SaskTel

Corporate Response to Mark H. Goldberg & Associates Report:

Impact of BCE/MTS Transaction on SaskTel
A high level risk assessment

December 12, 2016

Executive Summary

Mark H. Goldberg & Associates delivered a comprehensive review of the key risks that may impact SaskTel as a result of the proposed acquisition of Manitoba Telecom Services (MTS) by Bell Canada Enterprises (BCE). The key risks outlined in the report can be broken down into three major categories: ***regulatory***, ***competitive*** and ***financial***. This response document details SaskTel's analysis of and views toward the risk factors identified.

Goldberg & Associates indicate that potential regulatory changes resulting from the MTS sale to BCE represent the most fundamental set of risks with respect to impacts on SaskTel. We concur with this assessment. SaskTel has been materially impacted (often negatively but on occasion positively) by regulatory changes and policy positions since the company came under Federal regulation in the early 2000's. In recent years, regulatory bodies have tended to treat SaskTel no differently than the national Big Three carriers (Bell, Telus, Rogers) when it comes to both competition and wireless spectrum policies. Such policy approaches have often put SaskTel at a disadvantage versus both the Big Three and new market entrants despite the fact that SaskTel represents the de-facto fourth wireless carrier in the Saskatchewan market.

Given this history it is therefore conceivable that the loss of MTS as a wireless carrier in Manitoba could prompt Federal regulators to create even more incentives for additional wireless competition as pointed out by Goldberg & Associates. This could have impacts on SaskTel's ability to acquire wireless spectrum at fair prices, as experienced in the past, along with increasing competitive threats within and beyond Saskatchewan. SaskTel will need to continue to carefully manage regulatory risks going forward with the active support of the Provincial Government. Specific risk mitigation strategies are currently identified.

With respect to competitive risks, Goldberg & Associates outline several issues primarily related to how cable companies such as Rogers and Shaw will react to MTS' exit along with BCE establishing its western headquarters in Winnipeg. As pointed out in the report, both of these factors could create additional pressures on SaskTel in both the Consumer and Business markets. It should be noted that SaskTel has been successfully dealing with competitive threats for nearly three decades. The changing competitive environment in our industry is something that SaskTel pays very close attention to on an ongoing basis. The potential of Shaw entering the Saskatchewan market for wireless services is something that SaskTel has regularly monitored for several years but should this occur, it would change the competitive landscape. Shaw, in establishing a network, will need to acquire spectrum in Saskatchewan which may be a challenge. BCE's new western headquarters in Manitoba could also result in more aggressive marketing and sales activities throughout the province. Even if it is successful, BCE will still need access to SaskTel's extensive networks throughout Saskatchewan in order to serve any customers it wins. This will result in new wholesale revenues that will help to partially offset any losses from Bell's new positioning. SaskTel is a competitive regional carrier and it will need to remain competitive going forward in the face of a rapidly changing industry. The BCE/MTS deal does not change this fundamental situation although it heightens the risks. The degree of risk can only be quantified after the terms of the Federal approval is assessed in more detail.
The final key area of risk identified by Goldberg & Associates is financial.

These financial risks are consistent with the effects that the other risks identified in the report may cause.

These include MTS wireless roaming traffic migrating under the reciprocity agreement that SaskTel has with BCE, SaskTel's relatively small scale putting it at a disadvantage to both BCE and Telus for the attention of suppliers, and potentially the risk of a reduced ability to support the level of dividend payments that shareholders (the people of Saskatchewan) have come to expect. All of these risks represent potential threats to SaskTel's long-term profitability but they are all issues that SaskTel has been managing.

Constantly focusing on strong fiscal management and long-term profitability in the face of a rapidly changing industry is not new to SaskTel. SaskTel is constantly balancing the need for long-term profits and dividends with our public policy mandate to provide Saskatchewan businesses and consumers with the types of quality services and coverage that they are demanding and that the economy requires.

The potential of MTS roaming traffic migrating under the reciprocity agreement with BCE is an immediate risk. SaskTel is focused though on enhancing key partnerships with national carriers (including BCE), utilizing our position and vast network investment in Saskatchewan to help them fulfil their need for national coverage. SaskTel's small scale in a rapidly globalizing industry is a long-standing challenge that SaskTel has been able to manage to date. The acceleration in the virtualization of communications technology that is moving communications networks from hardware-based to software based systems may help to alleviate this scale issue. Our larger vendors are developing new solutions that will help smaller carriers such as SaskTel to more cost-effectively acquire scale economies.

Finally, SaskTel has been able to deliver positive returns and dividends to its shareholder over the past decade despite ongoing regulatory change and constantly intensifying competition. While our net income and dividends have varied based on conditions within the market and large capital investments that have been required in the transformation of SaskTel to an ICT company, we have delivered on average $100 million of net income and $80 million in dividends from 2000 to 2015. Both businesses and consumers across Canada are using wireless networks and the Internet more than they have ever done before, and for increasingly bandwidth-intensive tasks. In order to meet their growing needs and ever-increasing expectations in the coming years, ICT companies (including SaskTel) will need to make significant network and infrastructure investments. SaskTel's continuing need for large capital investments in the range of $300M per year for the next several years is a reflection of this situation. These investments are a major requirement for SaskTel to remain profitable and mitigate its financial risk but is recognized as a concern for the Government of Saskatchewan at a point where provincial debt is growing.

