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Behaviour of Chinese SOEs: Implications for Investment and Cooperation in Canada

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Author Biography

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The opinions expressed in this paper are those of the author and do not necessarily reflect the views of the Canadian International Council, its Senate or its Board of Directors, or the views of the Canadian Council of Chief Executives or its members.

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Executive Summary

After decades of expansion into emerging markets around the world, Chinese firms (both SOEs and entrepreneurial) are seeking to invest in OECD countries across a wide range of industries. The relative scale of the capital available for overseas investment, the interest in resource assets, and the importance of our trade with China all make this a critical issue for Canada. Misconceptions about the nature of Chinese state-owned enterprises (SOEs) delay and undermine efforts of both Canadians and Chinese sides to promote mutual understanding. The popular debate reflected in the media suggests widespread, if not clearly articulated, uncertainty about the purpose and operations of SOEs. In China these assumptions are challenged by a range of business people, industry observers, and government officials. Far from exerting unfair advantage over global competitors, Chinese SOEs are perceived to have faced undue resistance in OECD markets based on misconceptions of their purpose and behaviour. At the policy level, misperceptions about SOEs can influence the analysis of net benefit. These same misperceptions have an unproductive impact in commercial relationships as well.

The purpose of this paper is to narrow the range of misunderstanding. To the extent the purpose and behaviour of Chinese SOEs correspond to that of foreign investors, they should be treated in a like manner. To the extent that the ways in which they differ pose risks to Canada and local communities, even potentially, remedies should be considered. Investments in Canadian resources by Chinese SOEs offer an opportunity to Canadian firms (and governments) to accelerate this adaptive process of augmenting existing supply chains, managerial networks, and sources of technology. At the same time, Canada is in a position to assist Chinese resource SOEs in demonstrating that they are able to successfully operate in an OECD-level regulatory system for environmental protection, labour standards, and health and safety.

Résumé

Après plusieurs décennies d'expansion sur les marchés émergents du monde entier, les entreprises chinoises (sociétés d'État et entreprises indépendantes) cherchent à aujourd'hui à investir dans de nombreux secteurs des pays de l'OCDE. Pour le Canada, il s'agit là d'un enjeu crucial étant donné la part relative des capitaux destinés aux investissements à l'étranger, l'intérêt pour les biens en ressources et l'importance de nos échanges avec la Chine. Mais plusieurs malentendus sur la nature des sociétés d'État chinoises sapent les efforts de compréhension mutuelle entre Canadiens et Chinois. Sans l'exprimer ouvertement, le débat public relayé par nos médias jette ainsi le doute sur les intentions et les activités de ces sociétés d'État. Du côté de la Chine, ces assertions sont récusées par beaucoup de gens d'affaires, d'observateurs et de représentants gouvernementaux, selon qui les sociétés d'État chinoises sont loin de profiter d'un avantage indu par rapport à leurs concurrents mondiaux mais se heurtent au contraire à une résistance excessive des pays de l'OCDE, qui prêteraient foi aux malentendus entourant leur attitude et leurs intentions. Or ces malentendus peuvent nuire sur le plan stratégique à l'analyse des avantages nets et influer tout aussi négativement sur les relations commerciales.

Cette étude vise à dissiper ces malentendus. Car de deux choses l'une: soit l'attitude et les intentions des sociétés d'État chinoises correspondent à celles de véritables investisseurs étrangers, auquel cas elles doivent être traitées en conséquence ; soit leur conduite expose le Canada et les collectivités locales à des risques même potentiels, et il faut alors prendre les mesures qui s'imposent. Les investissements des sociétés d'État chinoises dans les ressources canadiennes offrent à nos entreprises (et à nos gouvernements) l'occasion d'accélérer un processus d'adaptation axé sur le renforcement des chaînes d'approvisionnement, des réseaux de gestion et des sources de technologies. Parallèlement, le Canada est bien placé pour aider les sociétés d'État chinoises à démontrer leur capacité de se conformer à des systèmes de réglementation du niveau de l'OCDE en matière de protection de l'environnement, de normes de travail et de santé et sécurité.

Introduction

Chinese companies are a major new source of capital investment. The relative scale of the capital available for overseas investment, the interest in resource assets, and the importance of our trade with China all make this a critical issue for Canada. We need a more informed and vigorous debate.

Public discourse on foreign investment occurs at many levels. There is a broad consensus among economists that foreign direct investment (FDI), including that by multinationals from developing countries, brings economic benefits that strengthen the host country. Jobs created locally translate into stronger domestic firms as well as supporting the growth of local communities.[1] As these firms integrate into the host country market they pull domestic firms into their supply chains and managerial networks. Domestic firms can accelerate this process by actively initiating business.[2]

Misconceptions about the nature of Chinese state-owned enterprises (SOEs) delay and undermine efforts of both Canadians and Chinese sides to promote mutual understanding.

The popular debate reflected in the media suggests widespread, if not clearly articulated, uncertainty about the purpose and operations of SOEs, namely: non-commercial orientation, state subsidization, regulatory compliance, and governance.[3] This paper will examine the evidence for a number of assumptions frequently heard in these discussions including: government ownership implies that SOEs are at least in part directed by the Chinese state in a way that serves the interests of the state and as such may operate to disadvantage local firms and markets. Their operations are taken to be funded by the state, with international acquisitions subsidized by borrowing from state banks at subsidized rates and soft repayment terms thereby enabling them to compete unfairly against global rivals. The key rationale for the formulation "SOE Guidelines" under the Investment Canada Act (ICA) is that SOEs behave differently as a function of their state ownership and presumed non-commercial orientation. These guidelines apply to all SOEs—those from the Middle East, China, as well as (nominally at least) OECD countries. The ICA requires that applications for control of Canadian businesses and assets be reviewed to ensure they provide net (cumulative) benefit to Canada. As a result of amendments in 2008, there is now a separate review (not addressed in this paper) with respect to national security that can be triggered if the Minister so requests.

In China these assumptions are challenged by a range of business people, industry observers, and government officials. Far from exerting unfair advantage over global competitors, Chinese SOEs are perceived to have faced undue resistance in OECD markets based on misconceptions of their purpose and behaviour. The Committee on Foreign Investment in the United States (CFIUS) and the SOE Guidelines of the Investment Canada Act are regarded as subjecting proposed SOE investment from a World Trade Organization (WTO) compliant-state (i.e., China) to additional investment hurdles and potentially discriminatory and/or protectionist in intent.

The 2009 approval of the China National Petroleum Corporation (CNPC) investment application in Athabasca Oil Sands Corporation (AOSC) and several subsequent transactions in the absence of a highly polarized public debate suggests some change in Canadian public opinion. However, the rancorous public debate in Australia over the Chinalco-Rio Tinto affair, including reactions to the subsequent arrest of Rio Tinto executives in China, suggests a broader syndrome of misunderstanding and mistrust that remains below the surface and crystallizes when a commercial dispute occurs.[4] The roots of these misunderstandings lie in political as well as commercial and institutional differences and are difficult to predict.[5] In their discussion of the China National Overseas Oil Corporation's (CNOOC) bid for the US-owned Unocal, David Marchick and Edward Graham note that the bid

1 Globerman and Schapiro, "Economic and Strategic Considerations Surrounding Chinese FDI in the US."
2 Sauvant, *Rise of Transnational Corporations from Emerging Markets*. See also Buckley, et al., "Explaining China's Outward FDI."
3 For a synopsis of these concerns see Kilgour, "China and Trust."
4 Shearer, "The China Paradox," 13.
5 Eden, and Miller, "Revisiting the Liability of Foreigness."

was negatively influenced by coming at a politically-charged moment in China-US relations.[6] Assessing this "political" climate can be quite a challenge for a firm in timing the launch of a commercial bid. At the policy level, misperceptions about SOEs can influence the analysis of net benefit. These same misperceptions have an unproductive impact in commercial relationships as well.

This paper endeavours to narrow the range of misunderstanding. To the extent the purpose and behaviour of Chinese SOEs correspond to that of foreign investors, they should be treated in a like manner. To the extent that the ways in which they differ poses risks to Canada and local communities, even potentially, remedies should be considered.

