INDEFEASIBLE RIGHTS OF USE AMIDST THE CAPACITY BOOM

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Abstract

This paper considers indefeasible rights of use (IRUs) against a backdrop of the heightened submarine cable construction and upgrade activity currently being undertaken in the trans-Pacific region. In the first part, this paper looks at the ever-increasing consumer demand for capacity and the response by industry that is seeing to the current capacity boom. The second part of this paper discusses IRUs as a means for industry participants to acquire some of the capacity that is becoming available, and some examples of common reasons for acquiring IRUs. As part of that discussion, this paper makes a superficial distinction between IRUs which are acquired because of the specific treatment afforded to them under Australian tax law (referred to in this paper as 'Tax IRUs'), and IRUs acquired for other reasons (referred to in this paper as 'General IRUs'). Finally, the third part of this paper considers some of the unique issues which can arise in structuring and negotiating an IRU agreement, whether for a General IRU or a Tax IRU. It is seen that these issues need to be carefully considered and addressed by the parties in order to conclude an IRU agreement that appropriately reflects and facilitates each of their commercial objectives both at the outset and throughout the term.

A new era of capacity demand and supply

The demand for capacity, as ever, is growing. The increase in demand in recent years can be attributed to a number of developments such as the uptake of high definition TV, IPTV and VoIP. To a large extent, it can also be attributed to the continuing growth of the Internet and the evolution of the way in which it is used. One example of this evolution which has contributed to the increased demand for capacity is the emergence of websites such as YouTube, MySpace and Facebook. These websites have two key things in common. Firstly, they all facilitate and rely significantly on user-generated content – that is, videos, photos and other forms of data uploaded by users. Secondly, they have all progressively grown in popularity.

Taking Facebook as an example, it was reported in May 2007 that the number of users of the website was growing 3% week on week.[1] Also, the number of users visiting the site in a given month grew in a period of less than 3 years from its launch in 2004 to a staggering 17 million or so users, as is depicted in the chart below.[2]

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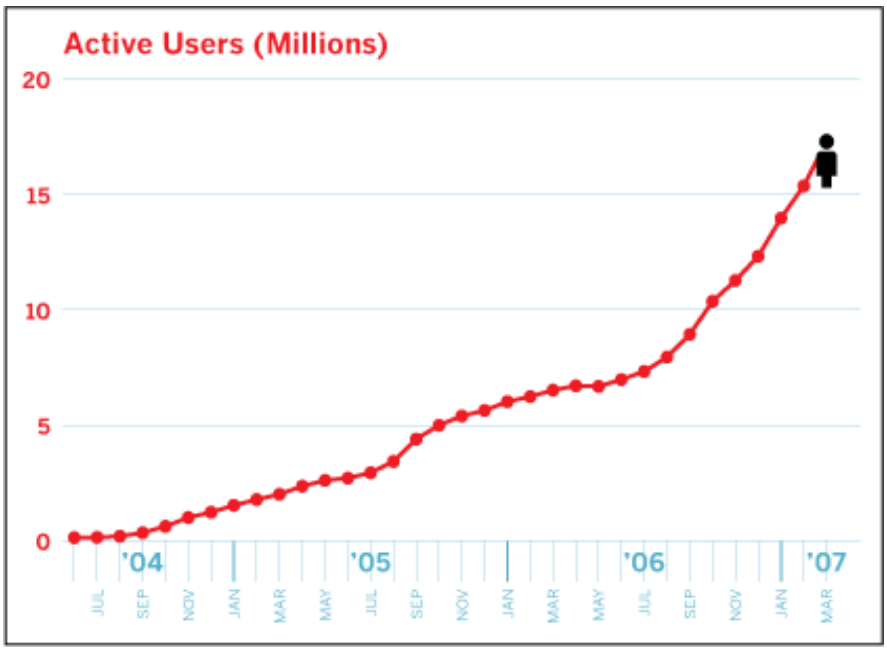
1 Fast Company, 'Facebook by the Numbers', Issue 115, May 2007, http://www.fastcompany.com/magazine/115/open_features-hacker-dropout-ceo-facebook-numbers.html.

