  
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# Regulation, Institutions, and Commitment

## Privatization and Regulation in the Argentine Telecommunications Sector

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ENTel's privatization appears to have had a net positive impact on Argentina's reputation and welfare. But failure to establish a regulatory regime in advance was costly in terms of the sale price the government received and the tariff levels demanded by investors. If this neglect persists, it may hurt the sector's performance.



## Summary findings

In 1990, Argentina privatized its state-owned telephone company, ENTEL. Shifting telecommunications to the private sector was one of the first actions taken under the reform program of the new president, Carlos Saul Menem.

In privatizing ENTEL, the government focused on privatization as a way of establishing its reform credentials. Establishing a post-privatization regulatory regime was given lower priority. A well-defined regulatory regime was not in place before the sale, but privatization took place nonetheless.

Hill and Abdala find that despite the delay in implementing a regulatory regime, ENTEL's privatization appears to have had a net positive impact, both on Argentina's reputation and on welfare. The reform program had its own "virtuous cycle," creating and reinforcing credibility in the short run. But the neglect of the regulatory regime appears to have been costly in terms of the sale price that the government received and the tariff levels that investors demanded. In the long run, this neglect, if it persists, may have a negative impact on the telecommunications sector's performance.

Regulation plays an important role in the private provision of telecommunications. Many argue that competition should be limited to allow economies of scale. But limited competition can lead to abuses of monopoly power and to demands from customers and suppliers for a regulatory regime to protect them from such abuses. In addition, the sector requires high sunk costs and asset specificity and the assets' owners are particularly exposed to the risks of expropriation — either outright (through nationalization) or gradual (through service requirements or low tariffs). A stable, credible regulatory environment reduces the risk of investment in this sector and reduces the expected rate of return that private investors would require to participate. Establishing a stable, credible regulatory regime before privatization increases the value of a privatized telecommunications firm to potential purchasers by reducing the risk associated with the purchase. This in turn affects the price generated by the selling government. By failing to establish such a regime in advance, the Argentine government received a lower sale price and increased the probability that buyers would capture windfall profits.

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REGULATION, INSTITUTIONS AND COMMITMENT:  
PRIVATIZATION AND REGULATION  
IN THE ARGENTINE TELECOMMUNICATIONS SECTOR

by

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## I. Introduction

Argentina is a very recent, and given its history, unexpected entrant to the small group of countries with privately owned telecommunications sectors. Argentina entered this club in November of 1990 when the government of President Carlos Saul Menem sold the Empresa Nacional de Telecomunicaciones (ENTel) to private investors. Although little time has passed since this sale and it is too early to make definitive judgements on its impact, the privatization of ENTel does present some interesting issues.

One of the most interesting aspects of the sale of ENTel was the sequencing of the privatization and the development of a regulatory regime. Argentine politics had presented the Menem government with a window of opportunity in which to introduce an economic reform program. Privatization was one of the central components of this reform program and ENTel was the first company presented for sale. As a result, the privatization of ENTel became a test of the Menem government's ability and resolve to reform the Argentine economy. The rapid completion of the sale became a priority. However, the development of a regulatory regime was initially neglected.

Shifting telecommunications into the private sector was a priority for the Argentine government. However, regulation also plays an important role in the private provision of telecommunications. Portions of the sector are characterized by economies of scale which many would argue implies that entry should be limited in the interests of efficiency. However, limited competition can lead to abuses of monopoly power and to demands from customers and suppliers for a regulatory regime to protect them from these abuses. Standards and interconnection rules affect the efficiency of the sector. The sector is also characterized by high sunk costs and asset specificity. Thus the owners of these assets are particularly exposed to the risks of expropriation. This problem is compounded by the temptation presented to government to regulate the telecommunications sector in an opportunistic manner, providing benefits for its other constituents by expropriating the sector's assets. This expropriation can be outright, as in the case of a nationalization, or gradual, through service requirements and/or low tariffs.<sup>1</sup>

In general, investment is a function of both the expected rate of return and the risk attached. A credible and stable regulatory environment reduces the risk attached to investment in the telecommunications sector and reduces the expected rate of return that private investors would require in order to participate.<sup>2</sup> The ability of government to provide a credible and stable regulatory environment depends largely on a country's institutional arrangements, particularly those that provide safeguards against opportunistic interventions by government. The design of new regulatory institutions or the reform of old ones can create new safeguards, but pre-existing institutions will constrain the options available.

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<sup>1</sup> The analysis in the paper is based on the framework developed by Brian Levy and Pablo Spiller in the research proposal for this project, "Regulation, Institutions, and Economic Efficiency: Promoting Regulatory Reform and Private Sector Participation in Developing Countries," February 26, 1991.

<sup>2</sup> This is true whether the entry and tariff provisions of a regulatory regime provides for high returns or low returns. The more stable and credible the regime, the lower the risks associated with investment and the more attractive the investment.

Privatization adds another dimension to the role of regulation in reducing the risk of investing in the telecommunications sector. The establishment of a stable and credible regulatory regime before privatization takes place increases the value of a privatized telecommunications firm to potential purchasers by reducing the risk associated with the purchase. This in turn will affect the price received by the selling government. Failure to establish such a regime will decrease the sale price and increase the probability that the buyers will capture windfall profits if a stable regulatory regime is introduced after the sale. In addition, the privatization process itself can create new safeguards. Wide-spread domestic shareholding of the privatized company can create a new constituency that should resist attempts by government to expropriate their assets for the benefit of other constituencies. Transparency and predictability in the privatization process are important signals of the government's later intentions.

In privatizing ENTel the Argentine government was focussed on the role of the privatization in establishing the government's reform credentials. The establishment of a post-privatization regulatory regime was given lower priority and as a result a well-defined regulatory regime was not in place before the sale. Nonetheless, the privatization took place and so far appears to have had a net positive impact, both on Argentina's reputation and on welfare. In this instance, it seems that the reform program had its own "virtuous cycle", creating and reinforcing credibility in the short-run. However, the neglect of the regulatory regime appears to have been costly in terms of the sale price obtained by the government and the tariff levels demanded by investors. In the long-run this neglect also may have a negative impact on the performance of the sector.

This paper attempts to answer the following questions. First, why and how did the economic reform program and the privatization of ENTel come about? Second, in the privatization process, in the definition of its regulatory framework, and in the subsequent implementation of the regulatory regime has Argentina succeeded in avoiding regulatory failure? That is to say, has the Argentine government demonstrated that it is committed to an environment that will support private investment and are the newly privatized companies responding by investing and improving services in the sector? Third, what lessons does the Argentine experience with privatization and regulation have to offer and what additional actions might the government of Argentina consider taking at this time? Finally, what impact has the privatization and subsequent regulatory regime had on welfare in Argentina?

The issues are addressed in the following order. The next section examines the dynamics of Argentine politics and attempts to explain why historically government policies have undermined Argentina's economic development and why this changed during the transition from the administration of President Raul Alfonsin to that of President Carlos Saul Menem in 1989. This section also reviews Argentina's institutional heritage in order to highlight the weaknesses of these institutions and the problems these posed for ensuring the credibility of the Menem administration's reform program. The third section gives a short history and overview of the Argentine telecommunications sector leading up to the start of the 1990 privatization. Section four discusses the actual process of the ENTel privatization and to what extent that process enhanced the government's credibility as a regulator. Section five examines the role played by regulation as a commitment mechanism during and after the privatization of ENTel. This section also outlines the legal framework for regulation of the telecommunications sector in Argentina. The preliminary firm and market evidence regarding the credibility and sustainability of the regulatory regime is reviewed in section six. Section seven highlights some changes the Argentine may wish to make to its telecommunications regulatory regime and suggests some lessons for other countries. Finally, in the conclusion the welfare impact of the

privatization is evaluated and found to be generally positive, and the link to the regulatory regime is discussed.

## II. Argentina's Political and Institutional Heritage

Political volatility in Argentina has taken its toll on the country's economy. Decades of destructive competition between political factions has undermined Argentina's economic and political development. By the late 1980's, Paul H. Lewis observed in The Crisis of Argentine Capitalism, that "...Argentina fascinates students of development because, in so many respects, it seems to be going backward. Although it possesses many modern institutions, they are decaying rapidly."<sup>3</sup> The economic policies introduced by the Menem government have been a departure from the policies of previous Argentine administrations. These liberal, market-oriented policies have resulted in two years of growth for the Argentine economy and a substantial reduction in inflation.<sup>4</sup> To understand how this change in policy came about and whether it will continue it is necessary to examine the underlying political and economic forces.<sup>5</sup>

### a. The Dynamics of Argentine Politics

Argentina's history since World War I has been characterized by a reversal of economic development paralleled by a reversal of political development. While Argentina appeared to be developing a broad-based participatory democracy in the first three decades of this century, since the 1930s control of government has fluctuated between authoritarian or exclusionary regimes and populist-corporatist ones. (See Table 1.) Since 1930 there have been five military coups and numerous military interventions in government, resulting in military rule for nineteen of the past sixty years. "Restrictive democracy" in which the constitutional niceties were "observed", but major parties were banned, was imposed for an additional nineteen years in this period. Changes of regime have been accompanied by radical changes in policy designed to serve the constituents of the new regime. These changes have been made at the expense of the groups then out of government and, ultimately, at the expense of the country as a whole. Successive governments have followed a type of "beggar-thy-neighbor" strategy, where the neighbor has been the constituents of the party out of government. Instead of cooperating to increase the level of income in Argentina, rival parties have competed in a zero-sum or negative-sum game.

This political discontinuity has been accompanied by a downward spiral of economic performance. Before World War I, Argentina's per capita income was similar to that of Germany, and

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<sup>3</sup> Paul H. Lewis, The Crisis of Argentine Capitalism (Chapel Hill, N.C.: The University of North Carolina Press, 1990), p.1.

<sup>4</sup> Real GDP growth was 8.5% in 1991 and 9.0% in 1992. Inflation has been dramatically reduced and the net investment level has increased. Tax revenues have gone up and tax evasion has gone down. Deregulation and increased competition have occurred. Trade liberalization has taken place.

<sup>5</sup> The subsection draws heavily on a report prepared by Mathew D. McCubbins of the University of California, San Diego, "Prospects for Stability in Argentine Politics", mimeo, March 15, 1993.



was higher than that of Sweden, France, Austria, Italy, and Japan. Before World War II Argentina's per capita income was still higher than that of Austria, Italy, and Japan. However, by 1965 Argentina's per capita income was only one-quarter of that of Japan and by 1982 its per capita income had fallen to a level comparable to that of Chile, Mexico, and Brazil.<sup>6</sup>

Argentina's political instability results from the interaction between three underlying conditions. First, industrial development has been limited. The Argentine economy was and, to a large extent, still is centered on export-oriented agriculture. This has been the only sector that could generate an economic surplus that could be used to support industrial development. However, government policies have penalized the agricultural sector to the benefit of other sectors of the economy, leading to a decline in the surplus generated by the sector and reducing the country's growth potential. Declining growth has exacerbated the tensions between, on the one hand, the urban working classes and, on the other hand, the agrarian elite and the urban middle class. The conflict over stagnant or shrinking real income has carried over into the political arena.

Second, the economy of Argentina is split regionally. With a few exceptions, what industry there is is concentrated around Buenos Aires while agriculture is the dominant economic activity in the rest of the country. This economic split has produced a political split; the interests of the industrialized region, which is highly dependent on import substitution, are at odds with those of the agrarian regions.

Third, and perhaps most importantly, Argentine national political institutions and the rules that govern elections combine to add another source of instability. Argentina is a federal republic with a constitution which provides for the co-existence of federal and provincial levels of government. The national government is comprised of three branches: executive, legislative, and judicial. Executive power is vested in the president of the republic, who is elected by an electoral college to a six-year non-renewable term and who serves as both the chief of state and head of government. The Congress is comprised of an upper and a lower house. The members of the Chamber of Deputies (the lower house) are elected by universal adult suffrage from a closed party list. The members of the Senate are elected by the provincial legislatures by plurality, with two from each province. The two senators from the capital region are elected through the same electoral college mechanism as the president.

Two features of the Congressional electoral rules undermine the potential for cohesive, national party coalitions and increase the probability that the electorate will produce divided partisan governments. First, deputies are elected provincially, not nationally, and the list of candidates are controlled by provincial party organizations. As a result, same-party deputies from a single province tend to have similar political view points, but there can be considerable variation between the view points of the provincial organizations and the national organization of the same political party. Second, the timing of elections reinforces the provincialization of the political system. The term of office for deputies is four years and for senators it is nine years. As a result, only half the deputies and one third of the senators are elected at the same time as the president. This provides a very

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<sup>6</sup> Carlos Waisman, Reversal of Development in Argentina: Postwar Counterrevolutionary Policies and Their Structural Consequences (Princeton, N. J.: Princeton University Press, 1987) and Alan Taylor, "External Dependence, Demographic Burdens, and Argentine Economic Decline After the Belle Epoque," The Journal of Economic History, Vol. 52, No.4 (Dec. 1992), 907-935.

limited incentive to nationalize and unify the federal and provincial party organizations. In addition, the staggering of elections means that the composition of any coalition will be constantly changing. A national election involving half the seats in the lower house occurs every other year, while every third year one third of the seats in the Senate are at stake.

As a result, in addition to a diversity of parties, there are significant divisions within parties. Today in Argentina, the two largest parties are the Radicals and the Peronists. While the Radicals generally represent the middle class, there are both moderate and extreme factions within the party and in various periods there have been more than one Radical party. The same is true for the Peronists, whose base is the urban, unionized working class. The Peronists have been represented by more than one party and the party has been segmented into moderate and extreme factions. In the recent Argentine elections the effective number of parties has been over three.<sup>7</sup> However, none of these parties cut across regional and class divisions.

The destructive pattern of politics described above began to change after the restoration of democracy and the elections in 1983. The election resulted in a divided government; the Radical party controlled the presidency and the Chamber of Deputies, but the Peronist party controlled the Senate. This resulted in a stalemate, where the discretion of the president was severely limited by the Peronists in the Senate. As result, the Radicals were unable to pursue their own interests at the expense of the Peronists. This deadlock ended the "beggar-thy-neighbor" behavior, but it did not result in any cooperative behavior that might have allowed Argentina to improve its economic performance. The economic situation continued to decline, threatening the viability of democratic government. Army rebellions confronted President Alfonsín in April of 1987 and December of 1988.

This stalemate ended with the elections of 1989 in which the Peronists won control of the Presidency and both houses of Congress. However, rather than returning to the historical pattern of "beggar-thy-neighbor" policies, the Peronists embarked on a program of economic reform. This change seems to have been made possible by a conjunction of events. The Argentine constitution provides for a long transition period between the elections in May and the swearing in of a new government in December, leaving the departing president as a "lame-duck". During this period in 1989 the economy deteriorated rapidly. Hyperinflation manifested itself for the first time in Argentine history, raising fears over the viability of the economic and political system.<sup>8</sup>

Faced with the possibility of a return to military rule, the Radical party concluded an agreement with the incoming Peronists. President Menem took office in July, five months ahead of

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<sup>7</sup> Matthew Soberg Shugart and John M. Carey, Presidents and Assemblies: Constitutional Design and Electoral Dynamics, (Cambridge: Cambridge University Press, 1992), 220. The effective number of parties is a number constructed to represent the number of parties that have a chance at competing for election. This is similar to constructing the effective number of new entrants in a market. There may be many potential entrants, while none are actually observed (or there may be many observed, but none are competitive).

<sup>8</sup> While Argentina had frequently suffered from high inflation the acceleration in the rate of increase in consumer prices from 343 % in 1988 to 3079 % in 1989 was unprecedented. (Source: IMF International Financial Statistics.)

schedule, and in return the Radicals in the Congress undertook to support his economic initiatives. This effectively created a coalition between the moderate factions of the Peronist and Radical parties and permitted the introduction of new economic policies designed to improve the performance of the Argentine economy. These policies potentially will benefit all Argentines. For the time being, politics in Argentina appear to have switched from a negative-sum game to a positive-sum game.

The challenge for President Menem as he entered office was to restore international and domestic confidence in Argentina. His administration acted quickly to institute an emergency austerity program and a privatization program. On August 17, 1989, the Argentine Congress passed the administration's "Reforma del Estado" (State Reform) law. This law laid out the procedures for privatization. It also granted the administration sweeping powers, including the power to change by presidential decree pre-existing legislation that was inconsistent with the privatization program. ENTel was the first enterprise on the list of the candidates for privatization annexed to the legislation.<sup>9</sup>

The privatization of ENTel was one of the first actions of a comprehensive reform program which included fiscal reform and tax enforcement; monetary reform; and deregulation. The program sought to fundamentally alter the roles of government, labor, and the private sector. The Menem government set out to change the reputation of the government and, by extension, the country. The success of the program was dependent on the government's improving its reputation as an economic actor. Speed in implementation was essential for the viability of the entire reform program. In this manner the reform program created its own dynamic which served to offset Argentina's existing institutional weaknesses. This is discussed in more detail in the following subsection.

#### **b. Argentina's Institutional Heritage and Implications for the Credibility of Reform**

For economic reform to succeed in attracting private investment, it must be credible to investors over the medium- to long-term. Otherwise private investors will be concerned about the potential for expropriation of their assets, either directly through nationalization or indirectly through regulation, price controls, high taxes and the like. If investors perceive that the risks of expropriation are high, they will demand high risk premia or, if these premia are not available, will not invest at all. The effect will be to lower the amount of new private investment and reduce the likelihood that the reform program will succeed. The Menem administration inherited Argentina's poor record and reputation for economic policy. When embarking on the privatization of ENTel the Argentine government was faced with the challenge of changing the country's reputation and boosting its credibility, both in general and in the context of the privatization and subsequent regulation of the telecommunications sector. Unfortunately, Argentina's institutional heritage did not offer many tools for this undertaking.

The comparative study of which this case is a part highlights the roles of three exogenous features in determining a country's capacity to develop a regulatory system that can provide a credible commitment that governments will refrain from arbitrary behavior: informal norms of behavior; a strong and independent judiciary; and the structure of legislative and executive institutions. Argentina's historical political culture lent little credence to informal norms; unlike, for example, in

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<sup>9</sup> Law 23,696/1989.

the United Kingdom, informal norms have not restrained political actors from acting punitively towards their antagonists. Similarly, the Argentine judiciary offered little in the way of credibility; confidence in the judicial system was low. In theory the judiciary was nominally independent; the Argentine constitution provided for judges to be appointed for life terms by the President with the approval of the Senate. However, in practice, changes in government typically have been accompanied by turnover among the judiciary. While the Menem government itself did not undertake a wholesale replacement of the judiciary, in 1997 it packed the Supreme court (with the agreement of Congress) by increasing the number of justices from 7 to 15.<sup>10</sup>

The structure of Argentina's legislative and executive institutions did offer some opportunity for commitment. Given the division of powers between the two branches of government and the probability that subsequent elections were likely to lead to the executive and legislature being controlled by different parties, any law enacted by the unified government under President Menem would be difficult to reverse. However, in the interest of speed in the privatization of ENTel and the implementation of the first stage of the reform program, the Menem administration chose not to use this mechanism.<sup>11</sup> It relied instead on the powers to act by executive decree given to it by the State Reform Law.

In Argentina, two additional mechanisms have enhanced the government's credibility. However, both of these mechanisms are transitory and are unrelated to institution building. First, the ENTel privatization was one of the first and most visible components of the Menem government's reform program. In order to ensure that it can continue its reform program, the government has an incentive not to act opportunistically towards the newly-privatized telecommunications providers, lest the credibility of the entire program be undermined. Second, the reform program has led to an improvement in Argentina's economic performance, increasing the incentives for political actors to continue to support reform. However, should Argentina's economic performance falter, this cooperation may be lost and politics may revert to operating on a "beggar-thy-neighbor" basis.<sup>12</sup>

After a brief review of the history of the Argentine telecommunications sector, the paper will return to an examination of the privatization process followed by a discussion of the roles of privatization and regulation in developing a credible environment for private investment in the telecommunications sector and to what degree this has been successful.

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<sup>10</sup> While confidence in the judiciary is low, the Menem administration is now taking steps to reform the judiciary. Once this process is complete, it will give the government additional means by which to commit itself.

