

Market-based Approach and Industry Regulation: The Case of Sri Lanka Telecom Industry

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Abstract

Sri Lanka, like many other developing countries, in line with market-oriented reform policies often prescribed by international aid agencies (IAAs) such as the World Bank and the International Monetary Fund (IMF), has embarked on striving reforms in the utility sector. Despite its global occurrence, the outcome in terms of sustainability has been in varying degrees, many suggesting those attempts have resulted in unintended outcomes. Many suggest that the telecommunications industry reforms in Sri Lanka - that are generally been claimed as one of the spectacular reforms - have brought positive outcome in terms of accessibility, choice and quality over the past ten years of reforms.

Nonetheless, by depicting the findings of a study conducted during 2006-2007 by the author for her doctorate degree, this paper argues that although reforms have brought many positive outcomes into the sector, two main deficiencies in regulatory arrangements: excessive political power and regulator's lack of efficiency and capability have been powerful enough to diminish intended outcome of reforms in line with market based approach. The study opens up the essence of assessing outcomes of reforms in other developing countries, in telecommunications as well as other sectors, to investigate practical outcome of market based reforms and their implications.

Keywords: Market-based approach, regulation, Sri Lanka, telecommunications

Introduction

The liberalisation of telecommunications industry in Sri Lanka was a result of both the emergence of a new market-based managerial approach in the 1980s and the financial, technical and managerial difficulties faced by the government

of the day. Pressure from the international aid agencies (IAAs), mainly the World Bank and the International Monetary Fund (IMF), was an influential factor in this regard (Azmat, 2007). By 1970s, like many other industries in the country, the telecommunications industry was suffering from inadequate capital

investment in modern technology, lack of corporate vision, outdated procurement systems and a high level of government debt (PERC, 1998). The reforms started in the 1980s led to partial privatisation of Sri Lanka Telecom (SLT) in 1997. Compared to reforms in other utility sectors in the country, it has been recognised as the most spectacular sector performing due to reforms. It was also accompanied by the establishment of a regulator to oversee the market with the prime objectives of developing a mechanism for ensuring efficiency, setting standards of service and for exercising financial audits separate from operational activities. The essence of market-based approach was to create an effective, level playing field for private operators (Minogue, 1998), to deliver cheaper and better quality services to customers, to be facilitated by an independent regulator, the Telecommunications Regulatory Commission (TRC) of Sri Lanka. It was believed that the regulator could ensure fair enforcement of government policy, hold the operator accountable for industry performance, address consumer issues, monitor transition of the industry needs and provide feedback to the policy making units and thereby ensure sustainable growth of the industry.

This paper investigates whether the intended outcome of regulation has been achieved by the TRC and if not, what major factors have been powerful enough in diminishing the intended outcome of reforms in Sri

Lanka.

Reforms in the Telecommunications Industry

The Sri Lankan telecommunications industry was inherited from the British colonial administration. Following independence in 1948, the industry received no investments, and therefore, was performing poorly. As an initial step to improve performance, the Department of Telecommunications (DoT) was separated from the postal service in 1980. However, neither the separation nor the investments channelled through loan funds obtained from the World Bank into this sector resulted in meeting the increasing demand. The reasons included:

- DoT was still subject to requirements that the government placed on its departments;
- DoT failed to take up the challenge which arose after open economic policies were adopted in 1977. Entry of private sector including foreign firms into the economy was a real challenge to the DoT;
- The extra demand for telecommunications created by Sri Lankans who went to the Middle-East for temporary employment after 1977 was difficult to meet. Applicants for telephone lines on the waiting list (about 245,000) exceeded the number of existing lines and the average waiting period was 10 years (Shetty, 1996);

- The high usage of existing facilities led to low quality of services. It was estimated that 38% of telephone lines in the greater Colombo area itself was out of order at any given time (Abeynayake, 1986 cited in Kelegama, 1993).

