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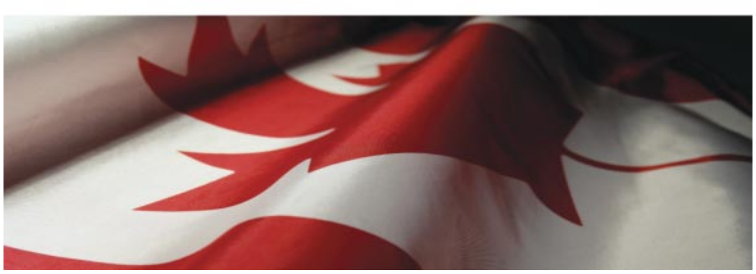
Foreign Investment Restrictions Applicable to TELECOMMUNICATIONS COMMON CARRIERS

DISCUSSION PAPER

CANADA'S INNOVATION STRATEGY



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November 2002

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Cat. No. Iu4-25/2002
ISBN 0-662-66985-1
53826B

Aussi offert en français sous le titre *Les restrictions à l'investissement étranger dans les entreprises de télécommunication*.

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INTRODUCTION

The Government of Canada is interested in better understanding how the telecommunications foreign investment restrictions are affecting the telecommunication industry. This document gives background on these provisions, describes the approaches adopted in the other countries and poses a number of questions for consideration.

This discussion document is designed to seek views and to ensure that an appropriate balance in Canada's policy objectives continues to be achieved.

CONTEXT

Canada's Innovation Strategy, which is intended to increase jobs and economic growth through a more competitive Canadian economy, became public on Feb. 12, 2002. The Minister of Industry released his portion of the strategy in a paper entitled *Achieving Excellence: Investing in People, Knowledge and Opportunity*. He called on business, academic and public sector leaders to work with all levels of government to help identify ways to meet the national goals identified in *Achieving Excellence*.

In *Achieving Excellence*, the Government of Canada set out goals, targets and priorities designed to encourage Canadian firms to invest in innovative products and ideas, and to attract the people and capital required to fuel innovation.

Those goals, targets and priorities are:

- *Better knowledge performance.* Create knowledge and bring ideas to market more quickly, with increased R&D investment across all sectors;
- *Enhanced skills.* Ensure that Canada has enough highly qualified people with the skills to succeed in the global knowledge-based economy;
- *More innovative environment.* Modernize business and regulatory policies to stimulate innovation excellence while protecting the public interest; and
- *Strengthened communities*. Support innovation at the local level to ensure that Canadian communities encourage investment and opportunity.

Central to this strategy is ensuring that Canada enhances its status as a magnet for foreign direct investment.

The 2002 Speech from the Throne emphasized that the knowledge economy demands more creative approaches to regulation. A series of Smart Regulation initiatives were outlined to formulate government regulations that protect the public while at the same time removing barriers to innovation and improving Canada's investment climate.

IMPLICATIONS FOR CANADA'S TELECOMMUNICATIONS SECTOR

In the telecommunications sector, the government recognizes that if innovation is to be stimulated, there is a need to examine regulatory policy as it affects investment — in particular, restrictions on investment by non-Canadians.

The Government of Canada has traditionally held the view that domestic ownership of Canada's telecommunications infrastructure is essential to national sovereignty and security. The *Telecommunications Act* put in place limitations on foreign voting equity and prohibited foreign control of companies in the sector. This regulatory regime, at the same time, recognizes that foreign investment is important for the industry as it provides much needed capital to expand and improve the telecommunications services so vital to the functioning of the Canadian economy and Canadian society as a whole. The importance of the telecommunications sector to the Canadian economy has become increasingly critical — the availability of low cost, sophisticated, universally available telecommunications services is one of the platforms on which an innovative society and economy are being built.

The Government of Canada therefore clearly recognizes that attracting foreign investment is vital to the Canadian telecommunications industry.

IMPACT OF CURRENT REGULATIONS ON INVESTMENT

In recent years the government has received many requests that the rules governing foreign investment in the telecommunications industry be reviewed.

In 2001, the National Broadband Task Force, whose membership reflected broad representation from Canadian industry, academia and other non-profit organizations, recommended that:

> ***"… the federal government should conduct an urgent review of foreign investment restrictions for telecommunication common carriers and distribution undertakings with a view to determining whether they are currently restricting or are likely to restrict increased industry participation in the competitive deployment of broadband infrastructure in Canada."***

Underlying such requests and recommendations has been clear concern that the foreign investment restrictions may be limiting access to capital in Canada, and may therefore be impeding innovation and expansion within the Canadian economy.