<sup>11</sup> Later privatizations, which took place after the expiry of the State Reform Law, were implemented by legislation. This was true of the privatizations of natural gas, power, oil, and the ports. While in some cases reliance on legislation caused delays in the privatization process, these delays did not have the same potential negative impact on the credibility of the reform program as a delay in one of the first privatizations might have had.

<sup>12</sup> One such instance would be if the deterioration in Argentina's terms of trade that has taken place since the introduction of the reform program were to be accompanied by a reversal of capital inflows.

### III. The Argentine Telecommunications Sector before Privatization

A large and relatively affluent country, Argentina has had both strong demand for telecommunications services and the resources to invest in the provision of these services. As a result the country has a large telecommunications infrastructure. Relative to other countries and given its income level, Argentina had a higher than average number of lines per capita. (See Figure 3.) Initially telephone services were provided by private companies with minimal regulation by the federal government. However, after the election of President Peron in 1946 the telephone companies were gradually nationalized. By 1990, 90% of telephone lines were owned by ENTEL. While the level of telephone penetration has been high, over time problems with the backlog of unmet demand, the quality of service, and level of corruption within ENTEL has increased. In 1988, the administration of President Raul Alfonsin attempted to reform the sector by partially privatizing ENTEL. This initiative failed because President Alfonsin's party did not control both houses of the Congress. However, only a year later, President Menem was able to initiate the ultimately successful privatization of ENTEL with the cooperation of the Congress.

#### a. The Early Years

Argentina's first telephone company was formed in 1880, four years after the invention of the telephone by Alexander Graham Bell. This company, Societe du Pantelephone de Loch, started operations in the city of Buenos Aires in 1881 with 20 lines. Shortly thereafter, two more companies began operations. In 1886, these three companies merged, forming the Union Telefonica del Rio de la Plata (UTRP). Backed by British capital, UTRP expanded to serve the more affluent provinces around Buenos Aires. Meanwhile, other small firms entered the market elsewhere in Argentina, operating under licenses granted by a province or city. There was no federal regulation of the sector until 1904, when the government of Argentina issued a decree requiring all private operators to report their activities to the Executive. In 1907 the federal government set the tariffs for telephone services in Argentina.<sup>13</sup>

In 1929, the American company, International Telephone & Telegraph (ITT), entered the Argentine market by buying UTRP. At approximately the same time, the Swedish group, Ericsson, took up equity in the Compania Argentina de Telefonos (CAT). Ericsson had originally been an equipment supplier to CAT and the company had run up large unpaid bills; this debt was exchanged for equity in the company. CAT operated in the provinces of Mendoza, San Juan, Santiago del Estero, Salta, Tucuman, and Entre Rios. By 1935, there were 43 different telephone companies operating in Argentina.

In this period, domestic integration of the telephone services in Argentina was very poor. A subscriber in the northernmost province of Argentina, Jujuy, could place a call to Europe without much difficulty, but it was virtually impossible to place a call to Buenos Aires. In 1935, the federal government instructed the individual telephone companies to make arrangements for inter-provincial connections. In 1936, an executive decree was issued, declaring that telephone services were national

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<sup>13</sup> Decree 4408/1904.

services under the federal jurisdiction. Henceforth, all private telephone companies would operate with a "precarious permit" status. The federal government would not grant formal concessions to operate and operating permits could be canceled at any time. The decree also gave the Argentine government the right to acquire the assets of operating companies.<sup>14</sup>

#### **b. Nationalization and State Control**

By the end of the Second World War, Argentina had accumulated foreign capital reserves of nearly US\$ 1.7 billion as a result of its exports of raw materials to the combatants. The Argentine government of President Juan Domingo Peron used these reserves to buy some of the large domestic firms that were controlled by foreign owners. These purchases included railways, ports, power companies, and the telephone companies. ITT's holding in the UTRP was purchased in 1946 for US\$ 95 million.<sup>15</sup> By 1948, the new firm was wholly owned by the Argentine government and it became the Direccion Nacional de Telefonos del Estado (DNTE). A year later companies in four northeastern provinces were acquired. This process of geographical expansion continued until 1969, encompassing 17 of Argentina's 23 provinces and 31 private companies. In 1956, DNTE was renamed ENTel.<sup>16</sup>

The exception to ENTel's expansion was CAT. Although Ericsson was prepared to sell its investment in CAT, it wanted a price comparable to that paid to ITT. A sale to the Peron government was virtually completed, but was interrupted by the 1955 military revolt. From 1948 to 1959 an executive decree prohibited CAT from making additional investments in its system while its sale was being negotiated. Finally, in 1959, the government of President Arturo Frondizi decided that it would not buy CAT and the company was allowed to raise its tariffs and expand its network. CAT continued to operate under provincial, and therefore precarious licenses, until 1992. It operated under the same tariff structure as ENTel; these tariffs were negotiated between the government and ENTel, and CAT was required to apply them in its territory.

Throughout this period, overall telecommunications policy was the responsibility of the Secretary of Communications. As defined in the 1936 executive decree, telecommunications were "national" services. This meant that the federal government had the right to both undertake and to control the provision of services, set prices, define investment services, and to grant precarious permits to private firms. The 1936 decree was succeeded by the National Telecommunications Law of 1972 which was enacted by the military government of President Alejandro Agustin Lanusse. The law reflected the growing nationalism and protectionism that emerged even before the return of Peron in 1973. The content of the law was not significantly different from that of the 1936 decree, but it was more comprehensive, including telex, radio, and television, and its language was more explicit than that of its predecessor. Under the law, the state held a legal monopoly of all telecommunications activities. As it deemed convenient, the federal government could provide these services itself or grant

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<sup>14</sup> Decree 91,698/1936.

<sup>15</sup> In 1946 terms.

<sup>16</sup> Lewis, pp. 177-195; Crawley, pp. 110-115; and James Scobie, Argentina: A City and a Nation, 2nd ed. (New York: Oxford University Press, 1971), p. 223.

permits with precarious status to other providers. The government was responsible for policing the sector, for encouraging research, for promoting the development of domestic industry, and for coordinating all activities in the sector.<sup>17</sup>

Despite the discontinuities in Argentine politics, there was a consistent theme in telecommunications policy. This was the development of an Argentine telecommunications equipment industry. As it did in many other sectors, the Argentine government promoted import substitution in telecommunications equipment, forcing ENTel to source its needs in Argentina. The result was that ENTel was limited in its access to technology and burdened with the cost of buying equipment at prices well above those in other countries. The outcome was equipment prices higher than in Europe or in the U.S and higher than in some other Latin American countries.

Despite the high costs imposed by Argentine industrial policy, by the late 1950s ENTel was one of the largest telecommunications carriers in the world. This may be both a reflection of Argentina's relative wealth and of the suppliers' demand for government patronage. In 1956 it was one of the ten largest firms in terms of the number of lines installed and it ranked seventh in the number of calls placed. In 1957 Argentina had 42.86 % of the telephones installed in South America and the telephone density in the city of Buenos Aires was almost twice as high as any other major urban area in Latin America. However, even as the system grew, the backlog of lines increased. In many areas where ENTel failed to provide service, local cooperatives sprang up to build and administer local networks.<sup>18</sup> In addition, ENTel developed managerial and labor problems: the quality of service provided was poor; the unions in some cases took over managerial activities; strikes were accompanied by sabotage; phantom workers collected salaries from the company; and clandestine telephone connections were made where payments were not made to ENTel but rather to ENTel staff. (See Figures 1 to 8 and Tables 1 to 4 at the end of the paper for more details.)

### **c. The 1988 Attempt by the Alfonsin Government to Privatize ENTel's Management**

The civilian government of President Raul Alfonsin first tried to improve the level of service and reduce the backlog of unmet demand by using dramatically higher connection charges to finance an increase in ENTel's level of investment. When that failed the Alfonsin government tried to partially privatize the firm in a bid to improve management and attract more capital. By 1985 the backlog represented 1,298,000 lines or 52.7% of the lines in service. (See Figure 5 and Table 2.) The Megatel expansion plan that was launched in 1985 was intended to both address this backlog and promote domestic industry.<sup>19</sup>

The Megatel Plan was to provide for the installation of 1 million lines between 1986 and 1989. Neither the Argentine government nor ENTel were able to finance this expansion, so the plan

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<sup>17</sup> Law 19,798/1972.

<sup>18</sup> ENTel Annual Reports, 1958-60. Local cooperatives did not appear in the areas served by CAT, apparently because CAT was able to meet demand.

<sup>19</sup> This plan was initiated within the executive branch and did not need the approval of Congress.

relied on telephone users to directly finance the expansion in services. Connection charges for residential users increased 486% and for businesses 629%. Users had to make this payment in advance to join the waiting list for a new telephone line. Only 650,000 customers subscribed to the plan.<sup>20</sup> Even so, the installation of lines under the plan was still not completed in 1990 and these liabilities were carried over into the privatized companies.

The appointment of a new Minister of Public Works (the ministry which included the Secretariat of Communications) in October 1987 marked a turning point in the government's attitude towards ENTel. Faced with a large government deficit, with a need for additional investment in the telecommunications sector that neither ENTel or the government could finance (even with the Megatel program), and with a high level of corrupt and irregular practices within ENTel, the new minister advocated the liberalization of the supply of telecommunications services and the introduction of new private management and the partial privatization of ENTel. The liberalization of the sector was initiated by three deregulation and demonopolization executive decrees that allowed the Secretary of Telecommunications to issue permits to private telecommunications service providers. These decrees were issued by President Alfonsín even though they were inconsistent with the 1972 National Telecommunications Law.<sup>21</sup>

Given the high level of political uncertainty and ENTel's administrative problems and internal corruption, the Alfonsín government decided to sell the company through negotiations, inviting a potential investor to evaluate the company and then discuss terms. The government planned to keep control of the company by retaining 51% of the shares, while 9% of the shares were to be transferred to workers for free, and 40% would be sold to a new investor who would be responsible for management of the company.

The government entered into a preliminary agreement with Telefonica of Spain. Under the terms of the agreement the partially privatized company would have a complete monopoly over the provision of all types telecommunications services in Argentina, including cable TV but not cellular telephone and public telegraph, for 25 years with an option to extend this monopoly another 10 years. This monopoly would extend over the regions served by CAT, which would lose its licenses. There was a provision for direct state assistance in providing service in areas with dispersed populations. The proposal left the company enormous discretion in other areas including accounting standards, the setting of tariffs, the determination of rules for interconnection, and the definition of which value-added services did and did not come under its exclusive license.

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<sup>20</sup> ENTel attributed this to an absolute lack of demand for lines. However, this is not very credible given the size of the pre-existing backlog. This shortfall in new subscriptions cannot be attributed entirely to the higher price either. Calculations of price elasticities of demand for lines indicate that demand should have been higher. The most likely explanation is that customers were skeptical as to whether they would receive the lines they subscribed for and that they feared that their funds would be drawn out of ENTel to finance the growing government deficit. See Abdala, 1991, pp. 51-52.

<sup>21</sup> Decrees 1651/1987, 1757/1987, and 1842/1987.



However, the Alfonsín administration was unable to persuade the Congress to approve its decision to partially privatize ENTEL. The Radical Party had lost the 1987 congressional elections and the Peronists held a majority in the Senate. Even though there was popular support for the partial privatization of ENTEL, the Congress opposed the government's proposal.<sup>22</sup> This opposition was due in part to some members ideological objections to privatization and in part to some members objections to the actual terms of the deal, particularly to the lack of competition and regulation. More importantly, the Peronists also anticipated winning the 1989 presidential election and for that reason were unwilling to support any action that would help the Radical Party candidate. Ultimately, the government ran out of time. The Peronist presidential candidate, Carlos Saul Menem, was elected in May 1989 and the Minister of Public Works, Rodolfo Terragno, was tapped to act as the liaison between the out-going and in-coming governments, ending his efforts to partially privatize ENTEL.

Thus, for political reasons, the Telefonica proposal in the end was unsuccessful. The proposal was flawed in that it neither provided for competition or for adequate regulation of the telecommunications sector. However, it opened the door for another, more complete reform of ENTEL.

#### **IV. The Privatization of ENTEL**

One of the most remarkable aspects of the 1990 privatization of ENTEL is that it happened at all. The unheralded shift from adversarial to cooperative politics provided a window of opportunity. The primary goal of the Menem government was to take advantage of the opportunity presented by the shift in Argentine politics and demonstrate its ability to transform the Argentine economy by reducing both the scope of government activity and the level of the government's indebtedness. By actually completing the privatization, the Menem government was able to demonstrate early in its term that it had the resolve and ability necessary to fundamentally change the role of government in the Argentine economy. The momentum for the sale was derived from the country's economic crisis and a rare political opportunity. This gave the sale its own dynamic; the fact that the completion of the sale was central to the government's attempt to establish its credibility imposed a discipline on the actors involved and limited the influence of the sale's critics. While the privatization team recognized the importance of the sale conditions and the need for a regulatory regime, these issues were secondary to the completion of the transaction. However, the conduct of the sale itself, as well as its completion, contained signals as to the future conduct of the Argentine government.<sup>23</sup> The chapter first gives a

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<sup>22</sup> Government polls had shown that while Argentineans did not approve of privatization in general, they did support the privatization of ENTEL. A poll conducted by Guillermo Bravo and Pessah consultants showed that 55-59% of the interviewed ENTEL users had expressed support of the proposal to partially privatize ENTEL.

<sup>23</sup> During the public ceremony in which the executive decree establishing the terms and conditions of the sale of ENTEL was signed the Minister of Public Works and Services, Jose Roberto Dromi explained that "the Government, complying with the mandate from the people, wished to change the structure of the state in Argentina," *La Nación*, January 8, 1990, "Se pone en marcha la privatizacion de ENTEL."

brief overview of the privatization process and then reviews how the process itself can signal and solidify the government's commitment the change in regime.

#### **a. The Process of Privatization**

Following the passage of the State Reform Law on August 17, 1989, the Menem government moved quickly to start the privatization process. The executive decree initiating the privatization process and laying out principles for the privatization of ENTel was issued on September 12, 1989. Drawing on the powers delegated to the executive by the State Reform law, this decree modified portions of the 1972 National Telecommunications law that were incompatible with the privatization, striking out its provisions that had reserved for the government the exclusive rights to provide and control telecommunications services. An intervenor was appointed to oversee the privatization. She and her team immediately began work on preparing the company for sale.<sup>24</sup>

Early in the privatization process the government of Argentina approached the World Bank for technical and policy advice. Eventually, the privatization of ENTel became one of the conditions for the Bank's Public Enterprise Reform Loan. This conditionality intensified the government's incentives to complete the transaction and provided the privatization team with leverage against parties who opposed the privatization.

In anticipation that political resistance to the sale of ENTel, both outside and inside the government, would grow over time a very tight timetable was set for the bidding process and for the accompanying institutional reforms. The need for speed also determined that the privatization would be implemented through executive decrees as provided for in the State Reform law, rather than through additional legislation which would have posed the risk of being caught up by interest groups in the Congress. These executive decrees were both more easily implemented and reversed than legislation. However, since they were officially issued by the President's office, they carried more weight than independent announcements from the privatization team.<sup>25</sup>

The "Pliego de Bases y Condiciones para la Privatizacion del Servicio Publico de Telecommunications" (Document of the Terms and Conditions for the Privatization of Telecommunications Services, henceforth referred to as the Pliego) contained in executive decree 62/90 of January 5, 1990 laid out the conditions for the sale of ENTel. Although subjected to numerous modifications in the course of the bidding process (which are discussed in more detail in the

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A December 14, 1989 article in the Wall Street Journal titled "Will Argentina's Menem Have the Guts?" questioned whether the president would actually carry through with his proposed reforms.

<sup>24</sup> Decrees 59/1990, 60/1990, 61/1990, and 62/1990.

<sup>25</sup> Later privatizations, that took place subsequent to the privatizations provided for in the State Reform Law, were implemented by laws passed by Congress rather than by decrees. This is true of the privatizations natural gas, power, oil, and the ports. While in some cases this caused delays in the privatization process, these delays did not have the same potential negative impact on the credibility of the reform program as a delay in one of the first privatizations might have had.

next subsection), the outline of the actual transaction largely followed that issued on January 5. ENTEl would be split into two companies that would each be granted a license to provide basic telecommunications services in Argentina. The first 60% of the shares in these companies was to be sold by competitive international bid. The remaining 25% was reserved for a public flotation, 5% for sale to cooperatives, and 10% for ENTEl employees. In addition the Pliego laid out the timetable and the principles of the regulatory regime for the sector. A copy of the timetable is included in Table 5 at the end of this case. The bid was to be announced almost immediately and it was planned that the transfer to the new owners would take place on October 8, 1990.

The Pliego presented two Licensee Companies for sale. These two companies, the "Northern Company" and the "Southern Company" were created by decree and were given the exclusive licenses to provide basic telephone services for a limited period. At the same time a new company with an exclusive license to provide international services for a limited period and a new company to provide "competitive" services also were created by decree.<sup>26</sup> The ownership of these two companies was split equally between the Northern Company and the Southern Company.<sup>27</sup>

The licensee companies were granted an exclusive license for the basic telephone service for a period of seven years, provided they met a set of minimum performance requirements for investment and quality of service.<sup>28</sup> They were also granted an option to extend the exclusive license for an additional three years if they met a higher set of performance targets. After the end of this period, the companies would continue to have a license to operate, but it would no longer be exclusive.<sup>29</sup> The

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<sup>26</sup> The services open to competition from other existing or potential licensees included data transmission, naval radio transmission, and telex.

<sup>27</sup> The assets of ENTEl were to be allocated amongst these four companies according to the services the companies were to provide. The Northern Company had an exclusive license to provide basic telephone services in the northern states of Argentina and in the northern half of the city of Buenos Aires. The Southern Company had an exclusive license to provide basic telephone services in the southern states and in the southern half of the city of Buenos Aires. The basic telephone service was defined as "...the provision of fixed telecommunication links that form part of the public telephone network or that are connected to such network and the provision of the means for urban, interurban and international live voice telephone service (Pliego of January 5, 1990, paragraph 8.1, contained in Decree 62/1990)." All other services were deemed to be open to competition.

<sup>28</sup> More exactly, this period is comprised of a two year transition period and a five year exclusive period.

<sup>29</sup> The government of Argentina had considered privatizing ENTEl without an exclusive license. However, this option was rejected. The exclusive license was the most valuable asset in the package. Without it, the government felt that it would be unlikely that there would be any bids. Exclusivity was also a necessary condition for generating the income that would be necessary to finance increased investment in the sector. (This was also the logic behind the exclusive license for international services.) However, by splitting the market for basic services into two exclusive geographical zones the government hoped to be able to create yard-stick competition between the two licensee companies. In

Pliego also laid out the obligations the licensee companies would have to fulfill in order to retain their licenses.<sup>30</sup> In order to prequalify to bid for either licensee company, a consortium had to meet a detailed set of criteria. The purpose of these conditions was to ensure that a winning consortium would have the technical ability to run a licensee company and the financial depth to make the purchase and to meet the obligatory investment goals.<sup>31</sup>

The minimum price for the licensee companies, set in a separate decree on February 28, 1990, had two parts: a cash component and a component to be paid by the cancellation of the Argentine government's debt. In addition, the Argentine government would assume all of ENTel's existing debts; these would be replaced by debt in the form of notes payable to the Argentine government. The minimum cash portion of the bid was set at US\$ 114 million for the southern licensee company and US\$ 100 million for the northern company. There was no minimum amount set for the sovereign Argentine debt component of the bid price. The level of corporate debt for the two companies was set at US\$ 202 million for the southern company and US\$ 178 million for the northern.<sup>32</sup>

Of the 14 potential purchasers who bought the bidding documents for US\$ 20,000 apiece, 7 submitted applications for prequalification by the April 19, 1990 deadline. These seven consortiums

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addition, by creating two companies, the government ensured that there would be at least two strong potential competitors at the end of the exclusive period.

<sup>30</sup> These obligations included the basic services goals the companies had to meet to keep the exclusive license; the obligation to prepare accounts in sufficient detail to permit regulation of the service and to ensure that there was no cross-subsidization between services, which was prohibited; and provision for interconnection between the licensee companies and with independent operators and the providers of competitive services. All purchases of goods or services over US\$ 500,000 would have to go out to competitive bid; local suppliers were given 10% price preference; minimum levels of local content were set; and the import of used equipment was banned.