The BCE/MTS transaction, if approved, does represent a set of risks for SaskTel going forward. Most of these risks existed prior to the MTS/Bell deal and have already been captured through the internal Strategic Planning and Governance, Risk and Compliance (GRC) processes although in several cases the magnitude of the risk has increased. SaskTel's corporate strategic goals and risk mitigation strategies are helping SaskTel to successfully deal with ongoing industry changes – the BCE/MTS deal however is a new unique challenge that SaskTel must face.

SaskTel intends to continue to invest in enhancing its competitive position, ensuring the company's ability to deliver the best possible products along with an award-winning level of customer service. At the same time, SaskTel's current transformation efforts will help to adjust the company's cost structure. All of this is intended to ensure SaskTel's long-term financial sustainability and its ability to offer world-class networks and services to customers.

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Introduction

All businesses in competitive markets are subject to uncertainty and risk that may affect their success in achieving their strategic goals. SaskTel is no different and we strive to balance risk exposures with ensuring alignment to business strategies, objectives and risk tolerance. The ability to successfully identify and respond to key risks resides within SaskTel's Governance, Risk and Compliance (GRC) framework, which takes an enterprise wide approach and ensures alignment between Strategic Planning, Risk Management, Operations and Internal Audit activities. Governance is provided by SaskTel's Board of Directors, Audit and Risk Committee, and Executive. The risks identified in the Mark H. Goldberg & Associates report *"Impact of BCE/MTS Transaction on SaskTel: A high level risk assessment"* have been considered as part of the Strategic Planning and Risk Management processes for 2016 and beyond. This corporate response document outlines the key points from this analysis.

Key Risks Identified in the Goldberg & Associates Report

The key risks identified in the Goldberg & Associates report can be broken down into three major categories: ***regulatory***, ***competitive*** and ***financial***.

Regulatory Risks

Throughout the Goldberg & Associates report, potential regulatory changes resulting from the MTS sale to BCE are considered fundamental risks with respect to impacts on SaskTel. The key regulatory risks identified in the report are summarized below:

Key Regulatory Risks
1. Reduced numbers of facilities-based carriers in Manitoba could lead government policy makers to create incentives for additional wireless competition to develop through lowered costs for new entrant spectrum or other measures. Such measures could reduce costs for competitors and increase costs or restrict capacity expansion for SaskTel.
2. Regardless of whether the transaction is approved, policy makers may account for the possibility of such transactions in setting rules…the impact could be felt immediately in all regulatory decisions and policy determinations from the CRTC and the federal department of Innovation, Science and Economic Development.
3. Federal regulators and policy makers, such as the CRTC and Innovation, Science and Economic Development Canada, [will not understand] the unique characteristics of SaskTel, as a large, province-wide regional operator, or as a provincial crown corporation.

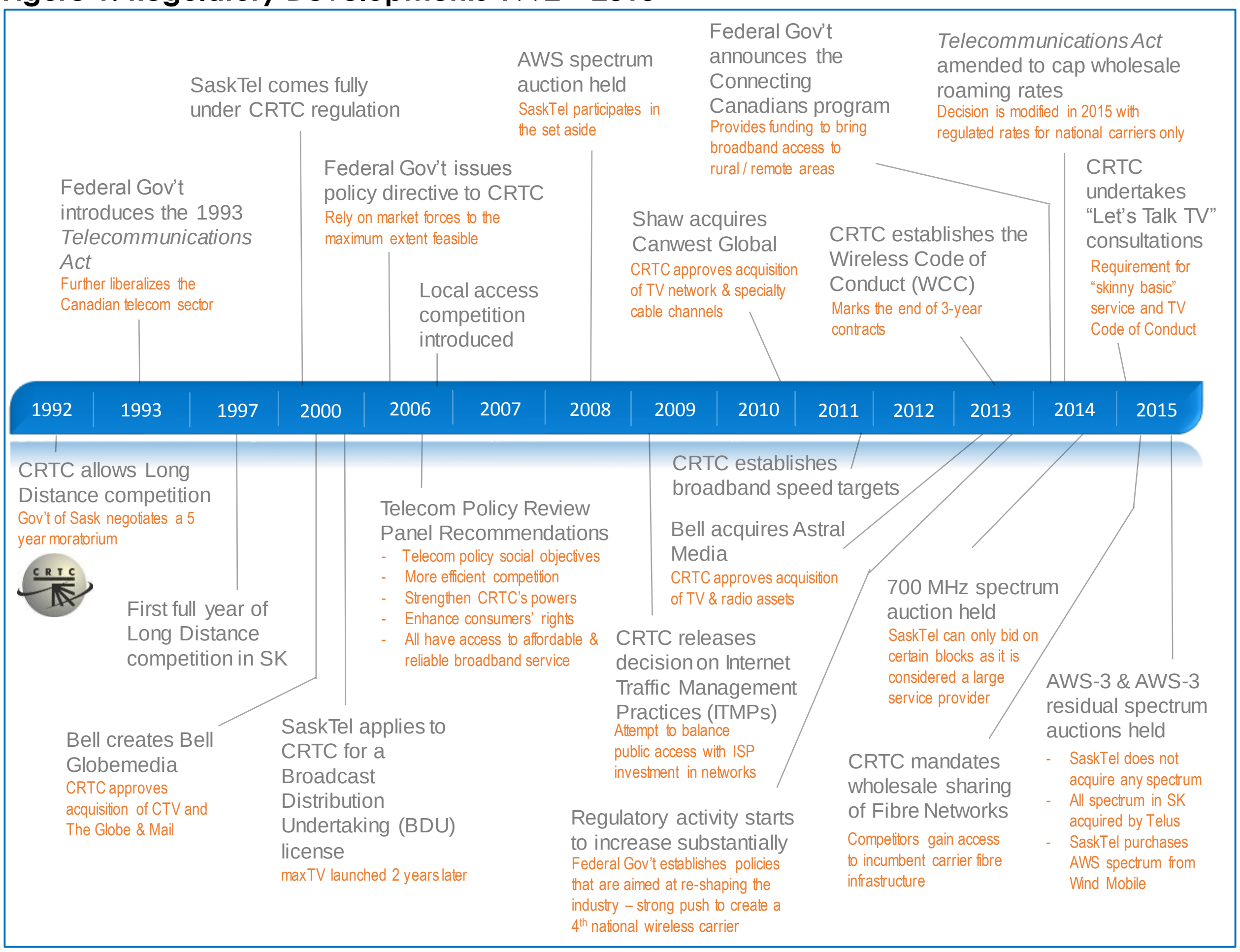
<u>SaskTel Response</u>:

Since 2013, the level of regulatory activity within the Canadian telecommunications market has increased substantially. This increase in activity has also resulted in a larger degree of regulatory uncertainty and risk.

Such regulatory uncertainty is not new to SaskTel – it has historically been identified as one of our most significant risks given that regulatory reforms can directly and indirectly impact the costs and complexity of our business.

As illustrated in Figure 1 below, since the CRTC introduced Long Distance competition in 1992 and undertook revisions to the *Telecommunications Act* in 1993, there have been numerous significant regulatory developments that have re-shaped the industry. SaskTel has successfully navigated these developments over the past twenty-five years.

Figure 1: Regulatory Developments 1992 – 2015



With respect to wireless spectrum, Goldberg & Associates indicate that SaskTel could be faced with either higher costs for spectrum or a reduced ability to purchase spectrum if there are regulatory incentives put in place that favour new entrants. This is dependent though on the specific spectrum auction rules established by Innovation, Science and Economic Development Canada (ISED). There have been cases in past auctions where SaskTel has benefitted from auction "set aside rules" for new/small players. In other more recent auctions, the rules have not been favourable to SaskTel as a small, regional player.

For example, in the AWS spectrum auction held in 2008, 40 MHz out of the total of 90 MHz being auctioned was set aside for new entrants only. This was codified in the November 2007 Industry Canada (the precursor to ISED) document *Policy Framework for the Auction* *of Spectrum in the 2 GHz Range:* "To be eligible for the set-aside, a new entrant is defined as: An entity, including affiliates and associated entities, which holds less than 10 percent of the national wireless market based on revenue."

This particular auction rule made all players eligible for the set-aside spectrum with the exception of the "Big Three" – Bell, Telus, and Rogers. In all other auctions since 2008, the regulator has treated SaskTel just like any other incumbent firm, to the detriment of our ability to acquire spectrum for our wireless operations.

The following table summarizes recent spectrum auction rules and their impact on SaskTel:

Spectrum Auction Rules and Impact to SaskTel				
Year	Auction	Set Aside	Other Rules	Impact
2008	AWS	Yes <u>Defined as</u>: An entity, including affiliates and associated entities, which holds less than 10% of the national wireless market based on revenue.	N/A	SaskTel participated in the set aside.
2014	700 MHz	No	Large service providers were limited to one paired block each of the four prime paired blocks. <u>Defined as</u>: An entity with greater than 10% market share nationally, or more than 20% of the market in any one province.	SaskTel was considered a "large service provider".

Spectrum Auction Rules and Impact to SaskTel (cont'd)				
Year	Auction	Set Aside	Other Rules	Impact
2015	AWS-3	Yes <u>Defined as</u>: An entity who is a small wireless service provider, be a licensed cellular operator and actually operates a network in the tier 2 license area.	Large service providers were limited to two "open" (5 +5) MHz paired blocks. <u>Defined as</u>: An entity with greater than 10% market share nationally, or more than 20% of the market in any one province.	SaskTel was considered a "large service provider".
2015	AWS-3 Residual	No	No	No restriction
2015	2500 MHz	No	Spectrum aggregation limit of 40 MHz.	SaskTel was over the limit and could not participate.

Given the tendency of ISED in more recent spectrum auctions (past 8 years) to treat SaskTel strictly as an incumbent firm (and therefore no differently than the Big Three national players) we will continue to strongly advocate that SaskTel be recognized as the 4th carrier in the Province of Saskatchewan. SaskTel competes directly with the Big Three throughout the province and should be included in any special arrangements for promoting cellular competition in Canada.

As the de facto fourth carrier in Saskatchewan, SaskTel is already fulfilling the Federal Government's policy position of having four carriers in regions across the country. We should therefore not be discriminated against and put at a disadvantage vis-à-vis the larger national carriers. The Big Three have already been using their market power against SaskTel through the use of aggressive regional wireless pricing strategies. Regional pricing ultimately has a negative impact on SaskTel's ability to re-invest into its wireless networks and hampers the company's ability to continue to provide world-class wireless services to customers throughout Saskatchewan or return a larger dividend to the local residents.