The Larger Policy Context: The New "Normal"

The global financial crisis of 2008–2009 highlighted the economic rise of Asia and China in particular. Strong new supply and demand relationships have emerged creating a global triangle with Asian workshop producer/savers, US/European consumer/borrowers, and commodity producers making up the three sides. Fortunately Canada finds itself on two overlapping sides[7] leading some to predict that resource exports put Canada at the cutting edge in adapting to the "new normal."[8]

After decades of expansion into emerging markets around the world, Chinese firms (both SOEs and entrepreneurial) are seeking to invest in OECD countries across a wide range of industries. This changing profile is driven by the rapid internationalization of these firms, intensification of competition in the domestic market, and the recycling of foreign exchange reserves. In Australia and Canada the emphasis remains resources because of the scale of investment required but both countries are increasingly the target of Chinese investment in many sectors—from telecommunications equipment to alternative energy as much by entrepreneurial firms as by SOEs.

Investments in Canadian resources by Chinese SOEs offer an opportunity to Canadian firms (and governments) to accelerate this adaptive process of augmenting existing supply chains, managerial networks, and sources of technology. At the same time, Canada is in a position to assist Chinese resource SOEs in demonstrating that they are able to successfully operate in an OECD-level regulatory system for environmental protection, labour standards, and health and safety.

Understanding the China Context

In OECD countries, SOEs (crown corporations) are created to fulfill a range of social and/or economic objectives not being satisfied by the market. In China, SOEs are a legacy of central planning. While the role of the state in the economy is materially different than in western economies, the key lesson learned from their socialist past was that government should leave issues pertaining to strategy and competition to the market to decide. Expectations that state involvement would fade as the Chinese economy matured have not materialized. However the nature of intervention has gradually been restricted to shaping the macro-economic environment combined with a final high level review and approval process of mega overseas investments.

Understanding the overseas investment and operating behaviour of Chinese SOEs requires some knowledge of Chinese economic reform and specifically the SOEs. There are significant differences amongst SOEs even at the state level in terms of size, sophistication of management, and governance.[9] The large energy SOEs (CNPC, Sinopec, and CNOOC) are amongst the largest of the Fortune 500 are nationally supervised by the State-owned Assets Supervision and Administration Commission (SASAC). Minmentals, which is relatively small

6 For an in-depth analysis of the US reaction to CNOOC's bid for Unocal, see Graham and Marchick, *US National Security and Foreign Direct Investment*.
7 Morgan, "New Economic Order Demands New Attitude."
8 El-Erian, "Driving Without a Spare."
9 Xu, "State-Owned Enterprises in China."

in comparison, China Non-ferrous Metals, and Chalco are nationally supervised but most mining companies are owned at the provincial and township level (POE and TVE respectively) or owned by entrepreneurs. China's energy firms were among the first to internationalize because of the global nature of the oil and gas industries and China's rapid growth. China became a net importer of oil in 1993.

SOE Reform: From Intervention to Supervision

China began to move away from a planned economy toward market prices in agriculture in 1978. Largely complete by 1993, this phase involved separating state ownership from the management function. The role of the Communist Party Secretary within each firm shrank while general and functional managers assumed effective control, subject to the veto of the enterprise Party Secretary who retained control over personnel issues. These SOEs were still responsible for significant social infrastructure (workplace hospitals, schools, etc.) but this was gradually phased out as the relevant level of government assumed the legacy costs of pensions and health care as well as the new portion of these social costs. During this period governments absorbed operating losses.

The second phase which involved closing, restructuring, and merging non-competitive SOEs was more disruptive. Rapid economic growth combined with regional incentives helped to cushion the economic shock especially in the long-industrialized north-east part of the country. At the same time, the state pushed competitive SOEs to adopt the market approach and functional management structure of their global competitors. This phase was highlighted and completed by China's accession to the World Trade Organization (WTO), finalized in 2003. This marks the year in which the approach officially shifted from intervention to supervision with the creation of SASAC. China chose an accelerated five-year, staggered grace period to full adherence to WTO commitments in an eclectic top-down, bottom-up industrial policy designed to force domestic firms to adapt rapidly to the demands of the international economy.

SOEs pursued initial public offerings (IPOs) on the Hong Kong, London, and New York stock exchanges as a direct route to internationalization binding themselves to adopt the disclosure and governance standards of these highly competitive markets. The state remained a significant shareholder in the listed companies. In all cases a portion of the SOE's assets were retained in an unlisted SOE "parent." It is these "residual" companies (for example, CNPC is the parent, PetroChina is the listed company) that carry the legacy costs of the socialist era. The role of the Party Committee in these "parents" has continued to shrink as general management is globalized. Some of these SOE "parents" operate globally in parallel with their listed arms. The SOEs have adopted the dual board structure of German governance with a Supervisory Council in addition to a board of directors.[10]

SASAC Supervision: Push to Public Markets

There are contending views of SOE supervision in China. The dominant one was expressed by Li Rongrong, the recently retired Chairman of SASAC, in an interview on China Central Television (CCTV) in February 2010. He indicated that SOEs could well become fully public entities once their marketization and globalization is complete with the "parent" eventually being "immersed" in the public company thereby winding up SASAC's supervisory role. The continued high growth and profitability of the companies is what makes it possible to even think of accommodating in the public company the major legacy costs held by these "parents". The annual SASAC pruning of unprofitable SOEs and the ongoing push to public markets suggests that Li Rongrong's vision is indeed the model.

10 For an analysis of SASAC's evolution see Naughton, "SASAC and Rising Corporate Power in China" and "Claiming Profit for the State." For studies of the managerial transformation of SOEs, see Guo as well as Shambaugh.

The Substance of Supervision is Financial

SASAC's mandate is to ensure that state-owned assets are managed according to the rules to generate an appropriate return for its percentage share, and to control for agency and corruption problems.[11] The latter role is shared with the Discipline Committee of the Chinese Communist Party (CCP). Executive compensation is based on financial rewards and penalties. The criteria include "market capitalization management" reflecting the conviction that, over time, stock price movements on the Hong Kong, London, and New York exchanges are a strong indicator of managerial effectiveness. SASAC supervision does not involve providing guidance on corporate strategy. This single-minded focus on profitability is the source of some popular criticism in China.

There is a practical imperative as well. Tax and dividend revenue from Chinese SOEs have financed China's highly ambitious, investment-driven growth for over three decades. SOEs paid tax at a 33% rate while foreign wholly-owned and joint venture (JV) enterprises paid 15%. The two rates were merged at 25% in 2008 but for much of the previous period there was strong SOE pressure to permit the use of retained earnings to finance growth. This dividend holiday has subsequently been rescinded no doubt partly in an effort to curb over-investment in a period of high profits.[12] SASAC supervises the entire SOE (including the listed portion).

Governance: A Spectrum of Performance

The foreign-listed arms of each SOE are subject to the robust transparency and continuing disclosure standards that apply to their global competitors. SASAC's Li Rongrong confirmed in the February 2009 annual CCTV interview that nationally-supervised SOEs fall along a spectrum of governance performance. He considered the best had already achieved global standards of audit and governance including effective internal controls. Others have some way to go. In China the governance of centrally administered SOEs is widely acknowledged to be superior to entrepreneurial firms due to the combined influence of their publicly listed status and the rigorous reviews carried out by SASAC.[13]

State Support for Internationalization of Chinese Firms

The daunting challenge for China's aspiring multinationals is that they are entering global markets already dominated by giants. Initial trade and investment moves by SOEs and entrepreneurial firms all followed trade which accelerated in the 1990s throughout Southeast Asia, the Middle East, Africa, and even Latin America. Exports met with success because Chinese consumer goods and machinery were simpler and better-priced than western goods for these markets. By 2005, China's leading firms had begun an investment push into OECD countries in an effort to compete against global rivals already well-established in the China market. Resource firms focussed on competing with the existing giants to acquire the global assets needed to provide the exploration and production assets necessary to sustain their anticipated global growth over the coming decades.

China recognized the need to support SOEs in their efforts to internationalize and compete against much more experienced global firms. By 2008 this state support for firm globalization expanded to helping entrepreneurial firms as well.