<sup>31</sup> A qualified consortium had to contain at least one telephone operating company who had to hold at least 10% of the consortium's equity. In addition the operator, a consortium had to continue one (or at the most two) shareholder that held at least 20% of its shares. The purpose of these requirements was to ensure that at least 30% of the consortium's equity was held by a maximum of three shareholders. The operator, the additional shareholder (or two shareholders) with more than 20% of the equity, and any other shareholders holding more than 10% of the equity had to be able to demonstrate that at the time of the prequalification that their assets exceeded US\$ 1 billion. For local firms whose membership was additional to the first 30%, this was reduced to US\$ 300 million. All members of the consortium with shareholdings above 10% were required to accept a joint and several obligation for the payment of the sale price. Changes in the composition of the consortium was limited. The consortium was required to delegate all management responsibilities to the operator; this management contract was subject to review by the regulatory authority.

<sup>32</sup> Decree 420, February 28, 1990.

were headed by Cable and Wireless; Nynex Corporation; Telefonica of Spain with Citicorp and Inversora Catalinas; Stet of Italy with J.P. Morgan; GTE Corporation; France Cables and Radio; and Bell Atlantic Corporation with Manufacturers Hanover and Cititel. All seven qualified to submit bids in the final round of the sale.

The three consortia that submitted bids were the consortium headed by Telefonica of Spain, the consortium headed by Bell Atlantic of the U.S.; and the consortium headed by France Cable and Radio with Stet of Italy. Telefonica and France Cable and Radio with Stet submitted bids for both the northern and southern regions while Bell Atlantic bid only for the northern region.

#### Bids for Southern Region

	Telefonica	Stet and Cable et Radio
Cash	114	114
Argentine debt	2180	1944
Interest on debt	540	389
Total	2834	2447

#### Bids for Northern Region

	Telefonica	Bell Atlantic	Stet and Cable et Radio
Cash	100	100	100
Argentine debt	1850	1856	1750
Interest on debt	458	371	350
Total	2408	2337	2200

Although the Telefonica consortium submitted the highest bid for both regions, the sale conditions outlined in the Pliego did not permit the award of both companies to the same consortium. As a result, Telefonica was awarded the southern company and, once it had matched Telefonica's bid, Bell Atlantic was awarded the northern company.

As a regional operator in the United States, Bell Atlantic was constrained in the size of its foreign investments. U.S. regulations restricted its investment to 4.9% of the consortium. To enable Bell Atlantic to qualify for the bidding process the Argentine government revised the terms of the Pliego to reduce the minimum size of the operator's share to 4.9%. This allowed Bell Atlantic's higher bid to stay on the table. However, Bell Atlantic had other difficulties. The Argentine members of the consortium wanted Bell Atlantic to carry their share of the consortium's investment, first at 40% and then at 15%. Bell Atlantic's banker, Manufacturers Hanover, then had problems raising enough Argentine debt to fulfil Bell Atlantic's bid. Even though the government gave Bell Atlantic additional time beyond the August 6 deadline for signature of the transfer contract to complete its

financing arrangements, Manufacturers Hanover failed to amass enough sovereign debt and Bell Atlantic had to withdraw its bid in early October.<sup>33</sup>

Following the procedures outlined in the Pliego, the privatization team then approached the France Cable and Radio/Stet consortium. The consortium was formally invited to enter negotiations for the purchase of the northern company on October 4. The consortium mobilized to deliver a bid of US\$ 100 million in cash and US\$ 2,309 million in debt and interest; this was an increase of US\$ 209 million in debt and interest over the consortium's original bid and nearly matched the failed bid of Bell Atlantic. The government accepted this bid and extended the deadline for taking possession of the northern and southern companies by one month to November 8. The consortium then had this short period in which to make its financial arrangements.<sup>34</sup>

The transfer contracts signed on November 8, 1990 transferred 60% of the shares in the northern company, henceforth known as Telecom Argentina, to the Nortel consortium operated by France Cable and Radio and STET and 60% of the shares in the southern company, now known as Telefonica de Argentina, to the Cointel consortium operated by Telefonica of Spain. The shareholding of these two consortia is in Table 6. The government of Argentina retained 40% of the shares in the two companies, 25% of which was to be sold to the general public, 5% to telephone cooperatives, and 10% to ENTel workers. The responsibility for liquidating this holding remained with the intervenor for ENTel.

The international and domestic public offerings of Telefonica's shares were made in the week of December 12, 1991 while the offerings of the government's shares in Telecom were made in the week of March 23, 1992. The 5% of the shares reserved for cooperatives was included in the offering. Cooperatives were given priority in the allocation of these shares, although there are no indications that they took up their entire allocation. Both offerings were oversubscribed and both garnered much higher revenues than the US\$ 300 million the government had anticipated. The December Telefonica sale brought in US\$ 830 million while the March sale of Telecom brought in US\$ 1,227 million. The cash value of these 30% shareholdings turned out to be higher than the cash value of the first 60% shareholdings the government had sold by tender.<sup>35</sup>

The sale price of the first 60% of ENTel in November 1990 was US\$ 214 million plus US\$ 5,029 million of Argentine debt and associated interest at face value. At the time of the transaction this debt traded in the secondary market was worth 19 cents on the dollar or US\$ 955 million. Thus the equivalent cash value of the price paid for the first 60% of ENTel was US\$ 1,169

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<sup>33</sup> Wall Street Journal, "Argentina Kicks Off Privatization Drive," June 26, 1990; La Nacion, "Se adjudico Entel a Bell y a Telefonica," July 2, 1990, and "Postergan la firma para la cesion de Entel," August 13, 1990; and Wall Street Journal, "Argentina Cancels Sale of Phone Unit to U.S.-Led Group," October 8, 1990.

<sup>34</sup> Decree 2096/1990; Telecom Argentina, Prospecto, March 1992, p.12; and La Nacion, "En una tensa jornada, se adjudico al grupo STET la Zona Norte," October 8, 1990.

<sup>35</sup> La Prensa, "Venden al publico el 25% de las acciones de ENTel," May 24, 1991.

million: US\$ 630.8 million for the southern company that became Telefonica and US\$ 538.7 million for the northern company that became Telecom.<sup>36</sup>

The arrangements for the 10 % of the shares reserved for WNTel workers were finally put in place in December 1992. The price was set at US\$ 16.6 million which is to be paid out of the dividends associated with the shares. Until this payment to the government is made in full, the shares will be held by a trustee, the Banco de la Ciudad de Buenos Aires.

#### **b. Privatization as a Commitment Mechanism**

Both the process of privatization and the resulting pattern of ownership can serve as commitment mechanisms. The degree of transparency and predictability in the sale process is an important signal of a government's willingness and its ability to commit itself to providing a stable regulatory environment post-privatization. The resulting pattern of ownership may strengthen the government's commitment by creating new political constituencies who identify with the privatized firms.

The signals created by the process of privatizing ENTel were mixed. The basic procedures which governed the bidding process were straight-forward and well-publicized. Rules were laid out governing all steps of the bidding process and the bids were opened in public to eliminate any suspicion that they might be fixed. Not surprisingly, the haste in which the privatization of ENTel was undertaken necessitated some technical clarifications of the bidding terms and conditions and revisions to the bidding schedule, although ultimately the sale was completed with only a one month delay beyond the deadline in the original schedule. More seriously, some of the terms of the bid were modified in the course of the bidding process, or were not resolved until after the final bids had been submitted. Most of the modifications and uncertainty were related to the nature of the regulatory regime and will be discussed in more detail in section five below. In addition, in mid-April, one week before the deadline to submit applications for prequalification the minimum asset levels that were prerequisites for membership in the bidding consortiums were changed. The effect of the modification was to reduce the number of eligible operators and thereby reduce the number of consortia that could qualify to bid. At the same time, the changes increased the number of non-operator members who would be eligible to join the bidding consortia. It is unclear exactly what the motivation and origin of these changes were, but they signalled an increase in risk and uncertainty attached to the purchase of ENTel.<sup>37</sup> Another issue that was still unresolved at the time of the final bids was the status of CAT.

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<sup>36</sup> While the secondary market value of a dollar of Argentine sovereign debt was US\$ 0.19, given the imperfections of the market, this was not necessarily the social value to Argentina of the debt repurchased. For a more detailed discussion, see Manuel Angel Abdala, Distributional Impact Evaluation of Divestiture in a High-Inflation Economy: The Case of ENTel Argentina, Ph.D. Dissertation, Boston University, Boston: 1991, 25-36.

<sup>37</sup> Decree 677/1990, April 11, 1990. The prerequisite assets levels for the operator member of the bidding consortium was increased from US\$ 1 billion to US\$ 1.5 billion. At the same time the minimum asset level for members of the consortium who were outside the principal nucleus (that included the operator and one or two additional shareholders with a minimum shareholding together of 30%) was reduced from US\$ 300,000 to US\$ 200,000 for domestic members of the consortium and

CAT's provincial licenses, which had been precarious in nature, had expired and the territory that CAT served was included in the new exclusive licenses that the government would provide to the two new private telecommunications companies. The Ministry of Public Works had been charged with the responsibility for negotiating the purchase of CAT's assets, but failed to do so before the final bids were submitted. This meant that negotiations for the purchase of these assets did not take place until after the award.

While the bidding process and the public offerings were open to foreign bidders, the resulting ownership structure includes a substantial participation by Argentines. Once the transfer of shares to the workers has been completed, the division of shares between Argentine and foreign shareholders will be the following:

	<u>Telecom</u>	<u>Telefonica</u>
A. Domestic	43.0%	47.4%
* Diverse	18.0%	17.4%
* Concentrated	15.0%	20.0%
* Employees	10.0%	10.0%
B. Foreign	57.0%	52.6%
* Diverse	12.0%	12.6%
* Concentrated	45.0%	40.0%
	100.0%	100.0%

The concentrated domestic shareholders are the members of the consortia; these are banks and influential industrial groups. The diverse domestic shareholders are mostly individuals; together with the workers they form a substantial bloc. The participation of Argentines in the shareholding of these two companies provides additional insurance against regulatory expropriation of the companies' assets. The expropriation of Argentine nationals' assets would not only be costly in terms of the government's credibility as a regulator, but it would also generate direct political pressures that would reduce the government's chances of being re-elected.

In addition, the operators of the two companies are either partially or entirely state-owned, Telefonica by the government of Spain, STET by the government of Italy, and France Cables by the French government. The operators, therefore, have direct links with their home country governments and the capacity to call on their support.

## V. Regulation as a Commitment Mechanism

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from US\$ 1 billion to US\$ 500,000 for foreign members. Altogether the members of the consortium would have to have combined assets in excess of US\$ 4 billion.



The regulatory regime is critical to the telecommunications firms' operating environment. The pre-privatization design and implementation of regulation affects potential buyers perception of risk and, therefore, the price they would be willing to offer. Post-privatization, the regulatory regime continues to affect the buyers' perception of risk and their investment behavior. In the privatization of ENTel, the most serious short-comings have been in the pre- and post-privatization implementation of the regulatory regime. During the bidding process, regulatory clarity was sacrificed to speed and to politics. The Pliego outlined the basic rights and obligations of the privatized companies and provided for general regulatory principles and the establishment of a regulator. However, little was done to implement this regime. It was not until more than a year after the privatization that the government of Argentina focussed on the problems of regulation and took steps to address them. The discussion below is divided into four sections: (a) the pre-privatization definition and implementation of the regulatory regime, (b) the legal framework for the regulatory regime, (c) the initial failure to implement to regulatory regime post-privatization, and (d) the administrative intervention of CNT.

#### **a. Pre-privatization Definition and Implementation of the Regulatory Regime**

The pre-privatization definition and implementation of the regulatory regime was the weakest part of the privatization process. The regulatory regime was not defined until the very end of the bidding process and substantial revisions took place during the bidding process. These problems were not entirely accidental. At the beginning of the bidding process a conscious decision was made by the Argentine government to give priority to rapid completion of the sale over the development of a regulatory regime. This reduced the number of political hurdles the privatization would have to clear. This was an important strategic decision which recognized the potential for resistance to the privatization. The decision was contrary to the advice that the Argentine government had received from the World Bank, which had urged the government to implement a regulatory regime before privatizing. However, in recognition of the importance of the post-privatization regulatory regime, the Pliego did lay out both the basic rights and obligations of the privatized companies and the basic principles and general concepts for regulation the telecommunications sector. In addition an initial set of pricing rules was set out and regulatory authority for the sector was conferred on the Secretary of Communications in the Ministry of Public Works.<sup>38</sup>

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<sup>38</sup> Rates were to be set prior to the presentation of offers to a level that would give "...an efficient operator a reasonable rate of return on the fixed assets used to offer the service (paragraph 12.2 of the original Pliego)." In the initial two year transition period the licensee companies would be permitted to up-date their rates according to monthly changes in the consumer price index. If during the period of transition, these adjustments did not allow the licensee companies to achieve a rate of return of 16%, the companies would be allowed to adjust their prices in order to achieve this level of return. However, in the transition period, the real price of residential services would not be allowed to increase in real terms except to maintain the relative price structure that existed at the time the assets of ENTel were actually transferred to the licensee companies. During the five year exclusive periods the licensee companies would not be allowed to increase the overall price of their services (net of connection charges) each year by more than the consumer price index minus 2%. Meeting this requirement was a prerequisite for an extension of the exclusive license for an additional three years. In the last three years of the license, increases in the general price level of the licensee companies' services (net of connection charges) would be limited to the consumer price index minus 4%.

The Secretariat of Communications was also responsible for developing a comprehensive regulatory decree based on the principles outlined in the Pliego. However, the Secretary and most secretariat staff did not support the government's privatization plans and did not believe that the privatization team would succeed. As a result the Secretariat of Communications did not approach the task of developing and implementing a regulatory framework with any sense of urgency. Although the Pliego had committed the government to issuing the details of the regulatory framework by February 28, this decree was not issued until June 22, 1990, just before final bids were to be submitted.<sup>39</sup> The decree had been circulating for some time in draft form, so its contents were no surprise to the bidders, but the government did not commit itself until the last possible moment. In addition, the delay in issuing the decree meant that no steps had been taken to implement the regulatory regime defined by the decree. Thus, the bidders had no information as to who would run the regulatory agency and how it would be staffed. After the decree was issued, the secretariat took no action to implement the decree. Not until after the privatization was completed did the Secretariat of Communications suddenly move to transform itself into the regulatory agency. The same cast of characters that had run the secretariat and had chosen not to support privatization now would run the agency. (Their role in implementing the regulatory regime is discussed in more detail in the subsection below.)

Additional regulatory uncertainty was introduced by the modification of the original pricing rules by a subsequent executive decree, limiting the rate base on which minimum rate of return was guaranteed for the newly privatized companies' first two years of operations. The original rules for determining the tariff levels had been based on the privatization team's estimate that together the licensee companies would need at least US\$ 500 million a year to fund the obligatory investment program outlined in the Pliego. The team was concerned that the licensee companies would have difficulty raising this amount of capital either domestically or from foreign sources. They therefore planned to design the tariff regime to provide at least this amount of net income. Based on the minimum rate of return of 16% provided for in the original Pliego, this would require a combined rate base of US\$ 3.2 billion.

However, as required by the State Reform Law, the National Development Bank (Banco Nacional de Desarrollo) had prepared an independent valuation of ENTel's assets which was completed on February 27, 1990. This valuation set the value of ENTel's assets as US 1.9 billion.<sup>40</sup> Opposition arose in Congress to allowing a rate base of US\$ 3.2 billion dollars when the assets of

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Connection charges were limited to 50% of the direct cost of the line for residential services and 100% of the direct cost for other services. During the transition period the connection charge would be treated like a telephone tariff. After that the charge would not be a charge, but rather a loan from the user to the company with a five year term and interest rate of 7% per annum. At the end of the exclusive period the regulatory agency would only continue to regulate rates in those parts of the country where there was no competition.

<sup>39</sup> Decree 1185/1990. This decree was drafted by a joint Argentine/World Bank team.

<sup>40</sup> Law 23,696, Article 19, August 17, 1989 and Decree 420, February 28, 1990.

ENTel were valued at US\$ 1.9 billion.<sup>41</sup> It was also argued that the minimum price was too low. President Menem was pressured by members of his own party to issue decrees limiting the rate base to US\$ 1.9 billion plus the licensee companies' additional investments and to increase the minimum bid to include US\$ 3.5 billion in total of Argentine government debt. The increase in the minimum bid was made in a March 28 executive decree and the reduction in the rate base was incorporated in the April 11, 1990 executive decree modifying the Pliego, one week before the deadline for submission of application for prequalification.<sup>42</sup> The privatization team opposed these changes and as a result there was speculation that the intervenor would be dismissed by President Menem. Her chief advisor did resign from the team in protest over the change in the rules governing the privatization. However, as the bidding process came to closure, it became evident that the few remaining bidders were focussed on the actual tariff levels at the time of the transfer and not on the minimum level of return provided for in the original Pliego.

The issue of the effective tariff level was still unresolved at the June 25, 1990 deadline for final bids and may have been a factor in the small number of bids received. Indeed the tariff issue was not resolved until after the awards had been made. On March 7 the intervenor had given the base rate for the tariff and the indexing mechanism for adjusting the tariff levels with inflation. As with most indexing formulas in use in Argentina, the adjustments were to begin in the following month. In this case the first adjustment would have been in April. However, the inflation rate for the month of March was 95% and the bidders wanted this accounted for in the tariff level. The government resisted this increase, but the bidders had persisted and the issue had not been resolved. The difference was reflected in the price of the basic unit used for calculating telephone charges: the government position was that the rate should be 193 australes per pulse (about 3 cents) while the bidders formula gave a price of 293 australes per pulse.

The two companies argued that such a rate was necessary to ensure their profitability and threatened to withdraw if it was not approved. On the government side, the Minister of Public Works threatened to resign if the government allowed the price increase. However, the government had very little bargaining power. It was running into its self-imposed deadline and had no alternative bidders to go to if the Telefonica and France Cable and Radio/STET consortiums withdrew. Holding a firm line may have meant the failure of the privatization of ENTel.<sup>43</sup>

The final agreement on the pulse price, which was incorporated in the two transfer contracts signed on November 8, 1990 was on an indexing formula that produced a tariff of 247.9 australes per

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<sup>41</sup> The focus of this opposition was the Comision Bicameral of the Congress that was overseeing the implementation of the State Reform Law.

<sup>42</sup> La Nacion, "Defendio Maria J. Alsogaray la privatizacion de Entel," March 12, 1990; La Nacion, "Se modificaron los pliegos de venta de Entel y de Aerolineas," April 2, 1990; Financial Times, "Crossed lines over privatisation," May 25, 1990; Decree 575, March 28, 1990; and Decree 677/90, April 11, 1990.

<sup>43</sup> Wall Street Journal, "Privatization Campaign in Argentina Bogs Down," October 25, 1990 and La Nacion, "Entel: el Gobierno opto por flexibilizar valores" and "El pulso telefonico ajustado por inflacion alcanzaria a Australes 293.68," October 29, 1990..

pulse (approximately 4.8 cents US). This change in the pricing regime had a large impact on consumers. For private consumers this resulted in a real increase of 96.57% in the pulse price relative to their previous bi-monthly bill. In return the two consortia gave up their rights for the minimum return of 16% on their rate base. This, however, was not much of a sacrifice, since the definition of the rate base had been dramatically narrowed in the April modifications of the Pliego.<sup>44</sup>

Problems in the definition and implementation of the regulatory regime before the privatization were followed by more problems in the implementation of the regime after privatization. The next section outlines the main components of the regulatory framework. Then the following section discusses the post-privatization implementation of the regulatory regime.

### **b. The Regulatory Framework**

The June 22, 1990 regulatory decree provided the legal basis for a regulatory agency and regime. Although long delayed, the decree provided a well-designed legal framework. It included and extended the regulatory principles outlined in the Pliego and created a telecommunications regulatory agency, the Comisión Nacional de Telecomunicaciones (CNT). CNT was to be headed by five commissioners, all of whom would be appointed by the executive and, as required by the Argentine constitution, all of whom could be removed by the president. The executive would also designate one of the commissioners as president of the commission. The commissioners would be nominated for five year terms and could be renominated for one additional term. CNT had the authority to make decisions within the parameters set by the degree, but parties could appeal CNT decisions to the national executive.