The liberalisation process commenced with the recommendations of the presidential committee appointed for this purpose in the mid 1980s. The enactment of Sri Lanka's Telecommunications Act No. 25 of 1991 separated policies, operations and regulation. The Act assigned responsibilities to the Ministry, Sri Lanka Telecom and Sri Lanka Telecommunications Authority (STA - the regulator) respectively. Subsequently, having realised the importance of assigning priority to policy changes, the national policy on the telecommunications industry was introduced in 1997 including necessary amendments to the existing Act. The main objectives of the policy were provision of quality telecommunications services to all by eliminating long waiting lists, allowing private sector competition, increasing local value addition through local manufacture and construction; and the protection of defence, security and environmental interests of the country (GOSL, 1991).

In the meantime, as a temporary precaution, the Government issued licences to private telecommunications bureaus for the provision of international, local and long distance calls and fax services.

These bureaus became flexible and customer-oriented but were not adequate to cope with the ever changing industry requirements. In the mid 1990s, the liberalisation process was extended by granting permission to two fixed line operators using wireless local loop (WLL) technology (SunTel and LankaBell) and four mobile telephone operators (CellTel, Mobitel, Lanka Cellular, and MTN).

SLT, the only state owned telecommunications services provider, was performing unsatisfactorily at this time. Its billing system was in arrears by three to four months and the annual financial reports were late by three to four years. It had an excessive number of employees (over 8,500) and its operating profit in 1997 was only US\$75 million. Of the annual turnover, about 46% was accounted for by international incoming calls. By the mid 1990s, it was estimated that an additional US\$450 to 500 million was urgently required to meet the estimated demand for telephones in 2000 (PERC, 1998).

In August 1997, the government divested 35% of its stake in SLT to Nippon Telegraph and Telephone Corporation (NTT) of Japan (for US\$225 million). Management control of SLT was assigned to the same company under a contractual agreement. At the same time 3.5% of SLT's shares was distributed among SLT employees. In December 2002, the Government floated another 12% of its stake at an initial public offering (IPO) leaving it with only

49.5%. In April 2008, NTT announced that it sold its holding entirety, i.e. 35.2 percent of SLT stake, to Global Telecommunications Holdings NV of Netherlands.

Regulatory Arrangements

The first regulatory body, STA, established in 1991 by the Sri Lanka Telecommunications Act no 25 of 1991 was unsatisfactory. It was argued that STA neither had independence, power, structure, resources nor accountability in its operations. In response, the Sri Lanka Telecommunications Act No. 27 of 1996 converted STA into a more independent body, namely the Telecommunications Regulatory Commission of Sri Lanka (TRCSL). The regulator had three broad objectives: (i) setting up cost-based tariff structure; (ii) preventing anti-competitive practices; and (iii) advising the Government on telecommunications related issues. Under these broad objectives, the responsibilities of the Commission were to:

- ensure the provision of qualitative, reliable and efficient national and international telecommunications services by operators while protecting and promoting the interests of consumers;
- maintain and promote effective competition within the industry; promote research & development activities for the industry in order to make Sri Lanka the hub for international transit services in the region;
- advise the Minister on granting licenses, policy issues, pricing, interconnection charges, tariffs, and matters relating to the International Telecommunications Union (ITU); and
- conduct inquiries on public complaints or public interests in telecommunications sector as directed by the Minister (GOSL 1991).

According to the market driven principles, regulatory regimes need to be independent of political and bureaucratic interventions in addressing market failures and should allow the private sector to increase efficiency relying on capital markets without abusing the monopoly power (Stelzer, 1989). Most importantly, it should facilitate the creation of market conditions, promote competition and maximise economic efficiency while ensuring consumer welfare. A regulatory framework allows the government to institutionalise a system to protect consumers and investors from market failures. In assessing the regulatory arrangements associated with the telecommunications industry liberalisation in Sri Lanka, despite early establishment of the regulator, and despite many developments that are taking place in the sector, it can be seen that its interventions have been deficient in creating favourable conditions for the private sector and meeting social obligations. The developments that are going on could have been better rewarding the true benefits of liberalisation to the consumers if the regulator had been effective in its

interventions. The following section deals with the main deficiencies of the regulatory interventions.