Recycling Foreign Exchange Surpluses Contributes to Investment Surge

Partly due to the non-convertibility of the currency, foreign exchange earned by Chinese firms remains under the jurisdiction of the State Administration of Foreign Exchange (SAFE) with the firms receiving *renminbi* (RMB) in its place. In the last few years, given China's high levels of foreign exchange reserves and in line with the

11 The World Bank served as advisor to China on the substance and process of SASAC supervision.
12 Dobson, *Gravity Shift*.
13 This view about the rigour of SASAC's review process is widely acknowledged by market participants in China.

government's effort to promote globalization, foreign exchange has been more readily available to firms seeking overseas investment.

The re-investment of foreign exchange surpluses on such a large-scale is a significant challenge. Having halted its crawling peg to the US dollar in summer 2008, China announced its intention to allow the RMB to move gradually in June 2010 at the time of the Toronto G-20 meeting. In order to put the foreign exchange to work—to recycle dollars in the international economy—they must be re-invested abroad. In early 2009, China began to allocate funds both to sovereign wealth funds (SWFs) such as the China Investment Corporation (CIC), the National Social Security Fund (NSSF), and others. At least one aspect of the rationale for this surge in allocation seems to be an effort to offset a decline in the currency in which much of the reserves are held (US dollars) with the purchase of physical productive assets through relatively recently established SWFs. The SWFs in turn invest both directly in overseas assets and in the foreign investments of large SOEs.

How Is FDI by Chinese SOEs the Same as FDI from Other Sources?

With this Chinese context in mind, we turn to an overview of the characteristics of the overseas investment and operational behaviour of Chinese SOEs relative to other FDI sources.

Profit-Driven to Their Core

The focus of SASAC-supervised SOEs is on near- and long-term profitability as reflected by the predominance of financial criteria in assessing performance. Profitability is also driven by compensation incentives for top management. There are obvious cyclical and industry-specific factors that affect profitability over time. From the earliest period of their international operations China's oil companies have been bidding aggressively against both international competitors and, occasionally, against one another when the assets are considered sufficiently suitable to their respective needs.[14]

The energy SOEs have the longest experience in the global market; their organization and strategies reflect and respond to those of their global rivals rather than the Chinese state.[15] The centrally-administered mining SOEs (Minmetals, Non-Ferrous Metals, and Chinalco) are the closest in organization to global mining giants. Provincially owned mining SOEs are moving along the same path as are entrepreneurial miners. As a global industry, mining is more diversified by geology and technology than oil and gas, which may explain why there are fewer examples of Chinese mining firms competing against one another. The firms are generally less established globally than the energy SOEs although this is changing rapidly.

Erica Downs, Fellow at Brookings Institute and former Energy Analyst at the Central Intelligence Agency (CIA), found no support for the notion that:

> NOCs are mere puppets of the state executing directives of their political masters ... Where many international analysts see a carefully devised strategy for the acquisition of overseas oil and natural gas assets driven from the 'top down', Chinese analysts see chaos generated from the 'bottom up'. Chinese commentators—with a clear preference for the kind of highly co-ordinated government/company plan for securing energy abroad that their foreign counterparts imagine exists—have complained that the foreign investment of China's [national oil companies] NOCs are like a battle in which "each soldier is fighting his own war" (*dan bing zuo zhan*)."[16]

14 CNOOC and Sinopec both bid for E&D properties in both the Sudan and Iraq.
15 Jiang and Sinton, *Overseas Investments by Chinese National Oil Companies*.
16 Downs, "The Fact and Fiction of Sino-African Energy Relations," 49.

Many observers, both inside China and abroad, call for co-ordination on bids to avoid over-paying. The western and Indian corporate voices represent the interests of buyers concerned about rising prices. Less is heard from the beneficiaries—the sellers of commodities (including Australia, Canada, and states in Africa).

CNPC's investment in Peru and the Sudan took place in the early 1990s long before the Chinese government regarded offshore investment in a positive light or gave approval for such investments and eight years before the emergence of civil war in Sudan.[17]

Product Is Traded Regionally to Maximize Profits

Popular concern in OECD countries that SOE investment warrant special treatment stems, in part, from the assumption that that Chinese extract resources for the purpose of shipping to customers in China and that by doing so, they reduce the amount of oil available to everyone else. Two Washington, DC-based scholars, Rosen and Houser, found no support for the above assumptions.[18] "Both are wrong." Any commodity can be obtained either by trade (imports) or by investing in overseas production and taking possession of the equity share of the output. The authors conclude:

> According to our calculations … these companies (China's NOCs) did not ship most of their [2006] overseas-pumped oil home, but instead sold it on the open market to the highest bidder. The newly constructed oil pipeline from Kazakhstan to China brought in only 50,000 bpd of the 260,000 bpd that CNPC produced. None of the production in Canada, Syria, Venezuela and Azerbaijan showed up on China's shores, and only a fraction of the production from Ecuador, Algeria and Colombia did. The percentage of oil CNPC produced in Sudan in 2006 that was sent back to China declined, as did the amount in volume terms … CNPC chose to sell more of it to Japan, probably because the offered price was higher. And despite CNOOC's strong presence there, Chinese imports from Indonesia fell by 48 percent … No one is concerned when Shell sells an equity deal somewhere in the world that the Netherlands is taking oil off the market and making everyone else less energy secure … Everyone assumes that Shell will sell its production to whomever is willing to pay the highest price. To date, Chinese oil companies appear to be doing the same and thus prioritizing profits over political considerations.[19]

Rosen and Houser continue:

> "Even if every barrel of equity oil were shipped to the China market that would mean that Chinese purchases of oil from Saudi Arabia, China's largest source of oil, and from Iran would decline leaving room for those sources to increase supply to OECD countries."[20]

The same logic applies to the output from equity interests of mining SOEs in overseas properties. Global commodity traders dealing in metals and minerals report the same trading patterns by Chinese resource firms. They continue to buy and sell minerals and metals on a regional basis to the highest bidder rather than automatically directing product to their home market. This pattern continued through the 2008–2009 global financial crisis.[21]

How do we relate this back to the Chinese government's quest for resource security? Following the same pattern as their western rivals—the international oil companies (IOCs)—China's energy SOEs have systematically developed their trading networks as well as global upstream (E&P) equity interests. As with the IOCs, they

17 Xu, "Chinese NOCS Overseas Strategies," 4. This is supported by Rosen and Houser, "China Energy: A Guide for the Perplexed." See also Rosen and Hanemann, "China's Changing Outbound FDI Profile."
18 Rosen and Houser, 33.
19 Ibid. These findings are confirmed in Jiang and Sinton.
20 Rosen and Houser, 33.
21 Private communication with Liu Na, Head Commodity Trader, ScotiaCapital Inc. See also Brautigam, *The Dragon's Gift*, 281.

build-in duplication of supply to cope with local and regional disruptions as and when they occur. These may vary—from operational outages to political unrest to supply captured in transit by pirates. Chinese officials may initially have conceived security of supply in terms of SOEs shipping oil or resources back to China. However, the commercial reality of a global supply network has surpassed the more limited bureaucratic vision of direct supply.

Claims of State Subsidization

a. Access to Subsidies?

One of the key claims about SOEs is that they are not only created from state assets (true) but continue to be subsidized from state coffers in various forms freeing them from the constraints of profitability that govern global competitors. It is also claimed that SOEs enjoy unlimited loans, either directly from the state or from state-owned banks as a matter of policy rather than a reflection of their creditworthiness.[22] Further these loans are assumed to be at below-market rates and not subject to commercial repayment terms. This charge was first laid during the political furor in the US Congress over CNOOC's bid for Unocal.[23] The financing appeared to carry state subsidies and this was seen as part of a much wider perceived "China threat" putting at risk market-based global competition for these resources. Washington, DC-based scholars began a series of studies to test the assumptions made by many witnesses appearing before the CFIUS. These reports essentially concluded that SOEs did not have access to bank loans at below market rates, nor to export or import subsidies or other actionable subsidies under the WTO.[24]

b. Access to Cheap Bank Loans

The key concern has been that Chinese SOEs have access to cheap bank loans and as such can afford to outbid western rivals. It matters whether this concern means "cheap" in relation to Chinese domestic borrowers or cheap relative to rivals raising funds in western capital markets to compete for the same assets. We assume the latter. Also there has been significant change in the position of China's SOEs since the CNOOC bid for Unocal in 2005. As Rosen and Haneman note, CNOOC International's bid included a two-year bridge loan interest free from its parent CNOOC. Foreign exchange controls in effect in 2005 prevented SOEs from borrowing from foreign banks. The energy companies would have been amongst the most creditworthy of all Chinese borrowers. "There is no shortage of banks interested in funding oil exploration—it is the most profitable sector in years."[25] China's resource SOEs are amongst the largest and most profitable firms in China.[26] But the key point is that bank loans are typically the most expensive layer of asset financings. Global resource firms have available sophisticated financial engineering techniques that reduce the amount of loans required.