CNT's primary sources of funding were to be a tax of 0.5% on telecommunications revenues and the license charges to users of the radio spectrum. These funds were to be deposited in an account at the Bank of Argentina and administered by CNT. Any funds not used by CNT in performing its assigned tasks were to be used to develop both public and official telecommunications and broadcasting services.

CNT's function was defined to be (i) administrative and technical regulation and (ii) control, supervision, and verification consistent with applicable norms and government policy. The objective of CNT was to assure the continuity, regularity, equality and broad availability of service, to promote the universal nature of the basic telephone service at a fair and reasonable price, and to promote the development of competitive services.<sup>45</sup> CNT's powers and responsibilities included: (i) granting and revoking licenses, authorizations, and permits beside those corresponding to the exclusive regimes granted as part of the privatization of ENTel; (ii) deciding whether the exclusive regimes should be

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<sup>44</sup> ENTel, Region Norte, Contrato de Transferencia, Section 16; ENTel, Region Sur, Contrato de Transferencia, Section 16; Abdala, 1991, p. 59.; Telecom Argentina, Prospecto, March 1992, p. 22; and Telefonica de Argentina, US Offering Prospectus, December 1991, p.33.

<sup>45</sup> In Chapter 8 of the Pliego basic telephone service was defined as the provision of fixed telecommunications links that form part of the public telephone network or that are connected to such network and provide the means for urban, interurban and international live voice telephone services.

extended; (iii) inspection and verification as to whether the conditions contained in the licenses, authorizations and permits were met; (iv) the review and approval of investment plans for operational compatibility, minimum quality of service, and interconnection of networks as well as the standards and rules for interconnection; (v) the resolution of consumer complaints; (vi) preventing anti-competitive behavior, particularly as a result of cross-subsidies; (vii) verification that requirements for competitive procurement were met; and (viii) approving tariffs in cases where rates must follow guidelines set in a license. The sanctions that CNT could apply, in addition to those defined in the Pliego for the exclusive regime, included warnings, fines, total or partial cancellation of exclusivity, and the cancellation of licenses, authorizations, or permits. Decisions of CNT would be deemed to have exhausted the administrative appeal process except for appeal to the national executive branch.

The decree also extended the Pliego's outline of regulatory procedures and policies. These included the following. New entrants were regulated by the requirement that the provision of telecommunications services would be subject to the prior procurement of a license. Supply was regulated by the requirement that an authorization be obtained before new facilities could be installed or operated. While CNT had the power to grant licenses that would be subject to future competition, the power to grant exclusive licenses was reserved to the executive branch of the national government.

Tariffs were to be published and available. All accounting and cost information required by licenses were to be supplied to CNT along with any other information the commission might reasonably require. Interconnection rules for the two companies with exclusive licenses were governed by the terms of the Pliego, which required interconnection between regions and with independent operators. The licensee societies were also required to provide non-discriminatory access to their networks to the providers of data services and other value-added services. In the first instance, the terms were to be negotiated between the interconnecting parties without the involvement of CNT. However, if there were a dispute CNT could be invited to intervene, or in any case CNT may intervene of its own accord to set prices or conditions of service. Beyond the period and scope of the exclusive licenses, interconnection was to be open between all technically compatible equipment and networks on a non-discriminatory prices and levels of services. As with the exclusive regime, the interconnecting parties were to negotiate their own conditions and prices with the potential for CNT intervention.

Although in its details the regulatory framework was well-designed, its implementation was problematic. These problems are outlined in the following section.

### **c. The Initial Failure to Implement the Regulatory Regime Post-privatization**

Initially, the regulatory agency did little to put the framework outlined by the regulatory decree into action. Thus, although a well-defined regulatory framework was legally in place, regulatory practice did not conform to the framework. This created an ambiguous setting for all the participants in the telecommunications sector. After more than a year of inactivity and mounting uncertainty, the Menem administration replaced the management of the agency.

The first incarnation of CNT was staffed entirely by former employees of the Secretariat of Communications and ENTel, including the former Secretary of Telecommunications who became the

president of the commission. This group, besides having no experience in regulation and little vision as to the role of a regulator, were not associated with the moderate portion of the Peronist party that backed reform and had not supported the privatization nor expected it to succeed. At the last moment, as the first stage of the privatization was completed, the Secretariat of Communications had set about transforming itself into a regulator in November 1990.

Then in early 1991, the Ministry of Public Works was merged with the Ministry of the Economy. This brought CNT under the purview of the new Minister of the Economy, who, as inflation has begun to accelerate again, had taken office at the end of January. The new minister's priority was to restore macro-stability in Argentina, which he tackled by introducing a convertibility plan on March 20. In this context, the reorganization of the merged department was a secondary concern. As a result, the functions of CNT received little attention from the minister. However, the commissioners and staff of CNT were clearly not members of the minister's economic team. As outsiders, they were not trusted and the ministry severely limited CNT's access to the funds raised by the special tax of 0.5% established to support CNT's activities.

Although it was charged with an enormous regulatory responsibility, CNT did little between November 1990 and the end of 1991. No clear regulatory processes were developed and a backlog of decisions began to pile up. There was an absence of experienced staff and a lack of resources to hire any additional staff or even pay existing staff on a regular basis. CNT's failure to perform had a negative impact on all parts of the telecommunications sector. In issues where it should have played an active role it seems to have played none. The most significant example was in the revision of the tariff formula that took place as a result of the introduction of the new convertibility law. This law was formulated in response to the accelerating inflation at the beginning of 1991. Its main component was the introduction of a new currency, the peso, that would be worth 10,000 australes and the fixing of the exchange rate at one peso equal to one US dollar. Another part of the law banned all price indexing formulas that were linked to the Argentine CPI. This made the telecommunications tariff indexing formula void.

The ban on the indexing formula meant that the nominal price of telephone services was frozen and subject to erosion by inflation. Under the terms of the Pliego and transfer agreements, any modification of the terms of the exclusive license was subject to indemnification. Yet the response of CNT was to do nothing. Its president was quoted in the press as saying that although the tariffs were frozen, they were high enough.<sup>46</sup> Needless to say, the CNT's unwillingness to replace the indexing formula in the Pliego reduced the credibility of its commitment to the rule of law.

Eventually the issue was resolved because the companies refused to participate in the preparation of the prospectuses for the public sale of the government's remaining shares in the companies. This brought the government to the negotiating table. However, the negotiations took place between the companies and the Ministry of the Economy and Public Works, not with CNT. The new formula -- which was agreed upon on November 28, 1991 -- fixed the tariff levels in US dollars and permitted an adjustment every six months based on the CPI in the United States. This allowed for adjustment of tariffs, but exposed the companies to the risk that the inflation rates in the US and

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<sup>46</sup> La Prensa, "La tarifa telefonica esta congelada, ya que es alta y remunerativa," April 7, 1991.

Argentina would diverge.<sup>47</sup> Firms were also given permission to begin rebalancing the relative rates between different classes of users in January of 1992. In addition they were allowed to keep the connection charge, which was to have been replaced with a debt instrument, but they were required to meet a schedule that would reduce the charge to US\$ 250 for all users by November 1997.<sup>48</sup>

CNT's sluggishness or failure to act caused problems in many other parts of the telecommunications sector as well. The six-month delay in CNT's response to CAT's tariff increase request greatly complicated CAT's negotiations with Telefonica and Telecom for the sale of CAT's properties. This delay occurred even though the requested tariffs were 40% below the tariffs in effect for Telecom and Telefonica. CNT also failed to begin addressing the imbalance in rates between local, long distance, and international service. Local service is subsidized by high long distance and international rates. This causes distortion in usage patterns and creates artificial incentives for new firms to enter the long distance and international markets to "cream-skim." Indeed, it appears the American telephone companies had been selling their international credit calling cards door-to-door illegally in Argentina. CNT's failure to police the telecommunications sector left the two licensed operators susceptible to the loss of a significant portion of their international revenue to these illegal sales.

The development of new telecommunications services was retarded by CNT's failure to develop standards and processes for issuing licenses. The development of these services also suffered from a pricing policy that treated them as end-user business customers, despite the fact that little use was made of existing telephone company infrastructure. This made most of these services uneconomic. Meanwhile, a number of radio operators and telephone cooperatives, faced with a delay in receiving licenses and little or no policing of their operations, started operations without licenses.

Consumers suffered from CNT's inability to effectively address customer service complaints. This undermined the reputations of the companies, who relied on CNT to arbitrate complaints.

The two licensee companies claimed to have exceeded the performance targets set for them under their contracts. However, CNT did not have the capacity to verify these claims, allowing, on one hand, the possibility of cheating by the companies and, on the other hand, increasing the risk that the companies would not be able to prove that they had met the targets and so were entitled to retain their licenses. This situation was further complicated by the fact the CNT had no input into the telephone companies' development of their internal information systems. This presented a potential handicap of the regulator's ability to review and verify whether the companies were meeting their performance targets.

CNT's methods of decision-making were also problematic. Rather than following an open and transparent process based on a clear set of rules with public analysis and comment, decisions were more idiosyncratic and made on the basis of personal relationships. This type of behavior increased

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<sup>47</sup> In fact there has been such a divergence. In 1992 the increase in the U.S. CPI was 3 % while the increase in the Argentine equivalent was 25 %.

<sup>48</sup> Decree 2585/91. In November 1992, the connection charge for commercial and professional users was US\$ 1,800 and US\$ 900 for residential users.

the risk associated with investing in the telecommunications sector. The regulator had been endowed with a broad range of responsibilities and powers and yet actions were unpredictable. Without well-defined regulatory rules and procedures the risk of making capital investments in the sector was increased, not only for the two licensee companies, but also for the providers of new services and consumers. This higher level of risk reduced the incentives to invest in the sector.

CNT's poor performance also had implications outside of the telecommunications sector. It also undermined the credibility of the government of Argentina's privatization program, both domestically and abroad. Telecommunications had been intended to be one of the flagship examples of the government's intention to transform the economy. The government had succeeded in transferring ownership of the sector to the private sector. However, it had failed to complete the privatization by implementing an effective regulatory regime. This failure was a bad signal as to the potential success of other privatizations. Without clear, universally applied, rules for the conduct of business after privatization, investors would be reluctant to participate in the process. Likewise, without a regulator to safeguard their interests as consumers, Argentineans would oppose the privatization of other government monopolies.

By the end of 1991 a consensus had emerged amongst the parties involved in the Argentine telecommunications sector regarding the need for a more effective regulator. Newly formed consumer advocacy groups viewed regulation as an avenue for improving the quality of telephone service and for assuring fair pricing. Both actual and potential new services providers needed clarification of the ground rules for operations in the sector. Even the two licensee companies, who might have been expected to profit from inefficient regulation, realized that the legal and political uncertainties associated with ineffective regulation could be costly for them.

#### **d. The Administrative Intervention of CNT**

In December 1991, the Subsecretariat of Communications was recreated in the Ministry of Economy and Public Works and a new Subsecretary of Communications was appointed. This appointment brought CNT under closer scrutiny by the government. In January 1992, the government instituted an administrative intervention of CNT, replacing its commissioners with an intervenor and four sub-intervenors. The catalyst for this intervention was a World Bank report that highlighted the deficiencies of the regulatory agency. Unlike the commissioners they replaced, the intervenors were associated with the political coalition supporting economic reform and, perhaps more importantly, with the Minister of Economy and Public Works. Although the executive branch had the power to dismiss the commissioners outright, it chose not to do so because of the bad precedent it would create. It chose instead to use an administrative intervention to signal that this was an exceptional situation. Administrative interventions are used in extraordinary cases, generally where mismanagement has taken place, and are by their nature temporary. Initially, the intervention of CNT was for twelve months, but was renewable.

The objective of the intervention was to reform CNT into an effective regulator. In collaboration with the World Bank, the Subsecretariat for Telecommunications formulated a plan for developing CNT's regulatory capacity. After an international competition, the government selected an independent international consulting team to assist it in implementing the reform. The role of the consultants was to collaborate with the staff of CNT in formulating an explicit set of regulatory



policies; in designing the functions, methods, procedures and systems that CNT would use; in the implementation of the systems and procedures; and in evaluating and fine-tuning this implementation.

The new management of CNT was faced with two competing tasks: (i) to address in the short term the pressing backlog of regulatory decisions and (ii) to chart out CNT's future strategy for the long term and obtain the human and financial resources necessary to implement this strategy. In the first six months of the intervention the short-term issues dominated CNT's agenda at the expense of the long term development of the commission. This may have been inevitable given the backlog of decisions left by the CNT's inaction in its first year, but it increased the risk that with the departure of the intervenors that CNT would revert to its previous ways.

By October 1992, CNT had issued licenses regularizing the status of 140 of the 300 independent telephone cooperatives and expected to complete the balance by the end of the year. It had initiated the bidding process for mobil telephone service in the regions outside of Buenos Aires. It had established the norms for domestic data transmission services, video conferencing, and private mobile radio, all of which are provided on a competitive basis. In order to promote competition in the provision of cellular telephones, it had ended regulations requiring partial fabrication in Argentina and allowed any equipment approved by the US Federal Communications Commission to be used in Argentina.

It established norms for the use of the radio spectrum and resumed monitoring to ensure that these norms were respected. It dramatically improved the collection of charges for the use of the radio spectrum. Up until the end of 1991 CNT had collected the equivalent of US\$ 2,880,000 in charges; in the first eight months of 1992 it collected more than US\$ 10 million. CNT had also initiated the process for selling one of the two satellite slots allocated to Argentina for domestic satellite communications. This process was completed in early 1993. To facilitate the collection, processing, and monitoring of consumer complaints, CNT signed a contract with a consumer advocacy group (Adelco). A decree drafted in collaboration with the licensee companies and defining the rights and obligations of consumers was issued on August 11, 1992 and went into effect on September 11, 1992.<sup>49</sup>

Despite its progress on these many fronts, CNT's initial actions did not reduce the legal and political uncertainty the regulatory regime had created for the licensee companies. Rather CNT's intervenors added to this uncertainty. This group appears to have been motivated by firm beliefs in the value of economic liberalization and competition. While respecting the core of the licensee companies' exclusive licenses for the provision of the basic telephone service, CNT took steps that eroded the companies' rights at the margin. In one instance, CNT issued decrees that would permit the creation of a competing long distance service linked to the future cellular licensees. These decrees were issued without any warning to or discussion with Telecom and Telefonica, who have appealed them to the national executive. The issue is still up in the air, but the government has appointed an arbitrator to resolve the dispute.<sup>50</sup>

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<sup>49</sup> Cited in a presentation made by the Sub-secretary of Communications, Dr. German Kammerrath, at the World Bank in Washington, D.C., October 23, 1992.

<sup>50</sup> Decree 506/1992 and Decree 663/1992. The arbitrator is the intervenor of ENTel.

While the licensee companies argued that the terms of the Pliego entitled them to the second cellular license, CNT did not agree.<sup>51</sup> Instead the granting of the second cellular license was linked to reductions in off-peak long distance rates and an acceleration by one year of the schedule for reducing connection rates that had been negotiated in December 1991. The decrease in the rates ranged from 9% to 17%, depending on the time and distance of a call. The approximate cost to each company, calculated as a net present value of the reduction over a five year period, was US\$ 145.6 million.

Another issue that is yet to be resolved is the technically difficult and politically awkward issue of the rebalancing of rates. The degree of subsidy from long distance and international service to local service is so large that while 75% of calls in Argentina are local, only 25% of the system's revenues are derived from local services. This high level of imbalance creates pressures to illegally by-pass the network and creates political pressures from would-be providers who wish to enter the markets for long distance and international services. While rebalancing is a politically difficult issue, the terms of the Pliego permit the operators to rebalance their prices, so long as the overall level of tariffs is not increased. Telecom and Telefonica are anxious to initiate this process so that by the time their exclusive license ends, their rates will more accurately reflect the costs of providing service.

Meanwhile, CNT's long term development remains to be addressed. The top staff of CNT are political and could leave at any time. To ensure continuity the commission needs to create positions, improve compensation, and recruit and retain skilled staff. It also needs to develop its internal systems and procedures. The team of outside consultants working with CNT since May has made progress in developing strategies and procedures. However, implementation relies on CNT's ability to obtain permission from the executive branch of the government to exempt CNT staff from civil service restrictions on pay.

CNT's long term effectiveness will also depend on its access to financial resources. Its current budget is approximately US\$ 27 million which is only a part of the revenues it generates. According to the decree that created the commission, CNT is supposed to control its own revenues and those revenues not used to fund the agency are supposed to be applied to the development of the telecommunications sector. However, in reality, CNT's access to funds is controlled by the Minister of Economy and Public Works and any surplus is applied to the public debt.

Despite these unresolved issues, it appears that the prognosis is good for CNT's role as an effective regulator. Staff and processes are now in place and should continue to function. Although incremental change may take place over time, a dramatic change in CNT's character seems increasingly unlikely.

While regulatory uncertainty was high during the privatization process and in the year following privatization, improvements have been made since the administrative intervention of CNT. The current management of CNT has been able to begin implementing the legal framework for regulation. Although much remains to be done to complete the implementation of the regulatory framework, as the evidence presented in the next sections shows, the initial indications are good.

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<sup>51</sup> The Pliego is imprecise as to the specific terms under which the licensee companies would be entitled to the second mobile band.

## VI. Preliminary Evidence Regarding Credibility and Sustainability

Barely more than two years has passed since the privatization of ENTel and the evidence regarding the credibility and sustainability of the regulatory regime and the implications for the performance of the telecommunications sector is scant. However, the evidence that is available suggests that, while uncertainty in the telecommunications sector may have been high at the time of privatization, it appears to have dropped since then. Indeed it appears that the reputation of Argentina as a country has improved and that both foreign and domestic investors are increasingly optimistic about the country's economic future. Two types of evidence are reviewed here, evidence related to the perception of credibility and sustainability in the telecommunications sector and evidence related to perceptions of the potential for continued success in the government's economic reform program and Argentina's economic future. In the first category evidence on the level of bidder interest in the first stage of the privatization, the returns earned by investors in the privatized companies, and the investment behavior of the companies are presented. In the second category evidence from the stock market, the secondary market for Argentine sovereign debt, and new foreign investment flows are presented.

Initial buyer interest in the privatization of ENTel was strong, but dropped off rapidly during the bidding process. 14 potential purchasers bought the bidding documents for US\$ 20,000 each. However, only seven consortia applied for prequalification on April 19, 1990. (All of whom qualified.) In the end only three bidders submitted final bids for the two new telecommunications firms on June 25, 1990 and one of the three then dropped out.<sup>52</sup> This attrition was correlated with modifications to the bidding process and uncertainty over the tariff levels at the time of transfer. The drop from 14 to 7 potential bidders took place just after the tariff regime and the prerequisites for prequalification had been changed. In addition, while the Pliego had committed the government to issue a detailed regulatory decree by February 18, 1990, no such decree had been issued. The drop from 7 to 3 then to 2 bidders took place at the end of the bidding process, when the regulatory framework had been clarified, but the starting tariff level (and therefore the potential profitability of the privatized companies) was still undefined. The fall in the number of bidders appears to be a reflection of the level of uncertainty in the privatization process. The fall reduced the level of competition and the government's leverage in the final round of bargaining; presumably, it therefore reduced the price offered for the two operating companies in the first stage of the privatization.