Growth after Liberalisation

The liberalisation of telecommunications industry since the 1980s has brought many developments into the industry. The highlights are as follows:

- **Increased number of fixed lines** - Reforms in the telecommunications sector resulted in an increased number of telephone lines. Between 1997 and 2006, the number of SLT lines increased by almost 277 percent indicating an annual average growth rate of 13 percent. The total number of fixed lines (including WLL connections) by the end of 2006 was 1896,000 compared to 80,000 in 1980 (CBSL, 2006). In 2006 itself, the fixed access network grew by 52% largely due to expansion of wireless network with the Code Division Multiple Access (CDMA) technology.
- **A booming mobile phone market** - The mobile telephone market showed a remarkable growth and is now 60% of the total phone market. It grew at an average annual rate of 35 percent from 1994 to 2006. The phenomenal growth in the mobile telephone services continued registering 61 percent increase in the subscriber network in 2006 following a 52% growth in 2005 (CBSL, 2006). This had resulted

in increase in national tele-density (number of telephones per 100 persons) to 37 by the end of 2006 (CBSL, 2006).

- **Number of licensed service providers** - The number of licensed service providers in the telecommunications industry by end of 2006 was 62 (CBSL, 2006).
- **Increasing number of applicants in the waiting list** - Despite the overall increase in service provision, the number of applicants in the waiting list has been experiencing an upward trend until recently. However, the rapid expansion of mobile services and CDMA based connections helped reduce the communication disparity in rural and urban areas due to easy access through these services (CBSL, 2006). Although the use of the internet in the country is very low for reasons such as the high rate of local call tariffs and expensive computer equipment, it shows an upward trend.

Figure 1 (Appendix 1) reveals the developments in fixed lines, mobile phone services and email and internet services from 1997 to 2006. One should also not forget the fact that these remarkable developments are occurring in a country where a civil war is mounting for nearly thirty years, hindering every aspect of development efforts.

The Main Deficiencies of Regulation

The deficiencies of regulatory regime are many fold. We argue that the main causes for poor performance of the regulator are two: excessive political power and lack of efficiency and capability of the regulator. These two main causes lead to adverse results which will be discussed later in this section.

Excessive Political Power

Having realised the importance of keeping policy, regulation and operations separate from each other, like in many governments, Sri Lanka instituted prior structural regulations to prevent monopoly abuses by creating STA in 1991. Subsequently, it was strengthened in 1996 by establishing a commission to oversee the telecommunications industry. This was done with the belief that the regulator would be immune from Government political pressures which was not the case due to many reasons. According to the theory, maintaining a high level of transparency and accountability through independent regulation helps maintain good governance. To ensure this, performance of the regulator should be supported by the other parts of the system. This was missing in the context of Sri Lanka (Balasooriya, Alam and Coghill, 2008); and as a result, different industries performed differently with market-based reforms (Balasooriya, Alam and Coghill, 2007).

The empirical evidence suggests that the lack of independence of the regulator in Sri Lanka was a critical factor contributing to poor governance. The first (single-person) regulator, STA, was functioning under the Ministry with no differences from a Government department, having no funds or expertise. The TRCSL was provided with resources to build expertise and experts were recruited from outside the public service. It developed some degree of independence at least financially, was able to initiate interconnection regime, and established a favourable foundation for competition when the duopoly operators were licensed. But the same Act made the Secretary to the Ministry of Telecommunications the statutory Chairman of the Commission. This was an indirect intervention by the Government. The appointment of three other Commissioners (who are experts in management, law and finance) was left to the minister. The minister in charge of the industry became the final authority to issue licenses and take other important decisions. This situation effectively curtailed the independence of the Commission. The regulator lacks power to act independently against political influences and pressure from interest groups. More interestingly, the existing reporting system evidences some ambiguity of conflict of interests, as both the TRCSL and the main operator, SLT report directly to the Minister. In addition, TRCSL has become an opportunity for employment for SLT's retired personnel. In the worst case, a

