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September 6, 1994

The Honorable Cardiss Collins
Chairwoman, Subcommittee on Commerce,
  Consumer Protection, and Competitiveness
Committee on Energy and Commerce
House of Representatives

Dear Madam Chairwoman:

As agreed, we examined reported restrictions on the marketing of U.S. telecommunications equipment in Canada. U.S.-based companies claimed that a long-term but recently ended preferred supplier arrangement between Bell Canada, Canada's largest telephone company, and its affiliated telecommunications equipment manufacturer, Northern Telecom, had unfairly restricted U.S. marketing opportunities in Canada. The companies alleged that, with certain exceptions, they could compete to sell telecommunications equipment to Bell Canada only when comparable equipment was not available from Northern Telecom. Northern Telecom and its U.S.-based subsidiary are also significant producers and suppliers of telecommunications equipment in the U.S. market. In a March 30, 1993, letter to the U.S. Trade Representative (USTR) you had expressed the subcommittee's concern over impediments to the free marketing of telecommunications equipment in Canada.

BACKGROUND

The USTR had for several years identified the preferred supplier relationship as a barrier to U.S. telecommunications equipment sales in Canada in its annual National Trade Estimate Report on Foreign Trade Barriers (NTE). In January 1993, the U.S. government issued advocacy guidelines to assist federal officials in planning efforts to provide support to qualifying companies that wish to compete for international procurement projects. Among the criteria that may be considered to determine whether a foreign-controlled company is eligible for such government assistance is whether equivalent market opportunities exist for U.S. firms in the company's home market. Northern Telecom believed that its U.S. subsidiary was being denied export advocacy assistance because the NTE report listed the preferred supplier relationship as a significant barrier to trade with Canada.

As you are aware, effective March 31, 1994, Bell Canada and Northern Telecom agreed to cancel their preferred supplier contract. Based on the termination, USTR did not include the Bell Canada/Northern Telecom preferred supplier relationship in its 1994 NTE report, although it had done so in all of the NTE reports issued from 1987 to 1993. As a result of this change, according to the U.S. Trade Representative, "U.S. exporters will have new opportunities in Canada, and Northern Telecom's U.S. subsidiary will be eligible for U.S. government support under the Commerce and State Department's export advocacy program."

As agreed with your office, because the offending trade barrier has apparently been terminated, there is no need to continue our examination. An enclosure to this letter describes the nature and resolution of the former trade barrier and concludes our work on this issue.

SCOPE AND METHODOLOGY

In order to determine the nature and extent of the Bell Canada/Northern Telecom preferred supplier relationship and its impact on U.S. telecommunications equipment suppliers, we interviewed and gathered information from U.S. and Canadian government officials and telecommunications industry representatives in both the United States and Canada. We did not verify the information provided by the Canadian government or the U.S. and Canadian telecommunications industry. We interviewed and obtained position papers from U.S. Telecommunications Industry Association officials and representatives of 10 U.S.-based telecommunications equipment manufacturers, including American Telephone and Telegraph Company. In Canada, we interviewed officials from Northern Telecom, Bell Canada, and two key telecommunications industry trade associations.

To gain a contextual and historical perspective of the market access issue and the status of U.S. government response efforts, we interviewed and obtained pertinent documents from officials with the Departments of State and Commerce, USTR, and the Federal Communications Commission. To determine the Canadian government's position on the issue, we interviewed Canadian embassy officials in Washington, D.C., and discussed the issue in Ottawa with Canadian government officials representing External Affairs and International Trade Canada; Communications Canada; Industry, Science and Technology Canada; Consumer and Corporate Affairs Canada; and the Canadian Radio-television and Telecommunications Commission.

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As agreed with you, we plan no further distribution of this correspondence until 30 days after its issue date. At that time, we will send copies to the Ranking Minority Member of the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the House Committee on Energy and Commerce. We will also send copies to USTR, the Department of Commerce, the Canadian embassy, and U.S. and Canadian telecommunications industry representatives. We will make copies available to other interested parties upon request.

If you have any questions concerning this letter, please call me at (202) 512-4812. The information in this letter and its enclosure was developed by Curtis Turnbow, Assistant Director, and Michael Kassack, Project Manager.