Telecommunications companies around the world — including Canadian companies — are facing significant financial challenges. No company has been insulated from recent difficulties in the industry. In Canada some telecommunications companies have ceased operations, others have been forced to seek protection from their creditors, and yet others have had to restructure financially. Most large companies have had their credit ratings downgraded. Given these financial challenges, it is not surprising that requests for a review of investment restrictions have intensified in recent months.

Within the context of *Canada's Innovation Strategy*, the commitment in the Speech from the Throne to Smart Regulation, and the recommendation of the National Broadband Task Force, the Government of Canada believes that this is an appropriate time to solicit views on our foreign investment restrictions. Canadians need to decide whether the current approach remains the best means of achieving the objectives of strong investment and national economic sovereignty.

BACKGROUND

In July 1987, Canada's then Minister of Communications* introduced a comprehensive policy document on telecommunications: *A Policy Framework for Telecommunications in Canada*. The document set out policy proposals on a number of telecommunications issues, including foreign investment. It noted "the government's longstanding view that domestic ownership of Canada's telecommunications infrastructure is essential to national sovereignty and security."

At that time, the then Minister announced:

"To harmonize Canadian policy with that of other countries and ensure our national sovereignty, security and economic, social and cultural well being, legislation will soon be tabled. The guidelines of Canadian control and 80 percent ownership for Type I carriers are effective from the time of announcement."

This was the first time that the Government of Canada had enunciated its intention to apply foreign investment restrictions to all facilities-based telecommunications service providers. However, as the Policy Framework pointed out, there had been previous examples of such measures having been implemented on an individual basis.

It was noted that "in the licensing of cellular communications, in 1984, the Minister of Communications had included provisions relating to domestic ownership and control." These provisions were put in place consistent with the government's longstanding view that "domestic ownership of Canada's telecommunications infrastructure is essential to national sovereignty and security." The document also referred to the *Teleglobe Canada Act* of 1987 and the *Telesat Canada Act* of 1991, which placed ownership restrictions on these two companies.

* *In 1993, responsibility for the* Telecommunications Act *was transferred to the Minister of Industry.*

The *Telecommunications Act* of 1993 established foreign investment restrictions consistent with the announcements of 1987. Section 16 of this Act requires that in order to be eligible to operate in Canada, a telecommunication common carrier must be a "Canadian-owned and controlled corporation," incorporated or continued under the laws of Canada. Subsection 16(3) of the Act specifies that a corporation is Canadian-owned and controlled if:

(a) not less than eighty per cent of the members of the board of directors of the corporation are individual Canadians;

(b) Canadians beneficially own, directly or indirectly, in the aggregate and otherwise than by way of security only, not less than eighty per cent of the corporation's voting shares issued and outstanding; and

(c) the corporation is not otherwise controlled by persons that are not Canadians.

In 1994, the Government of Canada promulgated the *Canadian Telecommunications Common Carrier Ownership and Control Regulations*, which set the minimum Canadian ownership level for ownership at the holding company level at 66 and two thirds per cent of voting shares. Section 10 of the *Radiocommunication Regulations*, effective November 27, 1996, made pursuant to the *Radiocommunication Act*, requires that persons or entities eligible to be issued radio licences as radiocommunication common carriers must meet Canadian ownership and control requirements that are identical to those established for telecommunications common carriers.

ACHIEVING BALANCE IN POLICY OBJECTIVES — ISSUES FOR REVIEW

The Government of Canada has consistently pursued economic sovereignty objectives through its regulation of the telecommunications sector. The *Telecommunications Act* of 1993 states that "telecommunications performs an essential role in the maintenance of Canada's identity and sovereignty." These objectives remain unchanged.

At the same time, the Government of Canada has long recognized the benefits of foreign direct investment to both the telecommunications sector and Canada's economy as a whole. Foreign investment stimulates job creation, technological advancement, and economic growth.

In the telecommunications sector, foreign participation is often necessary to permit the transfer of technology and the establishment of partnerships necessary to offer service in the international marketplace. Moreover, Canadian equity markets are not always in a position to provide the high risk capital required to create new companies, or to finance the deployment of new or improved services.

This is why the Government of Canada has taken a balanced approach by permitting significant amounts of foreign capital while at the same time requiring that every facility-based service provider be majority Canadian-owned and controlled.

Canada's economic structure is in the process of making a rapid transition to the new networked global economy. Electronic commerce is becoming increasingly important to every country's economic well being. Canadians have begun to rely on online services for the provision of everything from health care to education to enterprise to entertainment.

The telecommunications infrastructure is the platform over which all of these services are provided. The importance of the telecommunications sector to the Canadian economy has therefore grown as this trend has continued. The capital requirements of the telecommunications industry are growing, to provide traditional services in a competitive environment as well as to finance the provision of new services for the new networked economy.