former managing director of SLT became the director general (DG) of TRCSL in 1999. Hence, there is obvious ambiguity about the Commission's relationship with the Government, as was once questioned publicly by one of the WLL operators (Samarajiva, 2000; Zita and Kapur, 2004). So far, no remarkable action has been taken by the Government to loosen the tie between the regulator and the Government and according to recent interviews held with the telecommunications industry stakeholders such as operators, relevant senior bureaucrats, the regulator and industry experts by the author, the majority felt that there will be no initiative to change the situation as the one who is going to lose the power is the minister.

One could argue that in a democracy, the minister is the best person to decide on behalf of the public. But Sri Lanka as may be like any other country in the region is a country that has experienced all types of political violence and spreading corruption (Knight-John, 2004). Also, management culture is extremely difficult to change. The politicisation of procedures, wide acceptability of irregular payments and the readiness of clients to offer such payments have limited the much needed transparency and accountability in the process. It was revealed during recent interviews that the Minister has used his power to hit SLT, the main incumbent, by delaying CDMA frequency allocation as the final authority. The perception that many other operators held that government is in the hands of the

main incumbent was not proven with this research. But actual implications for the delay are not clear; what is clear is that the industry matters are in the hands of the Minister, not the regulator.

Thus, the main factor that was found in this research was the excessive political power experienced, which has been powerful enough to combat the regulator's performance. Whether in appointments, licensing, or in deciding allocation of scarce resources such as spectrum, the sole and final authority lays with a political figure. The nature of political appointments and the shorter government terms and the volatility of the political environment have resulted in limited efforts to change the situation. More importantly, political power has exceeded bureaucratic power, or the link between bureaucratic and political figures has further worsened the process.

Lack of Efficiency and Capability

One other main issue that came up during recent interviews conducted by the author with telecommunications stakeholders was the lack of capability of the regulator to address the complex issues pertaining to telecommunications industry. At its inception, the government hired internationally competent staff but was unable to retain them, resulting in a high turnover in its key positions which include three director-generals (DGs) in just three years and altogether nine DG's in its life

time of ten years. The Government simply was unable to offer them internationally competitive salaries and fringe benefits. The ultimate result was that ex-members of parliament and retired SLT employees joined the Commission, and neither independence nor the provision of regulatory expertise was at the top of their agenda. These short term leaders neither accumulated experience by themselves nor added something new to the practices. According to an operator, one of the recent DGs was controlling the organisation remotely, living out of the country. In the absence of an effective means of communication within the system to conduct official work remotely, this was a pathetic situation. Further, competent leadership, which is an important element for the success of any organisation, has been missing. This affected the strength and capability of the Commission, thereby creating lots of discrepancies in their decisions. As a result, almost every decision taken by the regulator has been challenged in court.

According to an operator, the regulator within them does not know what they are doing. Recently, there was a directive from the TRCSL to close down the analogue operations. Once the operator did it, subsequently, they have been questioned about the closure, possibly by another section of the regulator in dealing with consumer complaints due to lack of internal coordination. Capacity issue has been highlighted by many of the

stakeholder groups as the main weakness of the regulator. TRC gets assistance from international agencies such as international telecommunications union (ITU), but the capacity they have built so far is not recognised by the industry. Despite the fact that the top layer is affected by political decisions, if the second layer of the regulator has been able to build their capacity, they could have guided the newly appointed top level. There are many vacancies at the second level of the organisation and at the time of interview, three out of six director posts were vacant. The juniors are frustrated without having a career path. Due to these reasons, the regulatory directives have commonly been challenged by the operators. The perception that has built up among operators has led them to resolve issues through direct negotiations rather than regulatory interventions. Therefore, the regulatory interventions by the TRCSL have been questioned not only on its independence and capability but also impartiality, accountability and transparency (Balasooriya, Alam and Coghill, 2006; Jayasuriya and Knight-John, 2000; Samarajiva, 2000; Samarajiva and Dokeniya, 2004).