Erica Downs refers to a specific SOE merger and acquisition (M&A) bank financing at 4.05% as "significantly cheaper" than the announced commercial lending rate of Chinese banks of 4.85%.[27] Given the quality of the assets financed, the ability to sequester revenues, and the creditworthiness of the borrower the idea of unwarranted advantage seems difficult to sustain. In Canada and other OECD markets the best credits borrow well below the lending bank's average corporate lending rate. Most tellingly, global rivals financing a similar acquisition would access international bank lending rates typically around London Interbank Offered Rate (LIBOR) +1% at the time, well below the 4%-5% charged by Chinese banks.

22 This assumption was reflected through much of the testimony heard by the CFIUS/FINSA Congressional hearings on the bid for Unocal, See Graham and Marchick.
23 Graham and Marchick. See also Sauvant, *Investing in the United States*.
24 This research includes Downs, "The Chinese Energy Security Debate," "The Fact and Fiction," and "China's NOCs"; Evans and Downs, "Untangling China's Quest for Oil."; Rosen and Houser; Hufbauer, Moll, and Rubini, *Investment Subsidies for Cross-Border M&A*.
25 Rosen and Hanemann, 32.
26 Over the past decade PetroChina has frequently been the most profitable firm in Asia.
27 Downs, "China's NOCs."

c. Access to Advantageous M&A Deal Finance?

There have been various self-reinforcing reasons why until very recently Chinese banks fell far short of the capabilities of global investment banks in deal finance: domestic banking regulatory constraint, limited access to foreign exchange, and the lack of international transaction experience. Chinese banks have undergone a major transformation helping to narrow the gap. More telling perhaps is the fact that M&As by western resource (and other) firms can be financed off-balance sheet and deals may be structured to achieve that goal. SASAC requires SOEs to finance on-balance sheet which is more conservative and typically results in higher borrowing costs.

A further point is that the use of the balance sheet of the target firm is a common means of reducing the cost of an acquisition. To do so before the deal and thereby reduce the anticipated M&A cost, it must be a "friendly" takeover, i.e., directors of the target must approve the acquirer and the deal terms. The role of "white knight" or acquirer, in several controversial M&A deals in which China has been involved has been played by western firms (Billiton in the Chinalco-Rio failed bid, Chevron which supplanted CNOOC in the bid for Unocal, and Whirlpool which supplanted Haier in its bid for Maytag). It is puzzling that western sources persist in the view that Chinese SOEs enjoyed unfair advantage in financing deals during the 2005–2009 period when even a general look at financing realities suggests that western firms were likely to have the financing advantage.

Technological Innovation and Productivity Gains

Chinese energy SOEs have a history of collaboration with NOCs (national oil companies) on technology and other projects in emerging markets as a means for both the SOEs and their managers to integrate themselves and learn about local market conditions and practices.[28] The size and breadth of their global asset base, deep corporate pockets, in-house engineering talent, and long-term decision horizon enable Chinese resource SOEs to take a long-term view of the potential benefits of research. The possibility of applying technical advances to similar assets elsewhere increases their stake in research. Over the past decade Chinese stainless steel makers found ways to enrich pig iron with scrap nickel thereby reducing the required amount of imported nickel ingot.[29] Such an innovation has the potential to depress the price and volume of nickel ingot demand.

Governance and Accountability: SOEs Listed on Major Exchanges

The foreign-listed arms of resource SOEs typically take the lead in foreign acquisitions. However, the non-listed parents also trade and invest globally. The listed arms must comply with the robust transparency, continuous disclosure, and governance requirements of the NYSE, FTSE, and Hong Kong exchanges. This global standard is appropriately recognized by the Canadian authorities—in cases where the listed entity makes an investment application under the ICA—no additional governance undertakings are sought.

How Is FDI by Chinese SOEs *Different or Potentially Different* from FDI from OECD Sources?

Geopolitical Distance and Rivalry

There is an ongoing undercurrent in the debate on Chinese investment to the effect that China is a potential rival to the supremacy of the United States and its NATO allies and therefore its SOEs may behave in hostile ways. This unnecessarily anticipates and exacerbates the emergence of a state of mind of geopolitical conflict rather than co-operation between China and the US and North America generally. This is not, and need not, be so. For

28 Garver, *China and Iran*, 275.
29 Hoffman, "A Breakthrough in China."

Canada, as a resource nation, this mindset ignores the reality of the rise in Asian energy consumption with its attendant purchasing and investment power.

Michael Klare has written extensively about the ill-ease created as new powers, many of which are in Asia (democracies as well as authoritarian states) begin to compete with existing US and European firms for future resource supplies.[30] Given Canada's proximity to the US and the long involvement of US firms in the development of Canadian resources it is not surprising a special relationship exists. Carolyn Bartholomew, Chair of the US-China Economic and Security Review Commission objected to CNPC's proposed acquisition of a controlling stake in Athabasca Oil Sands Corp (AOSC) "in America's backyard" and suggested that Ottawa should "subject the proposed investment to a thorough review that would include national security."[31] This is one of many views within the US Congress and Administration with respect to the scope of the US interest in Canadian energy resources. At the other end of the spectrum, President Obama on his first visit to Canada in January 2009 expressed serious reservations with respect to future imports from the Canadian oil sands.

Geopolitical Distance in Reverse

A 2009 survey of Chinese attitudes to foreign investment highlighted the strong sense of vulnerability in China to incoming investment from the US.[32] In 2009 the US is the third largest source of FDI flow in China (excluding flows from Hong Kong and Taiwan).[33] Respondents expressed a preference for additional investment from Canada or Australia reflecting the popular desire to offset the economic influence in China of a country perceived to be uncomfortable with China's rise. Despite domestic sensitivities, China's interest is to mitigate geopolitical distance. With over 65% of China's GDP dependent on trade (a similar proportion to that of Canada), protectionism no longer makes sense.

China's leaders recognize that economic growth has benefitted hugely from increasing integration with the global economy. Furthermore, full globalization of Chinese firms of all types depends on continued access to global markets both for trade and investment. As newcomers to well-established global resource markets, Chinese energy firms began building their global asset base with properties that for some reason did not suit their global rivals. Chinese oil firms were initially unable to compete against IOCs for exploration and development E&D blocks where deep water drilling technologies and large-project management skills were required.[34] The failure of CNOOC's Unocal bid in 2005 and the perceived resistance to such acquisitions effectively pushed Chinese energy firms into a search for equity positions in other parts of the world—places shunned by global rivals due to weak prospects or instability.[35] The same logic applied in mining. Looked at through a different lens, this came to be seen (somewhat illogically) as a form of political provocation by China (in Iran, Myanmar, etc.) as distinct from the non-confrontational pursuit of legitimate interests. The persistent negative characterization of intentions has led to some resentment and cynicism about western motives.