Capital is not easy to come by in an environment in which investor confidence in the industry has been shaken by the collapse of high technology and Internet-based companies, coupled with many companies in the telecommunications field failing to meet financial targets. The Government of Canada recognizes that it is time to re-evaluate whether the current approaches represent the most effective means of achieving balanced policy objectives in the telecommunications sector.

The essential question for government and all Canadians comes down to this:

> ***"How can Canadians secure access to a larger capital pool for investment in new and improved telecommunications infrastructure without compromising their national sovereignty policy objectives?"***

CANADA'S INVESTMENT PERFORMANCE

Like Canada, many other countries are experiencing the transformation to the new networked economy and this has triggered a world-wide rush to invest in new telecommunications infrastructure. Many Organisation for Economic Cooperation and Development (OECD) countries once had foreign investment restrictions, but many reduced or removed their foreign investment limitations in 1996, in the context of the WTO Agreement on Basic Telecommunications Services (*see Appendix — Summary of Foreign Investment Restrictions in Other OECD Countries*).

The OECD's *Communications Outlook 2000* shows that in 1988, Canada's per-capita investment in telecommunications was $US 127, compared to $US 93 for the United States and an average of $US 83 for other OECD countries. By 1999, the latest year for which OECD data are available, Canada's per-capita investment had increased by about a third to $US 171, but meanwhile per-capita investment in the U.S. had more than tripled, to $US 324. The average for other OECD countries had increased to $US 134.

This pattern of growth in international telecommunication services has since shifted: declines in capital expenditures in the telecommunications sector began to show up in the United States in 2001, while they didn't appear in Canada until 2002.

QUESTIONS ON THE IMPACT OF FOREIGN INVESTMENT RESTRICTIONS

It is within the context of an industry that has shown such a high degree of fluctuation in recent years that the following questions are posed. The questions relate to three areas — overall investment, the experience of other countries and timing of implementation.

Overall Investment

Question 1

Do current Canadian foreign investment restrictions significantly affect the amount of capital available in Canada to invest in the telecommunications industry?

Question 2

Should Canada's relative per-capita investment performance in this sector be a source of concern, or has there simply been 'over-investment' in the U.S.?

Question 3

To what extent, if any, can differences in investment levels be attributed to foreign investment restrictions?

Foreign companies are currently allowed to make minority investments in Canadian telecommunications firms, but they are prevented from establishing and controlling a subsidiary in Canada.

Question 4

Are there foreign companies that would like to establish operations in Canada and, if so, would their entrance likely affect the provision of new or improved services to Canadians, and stimulate a more competitive Canadian market structure?

Establishing and sustaining telecommunications firms capable of competing with established service providers requires significant amounts of capital. A number of new competitive providers have recently experienced financial difficulty, while most others have yet to achieve profitability.

Question 5

Could altering Canada's foreign investment restrictions materially affect the ability of new competitive providers to establish and maintain financial stability, and to what extent can one link any relaxation of foreign investment restrictions with the creation of a more competitive Canadian telecommunications industry?

The Government of Canada is committed to making sure that all Canadian communities share in the benefits of the broadband revolution. The commitment has special import for rural and remote communities, where the business case for private investment in broadband infrastructure is weak.

Question 6

Would altering the foreign investment restrictions assist the deployment of broadband infrastructure in rural and remote communities?

The Experience of Other Countries

Countries around the world are facing the policy challenge of how to encourage investment in the telecommunications sector while retaining a significant degree of economic sovereignty. These countries have responded in a variety of ways, and their experience may provide useful guidance in the context of this review. The Appendix contains a summary of foreign investment restrictions in other OECD countries. Comment is sought on whether and how these approaches might be adapted to the Canadian situation.

State Ownership Approach

Some countries that had foreign ownership restrictions similar to Canada's now allow foreign companies to establish, own and control operations in their countries. At the same time they have retained direct state ownership and control of the traditional telecommunications provider. Since government ownership of telecommunications companies is limited to SaskTel and a number of smaller municipally owned companies, this model would appear to have limited applicability to Canada.

Restrictions on Traditional Providers Only

Other countries — like Spain, Japan, Australia, Portugal, Italy, Netherlands, New Zealand, Norway and Hungary — have allowed foreign companies to establish, own and control new telecommunications companies in their domestic markets, but have retained special restrictions over the ownership of the existing traditional telecommunications service providers.

Licensing Approach

Many countries have instituted a licensing regime for telecommunications companies. The United States, for example, requires a licence for all telecommunications companies. In principle there are no U.S. foreign investment restrictions for WTO member countries. But mergers and acquisitions are examined on a case-by-case basis. The proposed mergers and acquisitions may — on a case-by-case basis — be approved, approved with conditions, or denied. In Canada, only providers of international telecommunications services are required to be licensed.

Question 7

Should Canada adopt the approach of other countries by placing restrictions only on the existing traditional telecommunications service providers?