In the event that SaskTel continues to be disadvantaged at auction, there are other options SaskTel will focus on to obtain access to wireless spectrum. Spectrum that has been acquired by other carriers does occasionally become available for sale. SaskTel's recent purchase of spectrum from Wind Mobile is one example of this. In addition, network sharing arrangements between carriers may include opportunities for the leasing of spectrum. For example, SaskTel was able to recently lease spectrum from Rogers.

The overall impact of the loss of MTS as a regional player is uncertain at this time. As Goldberg & Associates point out, if the sale is approved SaskTel could be left as the only major regional player in Western Canada (note that Shaw is also a major regional player across Western Canada and CityWest Cable and Telephone is still offering service to approximately 15,000 residents and businesses in northwest British Columbia). While there will still be regional players in Ontario (TBayTel), Quebec (Videotron), and Atlantic Canada (Eastlink), SaskTel will be left surrounded by two of the large players – Telus in the West and BCE to the east. If this occurs, it provides additional credence to the argument that SaskTel must not be treated the same as the large national players from a regulatory perspective.

Regardless of whether or not MTS is absorbed by BCE or remains an independent entity, SaskTel will still need to carefully manage regulatory risks going forward. This is exacerbated by the fact that the new Federal Government has yet to make its policy position on telecom regulation clear. As a result, it is difficult to predict the direction that the Federal Government will take in the future.

With the assistance of the Government of Saskatchewan and the diligence of our regulatory experts, we have been able to manage these risks despite increasing levels of regulatory oversight and rules that have usually been unfavorable to regional carriers.

SaskTel has regulatory mitigation strategies in place to address these risks.

Competitive Risks

Several competitive risks were outlined in the report given that key competitors may make strategic decisions around the Saskatchewan Consumer and Business markets that could place increased pressure on SaskTel. The key competitive risks identified in the report are summarized below:

Key Competitive Risks
1. Rogers will look to replace its lost partnership with MTS by developing retail partnerships with cable companies in Manitoba and Saskatchewan.
2. Once Shaw launches a technically competitive mobile service, on its own or through a partnership arrangement, the entire portfolio of SaskTel's consumer communications services will face significant pressure.
3. Establishment of Winnipeg as a western headquarters for BCE could lead to erosion in SaskTel's share of the market for business services.

SaskTel Response:

Along with other telecommunications carriers in Canada, SaskTel spent the majority of its initial existence as a regulated monopoly.

This changed when mobile service was launched in 1989 and after the CRTC introduced competition to the Long Distance (LD) market in 1992 (note that SaskTel came under full LD competition in 1996). Local Access competition was then introduced in the mid-2000's.

As a result, successfully dealing with competitors across all lines of business is something that SaskTel has been doing for nearly 30 years.

Figure 2 provides a high-level overview of the history and evolution of competition that SaskTel has adapted to. Despite this increase in competition, SaskTel has been able to successfully increase gross revenues by reinvesting capital in a world class infrastructure and investing in new product lines. Figure 3 provides a historical view of revenue growth over the past 20 years.