Sincerely yours,

Allan I. Mendelowitz

Allan I. Mendelowitz, Managing Director
International Trade, Finance,
and Competitiveness

ELIMINATION OF A TRADE BARRIER AFFECTING U.S. ACCESS TO THE CANADIAN TELECOMMUNICATIONS MARKET

For several years, the U.S. Trade Representative (USTR) had identified the preferred supplier relationship between Bell Canada and Northern Telecom as a trade barrier in its National Trade Estimate Report on Foreign Trade Barriers (NTE). U.S.-based telecommunications equipment companies have claimed that this arrangement had unfairly restricted their marketing opportunities in Canada. This enclosure provides background information and describes the nature of the barrier, the events that led to its elimination, and the continuing concerns expressed by U.S.-based telecommunications equipment companies.

BACKGROUND

Bell Canada provides local and long-distance telephone service to Quebec and Ontario provinces. It is 100-percent owned by Bell Canada Enterprises (BCE), a vertically integrated holding company, which also owns shares in 7 of Canada's other 13 largest local exchange telephone companies. Moreover, BCE owns about 52 percent of Northern Telecom, a major manufacturer of digital switching and transmission systems for public and private communications networks. Northern Telecom also manufactures and markets data communications networks, fiber optic cable and equipment, telephones, and other telecommunications equipment. Northern Telecom has facilities located throughout the world. In 1993, it had about 60,000 employees, including 21,800 in Canada and 22,400 in the United States.

Northern Telecom has acquired significant market share for many of its products in the United States. For example, in 1992 Northern Telecom ranked second among the top seven companies providing central office switching equipment in the U.S. market and captured 38 percent of the market for such equipment shipped by the seven companies. Current information on Northern Telecom's market share in Canada was unavailable. In 1993, Northern Telecom derived $4.13 billion, or 51 percent, of its total revenue (based on customer location) from its sales in the United States and $1.65 billion, or 20 percent, of its total revenue from its sales in Canada, according to Northern Telecom's 1993 annual report.

Bell Canada and many of the other Canadian telephone companies are regulated by the Canadian Radio-television and Telecommunications Commission (CRTC), an independent federal government regulatory agency. Moreover, to ensure fair marketing practices, Bell Canada, Northern Telecom, and other major Canadian telecommunications companies are subject to Canada's federal Competition Act, Canadian embassy officials told us.

USTR IDENTIFIED BELL CANADA/NORTHERN TELECOM PREFERRED SUPPLIER RELATIONSHIP AS A TRADE BARRIER

USTR annually issues the NTE report.[1] The report identifies the most important foreign trade barriers affecting U.S. exports of goods and services. Equally as important, the report provides a tool for enforcing U.S. trade laws. The preferred supplier relationship between Bell Canada and Northern Telecom had been identified as a trade barrier in the NTE reports issued from 1987 through 1993.

A 1939 contract between Bell Canada and Northern Telecom formally established a preferred supplier relationship between the two companies. Northern Telecom agreed to manufacture or purchase materials required by Bell Canada; however, Bell Canada was not required to purchase any of the materials offered to it by Northern Telecom. Under this arrangement, according to the Canadian embassy, Bell Canada gave Northern Telecom the opportunity to satisfy its procurement needs before quotations were requested from the general supplier community. Although the preferred supplier contract did not expressly contain a provision requiring Bell Canada to provide Northern Telecom with an "opportunity of first proposal," Bell Canada viewed this opportunity as being implied.

Northern Telecom officials told us that Northern Telecom had to respond to a Bell Canada-initiated offer of first proposal for certain types of equipment, but emphasized that Bell Canada was not obligated to buy from Northern Telecom. Bell Canada and Northern Telecom officials stated that if Bell Canada did not accept Northern Telecom's first proposal, Northern Telecom was not eligible to compete for the subsequent procurement of that item. The Canadian embassy said that the Canadian government views purchasing arrangements by vertically integrated private sector telecommunications companies (such as BCE) from their own manufacturing units or subsidiaries as internal matters for those companies.