Question 8

If this approach were adopted in Canada, which companies would be required to continue to be Canadian owned and controlled? All incumbent providers? Just large incumbent providers?

Question 9

Should the current ownership and control limitations be maintained for these companies, or should the voting limitation be raised from the current 20 per cent limit for operating companies to some other level, while retaining the majority Canadian ownership and control? What would be an appropriate level?

Question 10

Should the U.S. approach of licensing be applied in Canada? Would all telecommunications carriers need to be licensed?

Question 11

The government could review all applications for licence transfers and ensure the continued Canadian ownership and control of 'major' companies in the context of merger and acquisition proposals. If this approach were taken, how should a 'major' company be defined?

Question 12

In cases in which mergers and acquisitions are approved, what conditions would be appropriate to ensure the achievement of other public policy objectives?

Timing of Implementation

Many industry representatives have commented to the government on the need for changes to these investment restrictions, and the best timing for implementation if changes are made. Some do not advocate any change. Some have said that change will eventually be required, but that the need is not immediate. And some have argued that immediate action is necessary to address the financial needs of companies that could make significant contributions to a competitive industry.

Question 13

Were the government to make any changes to these foreign investment restrictions, would it be appropriate to introduce some form of delay between when the changes would be announced and when they would take effect?

SUMMARY OF FOREIGN INVESTMENT RESTRICTIONS IN OTHER OECD COUNTRIES

Australia

Telstra, once full privatisation is implemented, will be subject to a 35% limit on total foreign ownership and a 5% limit on individual foreign ownership. There is a legislative requirement ensuring that Telstra's Chair, and the majority of Telstra's directors, are Australian citizens and that Telstra's head office, base of operations and place of incorporation remain in Australia. Prior approval is required for foreign involvement in the establishment of new entrants to, or investment in existing businesses in, the telecommunications sector.

Austria

No foreign ownership restrictions.

Belgium

No foreign ownership restrictions.

Czech Republic

No foreign ownership restrictions.

Denmark

No foreign ownership restrictions.

Finland

No foreign ownership restrictions.

France

20% limitation on direct foreign investment (for companies outside the European Economic Area) for the mobile communications sector.

Germany

No foreign ownership restrictions.

Greece

No foreign ownership restrictions.

Hungary

No foreign ownership restrictions.

Iceland

No foreign ownership restrictions.

Ireland

No foreign ownership restrictions.

Italy

No foreign ownership restrictions.

Japan

Foreign ownership of NTT is restricted to up to 20% of issued shares.

Korea

The limit of foreign shareholding for facilities-based service providers is 33% (20% for KT). Individual shareholding is restricted up to 10% for facilities-based service providers (15% for KT).

Luxembourg

No foreign ownership restrictions.

Mexico

Concessions are only granted to individuals or corporations of Mexican nationality. Foreign investment can be no greater than 49% except for cellular telephony services where permission is required from the Commission of Foreign Investment for a greater level of foreign participation.

Netherlands
No foreign ownership restrictions.

New Zealand
No single foreign entity is permitted to own more than 49.9% of shares of Telecom New Zealand and government permission is required for any single foreign investor wishing to own more than 10% of Telecom NZ. Government's Kiwi (or golden) share provides special voting rights to control the maximum shareholding of any single foreign party and transfers of blocks of shares among parties. No restrictions on other operators.

Norway
The PTO is a limited company in which the state must own shares. A change in ownership requires approval by Parliament.

Poland
Foreign ownership restriction for national and local telecommunication services, mobile services and cable television services: shares of foreign equity in company cannot exceed 49%, share of votes of the foreign organization and of the organisations controlled by foreign equity at the general shareholders meeting shall not exceed 49%; Polish citizens residing in Poland shall have the majority on the management and the supervisory boards. Provision of international telecommunication networks and services and radio-communications networks and services providing international services restricted to entities with 100% Polish capital share. Foreign ownership limitations cancelled when the Telecommunication Law entered into force (01/01/2001).

Portugal
No foreign ownership restrictions.

Spain
Preliminary administrative authorization required when any individual or corporation, whether national or foreign, is about to obtain control over 10% or more of Telefonica equity.

Sweden
No foreign ownership restrictions.

Switzerland
No foreign ownership restrictions; federal government required to retain majority shareholding in Swisscom.

Turkey
After the monopoly has ended in 2004 new licences will require not less than 51% equity by Turkish citizens.

United Kingdom
No foreign ownership restrictions

United States
20% of capital stock of a common carrier radio licensee may be foreign-owned. This level may be exceeded unless FCC determines that foreign ownership is not in the public interest. Wireline common carriers are not subject to these restrictions.

Source: Organisation for Economic Cooperation and Development, Communications Outlook 2001*, Paris 2001.*