Figure 2: Increasing Competition for Communication Services

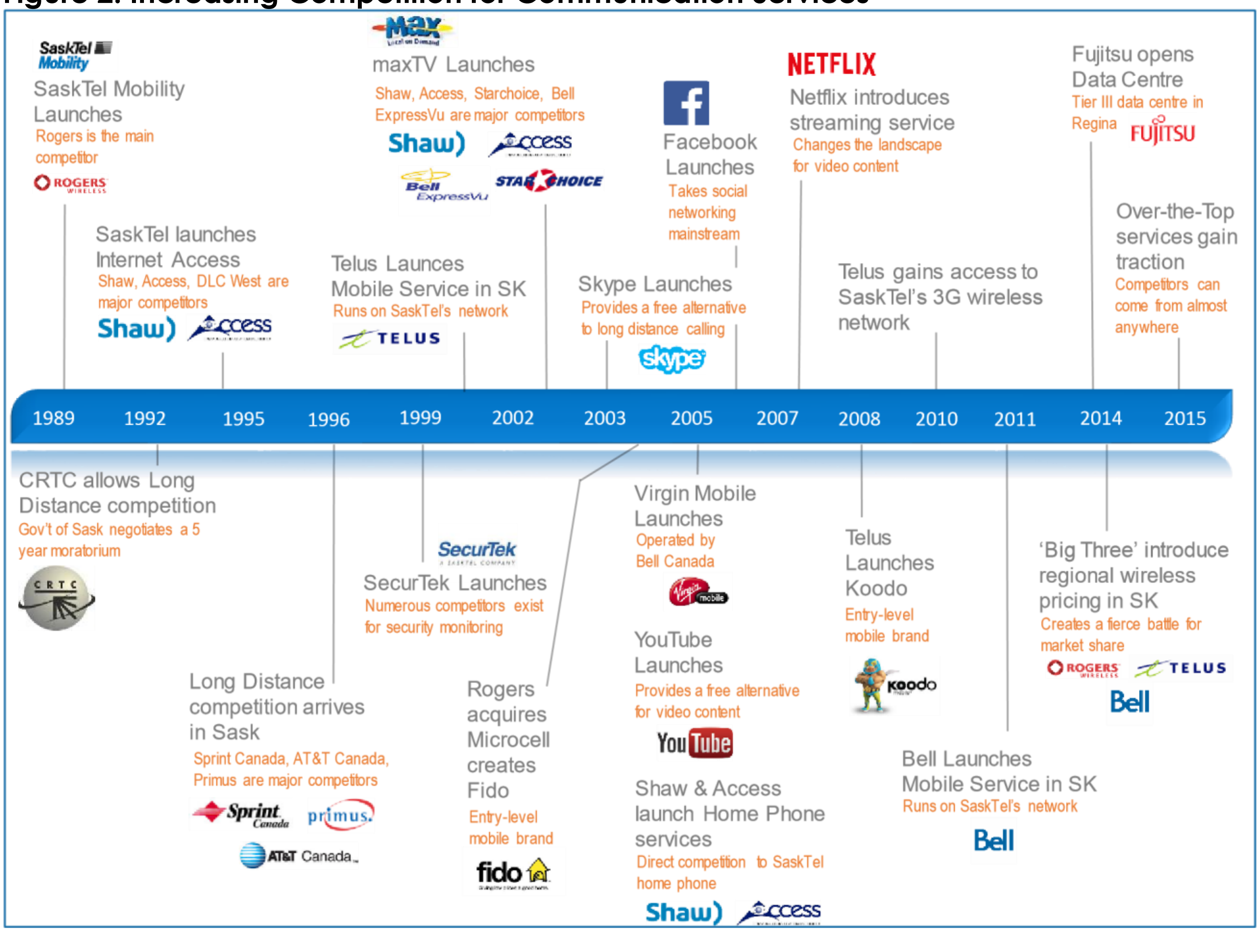
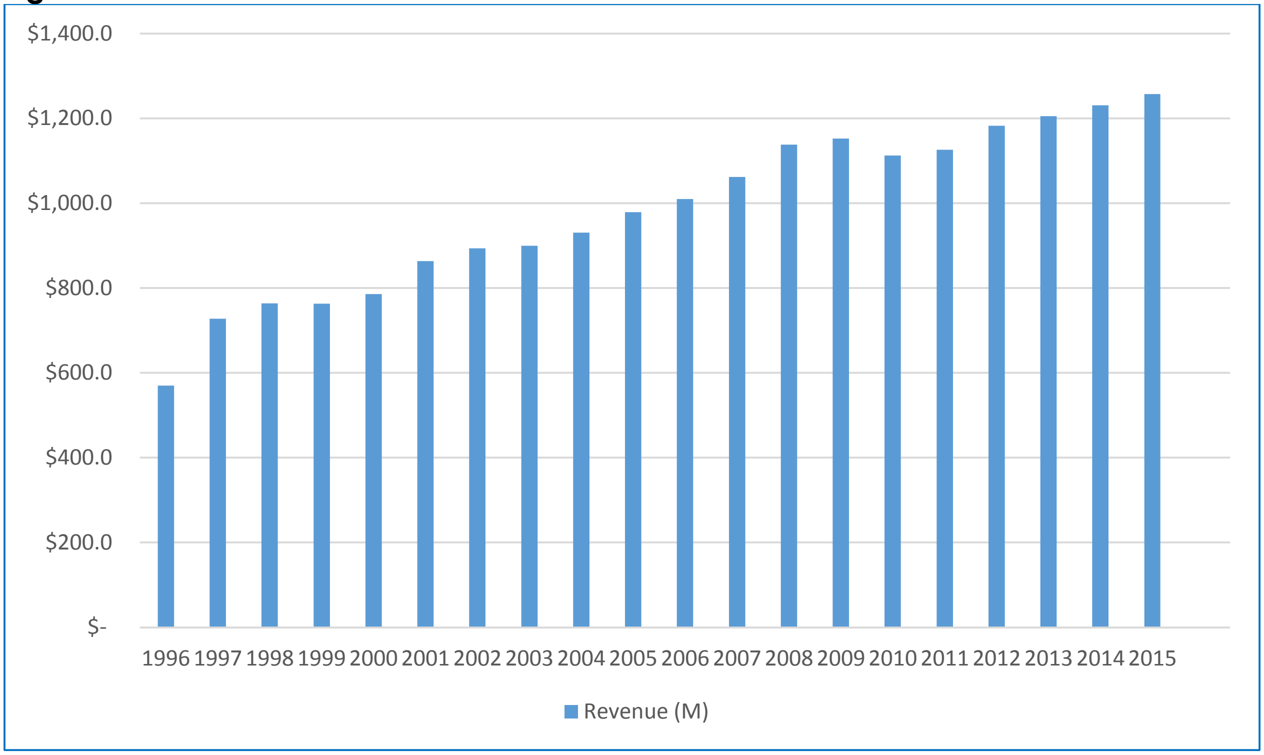


Figure 3: SaskTel – 20 Years of Revenue Growth



SaskTel's adaptation to competition was initially met with some skepticism. When competition was first introduced, there was a tendency to view it from a "scarcity mindset" as a zero-sum game with competitors grabbing market share at SaskTel's expense. As we gained more experience with competition though, it became evident that this was not always true. The introduction of competition to some lines of business actually resulted in growth of the total market. This is one of the contributing factors to the continuing growth in SaskTel's revenues. For example, when Long Distance rates were reduced in the 1990's during the run-up to full competition, it was assumed that our revenues would decrease substantially. The actual result was that lower rates stimulated more customer usage which increased the number of Long Distance minutes used. This increase in volume helped to partially offset the drop in revenue per minute. We recognize that in a market the size of Saskatchewan there is limits to growing market share with increasing competition.

