Executive Summary

POLICY STUDY OF THE CANADIAN TELECOMMUNICATIONS FOREIGN OWNERSHIP REGIME

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EXECUTIVE SUMMARY

This study provides an examination of current foreign ownership rules in the Canadian telecommunications sector. We conclude that current ownership restrictions have imposed unwarranted costs on the Canadian economy in terms of infrastructure development, competitiveness and the government's connectedness agenda.

We find that the urgency for policy change is being obscured by the outward signs of a healthy telecommunications sector: relatively low prices, a history of relatively substantial investment and a variety of telecommunications choices for Canadians. Looking beneath the surface, we discover evidence of falling investment levels, questions about the sustainability of competition in the sector, and a fundamental shift in the infrastructure elements upon which the economy of the future will be built.

We begin our examination of foreign ownership rules with an assessment of the Canadian telecom environment, finding that it generally displays indications of economic health and vigour. It has annual revenues in excess of $25 billion, it employs over 100,000 Canadians and it invests in the order of $6 billion annually. Based on our overall involvement with and knowledge of the industry, we believe that past and current regulatory and policy conditions have generally contributed to the achievements of the industry.

While recognizing that current indicators of competitiveness, investment and growth are positive, we also note that the challenges facing the industry are substantial. In particular, we note that the pace of technological change and the increasing globalization of telecommunications suggests that the Canadian industry must adapt continuously to its new environment or risk the loss of its achievements.

Against the backdrop of historical economic performance and growing challenges the advisability of the ownership rules is called into question. The rules, which were formalized in the 1993 - 1994 time-frame, can be summarized as follows:

(i) Canadians must own a minimum of 80% of the voting shares in facilities-based carriers ;

(ii) at least 80% of the board of directors must be Canadian ;

(iii) an investor company is "Canadian" if 66 2/3 of the voting shares are held by Canadians; and

(iv) in addition, the corporation must not be otherwise controlled by persons that are not Canadians.

It is worth noting that while we have concentrated on the ownership aspects of the regulations in this report, the critical condition under the regulations is "control", since a company can be controlled by a foreign owned firm even if foreign ownership is at or less than the limitations.

The original rationale for the ownership and control policy was enunciated in a 1987 government policy statement. The historical rationale stems from a desire to ensure that a key Canadian economic asset (i.e., the telecom infrastructure) would continue to grow and benefit Canadians through the creation of jobs and economic well-being. A second key rationale for ownership limits is associated with a stated desire to maintain Canadian sovereignty.

In our examination, we conclude that the ownership rules do not promote growth or efficiency and therefore undermine the achievement of the goals which they were originally designed to promote. We believe that telecom infrastructure as a key economic asset can best advance economic well-being and national sovereignty through measures to promote its growth. Furthermore, the economic power generated by an efficient and growing telecommunications infrastructure also increases the sovereign power of a nation.

The conditions that initially led to the establishment of ownership restrictions have changed materially. For example, the steadily growing importance of technological change and global trade support a continuation of liberalization. The trend in the last several years towards relaxation of ownership rules appears to reflect a recognition of those environmental changes. This notion is supported by international evidence whereby most OECD countries have decided to not employ major foreign ownership restrictions. Canada remains one of only a handful of OECD countries with major foreign ownership restrictions (the others being Turkey, Poland, South Korea and Mexico).

In the course of our research, we found only one potential theoretical economic rationale for the maintenance of current ownership rules. Anecdotal evidence suggests that many companies tend to locate R&D and other strategically important jobs in close proximity to corporate headquarters. If this is the case, then greater foreign ownership could result in headquarter operations being moved outside of Canada and related key R&D and strategic jobs also moved outside the country. A related point was offered that these key functions tend to cluster in certain locations (across several companies), thereby creating a critical mass of skills and knowledge in those geographic areas.

While we acknowledge the potential merit of this argument, we uncovered no formally conducted research which verified the claim. We would also note that the anecdotal evidence we examined on the location and clustering phenomena was specific to equipment manufacturers rather than telecom service companies. Telecom research and development is largely undertaken by manufacturers, not service providers.

While it is possible that a removal of ownership restrictions could result in the relocation of headquarters functions and associated key staff positions, we believe that other factors are more important in the mobility of human resources and that maintaining ownership restrictions will by no means ensure that resources will not migrate. A preferable policy approach to labour migration issues would focus on providing better opportunities within the country so as to create positive incentives to stay and work in Canada.