Changes in the price offered for the two operating companies between the first round of bidding and the general public offerings reflect changes in the buyers' assessment of the risks involved in the purchase. The Telefonica consortia paid US\$ 114 million in cash and US\$ 2,720 in Argentine sovereign debt and interest for the Southern operating company. The Telecom consortia paid US\$ 100 million in cash and US\$ 2,309 in debt and interest for the Northern company. At the time of the transaction this debt traded in the secondary market was worth 19 cents on the dollar. Thus the

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<sup>52</sup> One of these consortia was formed through the merger of the STET and France Cables consortia.

equivalent cash value of the price paid for the southern company was US\$ 630.8 million and US\$ 538.7 million was the cash equivalent for the northern company.<sup>53</sup>

The market's assessment of this risk seems to have decreased dramatically by the time of the public offering of the second tranche of Telefonica in December 1991 and of Telecom in March 1992. Investors paid US\$ 830 million for 30% of Telefonica and US\$ 1,227 million for 30% of Telecom. Adjusting for the size of the two blocks of shares, the price paid for Telefonica de Argentina's shares in the public offering was 3.6 times the price paid by the its operating consortium. The price paid in the public offering of Telecom's shares was 4.5 times the price paid by the Telecom operating consortium. Accordingly, the return to the investors who bought shares in the secondary offering is lower than that earned by the investors in the first tranche of the privatization. This implies that the risk premia demanded by investors in this sector declined and while the perception of credibility and sustainability seems to have improved over time.<sup>54</sup>

This apparent increase in credibility and sustainability is consistent with Telefonica and Telecom's investment behavior. Both companies have exceeded the investment levels required under the terms of their licenses. Their actual investments and their investment plans are outlined in Table 9. (The table also shows the number of lines the companies must install each year to meet its performance targets.) Telefonica invested US\$ 208.6 million in its network in the eleven months up to September 30, 1991 and an additional US\$ 615.2 million in the following year. Telecom, which started with a slightly smaller network, invested US\$ 132.0 million in its first eleven months and US\$ 609.0 million the following year.<sup>55</sup> Most of these funds were internally generated, but both companies have undertaken borrowings to finance investment and working capital. Their ability to borrow is an indication of lenders' optimism regarding the future of the sector.<sup>56</sup>

This investment was directed towards improving the quantity and quality of services available. Telefonica added 66,176 lines to its network in the eleven months up to September 30, 1991 and

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<sup>53</sup> While the secondary market value of a dollar of Argentine sovereign debt was \$0.19, given the imperfections of the market, this was not necessarily the social value to Argentina of the debt repurchased. For a more detailed discussion, see Manuel Angel Abdala, Distributional Impact Evaluation of Divestiture in a High-Inflation Economy: The Case of ENTel Argentina, Ph.D. Dissertation, Boston University, Boston: 1991, 25-36.

<sup>54</sup> While the price for the workers' 10% of the companies' shares was set in late 1992, it was linked to the price paid for the first tranche of the privatization and therefore does not reflect changes in market perceptions.

<sup>55</sup> As of September 30, 1992 Telefonica had paid out a cumulative amount of US\$ 115 million in dividends, while over the same period Telecom had paid out US\$ 51 million. These are small amounts relative to the level of investment.

<sup>56</sup> Telecom increased its debt by US\$ 74.9 million in 1992 and Telefonica increased its debt by US\$ 218.6 million.

276,364 lines in 1992. Telecom added 50,809 and 221,941 lines respectively.<sup>57</sup> In the five years leading up to the privatization, ENTel had added 98,000 lines a year on average to the entire system.<sup>58</sup> Further to these net additions to their networks, both companies invested in digitalizing their mainly electromagnetic systems. In total, Telecom installed 420,370 lines in 1992. Of these, 401,272 lines were digital and 198,429 were replacement lines. Telefonica increased the digitalization of its network from 18.1% in September 1991 to 24.0% in September 1992.

Investors' general perceptions of the prospects for private investment in Argentina seem very positive as demonstrated by the performance of the stock market and the increase in foreign direct investment. The market index has increased from a value of 23.70 at the end of May 1989 to 13,279.43 on March 19, 1993 (after peaking in mid-1992). The evolution of the stock market index is illustrated in Figure 9. (Changes in the prices of Telefonica and Telecom's stock have roughly paralleled the movement in the market.) Foreign direct investment in Argentina has more than doubled between 1989 and 1992. According to the IMF, foreign direct investment flows to Argentina were approximately US\$ 1.0 billion in 1989, US\$ 2.0 billion in 1990, and US\$ 2.5 in 1991. The level of investment in 1992 is estimated to be an additional US\$ 2.4 billion.

Overall perceptions of the health of the Argentine economy, as evidenced by the value of Argentine sovereign debt in the secondary markets, also have improved since the implementation of the reform program. The quoted value on the dollar of Argentine debt on May 22, 1989 was 13 cents; by March 1, 1993 this had improved to 46 cents.<sup>59</sup> The evolution of the secondary market for Argentine debt is illustrated in Figure 10. The conclusion of the Brady plan arrangements on April 7, 1993 gave another boost to confidence.

Thus, although the initial perceptions of risk in the telecommunications sector seem to have been high, they appear to have fallen over time as the privatization was implemented and the regulatory regime developed. The reduction in risk has been accompanied by substantial investment by the two newly privatized companies. At the same time the overall reform program has succeeded, not only in improving Argentina's economic performance, but also in improving expectations regarding the country's economic future.

This evidence indicates that the privatization of ENTel and the reform program of which it was a part was a success. However, there are some qualifications. With the benefit of hindsight, there are some actions that the Argentine government might have taken to improve the outcome of the privatization and there are some actions the government may still wish to take to this end. These are discussed in the following section.

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<sup>57</sup> These are the numbers reported by the companies and have not yet been verified by CNT.

<sup>58</sup> While it is possible to compare ENTel's physical level of investment with that of the two new companies, it is not meaningful to compare their levels of expenditure. ENTel paid much higher prices for its equipment and appears to have been less efficient in installing it.

<sup>59</sup> As quoted by Salomon Brothers.

## VII. An Evaluation of Regulation and Commitment in Argentina

Thus far, Argentina's success in establishing a credible and sustainable regulatory regime has been mixed. The evidence cited above indicates that the initial level of uncertainty in the reform and privatization process was very high and that this resulted in investors demanding high risk premia. This reduced the government's ability to capture the benefits from privatizing ENTel. These risk premia seem to have declined as the government made progress in implementing its regulatory regime and the rest of the economic reform program.<sup>60</sup> However, there remain a few actions that the government of Argentina may wish to undertake to improve the credibility and sustainability of its telecommunications regulation. In addition, Argentina's experience suggests some recommendations for other countries which are considering privatizing their telecommunications systems.

One means by which the Argentine government could improve the credibility of the existing regulatory regime would be to enshrine it in legislation. The government chose to use executive decrees to define and create the regulatory regime because of the ease and speed with which this could be done. While these were positive attributes during the privatization process, they are now negative attributes. With a change in administration the regulatory framework easily could be changed or abolished. Legislation would be more difficult to change as this would require cooperation between the Congress and the Executive. The current administration could take advantage of the fact that it has a majority in both chambers of Congress to enact legislation incorporating the current regulatory system.

Budgetary independence probably is not realistic for CNT. However, the problem with the current budgetary practice is that it is contrary to the provisions of the regulatory decree. The decree provides for a tax on telecommunications services to fund the activities of CNT and CNT is supposed to control all the revenues from this tax. In reality the funds are controlled by the Treasury and the CNT must obtain the permission of the Minister of Economy and Public Works to access these funds. This behavior on the part of the Argentine government does not increase confidence that it will abide by its own rules. These budgetary arrangements should be regularized.

Another change which Argentina eventually may wish to consider would be to modify the appeal mechanism. In the current regime appeals are made to the Executive rather than to the Judiciary. Given the general lack of confidence in the judicial system this may be the most appropriate mechanism for the time being. However, appeal to the Executive has a number of drawbacks. First, it removes the possibility of checks and balances between the different branches of government. Second, given that judicial appointments are in theory lifetime appointments and the president's term is limited to six years, the judiciary should be a more stable institution. Finally, it presumes expertise on the part of the Executive that it may not possess.<sup>61</sup> Argentina has initiated a

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<sup>60</sup> Because other economic reforms have taken place over the period, separating the increase in confidence due to improvements in regulation in the telecommunications sector and improvements due to progress in overall reform is problematic.

<sup>61</sup> Although in a recent appeal the Executive appointed an arbitrator with expertise in the field to handle the case.

program for judicial reform. Once this reform has become effective, the government of Argentina may wish to substitute judicial review for the existing appeal mechanism.

For other countries considering privatizing their telecommunications sector, one of the most important lessons from the Argentine experience is the importance of establishing a well-defined regulatory regime as early as possible in the privatization process and of adhering to a transparent and predictable process. This will reduce the risk premium demanded by investors. Argentina had a very narrow window of opportunity in which to implement the privatization of ENTel and so it chose not to wait until a regulatory regime was in place. Had it tried to implement both a regulatory regime and the privatization it may not have succeeded with either. However, this choice appears to have increased the risk premia required by investors and reduced the government's ability to capture the returns from the privatization.

Privatization in a series of staggered tranches of shares seems to provide governments with an opportunity to capture the returns from improved credibility. This strategy may be especially useful to countries where there are doubts as to governments' abilities to provide stable regulation. These countries may have to tolerate high risk premia in the sale of the initial tranche, but if they improve their reputations these premia will be lower in the sale of subsequent tranches. However, it is important the first tranche offered for sale be large enough to give a credible signal of a change in regime. In most cases this would mean selling a controlling interest in the firm. The widespread distribution of share ownership can also reduce the likelihood that the privatization would be reversed, as this reversal would affect too many parties.

Finally, in choosing strategies for price regulation, some caution should be exercised when selecting an RPI-X formula. Superficially, this seems to be a simple approach that requires little effort to monitor. A starting level of tariffs is set and then increases are held to inflation less some amount X which is intended to reflect technological innovation. However, the effect of this type of regulation is dependent on the starting price level. Setting this initial level is extremely problematic in cases where governments do not have the information required to determine what sort of return this generates. In such cases, as in Argentina, if the potential buyers are telecommunications operating companies, the buyers will have a significant information and therefore bargaining advantage. In Argentina this led to the government's agreement, without full knowledge, to an initial tariff level that was very profitable to the buyers at the expense of consumers.

## VIII. Conclusion

While it is too early to be certain of the outcome of Argentina's economic reform program in general and the privatization of ENTel in specific, the impact appears to be positive. As discussed in section six, expectations regarding Argentina's economic future seem to have improved dramatically since the beginning of the Menem administration. The net impact of the privatization of ENTel itself on welfare in Argentina is promising. If Argentina succeeds in implementing an effective regulatory regime along the lines outlined in the regulatory decree and if the telecommunications companies meet the performance targets outlined in the Pliego, the direct gains to the country from improvements in the telecommunications sector should be substantial. Based on a partial equilibrium analysis that is discussed in more detail in Annex A, the net benefit to Argentina over the next ten years of the move

from state to private ownership expressed in net present value terms is US\$ 1,946 million in 1991 dollars. The breakdown of these benefits is given in Table 7 and Figure 11. Of these benefits, US\$ 2,853 million accrued to the government. Most of the government's gains come from the higher taxes it will be able to collect, while a smaller proportion comes from the cash proceeds from the sale. The gain to government is essentially a gain to taxpayers, whose liability is reduced.

This gain to taxpayers is partially offset by a loss to consumers. Because of the large increase in the pulse rate, consumers of telephone services are projected to be US\$ 1,164 million worse off. Consumers will gain from the increased quantity of services that will become available because of the privatization. However, this increase in services is not projected to outweigh the effects of the price increase until 1996. The estimation does not take into account changes in quality; if the two companies meet the performance targets in the Pliego this should lead to an unmeasured benefit to consumers.

It is important to note that the pre-privatization rates charged to consumers did not reflect ENTel's costs of operation; as shown in Table 4, ENTel's losses were large and growing. As a result, Argentine taxpayers effectively had been subsidizing the consumers of telephone services. While telephone penetration in Argentina is reasonably high, not all taxpayers had access to telephone services. Those who did not were predominantly poor and rural. Thus the taxpayer subsidy to ENTel represented a transfer from these groups to urban middle- and upper-class groups.

Benefits of US\$ 69 million are projected to accrue to domestic non-labor shareholders; US\$ 174 million to ENTel's former employees; and US\$ 13 million to telephone cooperatives and other suppliers. In addition to the net domestic benefits, the foreign shareholders of the two companies are projected to accrue benefits of US\$ 3,345 million of which US\$ 3,214 million accrues to the foreign members of the operating consortia. (US\$ 31 million of the benefits to domestic shareholders were received by Argentine members of the consortia.) The high level of rents accruing to the consortia raises a question regarding the competitiveness of the bidding process. In theory, a competitive bidding process should have extracted future rents through the price paid in the auction. Yet, according to these estimates, this does not seem to have happened.

One possibility is that the successful consortia may have had access to inside information during the bidding process. However, there is no evidence that this happened. Another explanation is that when making their bid the consortia used higher discount rates than those used for the estimates. Uncertainty about the country, the risk of future regulatory changes, and the risk of renationalization are amongst the considerations that would lead foreign purchasers to have a higher discount rate. After the fact the consortia may have discovered that they had overestimated the risks and were therefore enjoying higher gains than they had anticipated. Finally, it may not be correct to classify the bidding process as fully competitive. Only three groups actually submitted bids and one of the three dropped out. This left the government of Argentina with very little leverage when negotiating the transfer contract and permitted the Telefonica and Telecom to hold out for higher pulse prices after the bidding process was over. This transferred rents from consumers to the telecommunications firms (and to the government via taxes).

These results reinforce the recommendations in section seven regarding the process of privatization and the sequencing of privatization with the implementation of regulation. Transparency and predictability in the privatization process itself are important, as is the development of well-



defined regulatory regime before privatization. If when privatizing ENTel it had been feasible to develop a regulatory regime earlier and if the privatization process itself had been more predictable, the government of Argentina probably would have been able to capture more of the benefits of privatization for its citizens. However, that being said, the benefits to Argentina of the privatization of ENTel do appear to be large and positive. More importantly, the reform program seems to have begun to alter the underlying structure of the Argentine economy, shifting the balance between the public and private sectors.

**ANNEX A. A Partial Equilibrium Analysis of the Net Impact of the Privatization and the Distribution of Costs and Benefits.**

One would expect that changes both in technical and allocative efficiency and in distribution would result from a change in ownership. These effects of privatization can be estimated in a partial equilibrium context using cost-benefit methodology developed by Jones, Tandon, and Vogelsang.<sup>1</sup> This involves developing projections for the flows generated by a firm, first in the case of private operation and then for the counterfactual case as if the firm continued to operate in the public sector. Comparison of these two cases permits the estimation of the change in benefits accruing to different groups as a result of the change in ownership. Since the focus is on the difference between the two cases, estimation is less problematic than the estimation of the absolute value of the flows in each case.

This partial equilibrium estimate of the change in welfare with the change in ownership can be broken down into a number of components. We have considered eight different groups: the domestic purchaser of the firm; the foreign purchasers of the firm; the employees of the firm; the firm's competitors; its suppliers; consumers of the firm's services; the government and citizens. This permits an estimate of relative changes in welfare between these groups.

This analysis focuses on the present value of the flows during the ten year period after ENTel's transfer in November 1990. This is consistent with the regulatory framework; ten years is the maximum period for which the government will grant monopoly power to Telecom and Telefonica. It is not clear to what degree competition in the area of basic services will take place after the year 2000. In addition, the consideration of flows after the ten year period will have a minimal impact on their present values.

The projected flows of Telecom and Telefonica are combined and treated as if they were those of a single firm. This facilitates the comparison to the counterfactual projections of ENTel operating as a single, government-owned firm. This consolidation is feasible since both Telecom and Telefonica face the same regulation and enjoy identical monopoly licenses for the same ten year period.<sup>2</sup>

All flows are projected in constant US dollars. The real discount rates used are 16.5% in 1990, 14% in 1991, and 11.5% from 1992 onwards. These rates reflect the fall in the country risk premium and international rates in general since 1990. For the purposes of the projection, real deposit

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<sup>1</sup> Leroy Jones, Pankaj Tandon, and Ingo Vogelsang, Selling Public Enterprises: A Cost-Benefit Methodology, (Cambridge, Ma: The MIT Press, 1990). This methodology is further developed in a paper presented at the World Bank conference on the welfare consequences of selling public enterprises, "Questions and Approaches to Answers" by Ahmed Galal, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang. For a detailed discussion of the application of this methodology to the case of telecommunications in Argentina see Manuel Abdala, Distributional Impact Evaluation of Divestiture in a High Inflation Economy: The Case of ENTel Argentina, Doctoral Dissertation, Boston University, 1992. The estimates presented in this case study are updated versions of the estimations presented in the dissertation.

<sup>2</sup> This does ignore the effects of potential economies of scope.

rates of 4% a year and loan rates of 12% are used. The spread between the two is high, but reflects current conditions for dollar denominated finance in Argentina.

The projections for the combined Telecom and Telefonica case are based on: (i) the valuation report prepared by the National Development Bank; (ii) the investment targets and pricing regime laid out in the regulatory framework; (iii) the accounts of the two companies through March 1992; and (iv) the business plans and quantitative information in the prospectuses for the firms' public offerings. The actual pulse price until August 1992 is used and then it is assumed that the pulse price will follow the new pricing formula to vary with the US CPI on a semiannual basis. Inflation in Argentina has been higher than that in the US, which means that the real pulse price has declined. It is assumed that this relative decline will continue. So far as their investment plans go, it is assumed that the firms will meet the quantitative targets necessary to extend the exclusive period to ten years. Intermediate input prices, mainly for equipment, are assumed to be exogenous and to grow at rate linked to wholesale prices and the exchange rate. Real average wage level for the private firms are projected to stay at the same level as in 1991. Based on actual data productivity gains are estimated at 14% in 1991 and at 8% and 1.5% for Telecom and Telefonica respectively in 1992. In accordance with current managerial expectations in the firms, an 8% productivity improvement is projected for 1993. After 1993, labor productivity improvements are assumed to be 4.2% per annum, 1% higher than ENTel's historical rate of increase of 3.2%.

The projections for ENTel are based on: (i) the firm's performance from 1980 to 1990 and (ii) on the information on the state of ENTel just prior to the privatization that was provided in the National Bank for Development's valuation of the firm. The assumptions in the counterfactual projection are different in a number of aspects. These involve the pricing regime, the treatment of labor, the level of investments, and the conditions of the sale. The basic assumption on the pulse price is that in the absence of the privatization the price would not have increased as much as it did. Instead, it is assumed that the pulse price would have been adjusted to compensate for the high level of inflation in the first quarter of 1991 and then would have stayed at the same real level for the duration of the period. The growth in labor productivity is estimated to be lower than in the private firm case; it is project to continue to increase a the historical rate of 3.2%. New investment is projected to continue at an annual level comparable to the average level achieved between 1980 and 1989. Without the debt restructuring that took place before the privatization, ENTel would have continued to operate with a higher level of debt and its associated expenses.

Based on these assumptions, it is estimated that as a result of the transfer in ownership, the value of the firm to society has increased by US\$ 5,209 million in constant 1991 dollars. (Table 7 presents the base case reflecting the assumptions outlined above and the outcomes when the discount and loan rates are vary by plus and minus 5%. The general results are robust.) Of this amount, US\$ 2,853 million accrued to the government. The most important effect is due to the change in tax revenue which brings in an additional US\$ 2,185 million. With the privatization the government gives up the collection of the indirect tax it levied on telecommunications, but this is more than out-weighed by the increased revenues from the value-added and corporate taxes. The cash proceeds from the sale, less transaction costs, are the second most important contribution to the governments' benefits, totalling US\$ 1,883 million. Quasi-rents of the order of US\$ 695 million that the government would have earned as a shareholder in ENTel are given up. While external debt worth US\$ 1,493 million was canceled the government took on debt of US\$ 2,013 from ENTel as part of its financial restructuring.

Consumers as a group are estimated to be US\$ 1,164 million worse off as a result of the privatization. The higher prices for service in the private firm scenario reduces consumer surplus, particularly in the first half of the nineties. This is offset in the second half of the nineties by the benefits accruing from the increase in the quantity of services available as a result of increased investment. Another source of benefits for consumers are the externalities created by the growth of the network, which makes telephone services more valuable to new and existing users. Aside from this network externality, changes in quality have not been included in the calculations.

Once discounted, the early costs to consumers resulting from the higher pulse price dominant the results. It is important to note that different categories of consumers will have different exposures to the change in prices. As prices are rebalanced, residential customers and those who make intra-urban call are likely to experience the largest price increase, while business customers and long-distance users should experience a relative decrease in prices.

It is also important to note that prior to the privatization ENTel operated at loss. That is to say, the prices charged to consumers did not cover the cost of the services provided. Since these losses were a liability of the Argentine federal government, effectively Argentine taxpayers were subsidizing the consumers of telephone services who were for the most part urban and relatively affluent.