As such, in the face of continually increasing competitive threats, SaskTel has been able to successfully compete as a result of consistently focusing on the following key factors:

- Delivering an outstanding customer experience
- Developing products and services that meet customer needs
- Providing a superior network and infrastructure
- Remaining local and committed.

It is important to note that none of the competitive factors that differentiate SaskTel are directly impacted by Bell's acquisition of MTS. All of these factors are areas that SaskTel would be focusing on regardless of who is the dominant communications service provider in Manitoba.

Although we have been successful in dealing with competitive threats to date, it is important to acknowledge that the competitive landscape of the industry continues to evolve and be more challenging. Consolidation of existing competitors and the emergence of new competitors are well-established environmental factors that have been on our radar for many years. These trends are playing themselves out both around the world and here in Canada.

For example, we have been paying close attention to Shaw's apparent desire to enter the wireless market in Western Canada. Shaw has purchased spectrum in the last several auctions and has aggressively developed its Wi-Fi network. In order for Shaw to launch a wireless network in Saskatchewan, they will need to either acquire spectrum and build or form an alliance and commence operations as a Mobile Virtual Network Operator (MVNO). Shaw may acquire spectrum in Saskatchewan at the next spectrum auction. From a technical perspective though, the 600 MHz band that will be put in play will be difficult to build out an entire network on.

In the case that BCE receives approval of its takeover of MTS, there is the potential threat of BCE attracting business customers in Saskatchewan. As Goldberg & Associates outline in their report, the establishment of Bell's Western Canadian office in Winnipeg will provide them with much greater proximity to Saskatchewan-based customers. Even in the worst-case scenario though, SaskTel is not likely to lose out completely given that we would partially be earning wholesale revenues from BCE accessing our networks.

SaskTel has remained competitive in the face of many industry changes for well over two decades and it will need to remain competitive going forward through continued reinvestment into the Company. The BCE / MTS deal does not change this fundamental situation.

SaskTel has competitive mitigation strategies in place to address these risks.

Financial Risks

Consistent with the regulatory and competitive risks that they identified, Goldberg & Associates also highlighted a number of financial risks that could result from the MTS transaction. The key financial risks are outlined below:

Key Financial Risks
1. MTS traffic may migrate to be covered under the network reciprocity agreement, with a resultant negative net impact on roaming revenues in the order of a few million dollars.
2. As Bell and Telus increase scale in neighboring Manitoba, SaskTel will be competing against much larger carriers in attracting attention from its suppliers of technology and services.
3. For all of the reasons identified in the report, there is a risk that SaskTel's net income will not support the level of dividends that have been returned to the province in recent years.

SaskTel Response:

SaskTel constantly focuses on building long-term profitability and sustainability. Given the regulatory and competitive risks that we face in a rapidly changing industry, strong fiscal management has been and will continue to be a priority. Our public policy mandate requires us to also balance the need for long-term profits with the long-term investments required to reposition SaskTel as a leading Information and Communications Technology (ICT) provider. Investment in this transformation will ultimately provide our shareholders (the people of Saskatchewan) with the types of quality services and coverage that they are demanding. We will continue to seek out this balance, keeping the company competitive while also fulfilling the needs for upgraded / new services and solid long-term financial returns.

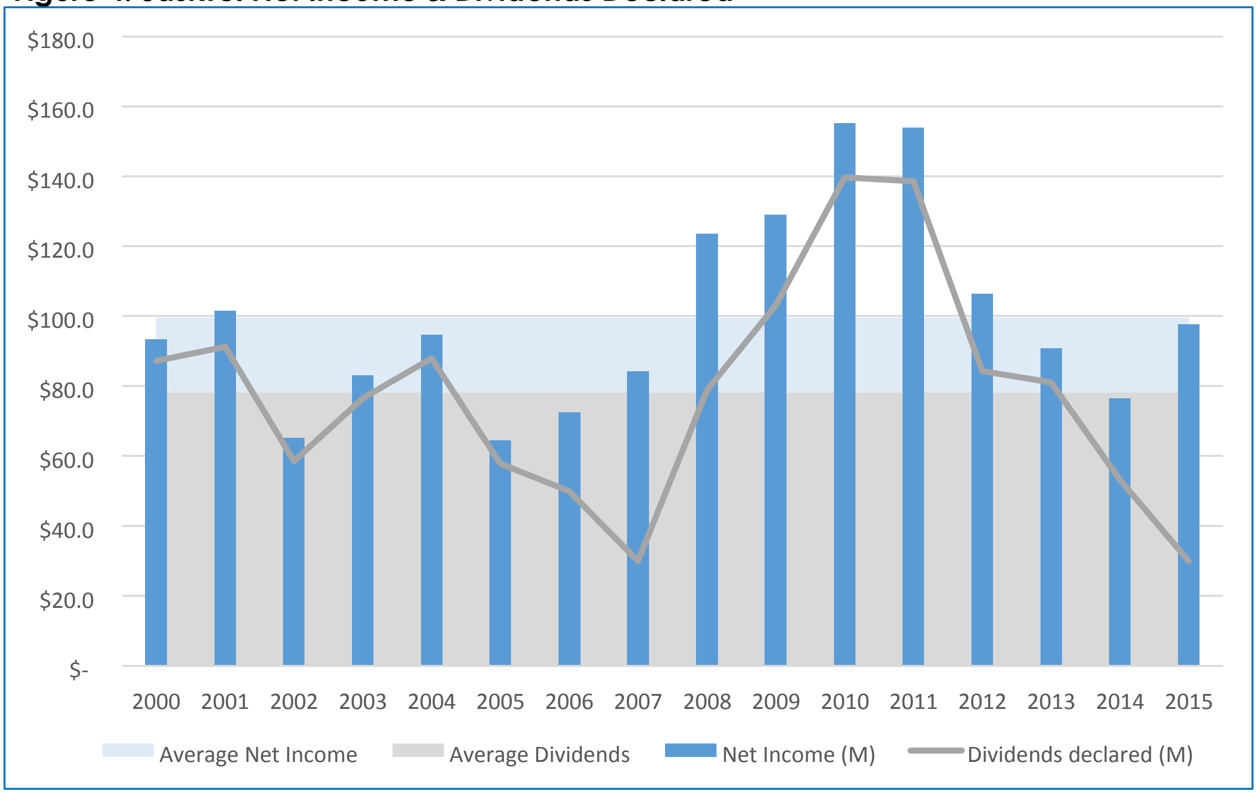
Goldberg & Associates highlight the issue of MTS traffic migrating to be covered by SaskTel's Network Reciprocity Agreement (NRA) with BCE and Telus (as a result of the current MTS and Rogers roaming agreement likely to be terminated). It is important to note that SaskTel is currently negotiating a new NRA.