The policy debate distinguishes between state-owned enterprises owned by OECD states such as Canada, France, and Norway and those of emerging markets, especially authoritarian ones such as China or those controlled by states with possible terrorist links.[36] The interests of SOEs from OECD states are perceived to be benign while those of more geopolitically distant and/or emerging states are seen as potentially risky or harmful. This suggests that the significant issue is their geopolitical distance rather than their ownership status. Karl Sauvant, the leading academic on investment from emerging countries, sees a protectionist element in this

30 Klare, *Rising Powers*.
31 The United States-China Economic and Security Review Commission supervised CFIUS hearings with respect to the CNOOC bid for Unocal. Ms. Bartholomew's remarks were quoted in McCarthy, "China's Move into Oil Sands Irks the U.S."
32 Hanson and Shearer, "China and the World." This survey occurred prior to the acrimonious Chinalco-Rio Tinto affair.
33 The US-China Business Council, "Foreign Direct Investment in China."
34 See comments on China's role in global energy markets in Gill and Reilly, "The Tenuous Hold of China Inc. in Africa," and Taylor, *China and Africa*.
35 Lee, Unpublished. Also Rosen and Houser, 42; Gill and Reilly; Garver; Taylor, *China's New Role in Africa*. Xu notes that investment in Sudan was made eight years before domestic civil war began. See Xu, "Chinese NOCS Overseas Strategies."
36 Globerman and Schapiro; Graham and Marchick; Sauvant R*ise of Transnational Corporations and Investing in the United States*.

among OECD states—noting a sharp rise from 2002 onwards in protectionist and anti-terrorist legislation in leading OECD states.[37]

Potential CCP Influence on SOE Strategy and Operations

The State Council, China's top government decision-making body, makes the final selection for the post of Chairman (or sometimes CEO) of the national SOEs on the advice of the Organization Committee of the Communist Party and SASAC. The Chairs of at least half of the SASAC-supervised national SOEs carry the rank of minister.[38] They are powerful figures in government and business and are closely connected to both the party and private sector leadership elites. They typically move to other top corporate and party positions in the economic establishment. Their advancement depends on success in their corporate managerial and visionary role.

The remainder of the executive suite is typically drawn from the senior executive ranks of the SOE itself on the basis of managerial and technical capabilities and is confirmed by SASAC. Strategy and operational decisions are developed within the executive suite. Neither the Party nor the State Council takes as its role the development of strategic or operational direction for SOEs. The driving rationale of economic reform has been to "let the market decide". In our discussions with non-SOE senior Chinese business people and industry analysts in Beijing we found a certain bafflement that either the Chinese bureaucracy or political leadership would have the time or inclination to try to guide SOE business strategy.

Nonetheless, the SOE Chair both influences and is influenced by members of the State Council and China's business elite more generally. The directives of SOE chairs would be readily carried out and thus they could be the conduit for directives from the State Council or the Party. However, with the Chair carrying the same bureaucratic rank as that of the Ministers of Commerce and Foreign Affairs, there are no obvious bureaucratic levers to impose outside views on such SOEs. Recent efforts to consolidate and strengthen energy policy making in the central government suggest to some observers that the direction of influence is more from the SOEs to the government than vice versa.

Institutional and Commercial Sources of SOE Independence

The relative independence of resource SOEs reflects both the shift in power and financial resources away from the bureaucracy and the fractured nature of bureaucratic responsibility for both energy and mining. Erica Downs found that:

> The power of the NOCs (i.e., energy SOEs) vis à vis the government has grown substantially especially since the turn of the century due to surging profits, their listing of subsidiaries on foreign stock exchanges, their globalizing senior management, and their reliance on international banks and consultancies for investment advice.[39]

The 2010 IEA paper on Chinese NOCs draws the same conclusion about relative SOE independence.

Those who see the state as interventionist and controlling see the fact that many SOE chairs are party members appointed by the State Council as clear proof that SOEs respond to political directives of the state. We have tried to present here a more nuanced view. During this period of super-growth and globalization the balance of influence has shifted to SOE management. It is conceivable, that the balance of institutional and corporate power could shift back to the bureaucracy and party. However such a shift would reflect a change in

37 Sauvant, *Investing*. See also Safarian, "International M&A, Sovereign Wealth Funds and the Canadian Policy Response."

38 The CCP organizing committee within the SOE functions as arbitrator of human resources and appointments and reports directly to the Chair.

39 Downs, "The Fact and Fiction," 49. In 2010, the State Council created a National Energy Agency and staffed it with heavyweight officials in a bid to bring greater cohesiveness to energy policy formulation and implementation.

economic and political philosophy as radical as the shift that occurs when a populist democratic party seeking to nationalize one or more industries takes power following the long tenure of a centre or centre-right party.

Do SOEs Promote China's Foreign Policy Agenda or Vice Versa?

Resource Security

China imported 55% of the oil it consumed in 2010, well above the level which triggers concerns about energy security. Some observers see this import dependence rising to 66% within the decade. In 2006, 71.8% of China's oil imports came by ship from the Middle East and Africa passing through narrow sea lanes such as the Straits of Malacca which China fears might be blocked in the event of conflict over Taiwan. Although it is not the most influential foreign power in any of these states, China has developed strong state-to-state relations across central Asia and Iran.[40] This is an area where the interest of SOEs and China's national interest are clearly aligned. Chinese energy SOEs have negotiated exploration and development rights through the region. In each of these areas (ex Iran) rival international oil companies (IOCs) are also well-established.[41]

To ensure some security of supply, the Chinese government has been pursuing a range of policies that facilitate an eventual overland pipeline transportation route from the Middle East across the states of central and southeast Asia to China. The 2010 IEA paper points out that the one area where we do see co-ordination between the Chinese state and the SOEs is with respect to pipelines being built in various places across Iran, central, and southeast Asia. These are typically part of a complex of infrastructure projects financed by China while the pipelines are financed and built by a specific energy SOE.

But this is only part of the story. Regional economic development is the goal that makes sense of developing trade, building pipelines, and road and rail transportation through a vast geographical area linking west and east Asia. Based on its own development experience there is a conviction that the economic development of western China rests on the revival and growth of south, central, and southeast Asia. This permeates China's geopolitical and economic actions in these regions.

What Is the Dominant Direction of Influence?

Would foreign policy activity be any different if China's resource companies were entrepreneurial rather than state-owned? Would it be less successful? The issue is not so much the ownership of these SOEs as the coincidence of interest between the firms and the state. While diplomatic support is offered to SOEs when requested, Chinese Embassy officers are as likely to hear about such deals after they are announced as before.[42] However, in the current period at least, the interests of the Chinese state and those of its globalizing companies, especially resource companies, are strongly aligned but the indicators are that the SOEs pursue their own interests fairly independently.

The more general point is that the national interests of MNC decision makers (i.e., the board of directors and top management) are the ones that tend to get taken into account first – especially in a crisis. This is as true of western MNCs as it is of Japanese and Chinese multinational enterprises (MNEs) (both state-owned and entrepreneurial).

40 It has done so through a concerted effort to court the states with contiguous borders as well as through the creation in 2001 of the Shanghai Co-operation Organization which includes Kyrgyzstan, Russia, Tajikistan, Uzbekistan, and China.
41 Garver.
42 Downs, "The Fact and Fiction."

Are SOEs Charged with Political Objectives?

Are SOEs asked to carry out the overseas political goals of the Chinese state or the Chinese Communist Party? Do the foreign operations of SOEs provide cover for industrial espionage? Could they undertake to undermine local interests in some way responding to direction of the Chinese government, say in response to some negative development in bilateral relations? Could they delay or defer exports and thereby reduce tax and other payments to the state?

Such claims are difficult to either prove or disprove conclusively. Let us take the concern that in a period of global scarcity of some commodity, the Chinese state might order SOEs to ship product from Canada to China at prices below the prevailing price in Canada.[43] Canadian transfer pricing rules and administration are designed specifically to prevent exports at below market prices. Another fear expressed is that the Chinese state might push an SOE to somehow disadvantage a Canadian market or a Canadian company for whatever reason. Again Canadian competition and other laws are in place to discipline any such move.

Looking at this from the perspective of the SOE, such behaviour would be contrary to the corporate interest. It would require the SOE to sub-optimize it own goals and performance putting at risk its corporate and financial integrity by undermining the good name and relationships that take decades to establish. These SOEs are contending for global position and leadership. It would entail direct reputational damage amongst buyers, suppliers, service providers to say nothing of attracting law suits, security investigations, etc. In any event, Canada has the legal system and security service in place should such a situation arise. When we address these concerns or threats individually they do not seem that realistic.