2 As above.



The impact of this phenomenon is that while 5 to 10 years ago, our networks mainly had to cope with user downloads and only minimal user uploading activity, they are now having to cope with extraordinary amounts of upstream data as well.

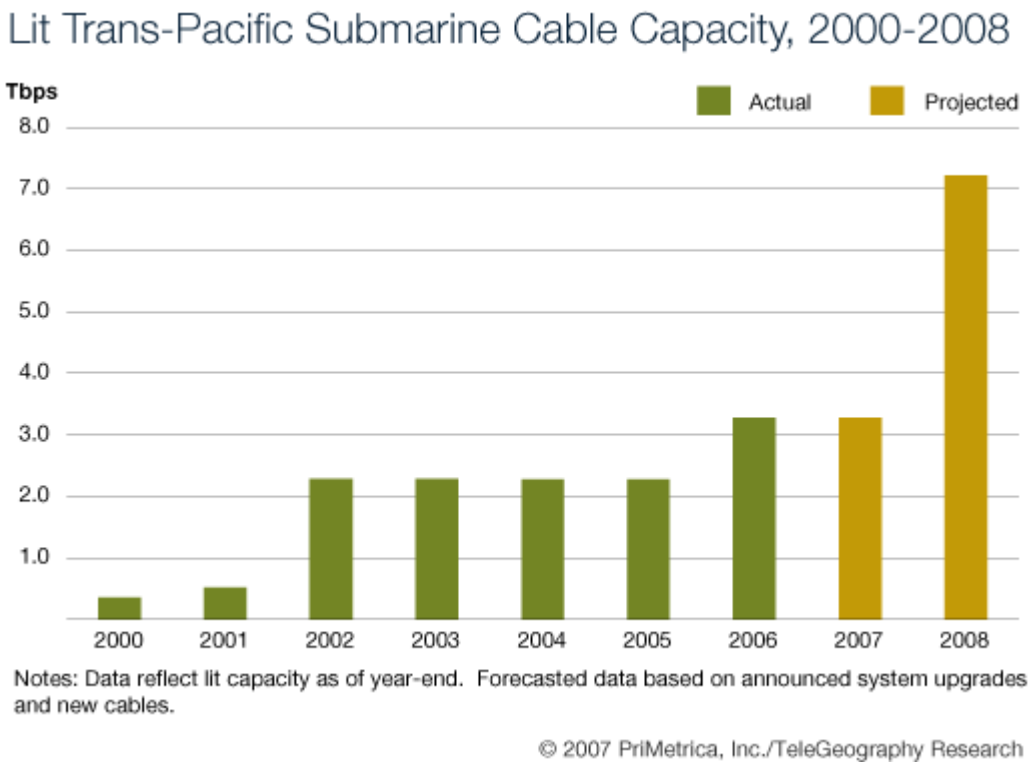
Industry players have clearly responded to the demand for capacity as is apparent from the profusion of submarine cable commission and upgrade projects announced over the past 2 years.

Some of the key projects in the trans-Pacific region include:

- PIPE Networks' construction of PPC-1 between Sydney and Guam, and its joint proposal with Kordia Group to construct PPC-2 between Sydney and New Zealand;
- Telstra's construction of a new cable between Sydney and Hawaii;
- the construction of the Unity cable between Japan and the US by a consortium involving Google, and the proposal by separate a Google consortium to construct the SJC cable to link Japan with Guam, the Philippines, Hong Kong, Thailand and Singapore;
- the upgrade of the Australia Japan Cable (completed in April this year); and
- the ongoing upgrades of the Southern Cross Cable Network being carried out this year.

The announcement of these projects makes the dramatic increase in forecasted available capacity in the region no surprise. The chart below, which is taken from a September 2007 industry report,[3] forecasts the available lit capacity in the region at the end of 2008 to more than double what was forecasted to be available at the end of 2007. In view of the further cable projects announced since the time of the report, we can only expect further a increase in 2009 and beyond.

[3] Telegeography, 'Yarrr! Google Enters the Transpacific Submarine Cable Market', 24 September 2007, http://www.telegeography.com/wordpress/?m=200709.



The various cable owners and consortium members appear to be driven by their own strategic objectives in their decisions to build or upgrade cables. It is clear, however, that this upsurge of activity is in all cases founded on at least one common factor, being the ever-increasing demand for capacity.