The capability issue that emerged in this research also suggests that lack of expertise in the regulator has limited its ability to exercise power. For instance, if the regulator had been able to employ the power conferred by the Act itself, without being captured by external forces, the impact on the industry would

have been different. The findings also suggest that the situation is not going to change, mainly because the politicians do not want to lose the power that they enjoy under current arrangements. But if the expertise to convince the Minister had been built within the organisation, regulatory interventions would have been more effective. The competence of the regulator was lacking, and as a result, it has been unable to combat unnecessary political interventions.

The following subsection briefly discusses the consequences of these main deficiencies.

Controversial Interconnection Charges - Telecommunications industry is regarded as a natural monopoly as only one company owns the widespread network. The regulatory issue appears as the interconnection regime for other users to use the main incumbent's network in a fair and efficient way. This most important aspect of regulation, despite its promise to arrange in a non-discriminatory way, appears to have been implemented very unsatisfactorily.

The TRCSL's practice with regard to interconnection matters has been to intervene only when the operators had been unable to come to a settlement. The current interconnection regime according to the views of operators is the best available for Sri Lanka where the sender keeps his entire base there. They criticised the fact that there is no policy protecting the smaller

companies as against the discriminatory behaviour of the bigger player. According to the theory, interconnection should be allowed at the nearest point of presence. But in Sri Lanka, interconnection is not happening at the nearest place resulting in operators terminating calls at the incumbent's network and having to pay at a national call rate which is a higher rate. This has been the biggest interconnection issue among smaller operators. So regulator's intervention with regard to interconnection has been very unsatisfactory. The regulator has been unable to enforce and implement a fair interconnection regime mainly due to its incapability and the problems related to governance issue as well as the arrogant type of behaviour of the main incumbent.

Inability to Introduce Competitive Price Regime - In 1994, the Government made a commitment to provide access to telecommunications facilities at cost based prices through its National Telecommunications Policy. But the TRCSL's ability to execute this commitment was limited mainly due to the absence of sound cost data. The implementation of price-cap regulation which was included in all three fixed line operators' licenses was suspended because of the permission given to SLT for rebalancing the tariff for five consecutive years after partial privatisation, until 2002. Since the privatisation of SLT, prices of domestic services especially the

connection charges have actually risen rather than fallen. Consumers have waited to experience the benefits of reforms. While this is typical in fixed line market, the mobile services market progresses through competition.

The extension of SLT's exclusive gateway rights given at the partial privatisation of SLT for international voice phone segment till 2002 (which was originally due in 2000) kept WLL operators in a disadvantaged position, settling them strategically in niche market segments and discouraging investments into the industry (Jayasuriya and Knight-John, 2000; Samarajiva and Dokeniya, 2004). In effect, the expansion of services was limited to the urban areas. Since 2005, the expansion of services into rural areas is evident due to CDMA rollout. Yet, customers will have to wait another few years to see if there is adequate competition among players.

Absence of CPP - Another main deficit with regard to telecommunications regulation is the implementation of calling party pays (CPP). It is generally accepted that public hearings are the main type of interventions for effective regulation as they provide a real picture of the industry from all stakeholders' point of view. On the CPP issue, despite several public hearings over many years, long waited CPP system is still pending and it was before the court at the time of data collection for this research. It has become a battle between fixed and mobile operators. There were

references indicating there had been some irregular payments by particular operator/s which made the government to decide there will be no CPP. But there is no firm evidence to prove that and the regulator's point is that about 99% of those who were present at the public hearing felt that they did not need CPP. What is really missing is adequate awareness among public about CPP.