CRTC appears to have endorsed the preferred supplier contract in a 1984 decision in which it concluded that a competitive bidding

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[1]The report is mandated by section 181 of the Trade Act of 1974 (P.L. 93-618), as amended by section 303 of the Trade and Tariff Act of 1984 (P.L. 98-573) and section 1304 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418).

process was not necessary to protect Bell Canada's subscribers. According to the decision, Bell Canada's prices for purchasing Northern Telecom equipment were to be as low as or lower than those paid by any other customers in Canada for comparable products and services sold by Northern Telecom. Moreover, CRTC required Bell Canada to submit to an annual audit by an independent accounting firm to ensure that this pricing principle was respected.

Bell Canada officials informed us that despite its preferred supplier relationship with Northern Telecom, Bell Canada has purchased a significant amount of equipment from U.S. firms and non-Northern Telecom suppliers. The Bell Canada officials also said that

-- Bell Canada's policy has been to give no preferential treatment to Canadian suppliers; and

-- Bell Canada considers low cost to be the key criterion for selecting a supplier, while giving due consideration to performance, quality, and continuity of supply.

In the same vein, Northern Telecom officials told us that

-- the Bell Canada/Northern Telecom preferred supplier relationship is typical of industrywide supplier/customer partnering;

-- foreign telecommunications equipment manufacturers, who make a commitment to the market, are successfully selling their products in Canada; and

-- Northern Telecom's relationship with Bell Canada was transparent, open, and subject to regulatory review.

To demonstrate that the Canadian telecommunications market was open, despite the preferred supplier relationship, Canadian embassy officials said that in 1992 Bell Canada spent $451 million on telecommunications equipment purchased from companies other than Northern Telecom. Of this amount, $132 million was directed to U.S. firms or Canadian subsidiaries of U.S. firms. Moreover, Bell Canada officials told us that in 1992 Bell Canada had purchased $32-million worth of equipment from a major Northern Telecom competitor--American Telephone and Telegraph Company (AT&T)--and over the past 3 years Bell Canada had awarded contracts worth $244 million to competitors of Northern Telecom.

Data provided to us by Bell Canada indicate that Bell Canada purchased about 85 percent of its telecommunications equipment from

Northern Telecom in 1992 under the preferred supplier arrangement. It is, perhaps, not unusual for vertically integrated companies to rely heavily on affiliates for intracompany purchases. However, this purchasing record demonstrates that the opportunity of first proposal gave Northern Telecom a decided advantage over potential competitors for supplying Bell Canada's telecommunications equipment. At least in theory, this process allowed Northern Telecom to have an advantage when setting prices for selling its telecommunications equipment to Bell Canada. The advantage could approximately equal the savings in administrative costs that Bell Canada would realize by not having to undertake a more formal, competitive procurement process.

U.S GOVERNMENT EXPORT ADVOCACY PROGRAM USED AS LEVERAGE TO END PREFERRED SUPPLIER RELATIONSHIP

On January 12, 1993, the Departments of State and Commerce jointly issued U.S. government advocacy guidelines to assist U.S. ambassadors and U.S. and Foreign Commercial Service officers from the Department of Commerce "in official advocacy activities on behalf of U.S. commercial interests abroad." The guidelines were intended to provide a means for (1) expanding U.S. exports and export-related employment, (2) determining the type and extent of U.S. government assistance to be provided to U.S.-based companies intending to do business abroad, and (3) determining the eligibility of companies for this support. According to the advocacy guidelines, one of the criteria that may be examined when determining the eligibility of a foreign-controlled company, such as Northern Telecom, for such assistance is whether equivalent marketing opportunities are available for U.S. firms in the company's home market for like products or services, as identified in USTR's NTE report.

The Canadian government and Northern Telecom felt that because the preferred supplier relationship was reported as a trade barrier in the NTE report, it was being used as a basis for precluding Northern Telecom from the U.S. government's export advocacy programs. In a number of letters to the Department of Commerce and USTR, the Canadian government requested removal of the Bell Canada/Northern Telecom preferred supplier relationship from the NTE report. The Canadian government contended that

-- Bell Canada was under no obligation to purchase from Northern Telecom and had made substantial purchases from other suppliers, including AT&T;

-- the preferred supplier relationship was an internal agreement between two private companies, no different than linkages between equipment suppliers and service providers common in many countries, including the United States;

-- there was no Canadian government policy that prevented Northern Telecom's competitors from selling to any Canadian carriers; and

-- CRTC regularly examined Bell Canada and all of its relationships with suppliers to ensure that the best interests of Canadian consumers were being served.