Getting hold of the capacity

We have seen that the continual emergence of new, data intensive applications, websites and services, has given rise to an increased demand for capacity. It is, therefore, reasonable to expect that the current cable construction and upgrade activity will be closely followed or paralleled by a similar flurry of commercial activity involving industry participants seeking to acquire capacity to meet the demands of consumers.

As for all types of commercial supply, the basis on which a contract for capacity supply is formed will differ in each case depending on the objectives of the parties. There are various ways in which capacity can be acquired – for example, this could be by way of a services arrangement or a finance lease. Given the range of prospective capacity customers in the current market (e.g. the traditional telecommunications companies, ISPs and media and content providers) we are likely to see even greater variations in the forms of capacity supply arrangements. The focus of this paper is on indefeasible rights of use (known in industry as 'IRUs'), which is one option for acquiring capacity that will inevitably be canvassed in any discussion between a cable owner and its prospective capacity customer.

So what then is an IRU, and why would capacity be acquired on this basis?

As is often observed, there is no universally accepted definition of 'IRU'. In Australia, a reference to 'IRU' generally means one of two things, being:

- a long term arrangement (typically anywhere between 15 to 25 years) under which the capacity customer pays a significant amount of money upfront for the right to use specified capacity on a cable during the term (a '**General IRU**'); or

- an 'IRU' as defined in the *Income Tax Assessment Act 1997* (Cth) (ITAA) (a '**Tax IRU**').[4]

Tax IRUs are chosen in situations where a particular tax outcome is important to a party (usually the customer). Specifically, Tax IRUs are regarded as depreciable assets under the ITAA, and IRU holders are therefore entitled to depreciate the Tax IRU over its effective life. This can often translate to significant tax savings.

The parties might choose an IRU for any number of reasons unrelated to tax (i.e. a General IRU). For example:

- in the case of the capacity customer – the lower cost of capacity associated with a long term arrangement; and
- in the case of the cable owner – the advantage of securing upfront payment from the customer, which is often the means of funding the cable construction or upgrade.

If structured appropriately, a General IRU can also be a Tax IRU. In practice, the parties often seek to structure their agreement for a General IRU as a Tax IRU to take advantage of the associated tax benefits, even if tax is not a primary consideration for them.[5]

Structuring the arrangement – issues unique to IRUs

Whether for a General IRU or Tax IRU, documenting an IRU agreement usually involves consideration of some unique issues that would not normally arise in the context of other capacity supply arrangements.

General IRUs

The unique issues that arise in relation to General IRUs are best illustrated by comparing IRU agreements to capacity services agreements by reference to some of their common elements. This paper looks at some of the key elements, being price, risk sharing and exit rights.

(a) Price

One of the main reasons why IRUs are advantageous to cable owners is that they mean significant revenue early on in the form of the upfront IRU fee, as opposed to revenue in the form of service fees paid at (for example) monthly intervals. This is particularly important where cable owner needs the money to fund the construction or upgrade of the cable. From the customer's point of view, the upfront IRU fee is obviously a big financial investment. Accordingly, the customer will generally expect to see clear benefits in order to determine that it is commercially viable to invest in an IRU.

In practice, cable owners often seek to incentivise customers by making certain commitments, such as offering operations and maintenance (O&M) services during the term of the IRU for a relatively low fee. The cable owner might also agree to provide cable upgrades at a fixed cost as new technologies emerge during the IRU term.

As with any promise to do something in 15, 10 or even 5 years time, these sorts of commitments are risky for cable owners because they require unrealistic foresight into the long term future. In terms of O&M costs, these will inevitably increase as the cable degrades over time, but it may be next to impossible to accurately predict what the increase will be. As

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[4] The distinction between General IRUs and Tax IRUs is a superficial one made for the purposes of discussion in this paper – this distinction is drawn on the basis of the reason for entering into a particular arrangement rather than any defined legal concepts.

[5] See further discussion in Part 0 below.

such, while the cable owner may be able to determine with some certainty how much it will cost to provide O&M services in the first five or so years of the IRU term, beyond that, the amount of those costs becomes progressively less certain.