Localization: Chinese SOEs Are Perceived as Different

Chinese resource SOEs are amongst the largest in the world but they are not well known to the North American public. This "foreignness" may be more extreme than the initial North American discomfort with Japanese FDI in the 1980s where the brands themselves were already highly-regarded. The roots of many Chinese firms that are currently internationalizing were relatively uni-cultural and uni-market—increasing the challenge of adapting to foreign business cultures. Many of the operational difficulties encountered to date can be traced to the initial failure to grasp subtle differences from home market structure, regulation, and business practice.[44] Globalization efforts began in earnest for the SOEs in the early 2000s with leading entrepreneurial firms following shortly thereafter. The limitations of China-centric management and lack of international market experience are openly acknowledged by Chinese management. The management style of US and European firms at early stages of internationalization was equally ethnocentric.

Many observers note the parallel between the suspicion and resistance that Chinese firms sometimes meet in OECD countries and that met by Japanese manufacturers in the 1980s.[45] Westerners active in trade and investment in China over the past 30 years note that these cultural misreadings and difficulties are not much different than the early experiences of western firms in China (different issues; same pattern). The norm was to make initial and often expensive mistakes and have to correct them before gaining a secure foothold in the market. This need to learn by one's mistakes accounts in part for the relative success of MNEs in China versus small and medium enterprises (SMEs) from the same countries. MNEs had the deep pockets needed to stay the course and their management's experience in other markets was useful in making the transition. SMEs had neither advantage.[46] There is every reason to think that Chinese firms will devote the necessary funds and persistence to achieve a similar transformation.

43 This was mooted during the debate about Minmetal's bid for Noranda.

44 Eden and Miller; Lee.

45 Graham and Marchick.

46 The near impossibility of getting everything right from the start and the lack of deep pockets to finance a second chance account for many of the failures of Canadian small and medium sized firms to become successful in China.

Overcoming Geopolitical Distance

Former CNOOC Chairman, Fu Chengyu, acknowledged the failure to lobby Congress to counteract the lobbying of commercial and other interests that opposed the bid for UNOCAL.[47] CNOOC did not accept geopolitical and institutional distance as a final bar but as something to be overcome with effort over time. This acknowledgement about the need for better public communications by Chinese corporations was repeated often during discussions in Beijing. However, there was also a sense that in that case perhaps no amount of advance communication would have counteracted the opposition.

However, there is a well-flagged path of successful measures for integrating into North American communities that Chinese firms may want to follow namely: hire locally, establish strong local economic and philanthropic relationships, develop relationships with local and state politicians, and spread the economic benefits of the firm as widely as possible.[48] After a very chilly welcome, the Japanese manufacturers in the 1980s adopted these same techniques. To this day the strongest political support for Japanese firms is at the local and state level offsetting opposing forces still heard in Congress. Over time the interaction of the foreign firms and the community in which they locate usually dispels mutual preconceptions and sense of geopolitical and institutional distance. Strong economic performance gives local communities a major stake in the new firms.

Regulatory Compliance: An Uncertain but Improving Record

Labour standards, health and safety, and environmental protection laws are largely a matter of provincial rather than federal jurisdiction in Canada. Lack of well-demonstrated experience in complying with OECD-level environmental, safety, and labour laws significantly increases the perceived risk of the investment to the local community. China's domestic laws are increasingly rigorous but there are differing perceptions about the rigour of enforcement. As in many countries, there is a period during which a transition to new standards takes place and a lag in recognition that the change has taken place. Given public scepticism about long-established MNEs in this respect, Chinese SOEs may have to put in years of rigorous adherence to rules both in China and abroad before they are widely recognized to have achieved these standards.

The experience operating in difficult conditions in Africa has been a salutary learning experience for Chinese resource firms (as it was in varying ways for western firms). Chinese firms, especially the SOEs, have been actively addressing these issues.[49] Over the past five years much effort has been expended to overcome well-recognized weakness and unfamiliarity with foreign laws and business practices and managing cultural differences.[50] The preference for corporate control has shifted to a more cautious use of joint ventures with the appointment of a mix of host country nationals and internationally experienced Chinese staff to gain experience in specific markets.

Nonetheless the degree to which Chinese SOEs are perceived to be willing and able to comply with advanced labour and environmental laws remains an issue which crystallizes popular concern both in Canada and other OECD jurisdictions.[51] This is more acutely felt in cases where the investment itself is controversial (regardless of the source country). Furthermore while these SOEs may have within their organization the expertise to comply in a timely and effective manner, it can be a daunting challenge for a relatively small operation in a remote community to meet exacting and complex requirements.

47 Quoted in Downs, "Lessons Learned," 31.
48 Graham and Marchick.
49 Brautigam, chapters 7 and 8, especially 230-1.
50 Jiang and Sinton, 7. See also Xu, "Chinese NOCs," 24-25.
51 Sauvant; Kilgour.

CNPC, China's largest and most profitable resource SOE, was challenged in the early 2000s with respect to shortcomings domestically (major industrial accidents and weak environmental protection) and internationally in terms of labour and the environment. Developing a response took time. CNPC published its first stand alone report on corporate social responsibility (CSR) in 2007. The detail provided was modest relative to similar reports of global competitors but it began the process. SINOPEC published its "Sustainable Development Report" in 2008. CSR conferences were the flavour of the month through 2007–2008 in Beijing. The Ministry of Foreign Affairs (MFA) and the Ministry of Commerce (MOFCOM) spearheaded an effort to establish operating labour, work safety, and regulatory compliance standards for Chinese firms bidding on China's EXIM-financed overseas projects. SINOPEC and CNOOC have also moved to internalize and institutionalize these disciplines.[52]

Abiding by foreign laws has been a key prescription for Chinese firms sensitive to the activities of foreign corporations in China in colonial times. Nonetheless there are cultural and experiential differences that make compliance at the level of OECD standards a challenge. Premier Wen Jiabao's March 2010 Work Program Report to the National Peoples' Congress contained a paragraph calling on Chinese companies to meet the highest global regulatory standards.[53]

Non-listed SOEs: Improving Their Visibility in Canada

Governance, Disclosure, and Accountability

Both listed and non-listed arms of SOEs invest overseas. With almost a decade of experience as publicly listed companies on the Hong Kong, London, and New York stock exchanges, the listed firms have demonstrated the ability to comply with the demanding disclosure and governance standards of those exchanges. For these firms making applications under the ICA, no additional governance undertakings are required. Although non-listed "parent" SOEs do publish annual reports, they do not provide the depth of information provided by their listed arms. Nor have they been accustomed to the same level and frequency of communication with stakeholders although this too is changing.

Changes in Global Energy Markets Affect Canada

The rise in global commodity prices may be both cyclical and a one-time step change to accommodate the emergence of China, India, and other emerging markets. South Korea, Japan, and other countries in Asia represent important existing markets. Spurred by this growth, NOCs worldwide have moved to increase their percentage capture of the profit and reduce that of the IOCs—fuelling resource nationalism. In metals there is a similar pattern. Corporate ownership has shifted somewhat to producing countries. As a major seller of commodities Canada has interests which may conflict with those of our primary political grouping, NATO. As Gwyn Morgan suggests,[54] this creates an extraordinary international opportunity for Canada. Leadership would be based on an in-depth understanding of the global balance of buyer and seller interests. Developing this understanding and sensitivity will also serve Canada's own interests as an informed seller.

Canada competes in global markets as a buyer and seller of commodities, related equipment and services, capital, technology, technical specialties, and global exploration and production management expertise. While much is made of Toronto as a global centre of mining finance, the loss of Canadian headquartered global mining and industrial companies has weakened our leadership (e.g. Alcan, Inco, Falconbridge, and Dofasco). In energy the tendency to focus on US markets has resulted in a continental rather than a global orientation. To remain relevant, a leadership position needs to be continually re-created. There are two elements to doing

52 50 of the 121 SASAC-supervised SOEs have issued a CSR report.
53 China. National People's Congress.
54 Morgan.

so. First, Canadians need to recognize the shift to Asia-based demand and investment. They need to address the issues necessary to build the transportation infrastructure to serve this demand,[55] integrate into Asia-based supply chains and managerial networks, partner Asian (and especially Chinese) companies in the development of resources in third markets, and collaborate in R&D to ensure that Canada remains at the cutting edge environmentally and productively.