The issue of SaskTel's small scale relative to BCE and Telus was identified in the risk review. This is a long-standing challenge and the risk that suppliers may not provide solutions scaled to a telco of our size has been identified.

As technology evolves, however, our vendors are looking at developing solutions geared towards smaller providers. Communications technology is becoming increasingly virtualized through the introduction of technologies such as Network Function Virtualization (NFV) and Software Defined Networks (SDN). These technologies are creating new opportunities for our vendors to offer "telecom factories" whereby smaller providers can cost-effectively acquire access to scale economies offered by our large vendors. The creation of such offerings may provide some relief from the scale shortcomings of a small company like SaskTel within an increasingly globalized industry.

Finally, Goldberg & Associates highlight the risk that, as a result of the other risks identified in their report, SaskTel's net income may not support the level of dividends that the public has come to expect. As illustrated in Figure 4, SaskTel, despite ongoing industry changes, has consistently been able to deliver a stream of positive earnings and dividends over the past sixteen years.

Figure 4: SaskTel Net Income & Dividends Declared



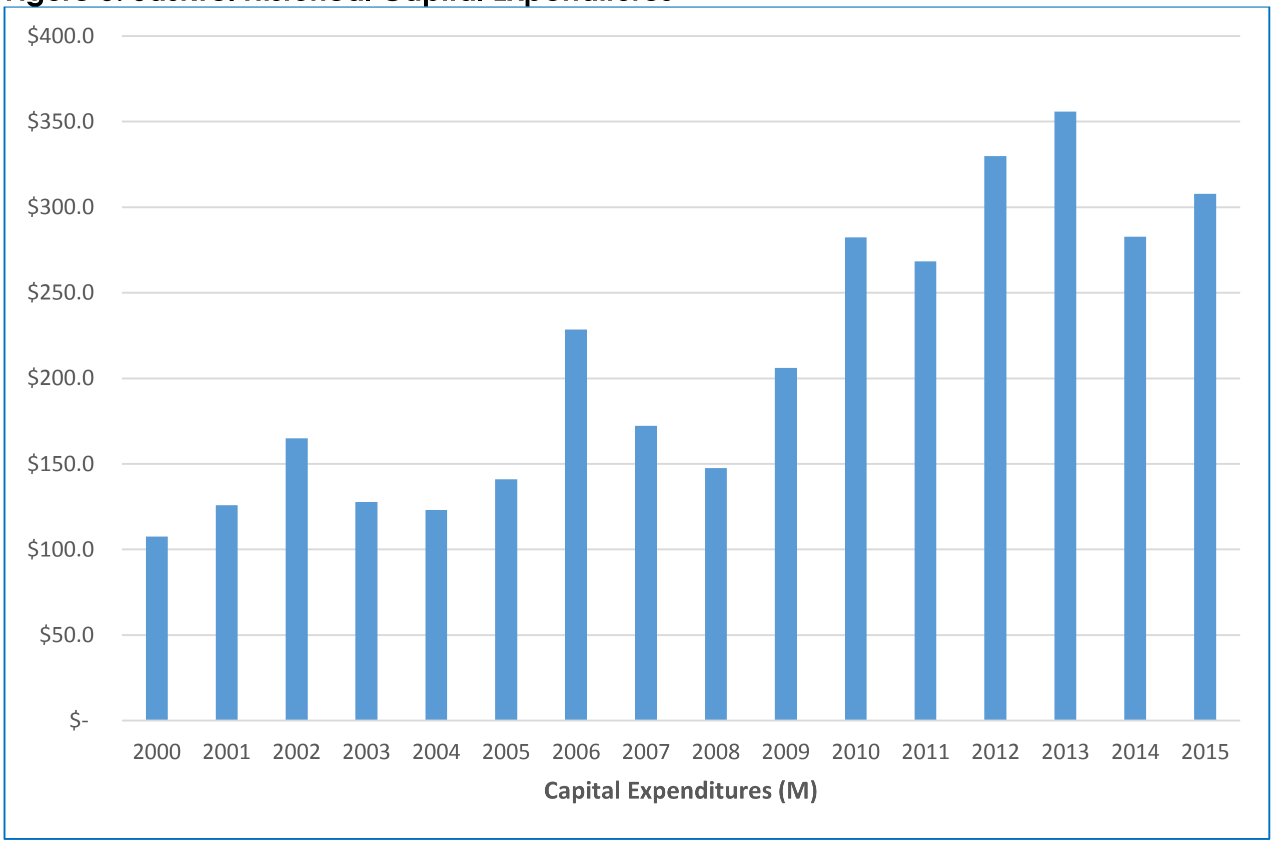
It is important to note that dividends will vary from year to year based on a number of factors including overall financial performance, one-time events that positively impact earnings, changes in costs and capital investments, and shareholder demands. As can be seen in Figure 4, SaskTel's dividend payments have varied based on changes in these factors. For example, the large dividend declared in 2010 was a result of one-time transactions.