Lack of Public Awareness - It has been accepted that giving voice to consumers' interests and ensuring those voices are treated seriously is one of the major roles of the regulator. The TRCSL in the past has taken commendable efforts to create awareness even among school children and it maintains a fairly well updated website. But due to the short term tenure of leaders at TRCSL, this task has not attracted enough attention in recent years. Further, the reality in Sri Lanka is that consumers prefer to get their matters attended through known sources, rather than attempting to change systems. Hence, with such a culture persisting in the country, the extent to which empowerment efforts by the regulator have been successful requires further investigation. If adequate awareness has been created, CPP would have been implemented by now.

Conclusion

An effective and efficient regulator is essential for fostering and maintaining competition within the telecommunications industry in order

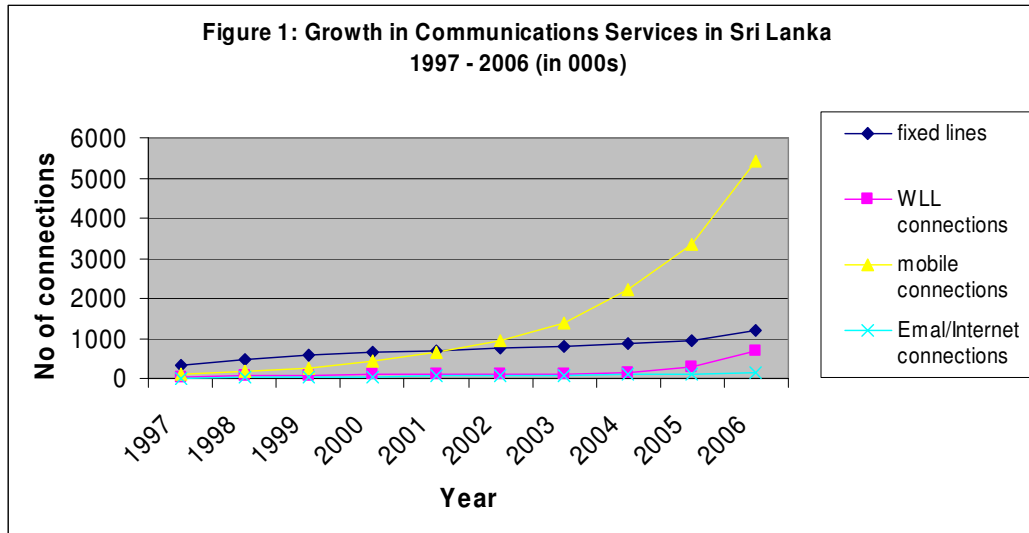
to deliver cheaper and better quality services to customers. The Sri Lankan experience suggests that the impact of telecommunications industry reforms and its new governance structure through regulatory regime has been counter productive. The industry has provided positive effects such as increased service provision, competition at least in some segments of the market, and a gradual increase in service quality. Yet, the Government's promise to provide telecommunications services at cost-based prices has not been fulfilled mainly due to the perverse behaviour of SLT in dealing with the interconnection regime. The newly created government watchdog body has not been able to function effectively to enforce competition. We argue that the main deficiencies in the regulatory interventions are the prevailing excessive political power and the lack of efficiency and capability of the regulator. In the absence of overall good governance practices in a country like Sri Lanka, private investors require assurances of transparency and consistency from the sector-specific regulators to build their confidence in future investments. The regulator has been working as a semi-bureaucratic organisation and not been able to separate regulation, operation and policy in the telecommunications industry. The attempts to introduce effective governance have been unable to achieve the objective and sustainability of growth in the communications industry.

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APPENDIX 1



Source: Central Bank of Sri Lanka, Annual Reports (multiple years)