Telephone cooperatives, together with other competitors providing private circuits and other miscellaneous goods, should register a net gain if they behave as price-takers and increase their prices to the same level as Telecom and Telefonica. The magnitude of the gain is small, US\$ 13 million, because the size of this segment of the industry is small.

The impact on the Argentine suppliers of telecommunications equipment has not been calculated. However, it appears that the impact of the privatization has been mixed. The prices these suppliers have been able to charge has been dramatically reduced, but, unlike ENTel, the two private companies can actually pay for the equipment they purchase.

Provided that the Argentine fulfills its commitment to transfer 10% of the privatized companies shares to ENTel former employees, labor gains from the transfer of ownership. After deducting the foregone rents associated with changes in their labor contracts, employees gain US\$ 174 million.

The value of the two firms combined private earnings is US\$ 6,753. Subtracting the US\$ 466 of the flows accruing to the workers' shares, this means that the present value of the 90% sold to the consortia and in the public offerings is US\$ 6,287. This is much higher than the US\$ 2,954 that the private owners paid for the two firms together. However, this is very close to the stock market value of the firm. Re-expressed in 1992 dollars, the projected value of the two firms together is US\$ 8,423.<sup>3</sup> The stock market value for 100% of the firm has ranged from a low of US\$ 5,789 million to a high of US\$ 10,082 and was US\$ 7,419 million at the end of August 1992.

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<sup>3</sup> Recall that the discount rates used in the model for are 16.5% for 1990 and 14% for 1991.

The domestic members of the holding companies enjoy a net benefit of US\$ 45 million from their participation in the transaction. The Argentine purchasers who bought approximately 60% of the stock available through the public offerings of the two firms enjoy a gain of US\$ 43 million. This is despite the fact that Telecom stock has dropped from its initial offer price of 0.399 a share to 0.288 at the end of August, 1992.

The foreign buyers of the two telecommunications firms, including both those in the consortium and those who bought shares in the public offering, are the largest beneficiaries of the transfer. The net benefit to this group is US\$ 3,245 million of which US\$ 3,214 million accrues to the foreign members of the operating consortia. Many of these buyers were financial institutions which swapped their holdings of Argentine government debt in order to make this purchase. This transaction appears to have been very profitable for these investors.

The high level of rents accruing to the consortia raises a question regarding the competitiveness of the bidding process. In theory, a competitive bidding process should have extracted future rents through the price paid in the auction. Yet, according to these estimates, this does not seem to have happened.

One possibility is that the successful consortia may have had access to inside information during the bidding process. However, there is no evidence that this happened. Another possibility is that when making their bid the consortia used higher discount rates than those used for the estimates. Uncertainty about the country, the risk of future regulatory changes, and the risk of renationalization are amongst the considerations that would lead foreign purchasers to have a higher discount rate. After the fact the consortia may have discovered that they had overestimated the risks and were therefore enjoying higher gains than they had anticipated. Finally, the bidding process may not have been fully competitive. Only three groups actually submitted bids and one of the three dropped out. This left the government of Argentina with very little leverage when negotiating the transfer contract and permitted Telefonica and Telecom to hold out for higher purchase prices after the bidding process was over. This transferred rents from consumers to the telecommunications firms (and on to the government via taxes).

Whatever the reason for the rents accruing to the members of the consortia, the fact that many of these benefits accrue to foreigners means that the net benefit to Argentina is less than the total social benefit resulting from the transfer. Subtracting the benefits accruing to foreigners, the net domestic benefit to Argentina from the transfer of ownership is US\$ 1,965 million. This is a substantial benefit, but it is less than half of the total estimated benefits. This raises the question as to whether this proportion might have been higher if there had been more competition or less uncertainty in the bidding process.

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**Table 1**                      **Presidents of Argentina, 1862-1992**

<u>Name</u>	<u>Period</u>	<u>Means of Accession to Office</u>
Bartolomé Mitre	1862-68	Military victory
Domingo Faustino Sarmiento	1868-74	Election
Nicolá Avellaneda	1874-80	-do-
Julio Argentino Roca	1880-86	-do-
Miguel Juárez Celman	1886-90	-do-
Carlos Pellegrini (vice president)	1890-92	Resignation of president
Luis Sáenz Peña	1892-95	Election
José Evaristo Uriburu (vice president)	1895-98	Resignation of president
Julio Argentino Roca	1898-1904	Election
Manuel Quintana	1904-06	-do-
José Figueroa Alcorta (vice president)	1906-10	Death of president
Roque Sáenz Peña	1910-14	Election
Victorino de la Plaza (vice president)	1914-16	Death of president
Hipólito Yrigoyen	1916-22	Election
Marcelo T. de Alvear	1922-28	-do-
Hipólito Yrigoyen	1928-30	-do-
José F. Uriburu	1930-32	Military revolt
Agustín P. Justo	1932-38	Election
Roberto M. Ortiz	1938-40	-do-
Ramón S. Castillo (vice president)	1940-43	Delegation of authority by president
Arturo J. Rawson	1943	Military revolt
Pedro Pablo Ramírez	1943-44	Coup d'état
Edelmiro J. Farrell	1944-46	-do-
Juan Domingo Perón	1946-55	Election
Eduardo Lonardi	1955	Military revolt
Pedro E. Aramburu	1955-58	Coup d'état
Arturo Frondizi	1958-62	Election
José M. Guido	1962-63	Coup d'état
Arturo Illia	1963-66	Election
Juan Carlos Onganía	1966-70	Military revolt
Roberto Marcelo Levingston	1970-71	Coup d'état
Alejandro Agustín Lanusse	1971-73	-do-
Héctor J. Cámpora	1973	Election
Juan Domingo Perón	1973-74	-do-
María Estela (Isabel)		
Martínez de Péron (vice president)	Jul 74-Mar 76	Death of president
Jorge Rafael Videla	May 76-Mar 81	Coup d'état
Roberto Viola	Mar-Dec 81	Resignation of president
Leopoldo Galtieri	Dec 81-Jun 82	-do-
Reynaldo B. Bignone	Jul 82-Dec 83	Military revolt
Raúl Alfonsín	Dec 83-Jun 89	Election
Carlos Saul Menem	June 1989-	Election

**Table 2  
ENTel's Demand Backlog**

<b>Year</b>	<b>Estimated Unfilled Line Orders (000's)</b>	<b>Lines in Service (000's)</b>	<b>Unfilled Orders as Percentage of Lines in Service</b>
1976	622	1678	37
1977	698	1692	41
1978	776	1728	45
1979	863	1797	48
1980	934	1879	50
1981	894	1992	45
1982	896	2124	42
1983	1026	2245	46
1984	1193	2357	51
1985	1298	2462	53
1986	1149	2606	44
1987	851	2721	31
1988	686	2856	24
1989	283	3058	9
1990	361	3096	12
1991	333	3220	10

*Sources: ENTel 1985 Report, SIGEP, and Telefonica and Telecom reports.*

**Table 3**  
**Selected Service Quality Indicators for ENTel**

<b>Year</b>	<b>Local Calls Completed (percent)</b>	<b>Long Distance Domestic Calls Completed (percent)</b>	<b>Average Pending Repair Orders as Percentage of Lines in Service</b>	<b>Average Repair Waiting Time (days)</b>
1975	NA	NA	1.6	16
1976	NA	NA	2.0	15
1977	NA	NA	3.0	30
1978	NA	NA	1.6	24
1979	NA	NA	0.7	12
1980	NA	NA	0.9	12
1981	NA	NA	1.0	14
1982	43.6	NA	1.0	10
1983	48.6	27.1	1.3	8
1984	47.0	24.8	1.9	12
1985	43.7	21.6	1.4	10
1986	44.6	18.4	1.5	10
1987	46.0	NA	1.3	10
1988	47.0	23.0	1.6	10
1989	48.9	29.2	2.0	11
1990	49.0	29.7	2.5	11
<b>Standard</b>	<b>95.0</b>	<b>85.0</b>	<b>0.5</b>	<b>2</b>

*Sources: ENTel, SIGEP, Telefonica and Telecom reports.*

Table 4  
**ENTel's Profits (Losses) and Investment  
 1980–1990 (millions of australes)**

YEAR	ENTel's Profits and Losses (current prices)		ENTel's Contribution to GDP (1970 australes) (3)	Argentina's GDP (1970 australes) (3)	ENTel GDP as Share of Arg. GDP (percent)	ENTel's Investment (1970 australes) (4)	Gross Investment in Argentina (1970 australes) (5)	ENTel's Investment as a Share of Gross Investment in Argentina (6)
	SIGEP (1)	PEPIS (2)						
1980	0.006	0.004	105.1	11295.3	0.930		137.58	
1981	0.020	0.047	106.9	10542.9	1.014	3.24	105.40	3.07
1982	0.028	(0.321)	116.7	10020.8	1.165	1.69	84.61	2.00
1983	0.472	3.912	124.9	10321.0	1.210	2.07	75.59	2.74
1984	(184.700)	(181.000)	131.8	10584.9	1.245	2.09	67.23	3.11
1985	(77.105)	(70.000)	142.5	9876.5	1.443	1.14	53.78	2.12
1986	(536.479)	(438.000)	152.5	10656.2	1.431	1.92	62.72	3.06
1987	531.945	753.000	160.9	10870.9	1.480	3.92	73.43	5.34
1988		(6,481.000)	169.6	10654.0	1.592	7.94	65.49	12.12
1989			151.7	9785.7	1.550	3.36	46.01	7.30
1990								

*Sources and Notes:*

(1) SIGEP, "Estados Contables de las Principales Empresas Públicas, 1980–1987."

(2) PEPIS. Profits and losses from ENTel's reports have been adjusted to correct for inflation accounting procedures and extraordinary items.

(3) IADE, "Realidad Económica 92–93" (based on SIGEP and BCRA).

(4) SIGEP. Data for 1981–86 period include Post Office.

(5) IEERAL.

(6) Data for 1981–86 period include Post Office.

**TABLE 5: ORIGINAL SCHEDULE FOR THE SALE OF ENTEL**

January 10, 1990	:	Publication of the call to bid.
January 22	:	Opening of the consultation period.
March 2	:	Last date to carry on consultations on the Document.
March 21	:	Deadline for the presentation of bidders for their prequalification, and the opening of the presentations at 18 hrs.
March 28	:	Notification of the results of the prequalification.
April 5	:	Opening of the period of access to information.
May 22	:	Closing of the period of access to information.
June 11	:	Deadline for the presentation of the proposals of the prequalified bidders, and opening of the proposals at 18 hrs.
June 14	:	Notification of the preaward.
June 22	:	Deadline for the presentation of objections to the preaward.
June 28	:	Deadline for the award by decree of the Executive Branch and resolution of the objections to the preaward.
August 6	:	Deadline to sign the Transfer Contract.
October 8	:	Deadline to Take Possession.

**Table 6**  
**Membership of the Cointel and Nortel Consortia**

TELEFONICA -- Shareholding in Cointel consortium

Investor	Percentage Ownership
CVC(Citicorp Venture Capital)	20.00%
Banco Rio de la Plata S.A.	15.26%
Telefonica International	10.13%
Inversora Catalinas	8.13%
Banco Central de Espana S.A.	7.04%
Sociedad Comercial del Plata S.A.	5.14%
Banco Hispano Americano S.A.	5.00%
Telarg Investment Corp.	4.33%
Southtel Equity Corporation	4.22%
Zurich Ltd.	4.16%
The Bank of Toyko Limited	4.16%
The Bank of New York	4.16%
Other Investors*	7.99%
	100.00%

\* No one of which owns 4.16% or more

TELECOM -- Shareholding in Nortel Consortium

Investor	Percentage Ownership
STET	32.50%
France Cables	32.50%
Perez Companac	25.00%
J.P. Morgan	9.75%
Morgan Capital Corporation	0.25%
	100.00%

**Table 7**  
**Evaluation of Impact of ENTel Divestiture (millions of 1991 dollars)**

	Base Case			Discount + Loan Rate 5% lower			Discount + Loan Rate 5% higher		
	PRIVATE	PUBLIC	Difference	PRIVATE	PUBLIC	Difference	PRIVATE	PUBLIC	Difference
<b>GOVERNMENT</b>									
+ Taxes	6,247	4,061	2,185	7,709	5,396	2,313	5,186	2,995	2,192
+ Net Quasi Rents	636	1,331	(695)	668	2,813	(2,145)	607	383	224
+ Net Sale Proceeds (cash)	1,883	0	1,883	1,972	0	1,972	1,803	0	1,803
+ Debt Takeover	(2,013)	0	(2,013)	(1,936)	0	(1,936)	(2,093)	0	(2,093)
<b>Government Subtotal</b>	<b>6,753</b>	<b>5,393</b>	<b>1,360</b>	<b>6,413</b>	<b>8,209</b>	<b>204</b>	<b>5,504</b>	<b>3,378</b>	<b>2,126</b>
+ Debt Cancelled at Market Value	955	0	955	955	0	955	955	0	955
+ Debt Cancelled at Excess Market Value	538	0	538	141	0	141	984	0	984
<b>Government Total</b>	<b>8,246</b>	<b>5,393</b>	<b>2,853</b>	<b>9,509</b>	<b>8,209</b>	<b>1,300</b>	<b>7,443</b>	<b>3,378</b>	<b>4,065</b>
<b>EMPLOYEES</b>									
+ As Shareholders	466	0	466	693	0	693	319	0	319
+ Labor Rents	0	292	(292)	0	351	(351)	0	248	(248)
<b>PRIVATE DOMESTIC SHAREHOLDERS</b>									
+ Diverse Shareholders	43	0	43	434	0	434	(204)	0	(204)
+ Concentrated Shareholders	45	0	45	61	0	61	32	0	32
<b>FOREIGN SHAREHOLDERS</b>									
+ Consortia	3,214	0	3,214	4,723	0	4,723	2,203	0	2,203
+ Diverse Shareholders	31	0	31	305	0	305	(143)	0	(143)
<b>COMPETITORS</b>	<b>123</b>	<b>110</b>	<b>13</b>	<b>169</b>	<b>152</b>	<b>17</b>	<b>91</b>	<b>81</b>	<b>10</b>
<b>PROVIDERS</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>CITIZENS</b>									
+ Via Shadow Increments	0	0	0	0	0	0	0	0	0
<b>SUBTOTAL</b>	<b>12,168</b>	<b>5,795</b>	<b>6,372</b>	<b>15,694</b>	<b>8,712</b>	<b>7,181</b>	<b>9,741</b>	<b>3,707</b>	<b>6,034</b>
<b>CONSUMERS</b>	<b>64,574</b>	<b>65,738</b>	<b>(1,164)</b>	<b>79,619</b>	<b>80,357</b>	<b>(739)</b>	<b>53,735</b>	<b>55,158</b>	<b>(1,422)</b>
<b>TOTAL</b>	<b>76,742</b>	<b>71,533</b>	<b>5,209</b>	<b>95,312</b>	<b>89,070</b>	<b>6,443</b>	<b>63,476</b>	<b>58,865</b>	<b>4,611</b>
<b>WELFARE RESULT</b>									
Net Change in Welfare within Argentina*			1,965			1,414			2,552

\*Total less foreign shareholder benefits.



**Table 8**  
**Operating Results for TELECOM and TELEFONICA**

Fiscal year ending September 30, (in millions of US dollars) /2.	TELECOM		TELEFONICA	
	1991 /1.	1992	1991 /1.	1992
Operating Revenues	890	1,211	1,161	1,597
Depreciation	273	288	217	265
Management fees	42	55	48	60
Net Income	56	152	122	221
Dividends /3.	51	111	29	86
Shareholders' equity at purchase price(\$)				
Consortium (60%)	539		631	
Diverse (30%)	1,227		830	
Internal Rate of Return				
Operator /4.	26.9%		203.2%	
Consortium	58.1%		72.4%	
Diverse	-67.5%		42.9%	

Note: Constant 1992 terms.

/1. Eleven months to September 30, 1991

/2. 1 US\$ = .9913 pesos

/3. TELECOM only: to be paid out in following year

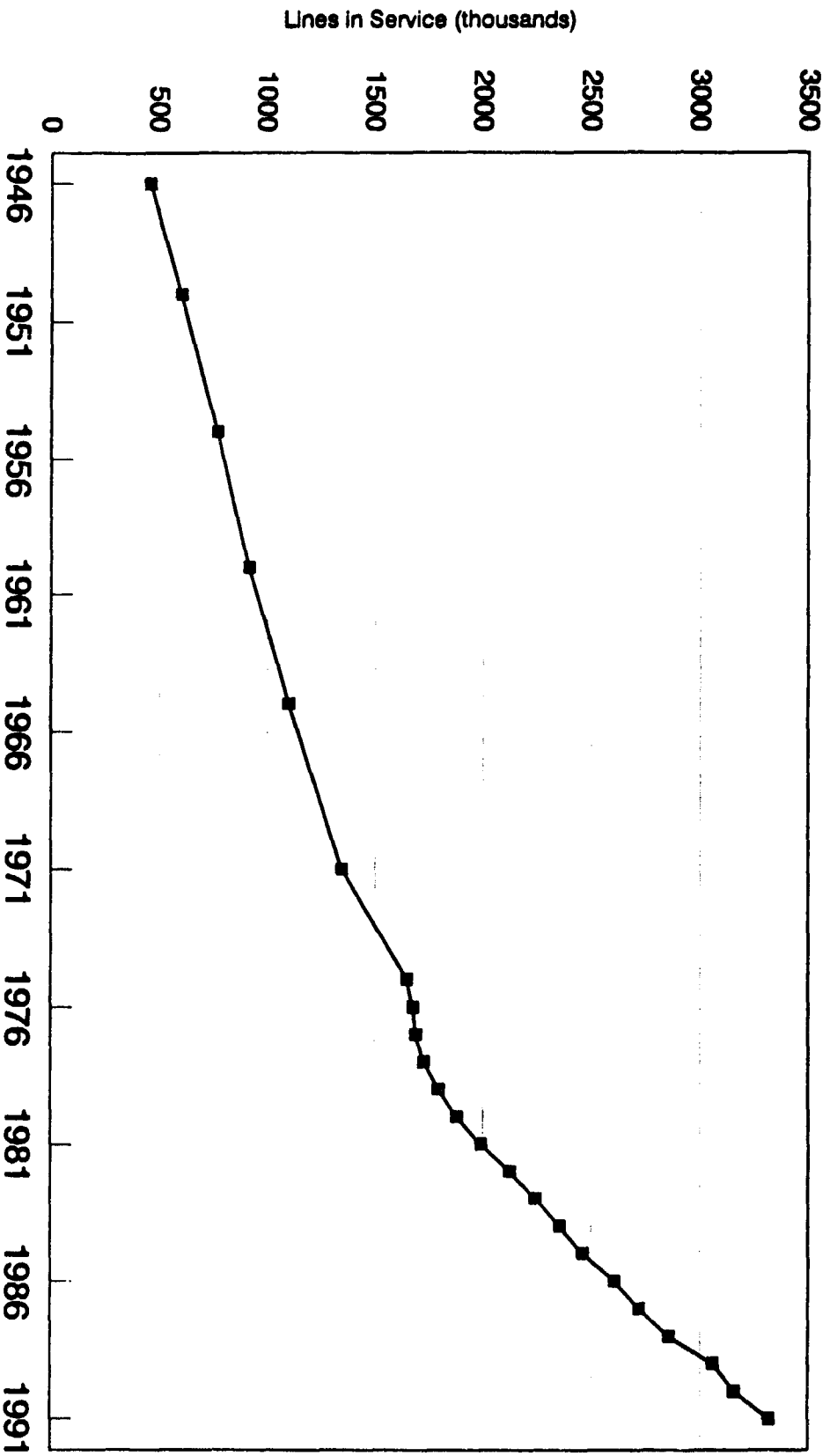
/4. Based on outlay for purchase and fees only