In recent competitions for major telecommunications equipment sales contracts in Greece, the People's Republic of China, and Saudi Arabia, U.S. Department of Commerce officials told us that the U.S. government initially provided Northern Telecom with advocacy assistance in one case, but declined to provide assistance in the other two cases for the reasons listed in the next paragraph.

-- Greece. Although Northern Telecom chose to compete for the contract as a Canadian company, the U.S. embassy nevertheless initially provided assistance. However, U.S. government support was terminated when it was determined that Northern Telecom's bid was no longer under consideration by the Greek government. The U.S. government did not invoke the export advocacy guidelines in this case.

-- People's Republic of China. Northern Telecom chose to compete as a Canadian company, rather than as a U.S. company, and requested and received advocacy assistance from the Canadian embassy.

-- Saudi Arabia. The Saudis only allowed one company per country to bid on this telecommunications modernization contract, and Northern Telecom bid as a Canadian company. Northern Telecom asked for and received advocacy assistance from the Canadian embassy.

In March 1994 discussions with the U.S. Trade Representative and the U.S. Secretary of Commerce, Northern Telecom agreed to terminate its preferred supplier relationship with Bell Canada effective March 31, 1994. This situation was announced by the U.S. Trade Representative in a March 29, 1994, statement. Resolution of the issue was documented through a March 1994 exchange of letters among Northern Telecom's Chief Executive Officer, Canada's Minister for International Trade, and the U.S. Trade Representative.

In his March 29 statement, the U.S. Trade Representative said that both Bell Canada and Northern Telecom have agreed to end the preferred supplier relationship and that the termination was confirmed by the Canadian government. Moreover, he said that the Canadian government will apply appropriate regulatory oversight to future Bell Canada purchases through the auspices of CRTC and under the provisions of the Canadian Competition Act. As a result, the U.S. Trade Representative stated that references to this relationship would be removed from the 1994 NTE report,[2] U.S. exporters will have new opportunities in Canada, and Northern Telecom's U.S. subsidiary will be eligible for U.S. government support under the U.S. export advocacy program. Finally, the U.S. Trade Representative noted that the U.S. government has the right to reinstate references to Canadian procurement practices in a future NTE report if the termination of the preferred-supplier relationship is "not effective."

A USTR official told us that USTR will rely on reports from U.S. telecommunications companies attempting to compete in the Canadian market, as well as related U.S. embassy reports, to monitor compliance with the understanding. A Department of Commerce official told us that although it has no arrangements to monitor compliance, there is an expectation that a competitive procurement system will evolve.

CONTINUING CONCERNS EXPRESSED BY U.S.-BASED TELECOMMUNICATIONS COMPANIES

Representatives of U.S.-based telecommunications companies we interviewed were generally pleased with the agreement by Northern Telecom and Bell Canada to terminate their preferred supplier contract. However, they told us that some important issues still need to be resolved. Of primary concern to the companies was whether abrogation of the Bell Canada/Northern Telecom preferred supplier contract included the termination of all related amendments and understandings between Northern Telecom and Bell Canada. In this context, they specifically pointed out Bell Canada's implied requirement (not specifically mentioned in the preferred supplier contract) to provide Northern Telecom with an opportunity of first proposal when Bell Canada wishes to procure certain telecommunications equipment.

Northern Telecom declined to comment on this or other issues but told us that the exchange of letters that settled the dispute and

[2]The 1994 NTE report, as issued, does not mention the preferred supplier relationship.

the statement by the U.S. Trade Representative announcing termination of the preferred supplier contract stand by themselves. However, a March 30, 1994, Northern Telecom news release announcing resolution of the dispute provides some insight into Northern Telecom's interpretation of the understanding. In the press release, Northern Telecom says that although it does not believe the preferred supplier contract was a barrier to international trade, it views the understanding as an acceptable solution that will benefit its international customers and its employees in the United States and Canada. It goes on to say that "[A]t the same time, Northern Telecom fully expects to maintain a strategic relationship with Bell Canada consistent with normal trade practices around the world, and similar to other strategic customer relationships it has developed over the last several years."

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