Despite the ups and downs in both net income and dividends declared, on average, we have delivered approximately $100 million in net income and approximately $80 million in dividends to the Province.

The reduction in dividends after 2010 is a direct reflection of the increase in critical capital investments (see Figure 5) that SaskTel has made into the transformation of our business over the past six years. These investments have included (among others):

- Network upgrades and enhancements through the Fibre to the Premise program, expansion of LTE service, and the implementation of the LTE-TDD fixed wireless solution in rural areas
- Upgrades and expansions to Tier II data centres in Regina and Saskatoon as well as the construction of a new Tier III data centre in Saskatoon
- Product development in the areas of IP-based communications and IT infrastructure services
- New systems and processes to provide customer self-serve options.

Figure 5: SaskTel Historical Capital Expenditures



All of these investments have been necessary in order to transform and competitively position SaskTel to succeed in the face of rapidly changing technologies and customer demands for increasing bandwidth. SaskTel's transformation initiatives are focused on:

- Profitability improvement through productivity and operational excellence activities.
- Revamping the company's cost structure.
- Migration and exits of classic services and legacy technologies.
- Crown collaboration initiatives.

Additionally, some investments have been required as a result of regulatory decisions over which SaskTel has no control, described as the ongoing regulatory risk we face.

The Goldberg and Associates report highlighted SaskTel's capital intensity ratio of 24% (21.7% excluding spectrum) for 2015, which reflects the percentage of the company's total operating revenues that were reinvested into capital expenditures. With average annual capital spending of $304 million over the last six years (as compared to the annual average of $170 million in the six years previous to 2010), SaskTel's capital intensity levels have increased. Customer demand for greater amounts of bandwidth have driven the advancement of SaskTel's wireless 4G/LTE network, continued roll out of the Fibre to the Premise (FTTP) program in the major centres, ongoing development of CommunityNet, and network investments that support Saskatchewan's First Nations and rural communities. The trend of rising capital investments throughout the Canadian industry is evidenced by the spending of other carriers as they also build out their networks. Scotiabank's August 29th, 2016 Converging Networks report stated that "in order for Telus to reach its goal of completing a majority of its FTTH network in five years, capex intensity will likely remain high at 22%."

SaskTel has financial mitigation strategies in place to address these risks but our need for an annual capital investment of close to $300M per year is a concern for the Government of Saskatchewan at a point where Provincial Debt is growing.

Conclusion

Goldberg & Associates have presented a thorough review of the key issues surrounding the BCE acquisition of MTS and the impacts that they may have on SaskTel. Many of the risk factors outlined in the report are known to SaskTel and we have been proactively managing them. Where new risks have been identified or old risks enhanced by the transaction, we will be analyzing them further and looking into the steps that should be taken to effectively mitigate them as part of our strategic planning and risk management processes.

We agree with Goldberg & Associates that the risk of increased regulatory activity aimed at encouraging additional wireless competition is the most fundamental risk arising from the BCE/MTS transaction. Given that the new Federal Government has yet to release a clear policy position on telecom regulation, there is currently a significant degree of uncertainty surrounding what future actions the CRTC and ISED will take. SaskTel and the Saskatchewan Provincial Government will need to aggressively lobby in Ottawa to ensure that our positions and the important role that SaskTel plays as a competitor in Saskatchewan are both heard and understood.

The proposed BCE/MTS transaction is an example of another industry development that SaskTel will need to adapt to and the degree of change can only be further quantified when the conditions of the approval from the regulator are known. Over the past several years, our industry has been undergoing rapid changes to regulation, competition, technology, and customer expectations. As documented in SaskTel's Strategic Plan and Risk Management Framework, we will continue to stay on top of and adjust to these changes.

We have been making significant investments in our transformation to an Information and Communications Technology (ICT) company through the adoption of new technologies, success in collaborating with Saskatchewan-based IT delivery partners, and the application of best operational principles. This transformation is enabling the development of new products and new value propositions that will competitively reposition SaskTel in the market supported by the ongoing demand for capital for reinvestment. Concurrently, we are also focused on the optimization of our classic lines of business. This is contributing to both the retention of revenues and the ongoing minimization of our cost structure.

Supporting this important transformation is SaskTel's strategic commitment to both the delivery of an exceptional customer experience (multi-year awards from JD Power & Associates are evidence of this commitment) along with offering the most comprehensive breadth of services of any ICT company in Saskatchewan.