**Table 9**  
**TELEFONICA and TELECOM Investment, 1991 – 1997**

	1991	1992	1993	1994	1995	1996	1997	Total
<b><u>TELEFONICA INVESTMENT</u></b>								
Telefonica's network investments (in millions of US dollars)	208.6	615.2	549.2 n.	558.5 n.	596.3 n.	639.0 n.		3,166.8
Lines in service added in fiscal year ending 9/30 (unaudited)	66,176	276,364						
Lines in services to be added per calendar year								
– for seven year exclusivity	70,000	105,000	154,000	136,000	85,000	69,000		619,000
– for ten year exclusivity	91,000	137,000	200,000	176,000	111,000	89,000		804,000
<b><u>TELECOM INVESTMENT</u></b>								
Telecom's network investments (in millions of US dollars)	132.0	609.0	771.4 n.	688.0 n.	600.8 n.	596.5 n.		3,397.8 (1991–1996)
Lines in service added in fiscal year ending 9/30 (unaudited)	50,809	221,941						
Lines in services to be added per calendar year								
– for seven year exclusivity	60,000	90,000	135,000	121,000	87,000	72,000	12,000	577,000
– for ten year exclusivity	79,000	117,000	175,000	160,000	114,000	92,000	15,000	752,000

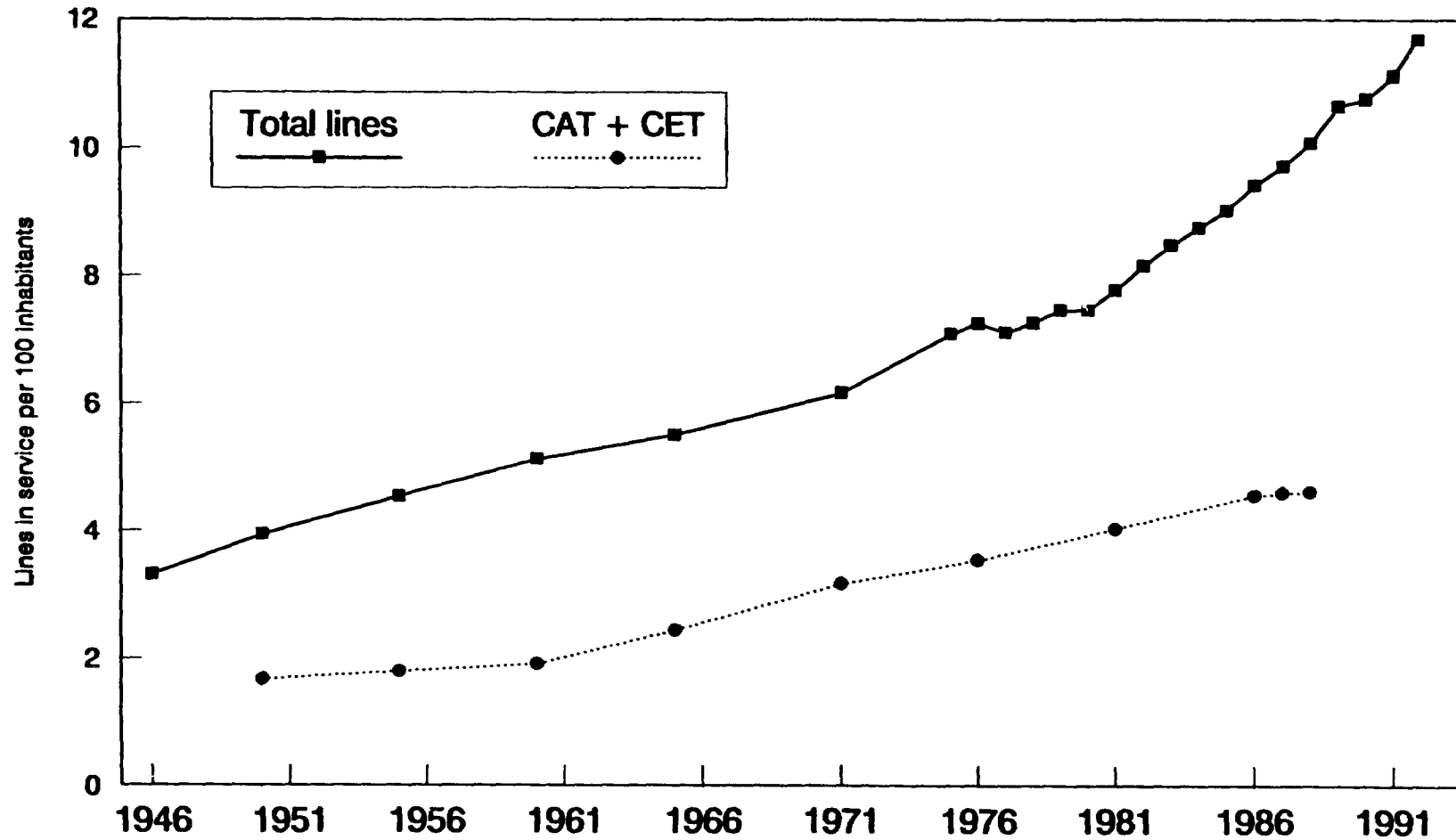
n. Company projections

**Figure 1**  
**Lines in Service, 1946 - 1991**



Sources: ENTEL and Telefonos Reports, Ghogri (1985), SKGEP, and BCRA

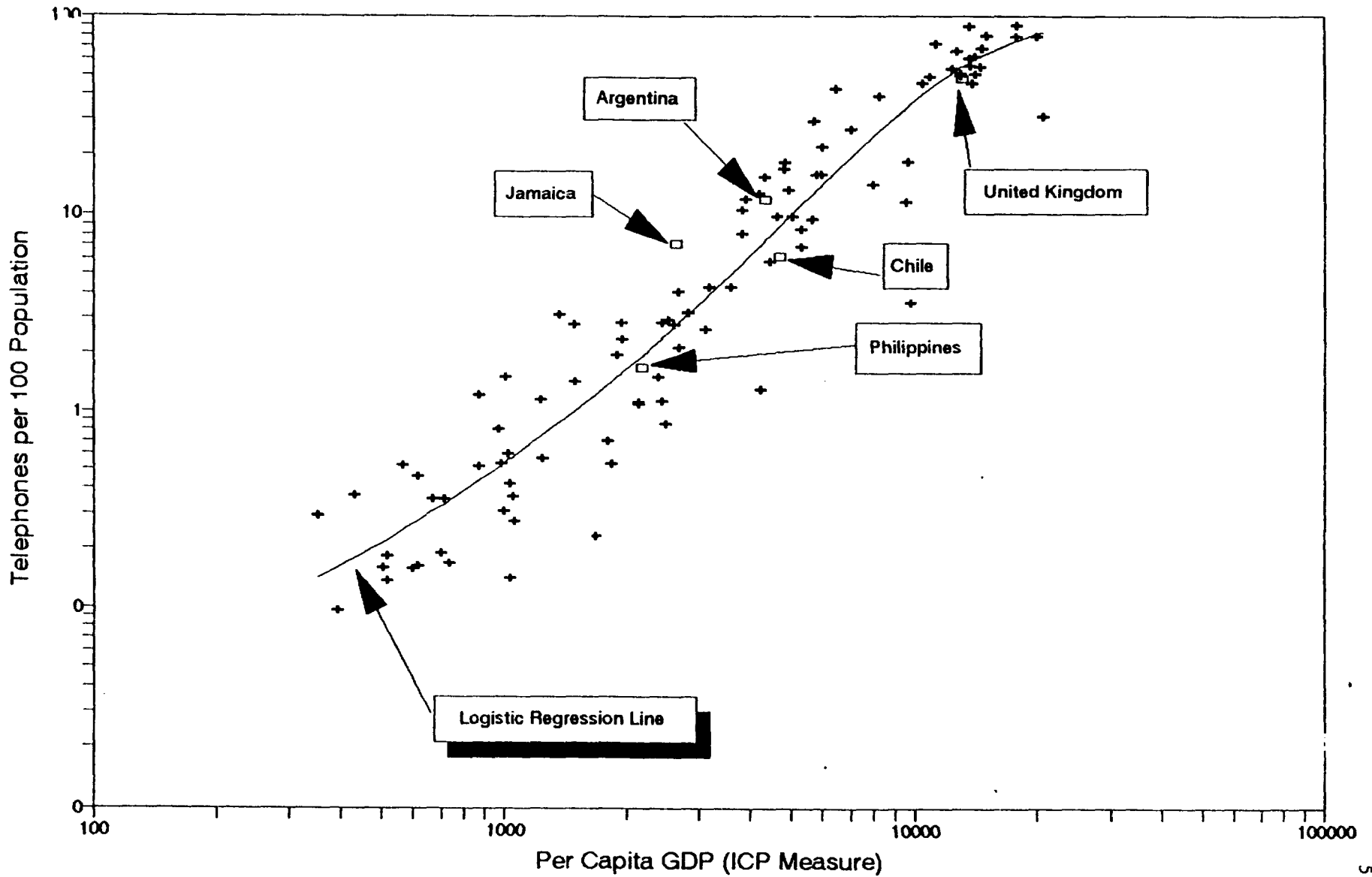
**Figure 2**  
**Telephone Density in Argentina, 1946 - 1992**



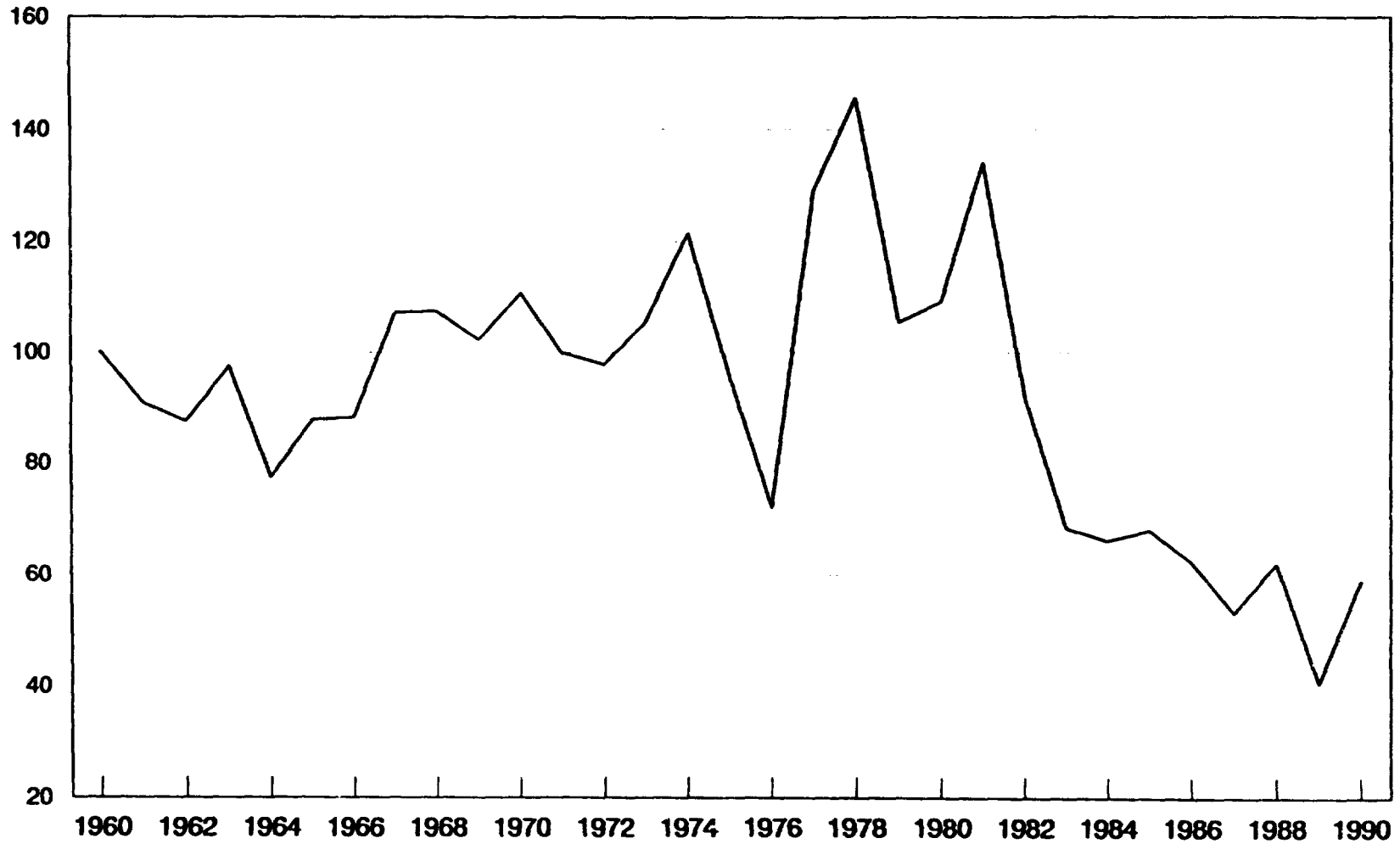
Sources: ENTel and Telefonica Reports, Givogri (1985), SIGEP, and BCRA.

Figure 3. Per Capita GDP and Telephone Density in 100 Countries (1988)

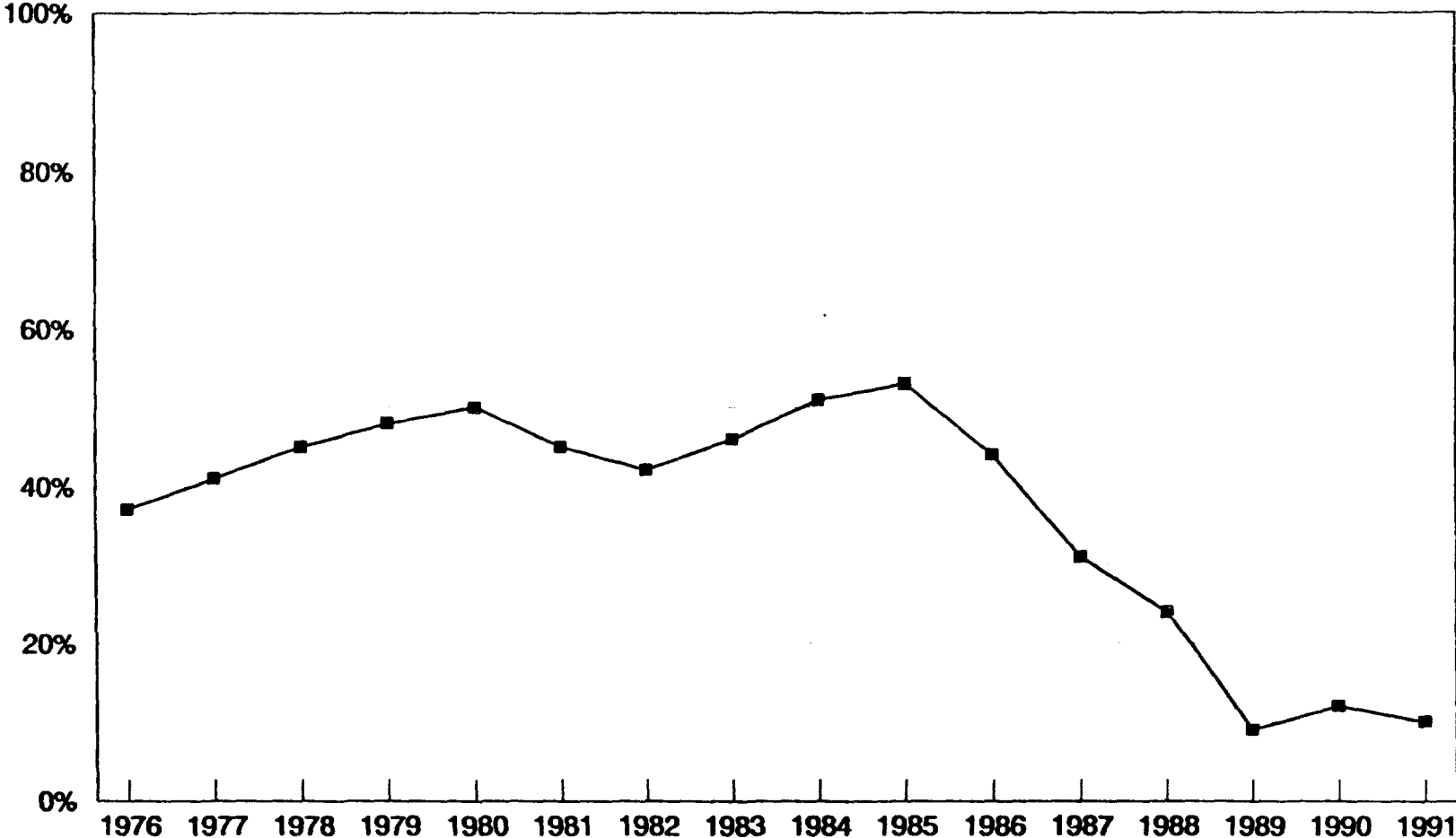
TEL DEN



**Figure 4**  
**SIGEP Communications Price Index, 1960 - 1990**  
(Constant Values: 1960 = 100)

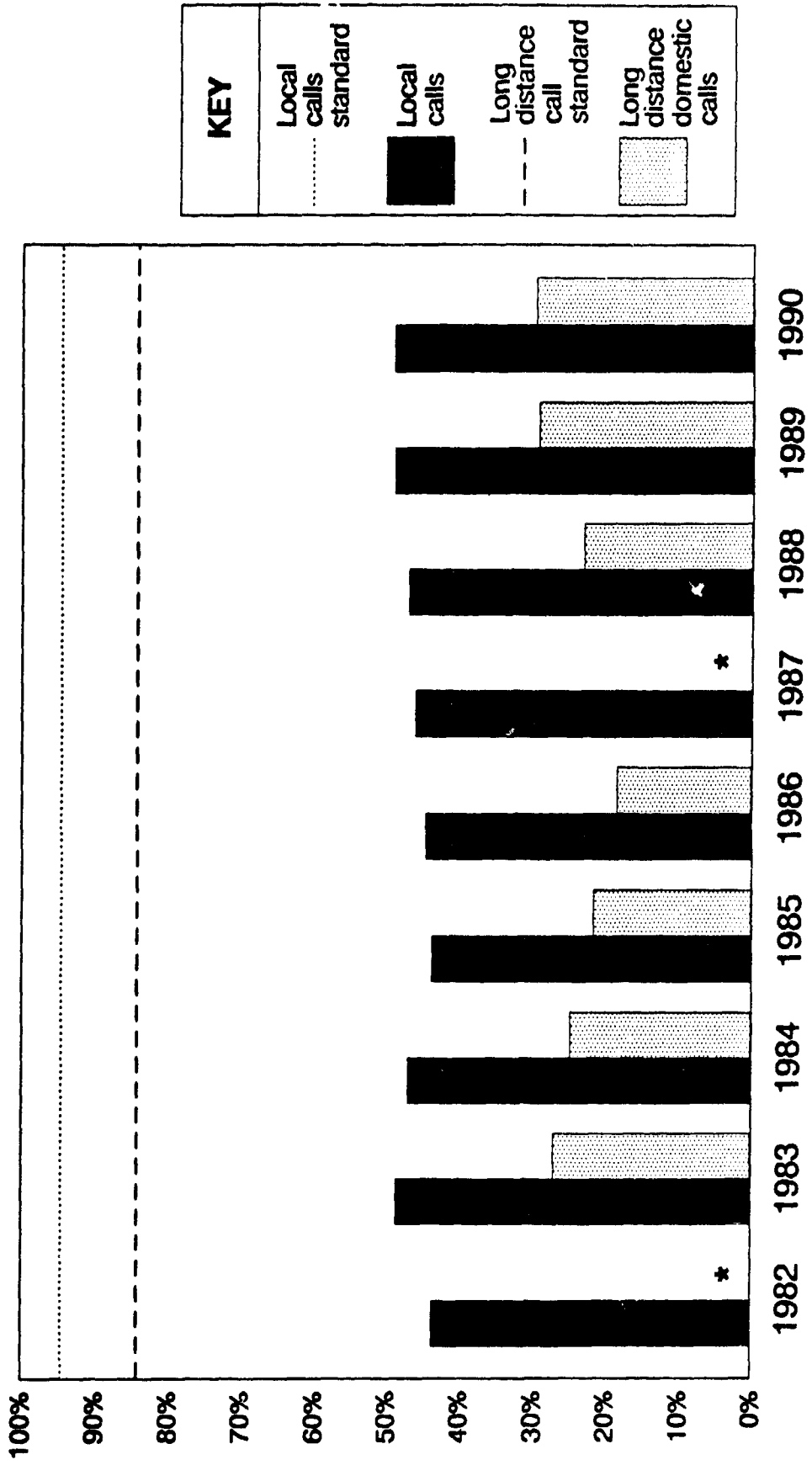


**Figure 5**  
**The Backlog at ENTel: Unfilled Line Orders as a Percentage of Lines in Service, 1976 - 1991**



Sources: ENTel 1985 Report, SIGEP, and Telefonica and Telecom reports.