Buyer and Seller Tug of War—The Relative Balance of Power Matters

Chinalco's 2009 bid to purchase a minority interest in Rio Tinto provides an example of the complex way in which the relative balance of economic power between buyer and seller affects both the foreign investors (in that case Chinalco) and the host country. There were many levels of resistance but negative Australian public opinion was critical. The key issue lay in the idea that Chinalco, an equity investor from China (which takes the majority of Australia's iron ore exports) would have access to commercially sensitive production cost and marketing information.[56] Rio Tinto and BHP Billiton are the dominant producers in Australia. In retrospect it seems clear that access by any foreign company from which info might leak to foreign buyers would be highly sensitive. If 54% of Australian iron ore exports went to the US market (instead of China) a bid by a major US mining company would likely have created considerable opposition (if not perhaps the same magnitude). In retrospect from a public policy perspective, it might have been better for the Australian government to have red circled these firms and saved the grief created by the Chinalco bid. Recall that Rio Tinto could was in financial straits at the time as a result of the Alcan takeover.

The entire affair has interesting parallels to the global energy and mining equity interests of Japanese trading companies in the 1970s and 1980s. At that time Japanese steel mills were amongst the largest global buyers of thermal coal and iron ore. The key fear (amongst commodity sellers) was that the Japanese would play mines in different jurisdictions against one another for price and other concessions. By investing in mines in different regions the Japanese sought overtly to ensure both steady supply and prices. For decades prior to the massive spurt in Chinese steel production, iron ore prices rose or fell annually in small increments. Our point is that the key issue in policy matters is more often the differing interests of buyers and sellers rather than the investor's ownership status.

A final lesson for Canada is that a high profile deal gone sour can serve as a flash point for a major negative turn in public opinion in both countries which in turn impacts bilateral relations.

Conclusions

Canadian Laws Provide Required Protections

Foreign corporations must all abide by Canadian laws and all Canadian jurisdictions have the wherewithal to enforce vigorously their health and safety, labour, and environmental protection laws. Canadian transfer pricing and administration is in place to address the concern that SOEs might try to export to China at prices at or below the Canadian price. Should an SOE be found to operate in non-commercial ways that disadvantage Canadian market or a Canadian company, Canada has a robust range of policy and legal forms of recourse. There is no specific claim (of which we are aware) of an SOE responding to the political dictates of the CCP or the bureaucracy. The most potent argument against the notion that they serve as tools of the state or Party is the massive reputational damage they would incur by doing so.

55 The current author supports the recommendations of the Wilson Committee regarding changes to securities law to permit directors of Canadian firms to explore certain takeover defenses.

56 The author understands from a source close to this deal that the Chinalco recognized this issue and their bid included arrangements for blocking the flow of such sensitive information.

Two factors are affecting the governance, labour, and environmental performance of Chinese SOEs. China's domestic regulation has moved toward OECD practice and SOEs are gaining managerial and technical experience in foreign markets.

Canadians are naturally concerned with how specific investments affect Canada. At the same time it needs to be acknowledged that the preponderance of political risk with respect to any asset "in the ground" is borne by the foreign investor—not the host country.

Localization Is the Best Antidote to Geopolitical Distance

Misperceptions of SOE behaviour rest in part on unfamiliarity, cultural differences as well as geopolitical and institutional distance. Successful localization is likely to be the best antidote to these differences. The SOEs themselves must take the lead by establishing strong relationships with local community, hiring locally and by ensuring the economic benefits of their business are felt as widely as possible in the community and beyond.

Canada offers a promising mix of support for integrating Chinese firms into the local economy: its large and varied resource base; its globally recognized managerial and technical expertise in energy and mining; its advanced OECD legal and regulatory standards; and its multicultural workforce. As one of the first OECD markets in which Chinese resource firms operate, this gives Canadian firms the opportunity of establishing strong commercial relationships, taking advantage of Chinese supply and managerial networks and collaborating on technological innovation.

Ways of doing business differ. It may require significant effort to capitalize on the opportunity. In the late 1980s and early 1990s following the arrival of Japanese auto makers in Ontario, Canadian parts makers had to begin the process of accreditation to the Japanese auto plants before they could get the orders. At the time there was widespread conviction that the Japanese parts makers were unwilling to give the business to North American parts makers. In retrospect several years were lost by the Canadian parts makers before initiating the process which opened up these new supply chains.

By structuring the investment application process and subsequent provincial regulatory interaction in a forward looking, pro-active way, Canada stands to play a constructive role contributing to SOE successful performance in Canada.

The Global Macroeconomic Situation Has Shifted in Canada's Favour

To enhance our interests as a global resource seller, Canada needs to adapt to new global patterns in resource supply and demand.

These include both the already large and growing Asian demand for virtually all metals and energy commodities and the shift in energy and metal resource ownership to emerging market firms (e.g. Vale, CVRD, Gazprom, CNPC, CNOOC, and ARAMCO). The scale and capital of these companies enable them to invest in technologies to improve the extraction of fossil fuels as well as the development of renewable sources. Asian firms, particularly those from China, are acquiring equity stakes in global resources. Unduly limiting their investment in Canada would reduce Canadian access to an important source of global capital, jobs, technologies, and supply chains as well as the ability of Canadian individuals to participate in the managerial networks that these firms create. These advantages are likely to gain salience with the continued global growth of China's SOEs.

A widespread change in attitude is required to recognize that the development of our natural resources represent the lion's share of our recurring exports and hence are the source, not the scourge of our standard of living in an intensely competitive world.

The failure of the Chinalco/Rio Tinto deal demonstrates the importance for Canada, as a global player in resources, to have in-depth understanding of both buyers and sellers. We tend to look at China's interest (and that of Asian buyers more generally) from the narrow perspective of the impact on Canada whereas an effective long-term leadership strategy requires a global perspective based on a clear-sighted assessment of the interests of all major players in light of changes in demand and supply—a far more ambitious undertaking.

The idea of limiting ourselves to a single market as sole buyer lacks economic sense. The rise of a range of large Asian buyers of which China is likely the largest offers an opportunity to pursue genuine market diversification. Attracting E&P investment from these customers and seeking the sizable additional capital from diversified sources needed to fund research to enhance Canada's oil and gas resource productivity while reducing the environmental impact.

Recommendations

Reduce transaction risk and politicization of the ICA review process

The ICA review process is time consuming and uncertain, exposing target companies to potentially destabilizing speculation. This vulnerability may well influence corporate boards in their perception of the value of an offer. It also carries a burden of disclosure well in excess of that required by other forms of equity participation in the Canadian market. These effects are part of due process but they still need to be mitigated to the extent possible. It is quietly acknowledged amongst legal experts that, well before the SOE Guidelines and the national security review were introduced under the ICA, foreign acquisitions of corporate assets in Canada were structured to avoid coming under the applicable legislation.[57]

Although this has not been a significant issue to date, there is an inherent scope for politicization of the ICA process wherein various interest groups, politicians, and domestic business rivals seek to oppose or delay and thereby raise the cost of the acquisition to the acquirer.[58] Politicization rests in part on the degree of popular and political misconception. There is also a risk of politicization should the timing of the application coincide with negative dynamics in the domestic economy or the bilateral relationship.[59] In light of the degree of misperception of SOE behaviour revealed in this study, it is incumbent on the Canadian side to avoid politicization of the application process to the extent possible.

Requests for undertakings should be carefully shaped to achieve the desired net benefit while avoiding, to the extent possible, putting Chinese firms at a disadvantage in terms of cost and restricted operating freedom. Such requests need to be evaluated in terms of the additional constraint they place on the freedom of investment for a WTO-compliant state.

An approach that is seen as efficient and constructive to investment by Chinese SOEs may well have longer-term benefits of creating opportunities for both Canadian firms and individuals to the supply chains, global projects, and corporate networks that Chinese SOEs are currently developing. The publication of reasons for Minister's decisions under the ICA, a practice followed without controversy by the Australian board of investment review, would contribute to greater transparency regarding the decision criteria. For listed arms of Chinese SOEs, the ICA recognizes that their governance standards are adequate. For the non-listed SOEs, the regulatory objective should be to achieve an acceptable threshold of protection and transparency without imposing conditions significantly more onerous than those faced by that firm's competitors in the Canadian market. Undertakings should be sought with respect not just to the appointment but also the specific duties of Canadian independent directors. This could achieve an acceptable level of protection of Canadian interests while involving Canadians in the governance of these firms and thereby facilitating localization.