Agreeing to provide upgrades at a fixed cost can be even more dangerous for cable owners because there is no certainty as to what technologies might emerge, let alone what costs would be involved in upgrading to those technologies. Some examples of costs that may be impossible to quantify at the time of contracting include:

- the cost of migrating the customer to another cable/fibre pair so that the upgrade can be performed, and then to migrate them back to the upgraded cable/fibre pair; and
- the cost of providing O&M services on the upgraded cable/fibre pairs (which would be utilising the new technology and new equipment).

These issues highlight the need for both the cable owner and customer to think very carefully about pricing in relation to IRUs. The primary concern for customers is to be assured that the significant financial investment is a worthwhile one. The cable owner, on the other hand, needs to ensure that any commitment it makes to provide this assurance will not be financially detrimental to them in the long run. The parties, therefore, need to work together to agree a pricing model that makes economic sense for each of them not only at the outset but also throughout the IRU term.

(b) Risk sharing

Cable operators and capacity customers will generally have very different perspectives on risk sharing in respect of IRUs. Typically, capacity customers will expect cable owners to accept greater responsibility for things that might go wrong during the term than they would under a services arrangement. Capacity services are usually provided on the supplier's standard terms, which in most cases contain significant exclusions of liability.

There are two main reasons for this difference in position:

- Firstly, the customer's decision to acquire an IRU is usually a strategic one. This means that the relevant cable link is often the primary link, or at least a critical link, for the customer's business.
- Secondly, the customer is required to pay a significant sum of money upfront and, understandably, wants certainty that they are getting what they are paying for.

In this light, the customer will expect the cable owner to accept liability for things like cable failures and interruptions during the term, usually by paying service credits. The customer will typically take a more aggressive stance on service credits and expect these to be higher than would be customary under a services arrangement. In addition to service credits, the customer will usually also insist that the cable owner accept liability for indirect or consequential losses, such as any loss of profits flowing from cable failures or interruptions. The quantum of such losses, of course, cannot be known at the time of contracting.

Broad exposure to excessive or unknown amounts of liability is never an attractive proposition to a supplier in any sort of commercial contract. It may be especially difficult for an IRU supplier to accept because of the extended duration of the exposure. Furthermore, the cable owner may not have the funds during the term to make payments under an onerous service credit regime, or to meet claims for consequential losses, particularly if the bulk of the revenue from the IRU has already been spent on the cable construction or upgrade.

It is imperative that the parties to an IRU agreement agree on a risk sharing regime that will be workable for the duration of the term. Any such regime needs to provide a sufficient level of protection to the customer, whilst is also economically feasible and not unduly onerous on the cable owner.

(c) Exit rights

The customer and supplier under a services agreement generally have a common intention to keep the contract on foot for as long as possible. This is because of the customer's desire for continuity of service, and the supplier's desire for continuity of revenue.

The dynamics change somewhat with IRUs.

The customer, of course, would still want the IRU to continue for as long as possible, and probably even more so considering the large amount of money they have paid for it. On the other hand, a cable owner who has been paid upfront would not be sacrificing any significant ongoing revenue if the IRU agreement were to end early. The cable owner might in fact benefit from being able to exit the agreement before the expiry of the term as this would reduce its long term risks as well as the period of exposure to those risks.

To illustrate, if the cable owner has (for example) agreed to provide O&M services during the term for a substantially underweighted fee, then the shorter the period in which it is obliged to provide those O&M services, the better it is for the supplier. Similarly, if the cable owner has agreed to provide upgrades during the term at a fixed cost, then they would benefit from a shorter the term as this would reduce the likelihood of the customer actually requesting an upgrade (which the cable owner might otherwise be obliged to provide at a financial loss).[6]

Clearly there is a fundamental inconsistency between the positions of the cable owner and customer in terms the parties' ability to bring an IRU to an end. One way to reconcile this inconsistency is to ensure that the other key provisions of the IRU agreement reflect an appropriate balance between the interests of the cable owner and customer. Where this is achieved, it is more likely that the arrangement will be mutually beneficial, which can mean that broad exit rights become less important to the cable owner.