Regarding arguments for the removal of restrictions, there are several significant arguments that have merit. One of the most compelling involves a higher cost of capital imposed on Canadian companies due to ownership rules. There is strong evidence which supports the view that Canadian firms tend to pay a higher cost of capital than comparable foreign firms. Canadian firms are forced to utilize less equity financing and increase their reliance on high yield debt financing. This is particularly critical for new entrants, which account for an increasing share of capital spending relative to incumbent carriers.

International comparisons indicate that countries with heavier ownership restrictions tend to exhibit lower telecom investment per capita than less restrictive countries. While Canada has performed reasonably well on the investment front, it has recently begun to fall off relative to countries such as the U.S., Australia, Japan and certain European Union countries.

This is an important finding because the telecom industry's capital requirements are projected to remain high and growing. Local wireline competition cannot take place until substantial investments are made in new local infrastructure. This could be initiated from a number of sources, including investments by incumbent telephone companies in each other's territories, investments by long distance carriers, investments related to modifying cable TV plant to offer telephony, or by entry from new players.

It is also clear that the growth of the Internet and demands for wireline and wireless high-speed services will tax the capacity of existing networks. The coming surge in on-line service demands will require substantial network upgrades, by both incumbents and new entrants. Most Canadian telephone and electronic information distribution companies are currently contemplating or planning the next stage of investment.

In other words, a new major phase of capital investment is required by the Canadian telecom industry, both to maintain competitive positioning in existing markets as well as to allow Canadian companies to capitalize on newly emerging opportunities. The foreign ownership rules work against achieving this investment, not only due to the higher cost of capital, but also because finding and obtaining capital from the more limited Canadian sources or having to seek financing outside the country slows the process down.

A potentially more serious consequence of the foreign ownership rules relates to the impact on investment in human capital. While there are many factors involved in the so-called "Brain Drain", the foreign ownership rules create an additional distortion that directly impacts the desirability of coming or staying to work in

Canada. This impact occurs in a number of ways but is most clearly seen in the impact of the rules on Canadian telecom service company share prices.

Publicly-traded companies of all sizes are negatively impacted by the rules. A lower share price reduces the overall market value of a company. Evidence examined for this study estimates that the Canadian telecom sector's shares trade at a substantial discount below its international peer group. The lower market value affects not only the rate at which the company can borrow, but also what it can afford to pay its staff, particularly those at senior levels. In today's environment, where senior staff compensation often involves compensation through stock options, lower share values directly impact the ability of Canadian companies to attract and retain the best human resources.

A similar problem occurs for start-up companies issuing an Initial Public Offering (IPO). An IPO on the Canadian market tends to be valued lower than a comparable U.S. issuance. The net result is that the Canadian company has less capital to work with than its U.S. counterpart. This will manifest itself through a lower ability to hire and retain the best staff.

The ownership rules also create a variety of practical (and costly) problems. These include the complexities of monitoring and juggling voting and non-voting shares to ensure compliance with the rules, concerns with hiring appropriate (i.e. non-foreign) senior staff or electing foreign persons to a Board of Directors.

We believe that telecommunications is undergoing a profound change which will largely determine the size and scope of a country's economic activities well into the 21st century. The engines of the new economy will be fuelled by the power of telecommunications infrastructure. As the platforms for that growth are being constructed presently, Canada is faced with an urgent choice: to take immediate steps which will provide strong incentives for investment in new capital infrastructure and which will foster the skills and job opportunities of Canadians, or to delay policy action, thereby imposing unnecessary and harmful limits on the economic potential of future generations of Canadians.

The relaxation of foreign ownership limits in telecommunications will by no means guarantee prosperity for Canadians. There are numerous and varied factors which will determine how the Canadian economy will perform in coming years. We are convinced, however, that failing to respond immediately to existing investment impediments will materially impact the economic potential of the country. While this should provide sufficient reason in itself to change the rules, we note that there is in any event very little downside to amending the rules. Virtually all of the objectives contained in the *Telecommunications Act* (setting aside the ownership and control objectives themselves) can be achieved without Canadian ownership and control. The performance of BC TEL and Quebec Tel (which have operated for many decades as non-Canadian carriers) provides conclusive evidence in this regard.

With so little to lose, and so much to gain, we believe immediate steps should be taken to liberalize ownership rules in the Canadian telecommunications industry. We believe that liberalized rules should apply to any and all companies that provide telecommunications services within and outside of Canadian borders.