57 Melnitzer, "Cash Rules." This was confirmed in conversations by numerous legal experts in this field.
58 Graham and Marchick have a compelling discussion of this process in their account of the CNOOC bid for Unocal in *US National Security and Foreign Direct Investment*.
59 Graham and Marchick identify the bilateral and domestic factors which created the negative context for public perceptions about the CNOOC bid.

As discussed above, although disclosure practices vary, non-listed "parent" SOEs generally do not provide the depth of information provided by their listed arms in their annual reports and are not accustomed to the same level and frequency of communication with stakeholders. For this reason every effort should be made to encourage (but not require) investments in Canada by the listed arm. Where non-listed arms invest, they would do well to address potential concerns by providing an acceptable level of visibility about the economic, environmental, and safety aspects of operations so that local communities are able to assess the likely impact of the proposed business. In the case of acquisitions of corporate control that fall under the ICA, the investor generally undertakes to report regularly to the government authorities concerning financial results, capital and research expenditures, and other relevant data. The general content of such undertakings should be known in advance and not constitute a laundry list of desirable information. It may be appropriate to negotiate regular reporting to the ICA on an evergreen rather than three year basis to provide the assurance of extended oversight in highly sensitive cases.

Given the growing economic weight of China in global resources, unduly restrictive hurdles carry the risk of reduced trade and investment opportunities in the future. Canada's continued high-level participation in global trading in energy and metals depends on strong relationships (typically based on personal and business ties). Effective interaction with Chinese resource firms in Canada and in other markets is a key foundation for these relationships. Approaches based on misperceptions of the drivers of SOE behaviour are counterproductive to our own interest.

Facilitate Successful Localization of SOE firms

There is an ongoing undercurrent of geopolitical distance in Canadian popular reactions to Chinese SOEs that only successful localization is likely to address.

a. Our finding with respect to the strong market orientation of SOEs suggests that the thrust of efforts by the ICA Bureau could best be directed at negotiating reasonable undertakings to accelerate localization and integration of these SOEs in Canada. A focus on facilitating adaptation to Canadian operating style and standards will be more productive than overly specific/unworkable commitments that become hurdles rather than opportunities.

b. SOEs: Steps to Successful Localization Chinese SOEs can best contribute to successful and speedy integration into the local and larger Canadian economy by hiring locally, establishing strong local economic and philanthropic relationships, developing relationships with municipal and provincial governments, and working to ensure the economic benefits of their firm are felt as widely as possible. Especially at the outset, they should ensure their business plan is broadly understood and address impacts this may have on the community. Where there is a broader public interest in their venture, a media and government relations firm may be able to provide a broader context and communications capability.

c. Governments should take a pro-active approach to regulatory compliance. All jurisdictions have the regulatory muscle to follow-up and discipline non-compliance of any kind in labour standards, health and safety, and environmental protection. Pro-actively facilitating effective compliance by ensuring a detailed understanding of regulatory standards in the Canadian context would be more effective. In the early stages of any start-up there is potential for misunderstanding and weak compliance. Initial guidance and support followed by regular contact will be helpful in building mutual corporate and community confidence. The responsibility for establishing good relationships with community leaders lies with management. For the sake of ongoing credibility it is incumbent on governments at every level that have actively courted a given investment to offer more active support in the post-investment period and to facilitate the localization process.

d. Accessing SOE supply chains: Chinese firms have their own supply chains and will no doubt continue to use them. Drawing Canadian companies into these networks would accelerate their integration into the Canadian economy. Canadian businesses can facilitate the process by seeking out these relationships.

e. Accessing new SOE managerial and technical networks: Canada's reputation as a world leader in both mining and energy is built in part on the participation of Canadian managers and technical specialists in the IOCs—a position which has been both comfortable and cutting edge. Expanding these networks to include Chinese and other Asian SOEs, even if these initially appear difficult to access, will enable Canada to remain globally competitive.

Develop Global Policy Leadership in Resources

a. Address the US interest in secure energy supply: Moves to supply multiple markets and become a global rather than a continental energy player must begin by developing and communicating persuasively a position which addresses reasonable US supply interests while creating the necessary space to pursue other commercial interests. To forego our commercial interest when we are not being asked to do so, makes no economic or political sense.

b. Develop a global perspective in each commodity: Both the private sector and governments in Canada need to develop a global focus on all commodity markets in which Canada is a player. Policy leadership will come from understanding and balancing the global balance of buyer and seller interests.

c. Support the needed transportation infrastructure to serve the Asian market: The changes in the structure of global supply in energy and metals make it essential for Canada to adapt to these changes including by the provision of needed transportation infrastructure. Financing this infrastructure should be done in a way that preserves the ability to sell product to the full spectrum of potential buyers.

d. Support growth of Canadian Resource MNEs. Rebuild Canada's global corporate presence in resources by encouraging the emergence of resource MNEs headquartered in Canada. Global energy and mining "giants" have the deep pockets needed to develop in-house technologies that reinforce their leadership. They typically deal with fellow giants when they want to partner to develop major resources. We support changes, proposed by the Wilson Committee Report with respect to the fiduciary responsibility of corporate directors in order to put Canada on a comparable footing with other OECD jurisdictions with respect to reasonable defence against takeover bids. Chinese firms (both SOE and entrepreneurial) are open to developing strong links with mid-size foreign firms including co-operation in third markets.

e. Promote technological collaboration to achieve cost and environmental breakthroughs: Canadian inventors have developed a range of not-yet-commercialized technologies relevant to improving the costs and reducing the environmental impact of exploiting Canadian resources. Chinese SOEs have the global reach, capital, and engineering capacity to participate in this commercialization. In reviewing investment applications under the ICA the Minister should encourage commitments to undertake research and technology development and/or consider (voluntary) research JVs designed to commercialize Canadian, Chinese, or other promising technologies. Canadian corporations may want to independently consider opportunities for such collaborative research.

f. Promote Canadian participation on the Corporate and Advisory Boards of leading Chinese SOEs. Board decisions are heavily influenced by the views expressed by directors and advisors, it is in Canada's long-term interest to have Canadians amongst the independent directors appointed to the boards of China's resource SOEs and/or their Advisory Committee.[60] Chinese executives and officials readily acknowledge Canadian expertise in global resource exploration and management; this is a natural area for Canadians to make a contribution. A collective Canadian effort should be made to identify and promote possible candidates to SOE Advisory and main boards.

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60 PetroChina has one foreign independent director Franco Bernabe.

g. Air for more nuanced and forward-looking understanding of China and Asia: Canada is not particularly far along the curve in terms of understanding China and of the nature of the global economic shift that is ongoing. The overall quality of media coverage is weak, with a narrow focus on Canadian concerns rather than an overall understanding of economic, political and social changes in China and Asia generally. A clear sighted understanding is essential to our ability to shape the future.

h. Implement language training and education: Because of the advantage of its ethnic diversity there has been a temptation for Canadian businesses to leave interfacing with China to Canadians of Chinese heritage. While this may be initially effective, longer term success with respect to China and the region depends on much more broadly based familiarity and expertise. Canada should consider a similar leap in terms of language training and education to that taken by Australia in the 1980s. We support the recommendations of the Canadian Chamber of Commerce and many others in advocating improved language programs at every level of education.

i. Address the reciprocity issue: The natural resource sector is one of several in which foreign investment in China has been discouraged, in fact, if not in theory. China is known to have significant unexplored mineral resources and could benefit materially from foreign technologies and expertise. The failure of provincial and local authorities to implement national regulations and guidelines has created an uneven playing field for foreign mining companies. Canadian juniors have been repeatedly stymied. Effective state-to-state negotiation to resolve these access and protection issues require clarity of purpose (i.e. the Canadian interest), patience, and a long decision horizon. In addition to an investment protection treaty, Canada needs to make clear to provincial officials in China and then senior leaders that Canadian mining companies can serve as valuable sources of sustainable mining technologies when resource development does become a priority. Canadian firms frustrated with lack of progress on exploration permits in China might consider following Rio Tinto's lead in linking up with Chinese firms to develop resources in third markets.

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