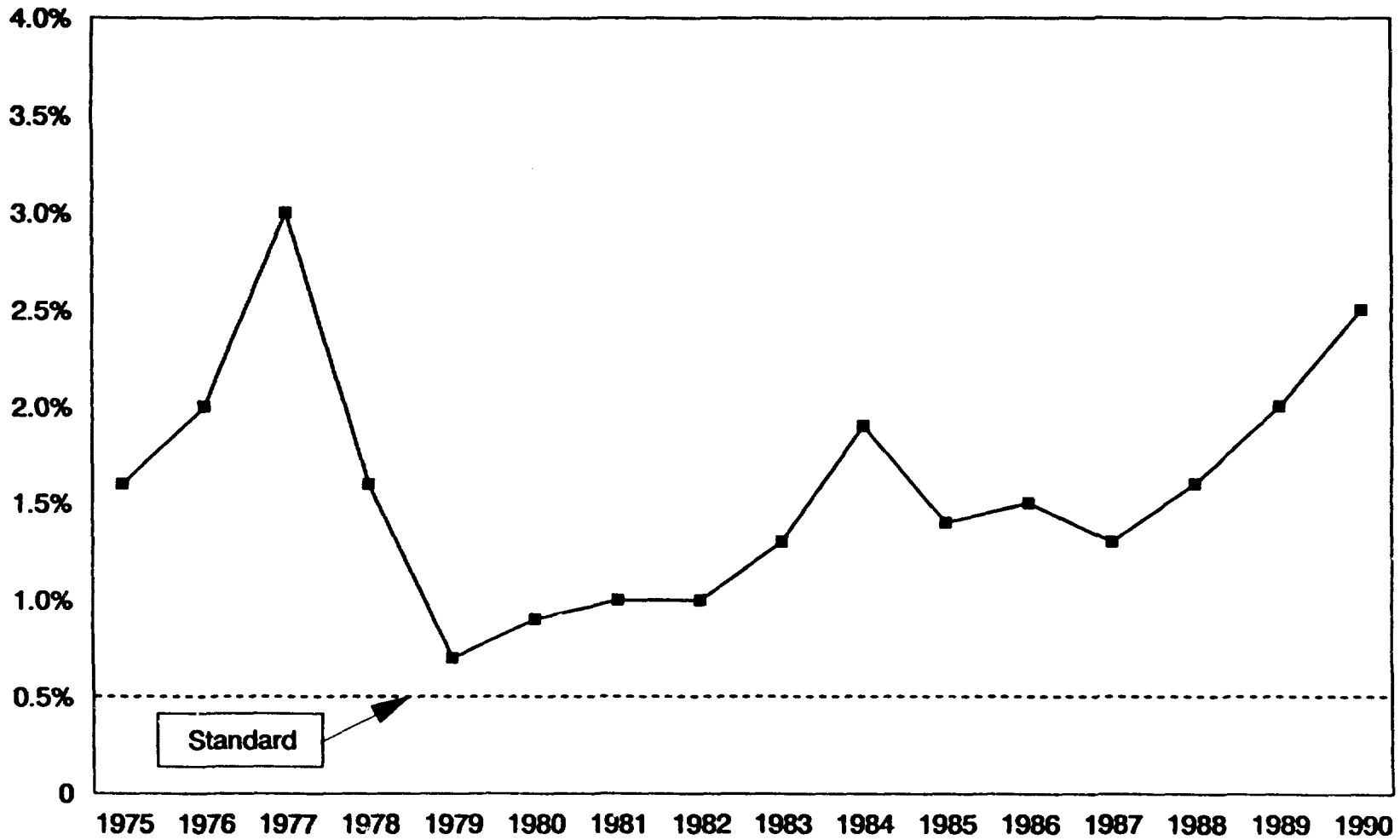
**Figure 6**  
**Call Completion Rates, 1982 - 1990**  
 (percent)



Notes: \* Data unavailable.  
 Sources: ENTel, SIGEP, Telefonica and Telecom reports.

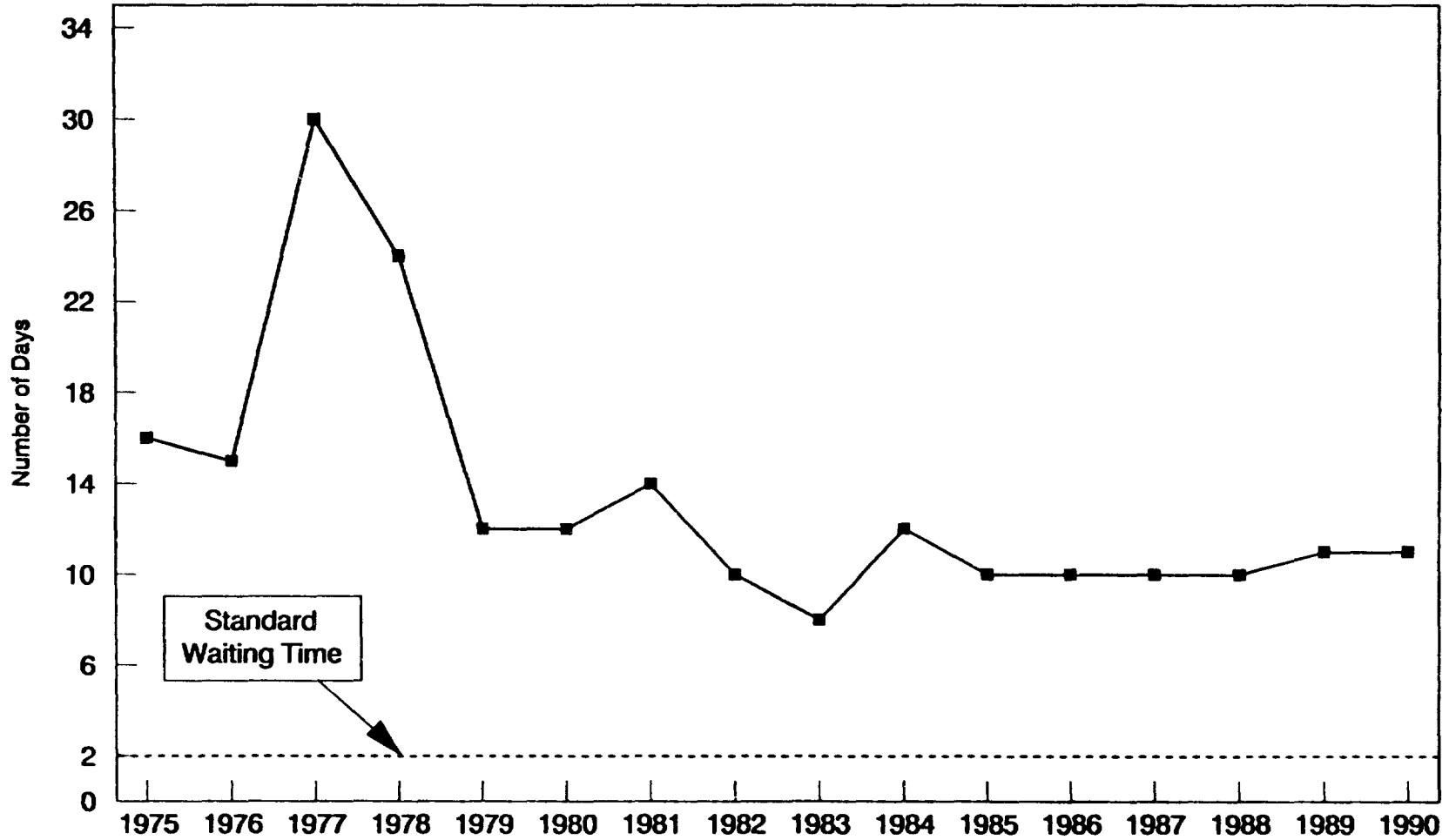


**Figure 7**  
**Pending Repair Orders**  
**as Percentage of Lines in Service, 1975 - 1990**



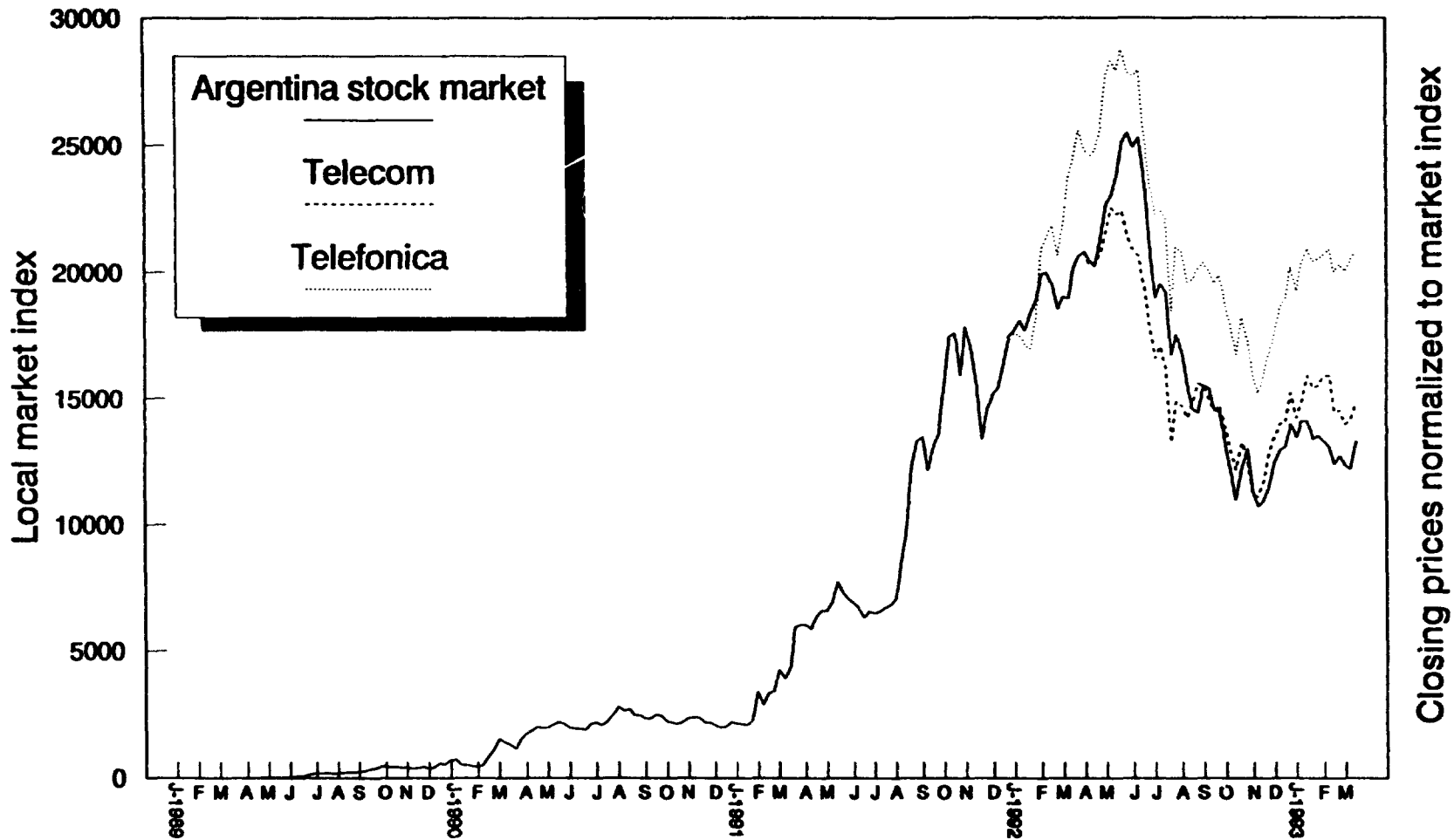
Sources: ENTel, SIGEP, Telefonica and Telecom reports.

**Figure 8**  
**Average Repair Waiting Time, 1975 - 1990**



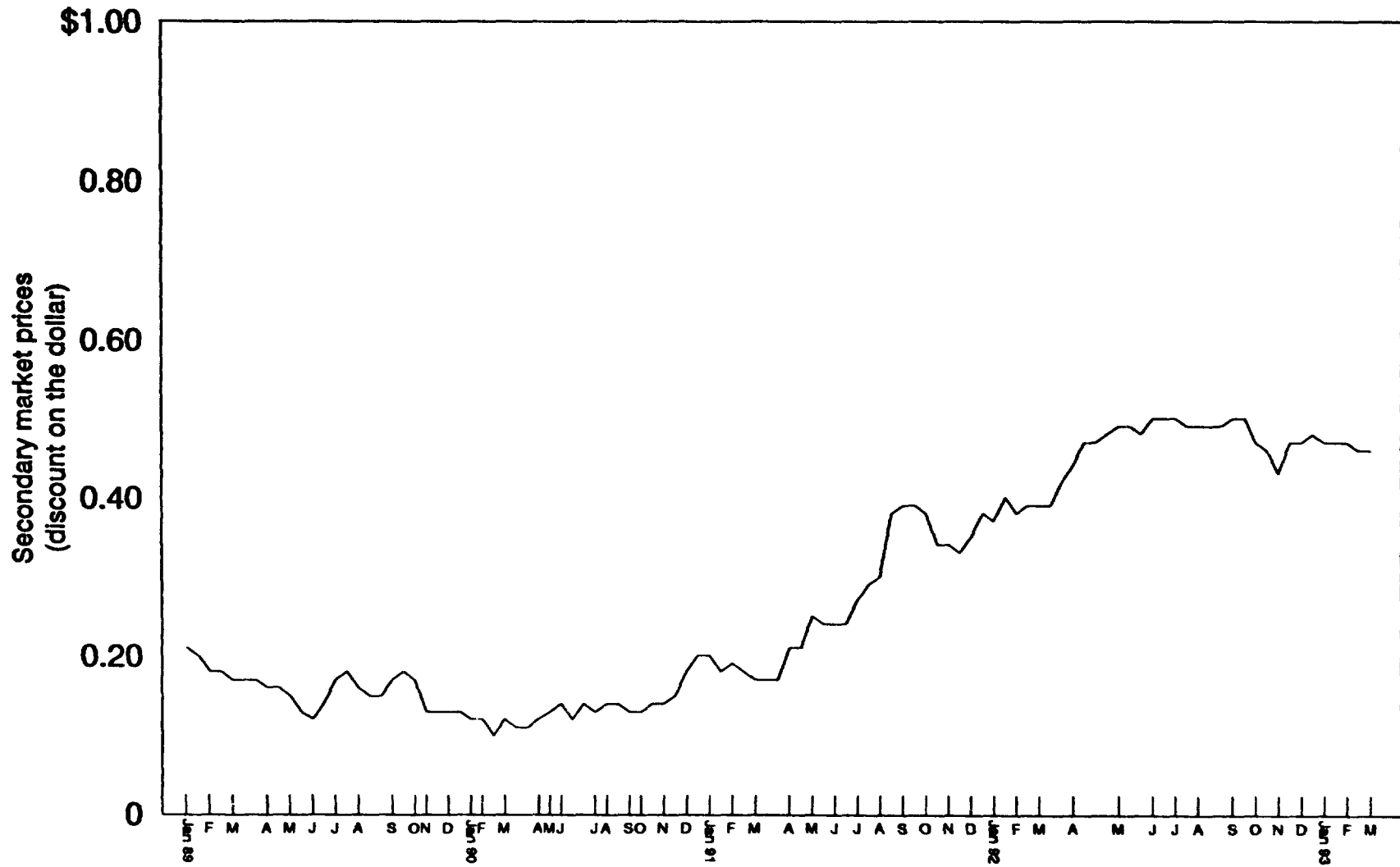
Sources: ENTel, SIGEP, Telefonica and Telecom reports.

**Figure 9**  
**Argentina Stock Market Index**  
**and Closing Prices for TELECOM and TELEFONICA**  
**(January 1989 - March 1993)**



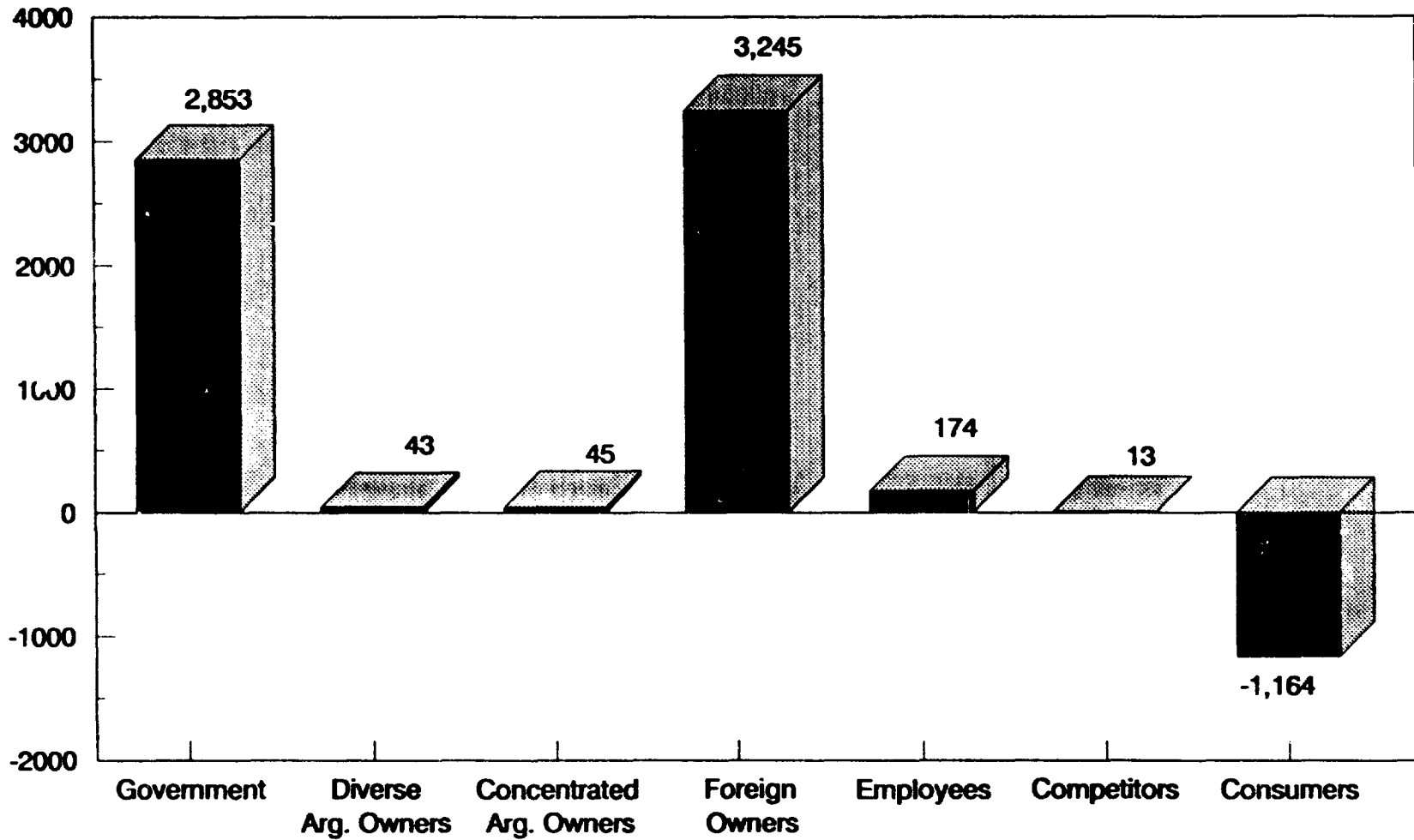
Source: IFC Emerging Markets Data Base - Weekly Index data

**Figure 10**  
**Argentina: Value of Sovereign Debt in Secondary Markets**



Source: Salomon Brothers

**Figure 11**  
**Distributional Results of Divestiture**  
(\$US million)



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