Tax IRUs

As mentioned above,[7] parties who (at the outset) wish to enter into a long term capacity supply arrangement for reasons unrelated to tax (i.e. a General IRU) may, nevertheless, subsequently seek to structure their agreement as a Tax IRU. This might occur where many of the agreed terms of the arrangement are already consistent with some of the characteristics of Tax IRUs (discussed below). In these situations, the parties may consider it advantageous to make adjustments to the agreed terms so as to fit the ITAA definition, recognising the tax benefits that might flow from doing this. Accordingly, the structuring issues associated with Tax IRUs can potentially arise in any IRU agreement negotiation.

The ITAA itself simply defines 'IRU' as 'an indefeasible right to use a telecommunications cable system'.[8] The Explanatory Memorandum to the legislation which introduced the concept of IRUs to the ITAA[9] gives further guidance as to what constitutes an 'IRU' for the purposes of the ITAA by describing the characteristics of an IRU. Generally speaking,

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6 See discussion under point 0 (Price) above as to reasons why the cable owner might make these sorts of commitments.

7 See discussion in Part 0 above.

8 Section 995-1(1).

9 The *New Business Tax System (Capital Allowances) Act 1999* (Cth).

capacity supply arrangements need to have those characteristics in order to be regarded as a Tax IRU.

The key characteristics of an IRU, as set out in the Explanatory Memorandum,[10] are that an IRU:

- confers a permanent indefeasible and exclusive right of access to some or all of the raw capacity in a telecommunications submarine cable system to another party;
- is specifically called 'indefeasible' as it cannot be defeated or terminated by the unilateral action of one party to the IRU agreement; and
- is broadly equivalent to ownership of the cable system in terms of cable operation, meaning that the IRU holder:
  - uses the applicable cable system capacity to which it is entitled on the same terms and conditions as the cable system owners;
  - is generally required to contribute an upfront capital payment and to pay on-going amounts for the operation and maintenance of the cable;
  - is usually required to contribute to its proportional share of any costs which arise from the liquidation of the cable system or from claims by third parties;
  - may also be entitled to any proportional share of proceeds which arise from liquidation of the cable system or from claims against third parties in respect of it; and
  - is not entitled to any compensation for the failure in or breakdown of the cable system or for any interruption of the use of the cable system.

Perhaps not surprisingly, some of the above characteristics are often inconsistent with the actual commercial expectations of the parties to the arrangement. For example:

- a cable owner will usually expect the agreement to contain at least limited rights of termination;
- a capacity customer would not normally expect to contribute to the cost of defending third party claims in respect of the cable, just as cable owners would not normally expect to share any proceeds arising from such claims; and
- a capacity customer will almost always expect an entitlement to service credits for cable failures and interruptions.

Given these inconsistencies, structuring a capacity arrangement so that it exhibits the characteristics of a Tax IRU but still reflects the commercial expectations of the parties can be challenging. The means of doing this will depend on the specific objectives of the parties in each case, and will often involve considerable legal ingenuity incorporating tax and other specialist advice.[11]

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[10] See Chapter 5 of the Explanatory Memorandum to the *New Business Tax System (Capital Allowances) Bill 1999* (Cth).

[11] See Halliday and Tran, 'When Worlds Collide: Indefeasible Rights of Use, tax and commercial reality', *Communications Law Bulletin*, 27(1) September 2008, p3, for a detailed discussion on structuring IRUs, with a focus on the inconsistencies between the characteristics of IRUs under the ITAA and the typical commercial expectations of parties.

Conclusion

The IRU agreement is clearly different to the typical commercial contract. The issues discussed in this paper illustrate that the parties on either side will tend to be more cautious when negotiating an IRU agreement, mainly because of the length of the arrangement and the uncertainty which accompanies the long term. The most workable IRU agreements, and those that ultimately provide the best protection to both parties, are therefore the ones which incorporate appropriate flexibility to accommodate the unknowns. In practice, reaching that agreement usually requires the parties to have a very clear position on fundamental issues, which will not always be consistent with the typical commercial contract provisions. In the height of this capacity boom, the key for both cable owners and customers is, therefore, to take the time to carefully consider their risk and reward profile when negotiating an IRU, remembering always that foresight into the long term is critical.